

*Economics  
of Human  
Capital*

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Philipp Eisenhauer

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# Economics of Human Capital

## Introduction

Philipp Eisenhauer

Human capital is defined as:

*The knowledge, skills, competencies and attributes embodied in individuals that facilitate the creation of personal, social and economic well-being.*

- OECD (2001)

## **Tasks**

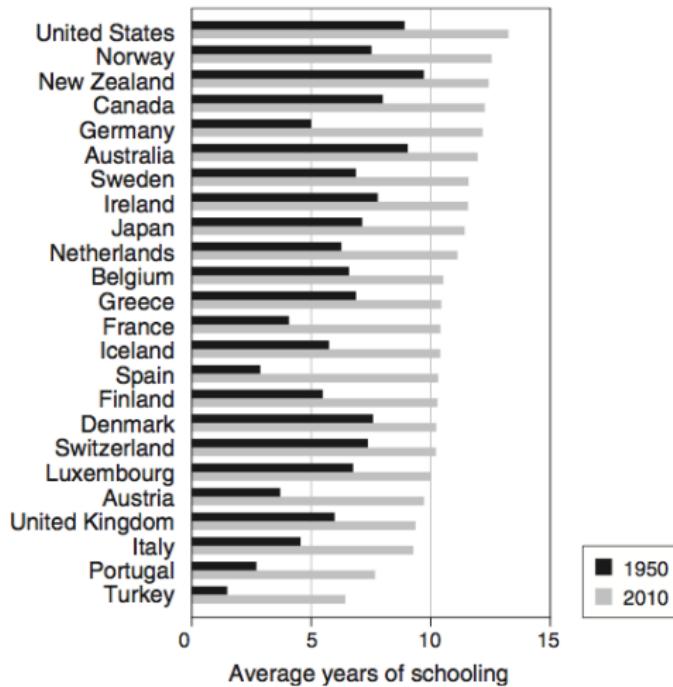
- ▶ definition and measurement of human capital
- ▶ determining the effect of human capital on a variety of personal, social and economic outcomes
- ▶ understanding the formation of human capital

## **Tasks**

- ▶ identifying the driving forces behind the observed heterogeneity across and within countries
- ▶ search for effective policies to ameliorate disparities
- ▶ ...

# **Facts**

## Figure: Years of schooling



**FIGURE 4.4**

Years of schooling of the total population aged 25 and older.

Source: Barro and Lee (2010, education data set, available at [www.barrolee.com/data](http://www.barrolee.com/data)).

## Figure: Unemployment rates

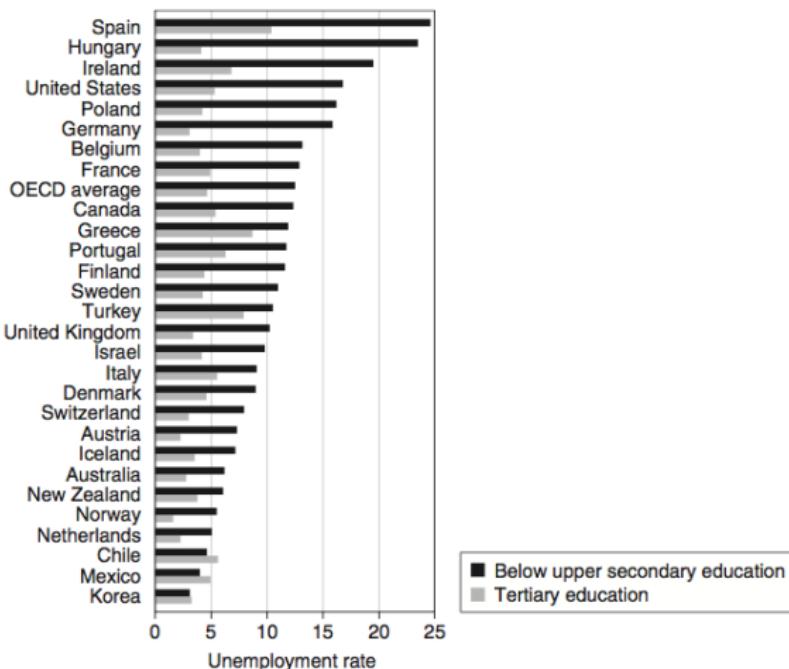


FIGURE 4.6

Unemployment rates by level of educational attainment for 25- to 64-year-olds, 2010. The OECD average is the nonweighted average of the 34 OECD countries, including those not represented on this figure. Data missing for non-OECD countries.

Source: OECD (2012, table A7.4a, p. 133).

## Figure: Tertiary education

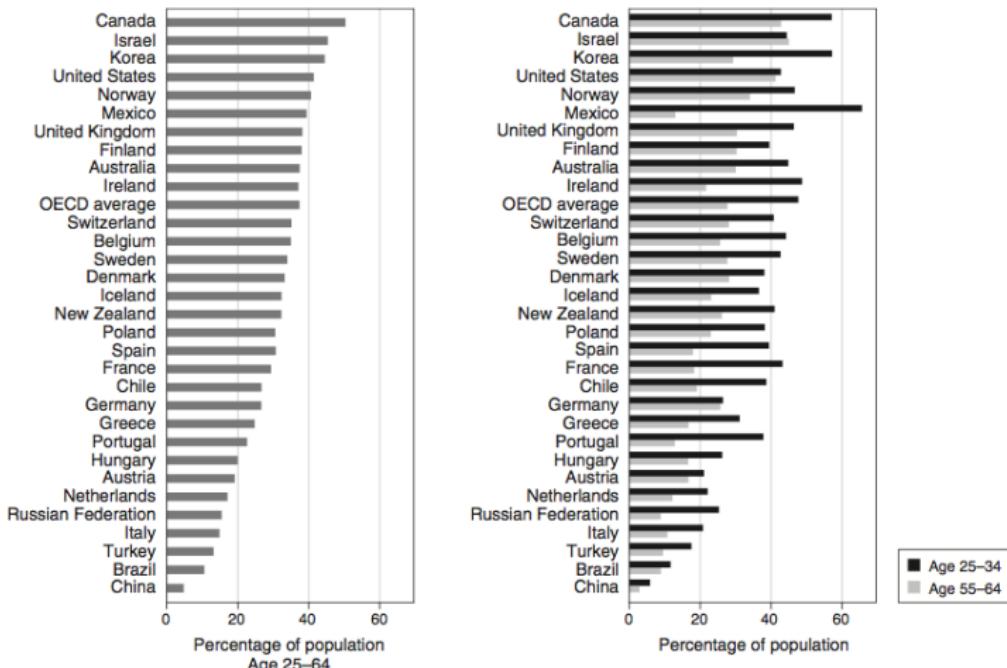


FIGURE 4.3

Percentage of the population that has attained at least tertiary education or advanced research programs, by age group, 2010. The OECD average is the nonweighted average of the 34 OECD countries, including those not represented in this figure. Brazil, China, and the Russian Federation are not part of the OECD.

Source: OECD (2012, table A1.3a, p. 36).

## Figure: Secondary education

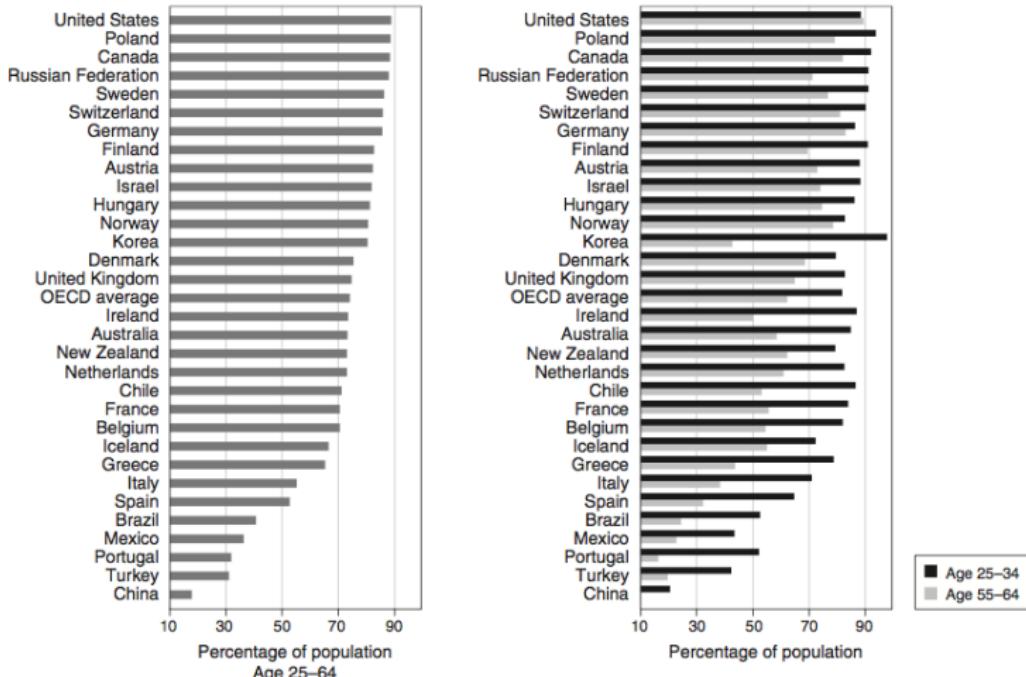


FIGURE 4.2

Percentage of the population that has attained at least upper secondary education, by age group, 2010. The OECD average is the nonweighted average of the 34 OECD countries, including those not represented in this figure. Brazil, China, and the Russian Federation are not part of the OECD.

Source: OECD (2012, table A1.2a, p. 35).

## Figure: Expenditures

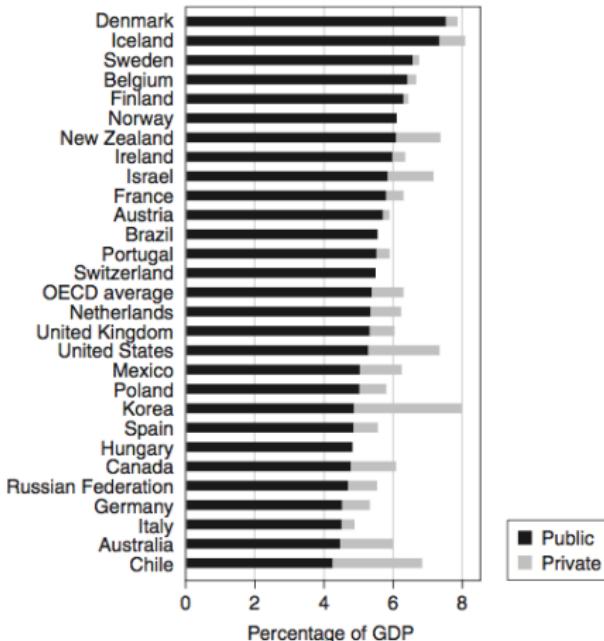


FIGURE 4.1

Expenditure on educational institutions as a percentage of GDP, 2009. The OECD average is the nonweighted average of the 34 OECD countries, including those not represented in this figure. Brazil and the Russian Federation are not part of the OECD. Private expenditure is missing for Brazil, Hungary, Norway, and Switzerland. Data are missing for China, Greece and Turkey.

Source: OECD (2012, table B2.3, p. 246).

## Figure: Relative earnings

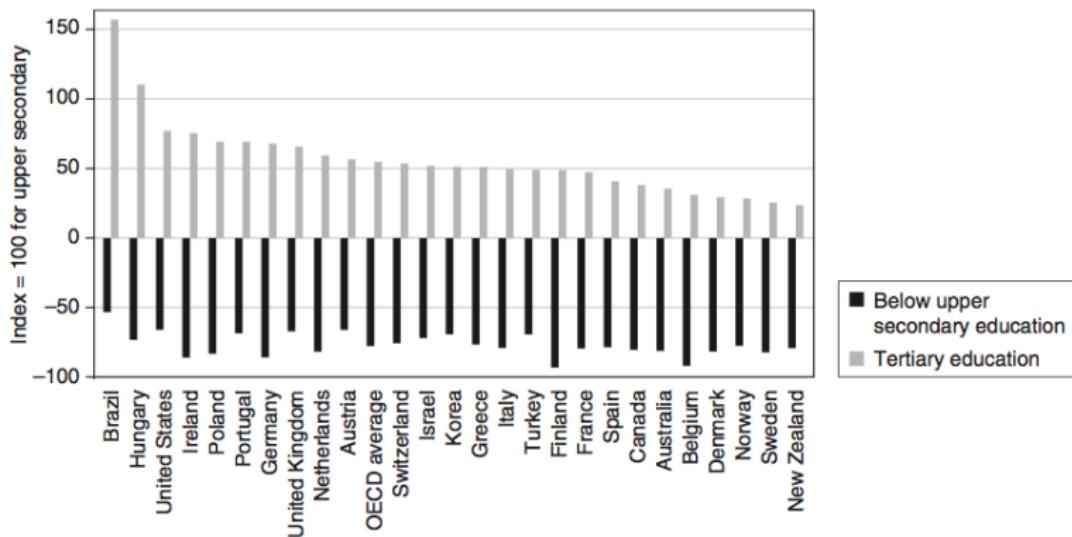


FIGURE 4.5

Relative earnings from employment among 25- to 64-year-olds, by level of educational attainment (2010 or latest available year). Upper secondary and post-secondary nontertiary education = 100. The OECD average is the nonweighted average of the 34 OECD countries, including those not represented in this figure. Brazil is not part of the OECD. Data missing for Chile, China, Iceland, Mexico, and the Russian Federation.

Source: OECD (2012, chart A8.1, p. 140).

## Figure: Unemployment rates

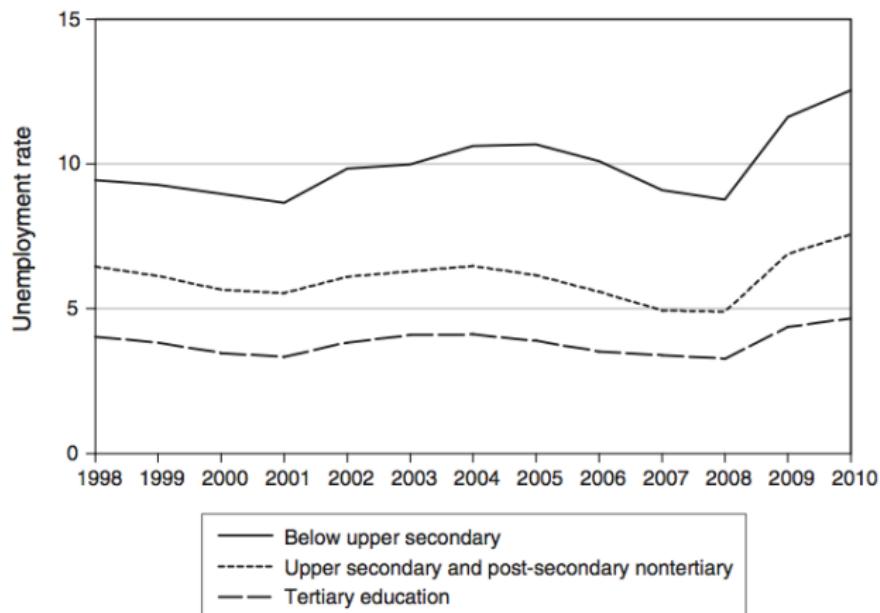


FIGURE 4.7

Unemployment rates by level of educational attainment for 25- to 64-year-olds, 2010. The OECD average is the nonweighted average of the 34 OECD countries.

Source: OECD (2012, table A7.4a, p. 133).

# **Life-cycle of earnings**

## **Stylized Facts**

- ▶ Life-cycle earnings are increasing at early ages and decline towards the end.
- ▶ Wages tend to increase over the life-cycle with a weak tendency to decline at the end of working life.
- ▶ Hours of work increase at early ages and decline in old age, with the peak occurring earlier than in the wage profiles.

See Weiss (1986) for comprehensive modeling framework that allows to interpret all these facts.

Figure: Wage gains

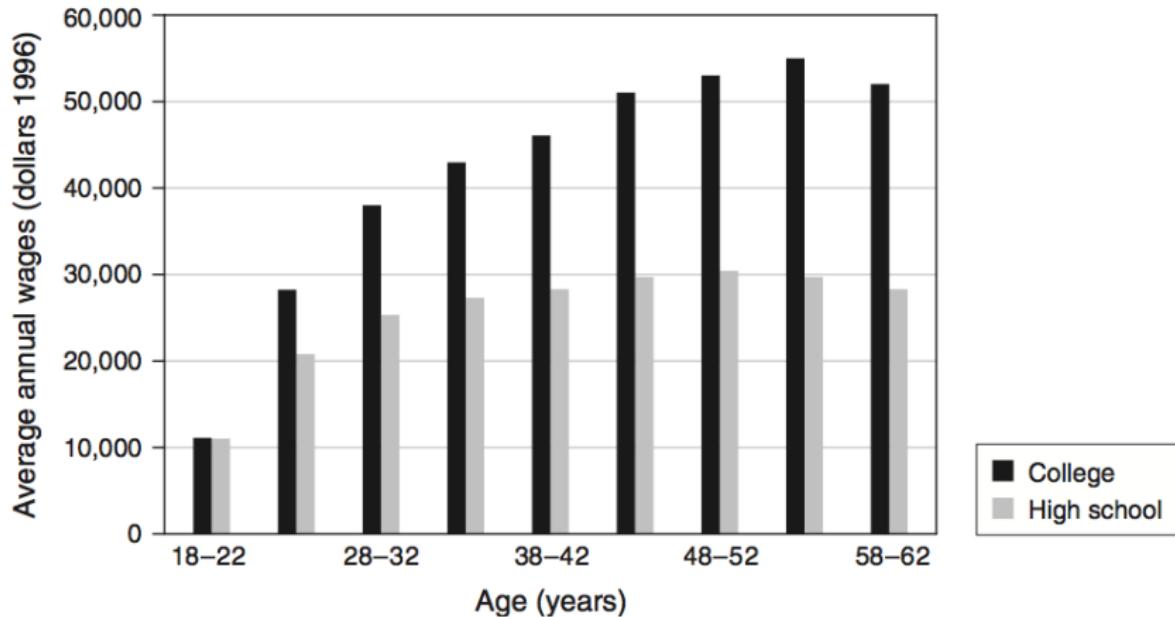


FIGURE 4.8

Average wage gains for college and high school graduates in the United States in 1996.

Source: Ashenfelter and Rouse (1999).

We study a version of the seminal Ben-Porath Model (Ben-Porath, 1967) that relates human capital accumulation to life-cycle earnings.

Why do economists use mathematical models? ([slides](#))

This material is best studied using the following resource.

- ▶ Cahuc, P., & Zylberberg, A. (2004). *Labor economics* (1st ed.). Cambridge, MA: MIT Press.

## Basic Notation

$s(t)$  fraction devoted to training

$h(t)$  stock of human capital

$w(t)$  wage

$\delta$  depreciation of knowledge

The individual's objective is to maximize the discounted sum of wages over their life-cycle.

$$\Omega = \int_0^T w(t) e^{-rt} dt$$

Their economic environment is characterized by the production functions for wages and human capital.

$$w(t) = A[1 - s(t)]h(t)$$

$$\dot{h} = \theta g(s(t), h(t)) - \delta h(t) \quad g' > 0, g'' < 0$$

## **Notable Features**

- ▶ Individuals cannot work and learn at the same time.
- ▶ There is no individual heterogeneity.
- ▶ There is no direct cost of education but there are the opportunity cost of lost wages.
- ▶ ...

## Model Specification

We study the implementation in Cahuc and Zylberberg (2004).

$$g(h(t), s(t)) = (h(t)s(t))^{0.71}$$

$$A = 0.75 \quad \delta = 0.06 \quad r = 0.05$$

$$h_0 = 5 \quad T = 60 \quad \theta = 0.5$$

**Figure:** Contour plot of human capital production function

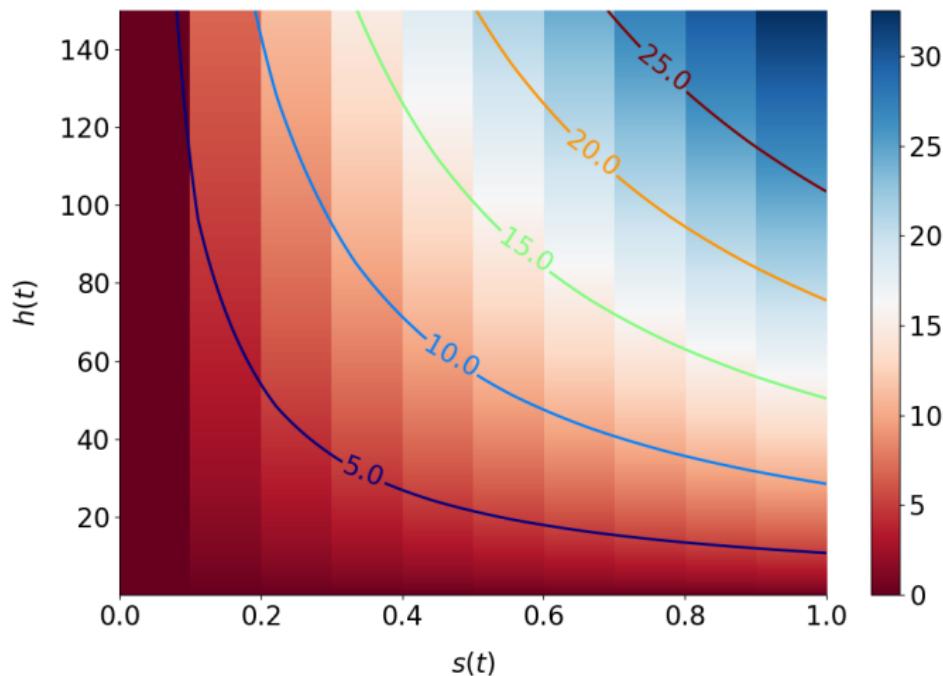


Figure: Surface plot of human capital production function

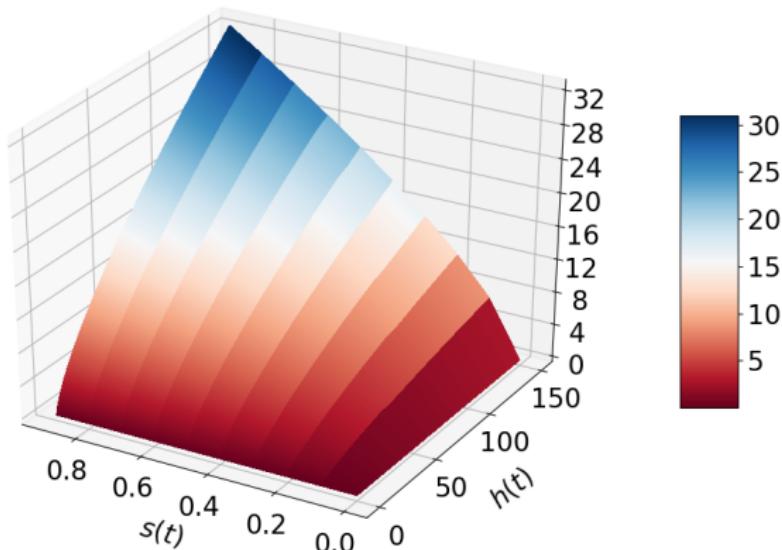


Figure: Wage production

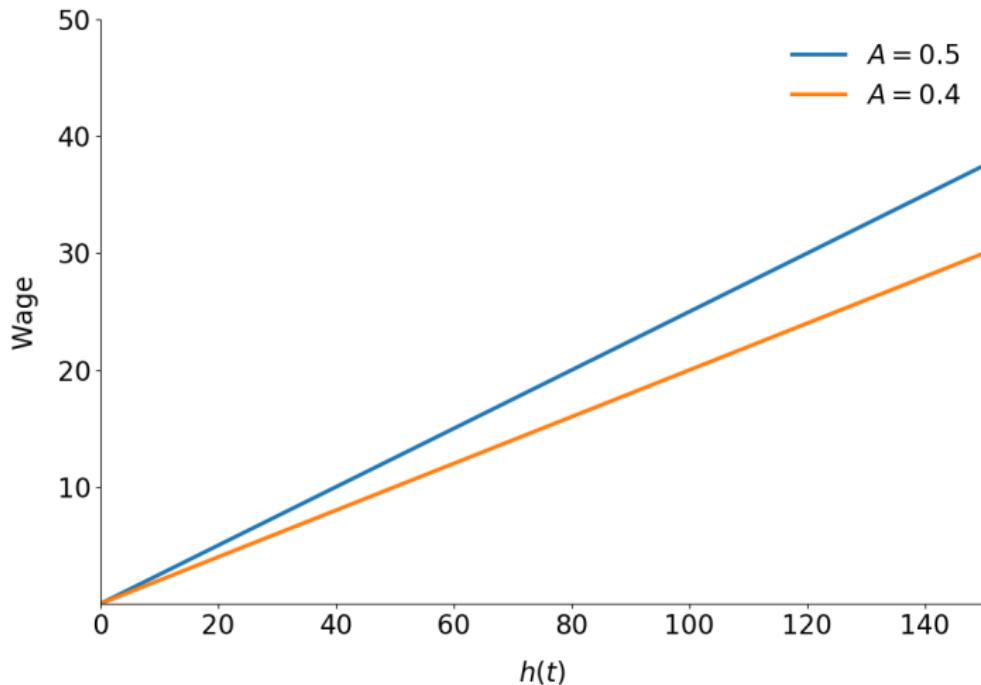
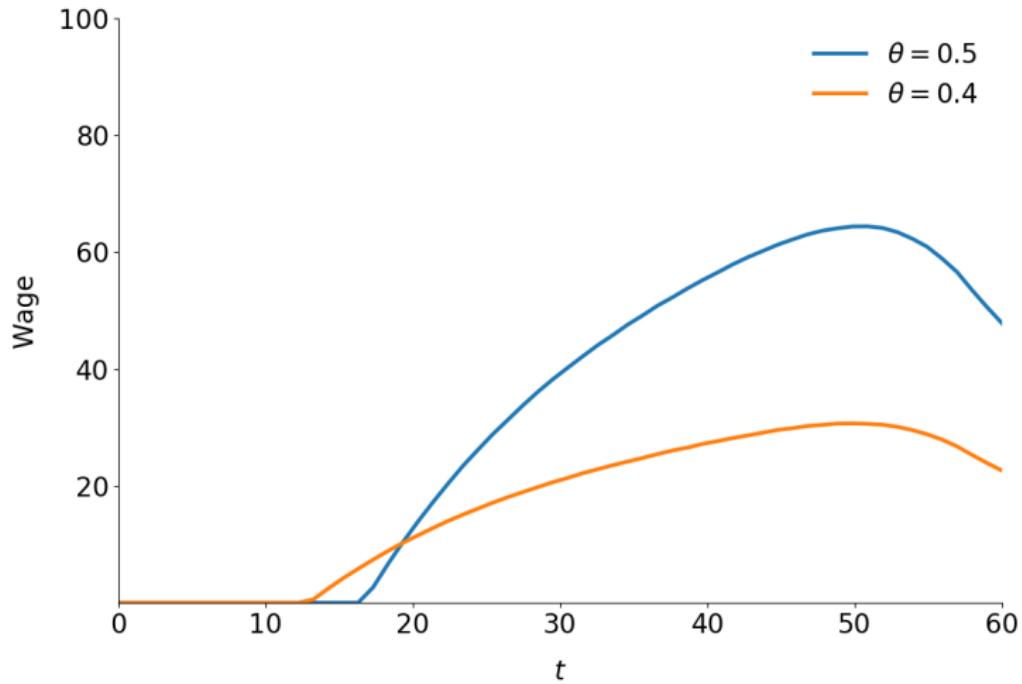


Figure: Wage  $w(t)$  over the life-cycle



**Figure:** Stock of human capital  $h(t)$  over the life-cycle

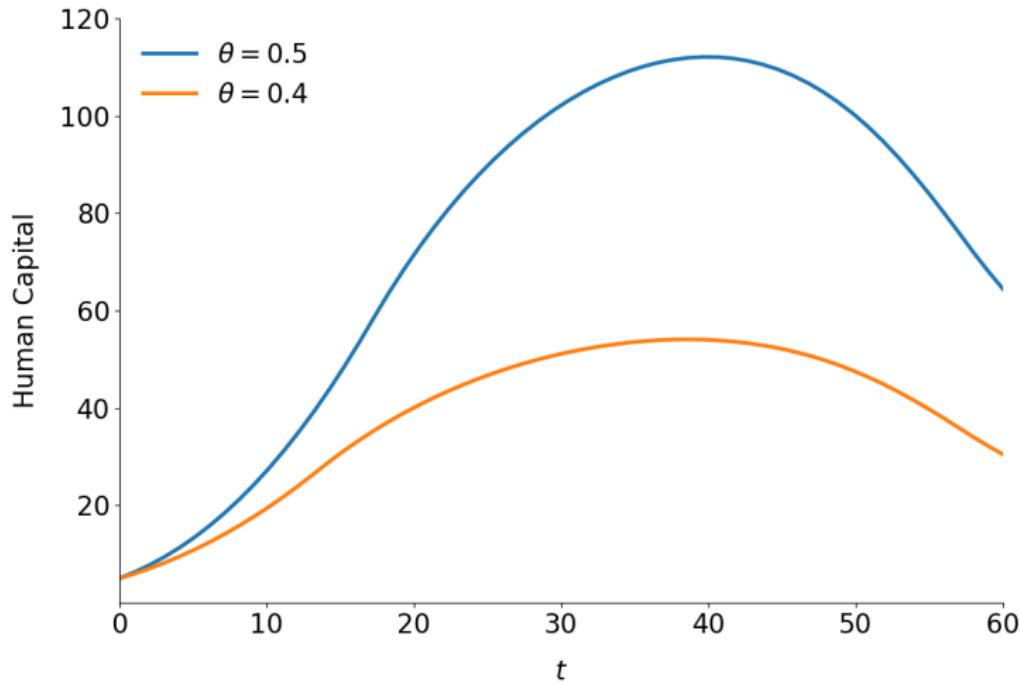


Figure: Human capital investment  $s(t)$  over the life-cycle

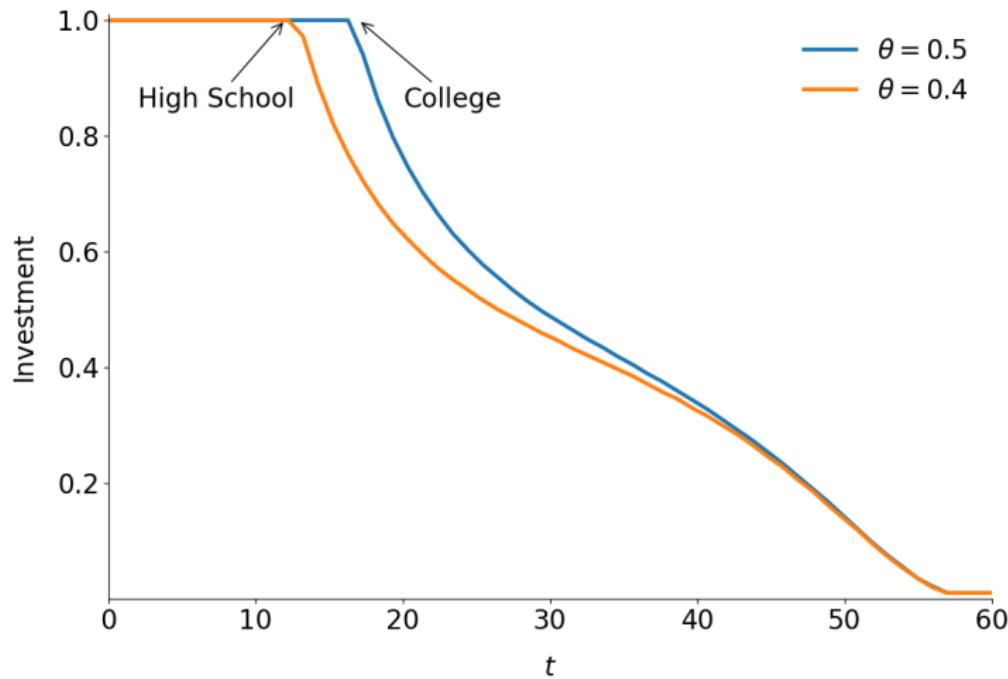
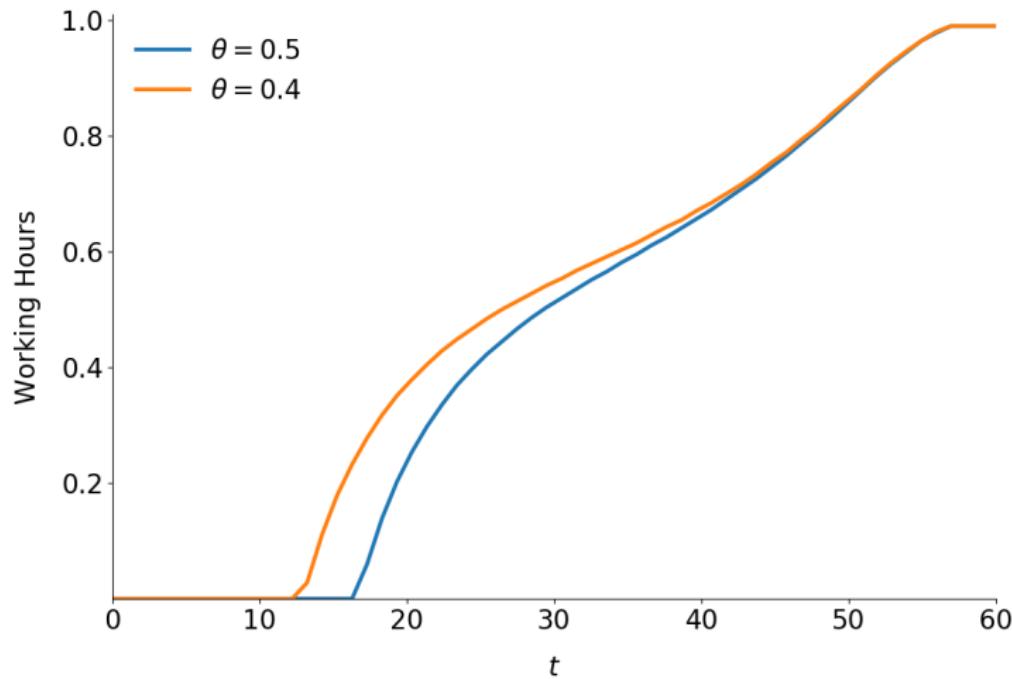


Figure: Hours worked ( $1 - s(t)$ ) over the life-cycle



How well does the model do?

## **Extensions**

Weiss (1986) reviews a host of alternative extensions to the basic model.

- ▶ general versus specific training
- ▶ hours worked
- ▶ uncertainty
- ▶ borrowing-constraints
- ▶ ...

# **Job market signaling**

This material is best studied using the following resource.

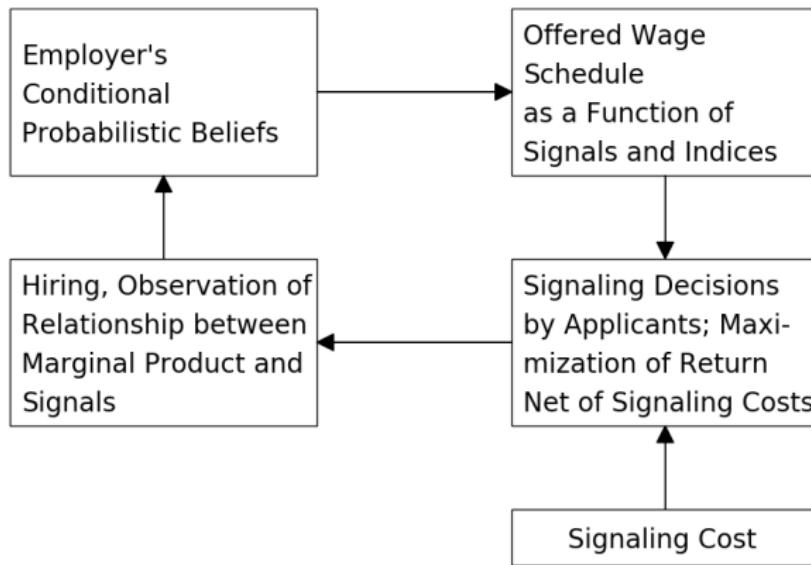
- ▶ Spence, M. (1973). Job market signaling. *The Quarterly Journal of Economics*, 87(3), 355-374.

We study the seminal model presented in Spence (1973).

- ▶ There are two groups  $j \in \{H, L\}$  in the population facing one employer, where  $h_{j \in \{L,H\}}$  denotes the respective level of productivity.
- ▶ Group  $L$  is a proportion  $q_L$  in the population.
- ▶ Education  $y$  is measured by an index  $y$  of level and achievement and is subject to individual choice.
- ▶ Education costs are both monetary and psychic and differ by group  $c_{j \in \{L,H\}}$ .

- ▶ The productivity type is unobservable by the employer.
- ▶ Individual decisions about  $y$  can provide a signal about the underlying productivity.
- ▶ Wage schedule is set conditional on  $y$ .

Figure: Informational feedback



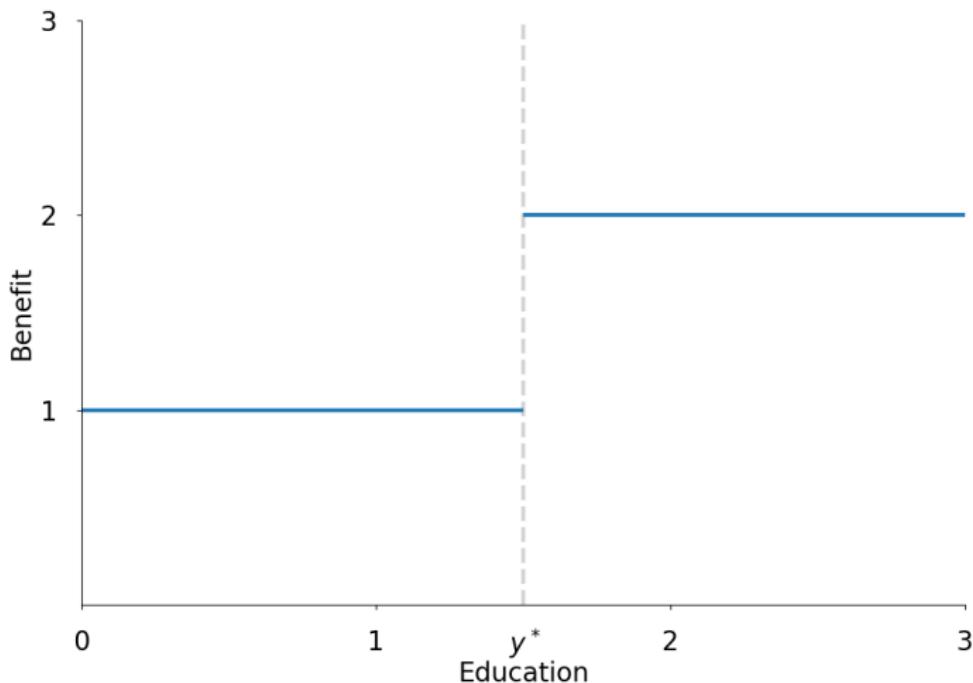
We explore the following parameterized version.

$$h_L = 1 \quad h_H = 2$$

$$c_L = y \quad c_H = \frac{1}{2}y$$

Thus there is an inverse relationship between productivity and signaling cost.

Figure: Benefit of education



**Figure:** Cost of education

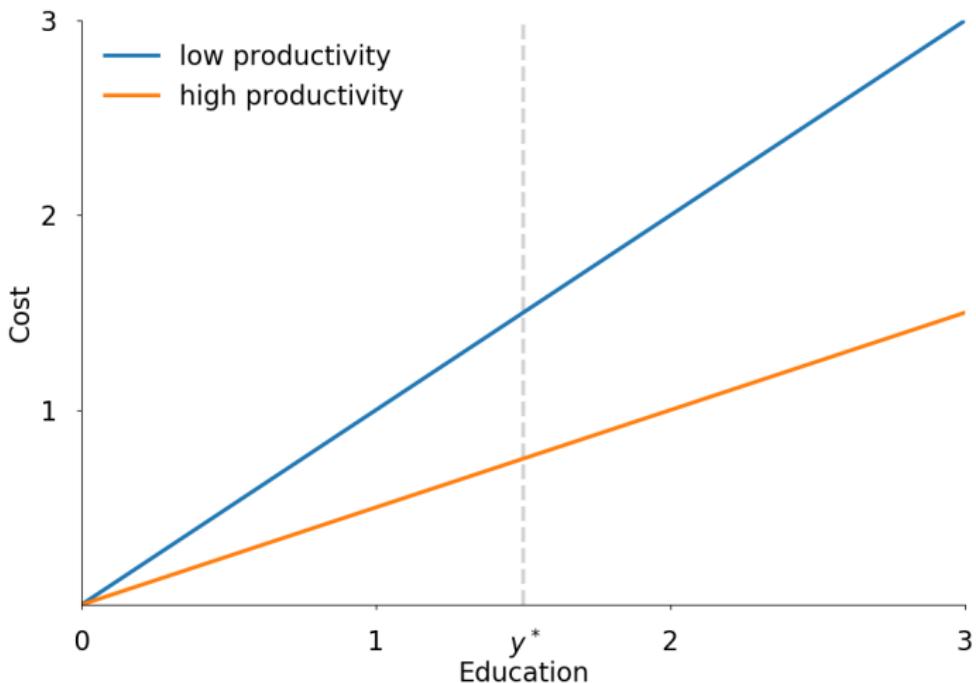
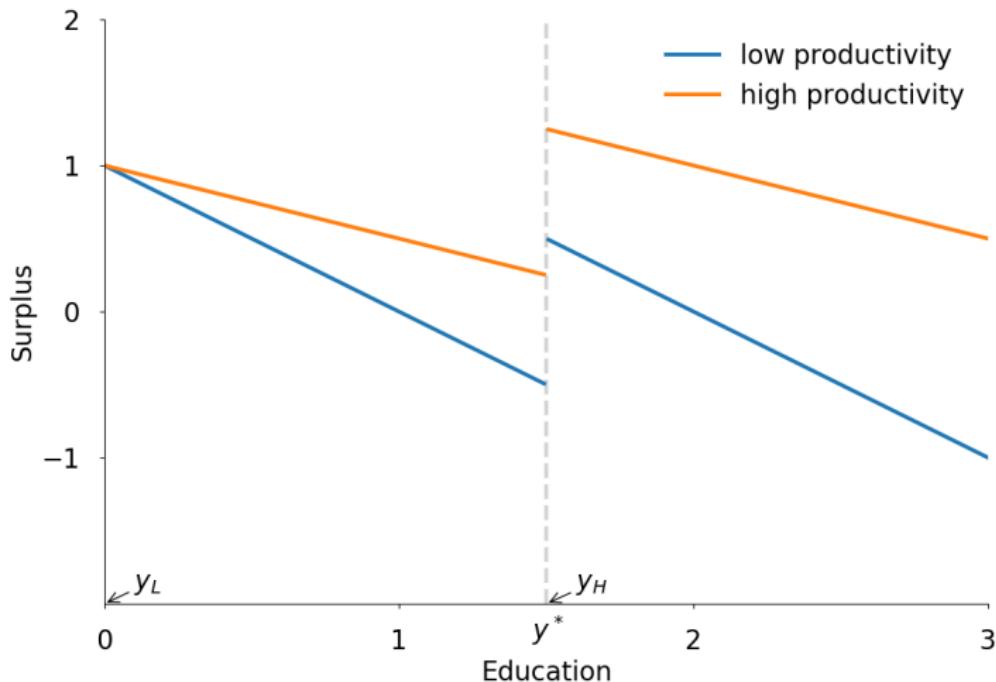


Figure: Surplus of education I



- ▶ For  $y^* = 1.5$  the employer's beliefs are confirmed. More generally,  $L$  chooses  $y_L = 0$  if  $1 > 2 - y^*$  and  $H$  acquires  $y_H = y^*$  provided that  $2 - 0.5 y^* > 1$ .
- ▶ Beliefs are confirmed provided that the following holds:

$$1 < y^* < 2$$

Figure: Surplus of education II

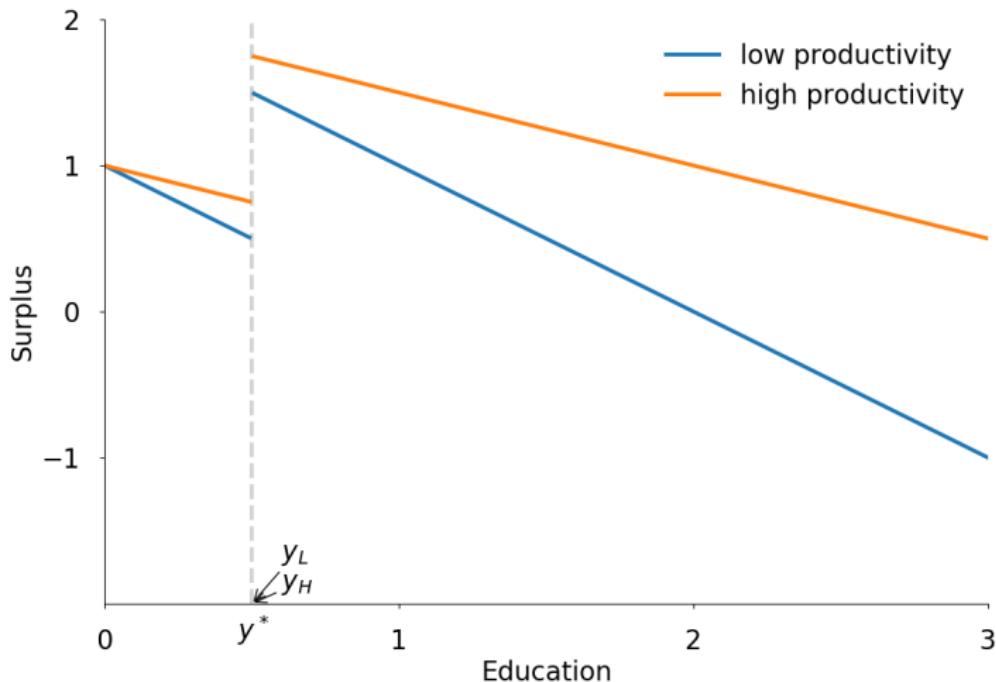
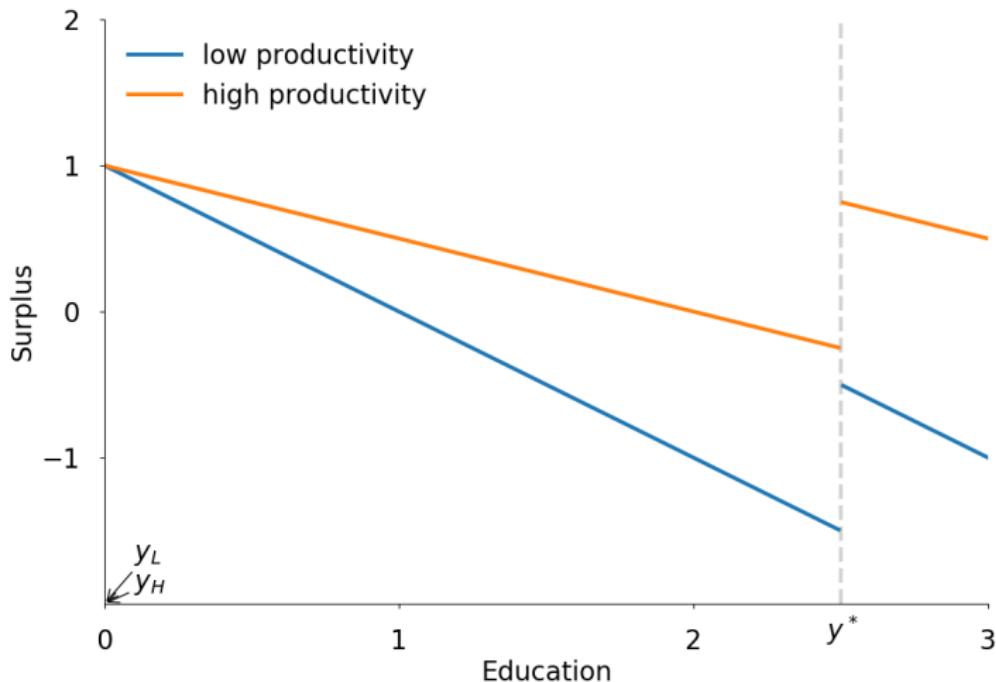


Figure: Surplus of education III



- ▶ From the outside, education appears to be productive and is for the individual. However, there is no real effect on the marginal product.

Can we distinguish between the two models based on simple information on individual education and wages?

- ▶ In the absence of signaling, both groups are paid the unconditional expected marginal product.

$$q_L \times 1 + (1 - q_L) \times 2$$

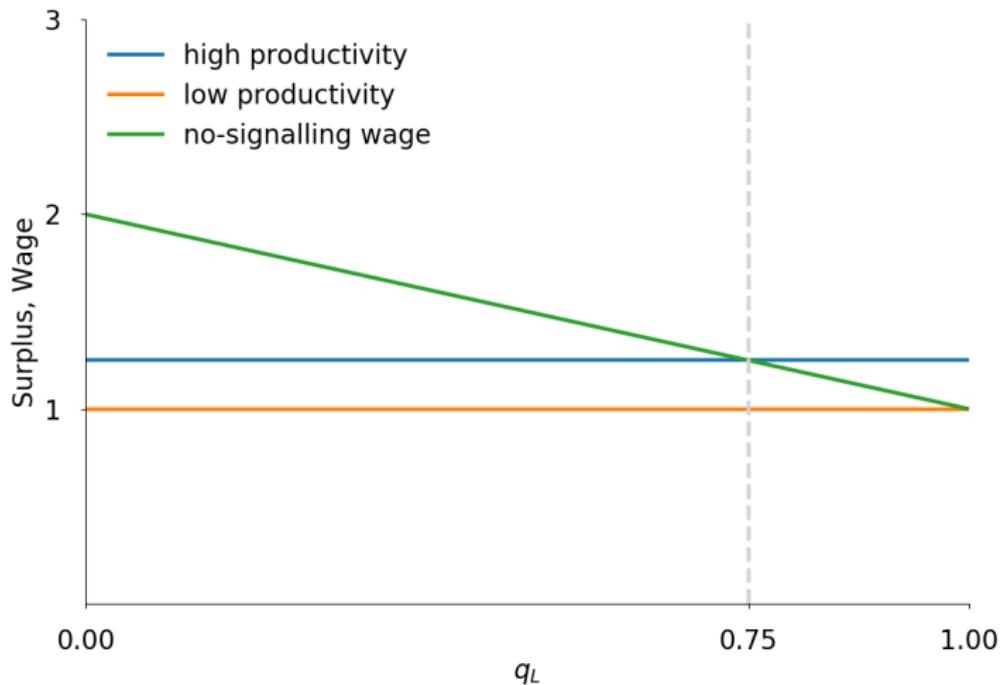
- ▶ It depends on the share of low productivity individuals whether high productivity individuals actually prefer a no-signaling case. Their surplus is determined as follows:

$$\text{signaling} \quad 2 - \frac{1}{2}y^*$$

$$\text{no-signaling} \quad 2 - q_L$$

- ▶ High productivity individuals prefer the signaling case as long as  $y^* \leq 2q_L$ .

**Figure:** Market structure



- ▶ The ability to signal has a detrimental effect on low productivity workers, while the consequences are ambiguous for high productivity workers.
- ▶ High productivity workers benefit from their ability to send a signal if their proportion is sufficiently small with respect to the productivity gap to low productivity individuals.

# **Dataset**

I present a basic overview on the **National Longitudinal Survey of Youth 1979 (NLSY79)** dataset (Bureau of Labor Statistics, 2014). The slide deck is under constant development and available at the link below.

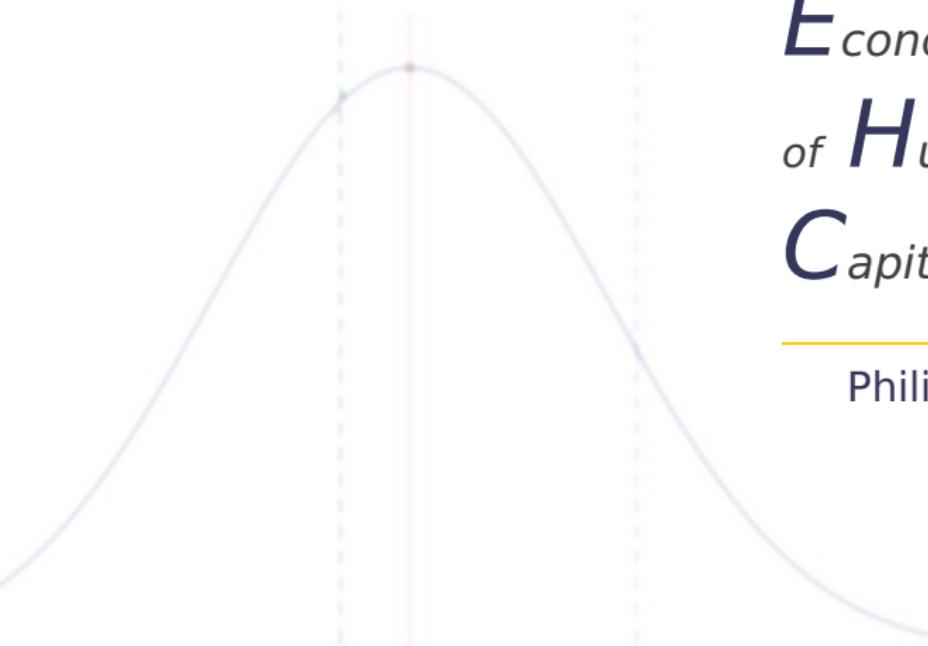
<http://bit.ly/2JeEGGt>

# **Appendix**

# *References*

- Becker, G. S. (1964). *Human capital* (1st ed.). New York City, NY: Columbia University Press.
- Ben-Porath, Y. (1967). The production of human capital and the life cycle of earnings. *Journal of Political Economy*, 75(4), 352–365.
- Bureau of Labor Statistics. (2014). *National longitudinal survey of youth 1979 cohort, 1979-2012 (rounds 1-25)*. Columbus, OH: Produced and distributed by the Center for Human Resource Research, The Ohio State University.
- Cahuc, P., & Zylberberg, A. (2004). *Labor economics* (1st ed.). Cambridge, MA: MIT Press.

- Spence, M. (1973). Job market signaling. *The Quarterly Journal of Economics*, 87(3), 355-374.
- Weiss, Y. (1986). The determination of life cycle earnings: A survey. In O. C. Ashenfelter & R. Layard (Eds.), *Handbook of labor economics* (Vol. 1, pp. 603–640). Amsterdam, Netherlands: North-Holland Publishing Company.



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# Economics of Human Capital

Returns to schooling

Philipp Eisenhauer

# **Introduction**

I heavily draw on the material presented in:

- ▶ Heckman, J. J., Lochner, L. J., & Todd, P. E. (2006). Earnings functions, rates of return and treatment effects: The Mincer equation and beyond. In E. A. Hanushek & F. Welch (Eds.), *Handbook of the economics of education* (1st ed., Vol. 1, pp. 307–458). Amsterdam, Netherlands: North-Holland Publishing Company.

## **Importance of returns**

- ▶ explain wage inequality within countries
- ▶ explain growth differentials across countries
- ▶ assess schooling investment on individual level
- ▶ evaluate public policies to foster educational attainment
- ▶ ...

## **Core parameter**

The internal rate of return is the discount rate that equates the present value of two potential income streams (Becker, 1964).

## Different return concepts

- ▶ Mincer rate of return
  - ▶ internal rate of return
  - ▶ true rate of return
- ⇒ We will also distinguish between ex ante and ex post returns when introducing uncertainty and the sequential revelation of uncertainty.

# **Mincer rate of return**

## Mincer Equation

$$\ln Y(s, x) = \alpha + \rho_s s + \beta_0 x + \beta_1 x^2 + \epsilon$$

⇒ How to interpret the *Mincer Coefficient*  $\rho_s$ ?

## **Key features**

- ▶ linear and homogeneous returns to schooling
- ▶ additive separability

## **Conceptual Frameworks**

- ▶ compensating differences
- ▶ accounting-identity

## *Compensating Differences Model*

Let  $Y(s)$  represent the annual earnings of an individual with  $s$  years of education, assumed to be constant over his lifetime. Let  $r$  be an externally determined interest rate and  $T$  the length of working life, assumed not to depend on  $s$ . The present value of earnings associated with schooling level  $s$  is

$$V(s) = Y(s) \int_s^T e^{-rt} dt = \frac{Y(s)}{r} (e^{-rs} - e^{-rT}).$$

Note that one's working life can either be spent in school or in the labor market.

Figure: Earnings

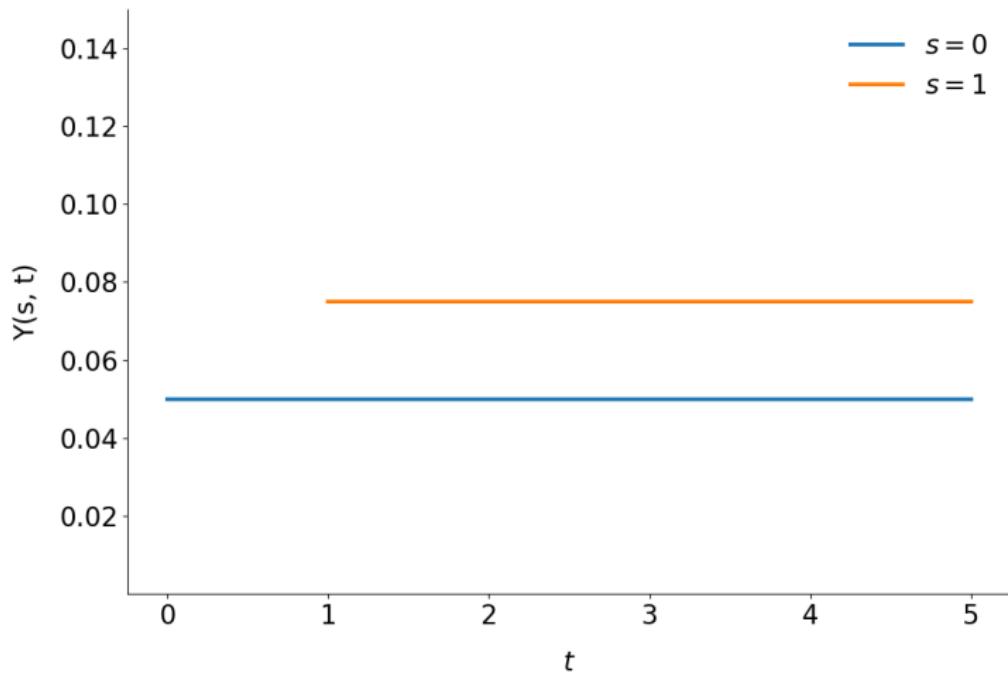
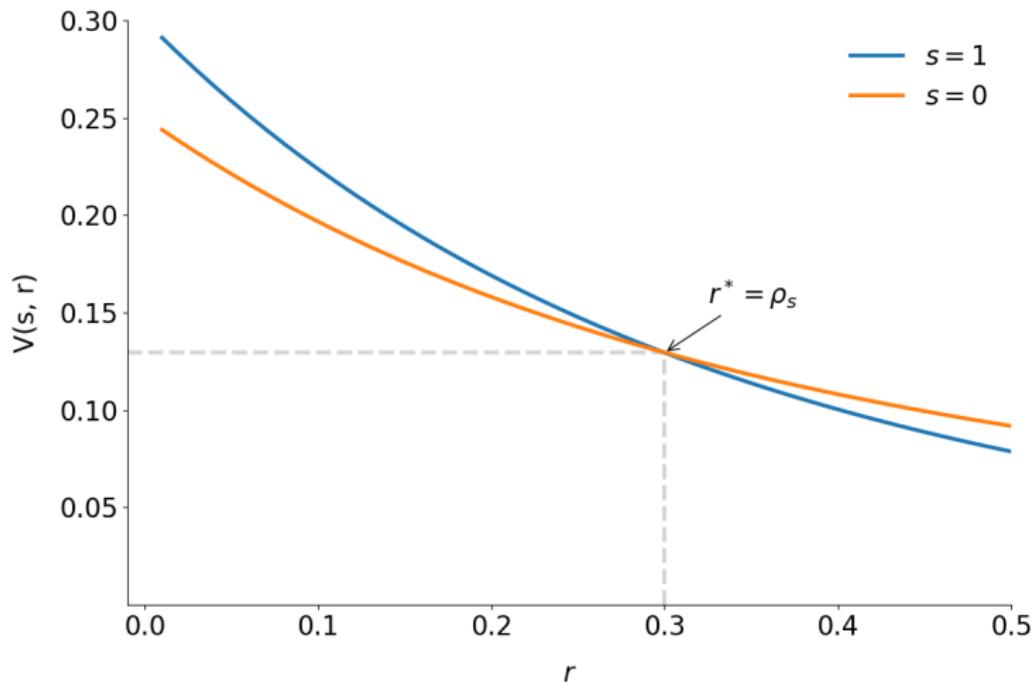


Figure: Value



Equilibrium across heterogeneous schooling levels requires that individuals be indifferent between schooling choices with  $V(s) - V(0) = 0$ . Equating earnings streams across schooling levels yields:

$$\frac{Y(s)}{r} (e^{-rs} - e^{-rT}) - \frac{Y(0)}{r} (1 - e^{-rT}) = 0$$

$$Y(s) = Y(0) \left( \frac{1 - e^{-rT}}{e^{-rs} - e^{-rT}} \right)$$

$$Y(s) = Y(0) \left( \frac{1}{e^{-rs}} \right) \left( \frac{1 - e^{-rT}}{1 - e^{-r(T-s)}} \right)$$

Taking the natural logarithm:

$$\ln Y(s) = \ln Y(0) + rs + \ln \left( \frac{1 - e^{-rT}}{1 - e^{-r(T-s)}} \right)$$

$\Rightarrow \rho_s$  equals the market interest rate and the internal rate of return to schooling by construction (as  $T$  gets large)

## **Model features**

- ▶ identical abilities and opportunities
- ▶ no credit constraints
- ▶ perfect certainty
- ▶ no direct cost of schooling
- ▶ no nonpecuniary benefits of school and work

# *Accounting-Identity Model*

## Model ingredients

$P_t$  potential earnings at  $t$

$C_t = k_t P_t$  investment cost of training at  $t$

$\rho_t$  average return to investment at  $t$

$K$  decline in post-school investment with  $T$

$$P_t \equiv P_{t-1}(1 + k_{t-1}\rho_{t-1}) \equiv \prod_{j=0}^{t-1} (1 + \rho_j k_j) P_0$$

Formal schooling is defined as years spent in full-time investment ( $k_t = 1$ ), which is assumed to take place at the beginning of life and to yield a rate of return  $\rho_s$  that is constant across all years of schooling.

$$\begin{aligned}\ln P_t &\equiv \ln P_0 + s \ln(1 + \rho_s) + \sum_{j=s}^{t-1} \ln(1 + \rho_0 k_j) \\ &\approx \ln P_0 + s\rho_s + \rho_0 \sum_{j=s}^{t-1} k_j\end{aligned}$$

Note that we also assume that the return to post-school investment is constant over ages and equals  $\rho_0$ .

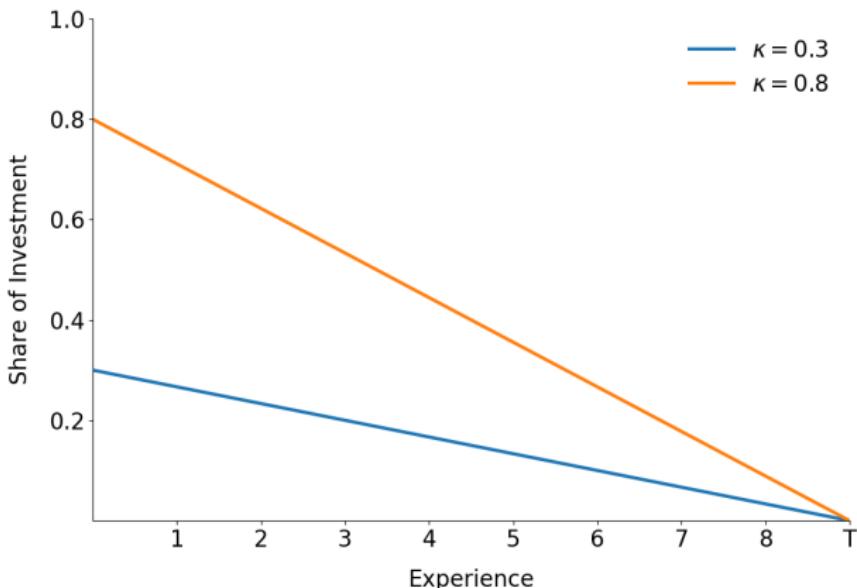
Mincer (1974) assumes a linearly declining rate of post-school investment:

$$k_{s+x} = \kappa (1 - x/T), \text{ where } x = t - s$$

Thus,

$$\ln P_{x+s} = \ln P_0 + s\rho_s + \rho_0 \sum_{j=0}^{x-1} \kappa (1 - j/T).$$

**Figure: Post-School Investment**



The derivations draws on the following results for arithmetic series (Chapman & Hall, 2018).

$$\sum_{i=0}^n i = \sum_{i=1}^n i = \frac{n(n+1)}{2}$$

We need to further decompose the experience addition and use results on arithmetic series.

$$\begin{aligned}\rho_0 \sum_{j=0}^{x-1} \kappa(1-j/T) &= \rho_0 \sum_{j=0}^{x-1} \kappa - \rho_0 \kappa \sum_{j=0}^{x-1} (j/T) \\&= \rho_0 \kappa x - \frac{\rho_0 \kappa}{T} \sum_{j=0}^{x-1} j \\&= \rho_0 \kappa x - \frac{\rho_0 \kappa}{T} \left( \frac{(x-1)((x-1)+1)}{2} \right) \\&= \rho_0 \kappa x - \frac{\rho_0 \kappa}{T} \left( \frac{x^2 - x}{2} \right) \\&= \left( \rho_0 \kappa + \frac{\rho_0 \kappa}{2T} \right) x - \frac{\rho_0 \kappa}{2T} x^2\end{aligned}$$

Now we can substitute the experience effect back into the baseline equation of potential earnings.

$$\ln P_{x+s} = \ln P_0 + s\rho_s + \left( \rho_0 K + \frac{\rho_0 K}{2T} \right) x - \frac{\rho_0 K}{2T} x^2$$

Accounting for the difference in potential and observed earnings:

$$\begin{aligned}\ln Y(s, x) &\approx \ln P_{x+s} - \kappa(1 - x/T) \\&= [\ln P_0 - \kappa] + \rho_s s + \left(\rho_0 \kappa + \frac{\rho_0 \kappa}{2T} + \frac{\kappa}{T}\right)x - \frac{\rho_0 \kappa}{2T}x^2\end{aligned}$$

$\Rightarrow \rho_s$  is the average earnings increase with schooling

## Standard Mincer Equation

$$\ln Y(s, x) = \alpha + \rho_s s + \beta_0 x + \beta_1 x^2,$$

where

$$\alpha = \ln P_0 - K$$

$$\beta_0 = \left( \rho_0 K + \frac{\rho_0 K}{2T} + \frac{K}{T} \right)$$

$$\beta_1 = -\frac{\rho_0 K}{2T}$$

What about heterogeneous returns?

## **Random Coefficient Version**

$$\ln Y(s_i, x_i) = \alpha_i + \rho_{si}s_i + \beta_{0i}x_i + \beta_{1i}x_i^2$$

and let

$$\begin{aligned}\bar{\alpha} &= E[\alpha_i] & \bar{\rho}_s &= E[\rho_{si}] \\ \bar{\beta}_0 &= E[\beta_{0i}] & \bar{\beta}_1 &= E[\beta_{1i}]\end{aligned}$$

Dropping individual subscripts ...

$$\ln Y(s, x) = \bar{\alpha} + \bar{\rho}_s s + \bar{\beta}_0 x + \bar{\beta}_1 x^2 + \underbrace{[(\alpha - \bar{\alpha}) + (\rho_s - \bar{\rho}_s)s + (\beta_0 - \bar{\beta}_0)x + (\beta_1 - \bar{\beta}_1)x^2]}_{\epsilon}$$

⇒ If the schooling decision is determined by individual returns, then we are back in the case of a correlated random coefficient model (Heckman, Urzua, & Vytlacil, 2006).

Table 2: Estimated Coefficients from Mincer Log Earnings Regression for Men

		Whites		Blacks	
		Coefficient	Std. Error	Coefficient	Std. Error
1940	Intercept	4.4771	0.0096	4.6711	0.0298
	Education	0.1250	0.0007	0.0871	0.0022
	Experience	0.0904	0.0005	0.0646	0.0018
	Experience-Squared	-0.0013	0.0000	-0.0009	0.0000
1950	Intercept	5.3120	0.0132	5.0716	0.0409
	Education	0.1058	0.0009	0.0998	0.0030
	Experience	0.1074	0.0006	0.0933	0.0023
	Experience-Squared	-0.0017	0.0000	-0.0014	0.0000
1960	Intercept	5.6478	0.0066	5.4107	0.0220
	Education	0.1152	0.0005	0.1034	0.0016
	Experience	0.1156	0.0003	0.1035	0.0011
	Experience-Squared	-0.0018	0.0000	-0.0016	0.0000
1970	Intercept	5.9113	0.0045	5.8938	0.0155
	Education	0.1179	0.0003	0.1100	0.0012
	Experience	0.1323	0.0002	0.1074	0.0007
	Experience-Squared	-0.0022	0.0000	-0.0016	0.0000
1980	Intercept	6.8913	0.0030	6.4448	0.0120
	Education	0.1023	0.0002	0.1176	0.0009
	Experience	0.1255	0.0001	0.1075	0.0005
	Experience-Squared	-0.0022	0.0000	-0.0016	0.0000
1990	Intercept	6.8912	0.0034	6.3474	0.0144
	Education	0.1292	0.0002	0.1524	0.0011
	Experience	0.1301	0.0001	0.1109	0.0006
	Experience-Squared	-0.0023	0.0000	-0.0017	0.0000

Notes: Data taken from 1940-90 Decennial Censuses. See Appendix B for data description.

We can analyze this model in a Jupyter Noteboook. Visit

<http://bit.ly/2kAtcyg>

for the implementation.

## *Implications*

- ▶ Log-earnings experience profiles are parallel across schooling levels.

$$\frac{\partial \ln Y(s, x)}{\partial s \partial x} = 0$$

- ▶ Log-earnings age profiles diverge with age across schooling levels.

$$\frac{\partial \ln Y(s, x)}{\partial s \partial t} = \frac{\rho_0 K}{T} > 0$$

Figure: Experience profiles

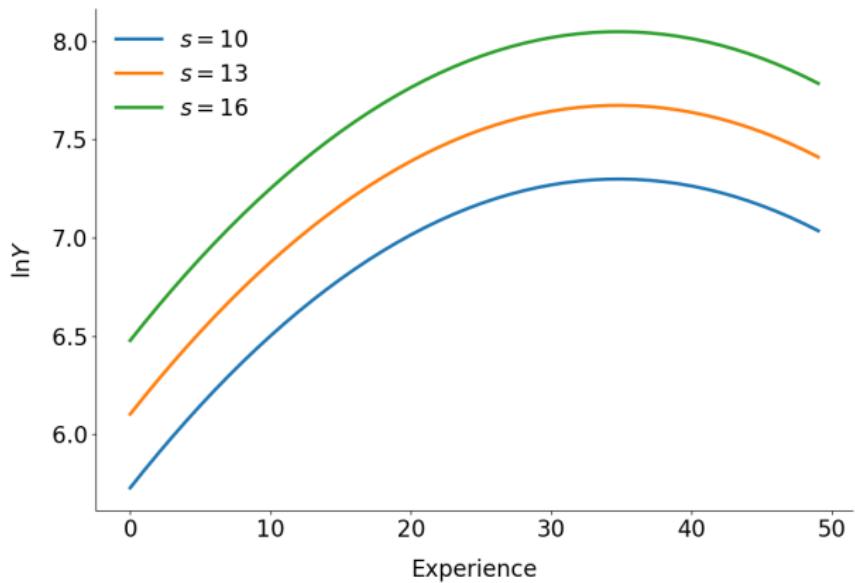
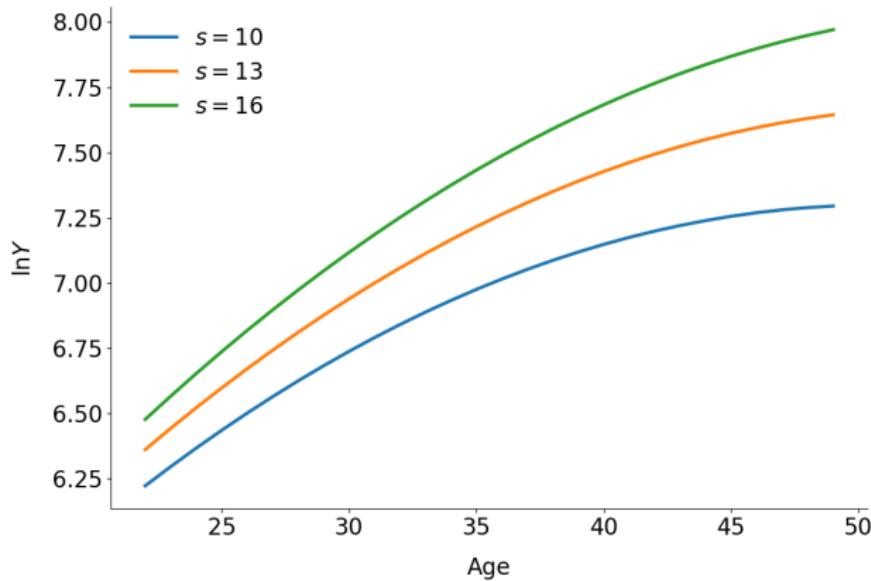


Figure: Age profiles



- ▶ The variance of earnings over the life cycle has a U-shaped pattern.

## Derivation for minimizing variance

$$\begin{aligned}\ln Y(s, x) &= \ln P_{s+x} + \ln (1 - k_{s+x}) \\ &\approx \ln P_s + \rho_0 \sum_{j=0}^{x-1} k_{s+j} - k_{s+x}\end{aligned}$$

Further, using the assumption of linearly declining investment yields

$$\ln Y(s, x) \approx \ln P_s + \kappa \left( \rho_0 \sum_{j=0}^{x-1} (1 - j/T) - (1 - x/T) \right)$$

Assuming only initial earnings potential  $P_s$  and investment levels  $\kappa$  vary in the population, the variance of log earnings is given by

$$\begin{aligned}\text{var}(\ln Y(s, x)) &= \text{var}(\ln P_s) \\ &\quad + \left( \rho_0 \sum_{j=0}^{x-1} (1 - j/T) - (1 - x/T) \right)^2 \text{var}(\kappa) \\ &\quad + 2 \left( \rho_0 \sum_{j=0}^{x-1} (1 - j/T) - (1 - x/T) \right) \text{cov}(\ln P_s, \kappa).\end{aligned}$$

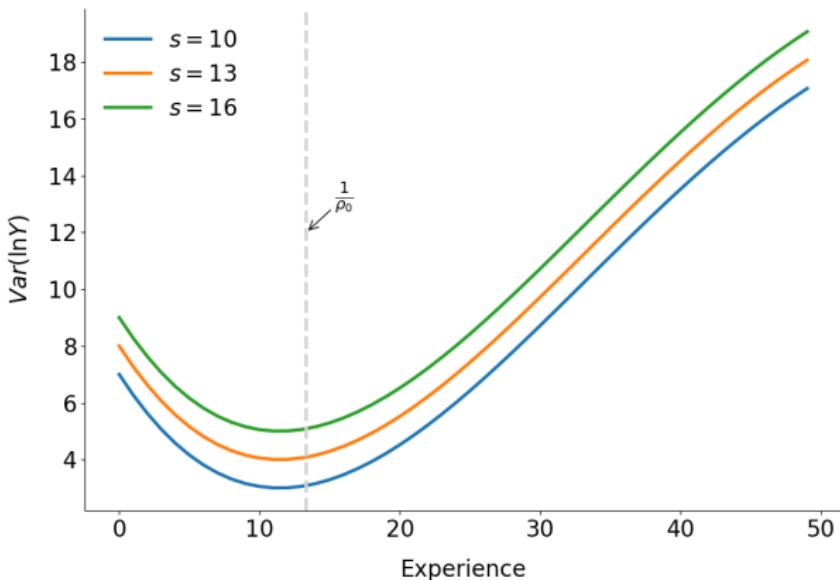
If  $\kappa$  and  $\ln P_s$  are uncorrelated, then earnings are minimized (and equal to  $\text{Var}(\ln P_s)$ ) when

$$\rho_0 \sum_{j=0}^{x-1} (1 - j/T) = 1 - x/T, \text{ or}$$

$$\rho_0 \left( x - \frac{x(x-1)}{2T} \right) = (1 - x/T).$$

Clearly,  $\lim_{T \rightarrow \infty} x^* = \frac{1}{\rho_0}$ , so the variance minimizing age is  $\frac{1}{\rho_0}$  when the work-life is long.

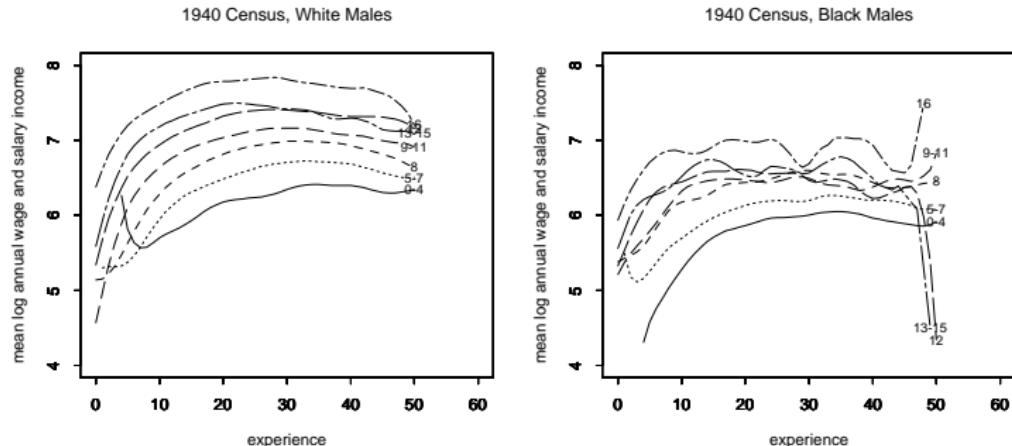
Figure: Variance profiles



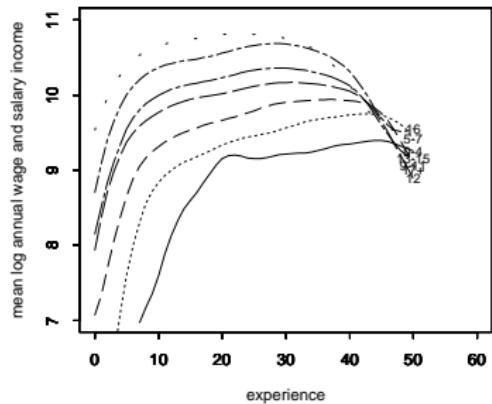
# *Empirical Evidence*

The following results are based on the synthetic cohort approach using the United States Census.

Figure 1a: Experience-Earnings Profiles, 1940-1960



1990 Census, White Males



1990 Census, Black Males

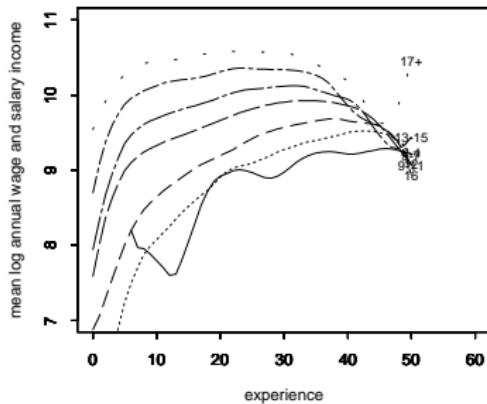
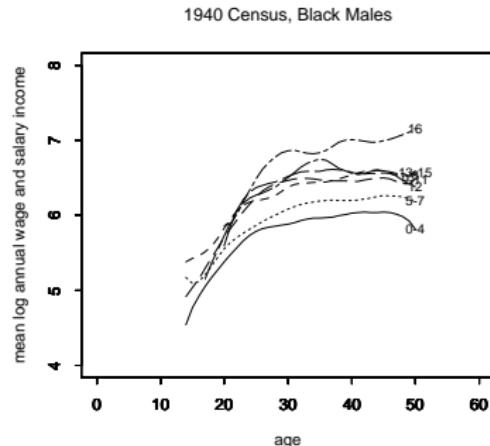
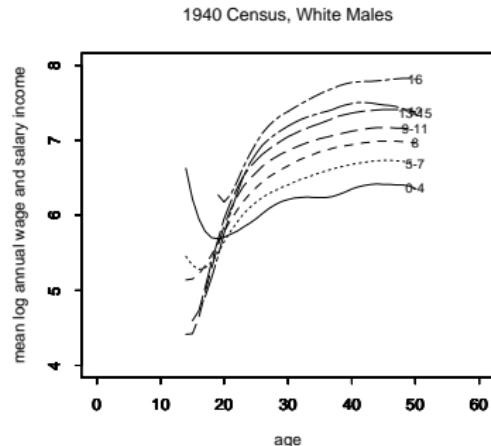


Table 1: Tests of Parallelism in Log Earnings Experience Profiles for Men

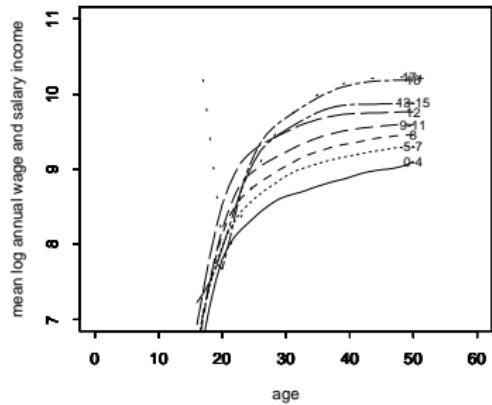
Sample	Experience Level	Estimated Difference Between College and High School Log Earnings at Different Experience Levels				
		1940	1950	1960	1970	1990
Whites	10	0.54	0.30	0.46	0.41	0.37
	20	0.40	0.40	0.43	0.49	0.45
	30	0.54	0.27	0.46	0.48	0.43
	40	0.58	0.21	0.50	0.45	0.27
	p-value	0.32	0.70	<0.001	<0.001	<0.001
Blacks	10	0.20	0.58	0.48	0.38	0.70
	20	0.38	0.05	0.25	0.22	0.48
	30	-0.11	0.24	0.08	0.33	0.36
	40	-0.20	0.00	0.73	0.26	0.22
	p-value	0.46	0.55	0.58	0.91	<0.001

Notes: Data taken from 1940-90 Decennial Censuses without adjustment for inflation. Because there are very few blacks in the 1940 and 1950 samples with college degrees, especially at higher experience levels, the test results for blacks in those years refer to a test of the difference between earnings for high school graduates and persons with 8 years of education. See Appendix B for data description. See Appendix C for the formulae used for the test statistics.

Figure 2: Age-Earnings Profiles, 1940,1960,1980



1980 Census, White Males



1980 Census, Black Males

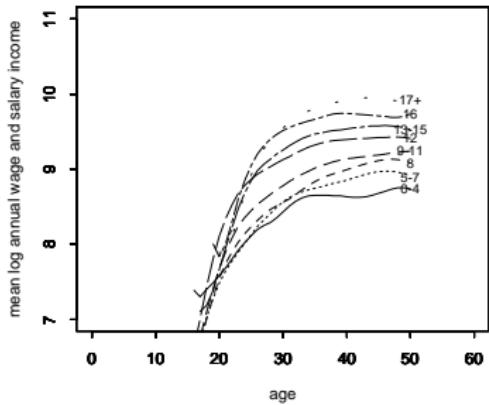
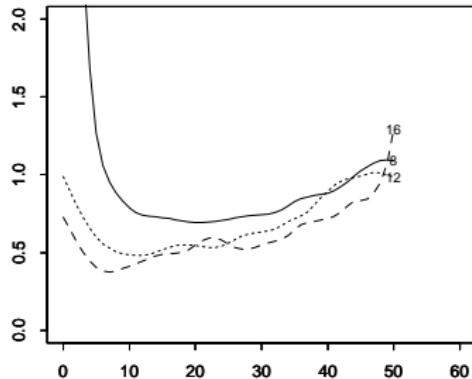
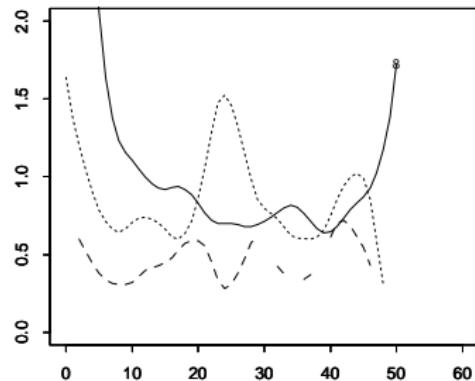


Figure 3: Experience-Variance Log Earnings

1940 Census, White Males

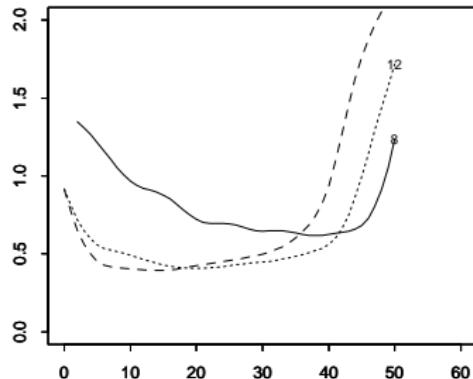


1940 Census, Black Males



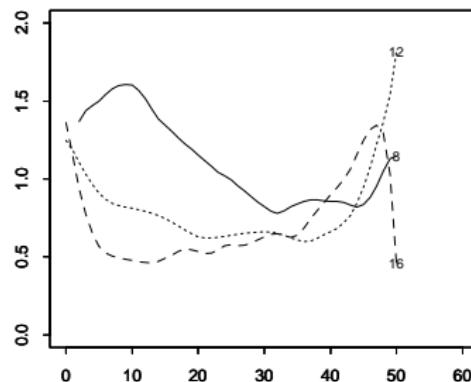
1980 Census, White Males

16



1980 Census, Black Males

16



In the end, Heckman, Lochner, and Todd (2006) conclude:

*In common usage, the coefficient on schooling in a regression of log earnings on years of schooling is often called a rate of return. In fact, it is a price of schooling from a hedonic market wage equation. It is a growth rate of market earnings with years of schooling and not an internal rate of return measure, except under stringent conditions which we specify, test and reject in this chapter.*

# **Internal rate of return**

We study two different concepts of the rate of return in schooling:

- ▶ marginal differences
- ▶ non-marginal differences

We treat schooling as a continuous choice initially but then account for its discrete nature.

## **Income Maximization under Perfect Certainty**

- $s$  schooling level
- $x$  experience level
- $Y(s, x)$  wage income
- $T(s)$  last age of earnings
- $v$  tuition and psychic cost of schooling
- $\tau$  proportional tax rate
- $r$  before-tax interest rate

## **Present Discounted Value of Lifetime Earnings**

$$V(s) = \int_0^{T(s)-s} (1-\tau)e^{-(1-\tau)r(x+s)}Y(s,x)dx \\ - \int_0^s ve^{-(1-\tau)rz}dz$$

## First-Order Condition

$$\begin{aligned}& [T'(s) - 1] e^{-(1-\tau)r(T(s)-s)} Y(s, T(s)-s) \\& - (1-\tau)r \int_0^{T(s)-s} e^{-(1-\tau)rx} Y(s, x) dx \\& + \int_0^{T(s)-s} e^{-(1-\tau)rx} \frac{\partial Y(s, x)}{\partial s} dx \\& - \frac{v}{1-\tau} = 0\end{aligned}$$

Rearranging and defining  $\tilde{r} = (1 - \tau)r$  ...

$$\tilde{r} = \frac{[T'(s) - 1]e^{-\tilde{r}(T(s)-s)}Y(s, T(s) - s)}{\int_0^{T(s)-s} e^{-\tilde{r}x}Y(s, x)dx} \quad (1)$$

$$+ \frac{\int_0^{T(s)-s} e^{-\tilde{r}x} \left[ \frac{\partial Y(s, x)}{\partial s} \right] dx}{\int_0^{T(s)-s} e^{-\tilde{r}x}Y(s, x)dx} \quad (2)$$

$$- \frac{\frac{v}{1-\tau}}{\int_0^{T(s)-s} e^{-\tilde{r}x}Y(s, x)dx} \quad (3)$$

## **Interpretation**

- ▶ (1) ... the change in the present value of earnings due to a change in working-life with additional schooling
- ▶ (2) ... weighted average effect of schooling on log earnings by experience
- ▶ (3) ... tuition and psychic costs

All components are expressed as a fraction of the present value of earnings measured at age  $s$

## Getting back to Mincer

- ▶ no tuition and psychic costs of schooling  
 $\Rightarrow v = 0$
- ▶ no loss of working life from schooling  
 $\Rightarrow T'(s) = 1$
- ▶ multiplicative separability between schooling and experience component of earnings  
 $\Rightarrow Y(s, x) = \mu(s)\psi(x)$

$$\tilde{r} = \frac{\mu'(s)}{\mu(s)} \quad \forall \quad s$$

Thus, wage growth must be log linear in schooling and  $\mu(s) = \mu(0)e^{\rho_s s}$  and  $\tilde{r} = \rho_s$ .

## Structural Approach for the IRR

The internal rate of return for schooling level  $s_1$  versus  $s_2$ ,  $r_I(s_1, s_2)$  solves ...

$$\begin{aligned} & \int_0^{T(s_1)-s_1} (1-\tau)e^{-r_I(x+s_1)} Y(s_1, x) dx - \int_0^{s_1} ve^{-rz} dz \\ &= \int_0^{T(s_2)-s_2} (1-\tau)e^{-r_I(x+s_2)} Y(s_2, x) dx - \int_0^{s_2} ve^{-rz} dz \end{aligned}$$

Back to Mincer ....

- ▶ no taxes and no direct or psychic costs of schooling

$$\Rightarrow v = 0 \text{ and } \tau = 0$$

$$\int_0^{T(s_1)-s_1} e^{-r_l(x+s_1)} Y(s_1, x) dx = \int_0^{T(s_2)-s_2} e^{-r_l(x+s_2)} Y(s_2, x) dx$$

- ▶ equal work-lives irrespective of years of schooling

$$\Rightarrow T = T(s_1) - s_1 = T(s_2) - s_2$$

$$\int_0^T e^{-r_l(x+s_1)} Y(s_1, x) dx = \int_0^T e^{-r_l(x+s_2)} Y(s_2, x) dx$$

- ▶ parallelism in experience across schooling categories

$$\Rightarrow Y(s, x) = \mu(s)\psi(x)$$

$$\int_0^T e^{-r_I(x+s_1)} \mu(s) \psi(x) dx = \int_0^T e^{-r_I(x+s_2)} \mu(s) \psi(x) dx$$

- ▶ linearity of log earnings in schooling

$$\Rightarrow \mu(s) = \mu(0)e^{\rho_s s}$$

$$\int_0^T e^{-r_l(x+s_1)} \mu(0) e^{\rho_s s_1} \psi(x) dx = \int_0^T e^{-r_l(x+s_2)} \mu(0) e^{\rho_s s_2} \psi(x) dx$$

After some further rearranging ...

$$e^{(\rho_s - r_l)s_1} = e^{(\rho_s - r_l)s_2}$$

$$\Rightarrow \rho_s = r_l$$

Heckman, Lochner, and Todd (2006) thus establish ...

*After allowing for taxes, tuition, variable length of working life, and a flexible relationship between earnings, schooling and experience, the coefficient on years of schooling in a log earnings regression need no longer equal the internal rate of return.*

# *Empirical Evidence*

## Specifications

- ▶ **relax linearity in  $S$** , including indicator variables for each level of schooling
- ▶ **relax linearity and parallelism**, nonparametrically estimated functions of experience, separately within each schooling level

Table 3a: Internal Rates of Return for White Men: Earnings Function Assumptions  
 (Specifications Assume Work Lives of 47 Years)

	Schooling Comparisons					
	6-8	8-10	10-12	12-14	12-16	14-16
1940						
Mincer Specification	13	13	13	13	13	13
Relax Linearity in S	16	14	15	10	15	21
Relax Linearity in S & Quad. in Exp.	16	14	17	10	15	20
Relax Lin. in S & Parallelism	12	14	24	11	18	26
1950						
Mincer Specification	11	11	11	11	11	11
Relax Linearity in S	13	13	18	0	8	16
Relax Linearity in S & Quad. in Exp.	14	12	16	3	8	14
Relax Linearity in S & Parallelism	26	28	28	3	8	19
1960						
Mincer Specification	12	12	12	12	12	12
Relax Linearity in S	9	7	22	6	13	21
Relax Linearity in S & Quad. in Exp.	10	9	17	8	12	17
Relax Linearity in S & Parallelism	23	29	33	7	13	25
1970						
Mincer Specification	13	13	13	13	13	13
Relax Linearity in S	2	3	30	6	13	20
Relax Linearity in S & Quad. in Exp.	5	7	20	10	13	17
Relax Linearity in S & Parallelism	17	29	33	7	13	24
1980						
Mincer Specification	11	11	11	11	11	11
Relax Linearity in S	3	-11	36	5	11	18
Relax Linearity in S & Quad. in Exp.	4	-4	28	6	11	16
Relax Linearity in S & Parallelism	16	66	45	5	11	21
1990						
Mincer Specification	14	14	14	14	14	14
Relax Linearity in S	-7	-7	39	7	15	24
Relax Linearity in S & Quad. in Exp.	-3	-3	30	10	15	20

Table 3b: Internal Rates of Return for Black Men: Earnings Function Assumptions  
 (Specifications Assume Work Lives of 47 Years)

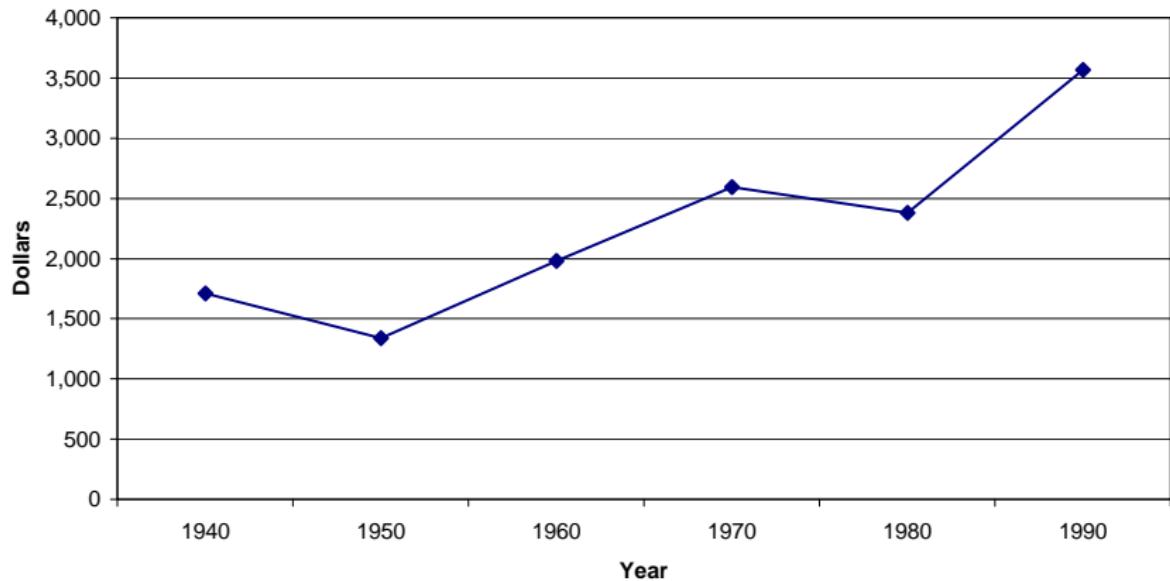
	Schooling Comparisons					
	6-8	8-10	10-12	12-14	12-16	14-16
1940						
Mincer Specification	9	9	9	9	9	9
Relax Linearity in S	18	7	5	3	11	18
Relax Linearity in S & Quad. in Exp.	18	8	6	2	10	19
Relax Linearity in S & Parallelism	11	0	10	5	12	20
1950						
Mincer Specification	10	10	10	10	10	10
Relax Linearity in S	16	14	18	-2	4	9
Relax Linearity in S & Quad. in Exp.	16	14	18	0	3	6
Relax Linearity in S & Parallelism	35	15	48	-3	6	34
1960						
Mincer Specification	11	11	11	11	11	11
Relax Linearity in S	13	12	18	5	8	11
Relax Linearity in S & Quad. in Exp.	13	11	18	5	7	10
Relax Linearity in S & Parallelism	22	15	38	5	11	25
1970						
Mincer Specification	12	12	12	12	12	12
Relax Linearity in S	5	11	30	7	10	14
Relax Linearity in S & Quad. in Exp.	6	11	24	10	11	12
Relax Linearity in S & Parallelism	15	27	44	9	14	23
1980						
Mincer Specification	12	12	12	12	12	12
Relax Linearity in S	-4	1	35	10	15	19
Relax Linearity in S & Quad. in Exp.	-4	6	29	11	14	17
Relax Linearity in S & Parallelism	10	44	48	8	16	31
1990						
Mincer Specification	16	16	16	16	16	16
Relax Linearity in S	-5	-5	41	15	20	25
Relax Linearity in S & Quad. in Exp.	-3	-3	35	17	19	22

Table 4: Internal Rates of Return for White & Black Men: Accounting for Taxes and Tuition  
 (General Non-Parametric Specification Assuming Work Lives of 47 Years)

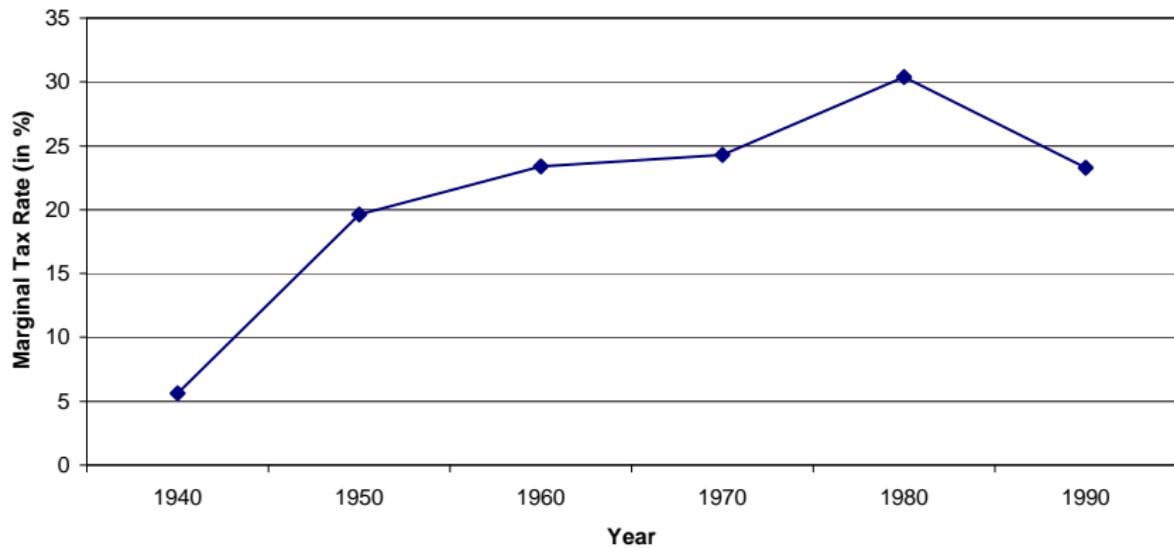
		Schooling Comparisons					
		Whites			Blacks		
		12-14	12-16	14-16	12-14	12-16	14-16
1940	No Taxes or Tuition	11	18	26	5	12	20
	Including Tuition Costs	9	15	21	4	10	16
	Including Tuition & Flat Taxes	8	15	21	4	9	16
	Including Tuition & Prog. Taxes	8	15	21	4	10	16
1950	No Taxes or Tuition	3	8	19	-3	6	34
	Including Tuition Costs	3	8	16	-3	5	25
	Including Tuition & Flat Taxes	3	8	16	-3	5	24
	Including Tuition & Prog. Taxes	3	7	15	-3	5	21
1960	No Taxes or Tuition	7	13	25	5	11	25
	Including Tuition Costs	6	11	21	5	9	18
	Including Tuition & Flat Taxes	6	11	20	4	8	17
	Including Tuition & Prog. Taxes	6	10	19	4	8	15
1970	No Taxes or Tuition	7	13	24	9	14	23
	Including Tuition Costs	6	12	20	7	12	18
	Including Tuition & Flat Taxes	6	11	20	7	11	17
	Including Tuition & Prog. Taxes	5	10	18	7	10	16
1980	No Taxes or Tuition	5	11	21	8	16	31
	Including Tuition Costs	4	10	18	7	13	24
	Including Tuition & Flat Taxes	4	9	17	6	12	21
	Including Tuition & Prog. Taxes	4	8	15	6	11	20
1990	No Taxes or Tuition	10	16	26	18	25	35
	Including Tuition Costs	9	14	20	14	18	25
	Including Tuition & Flat Taxes	8	13	19	13	17	22
	Including Tuition & Prog. Taxes	8	12	18	13	17	22

Notes: Data taken from 1940-90 Decennial Censuses. See discussion in text and Appendix B for a description of tuition and tax amounts.

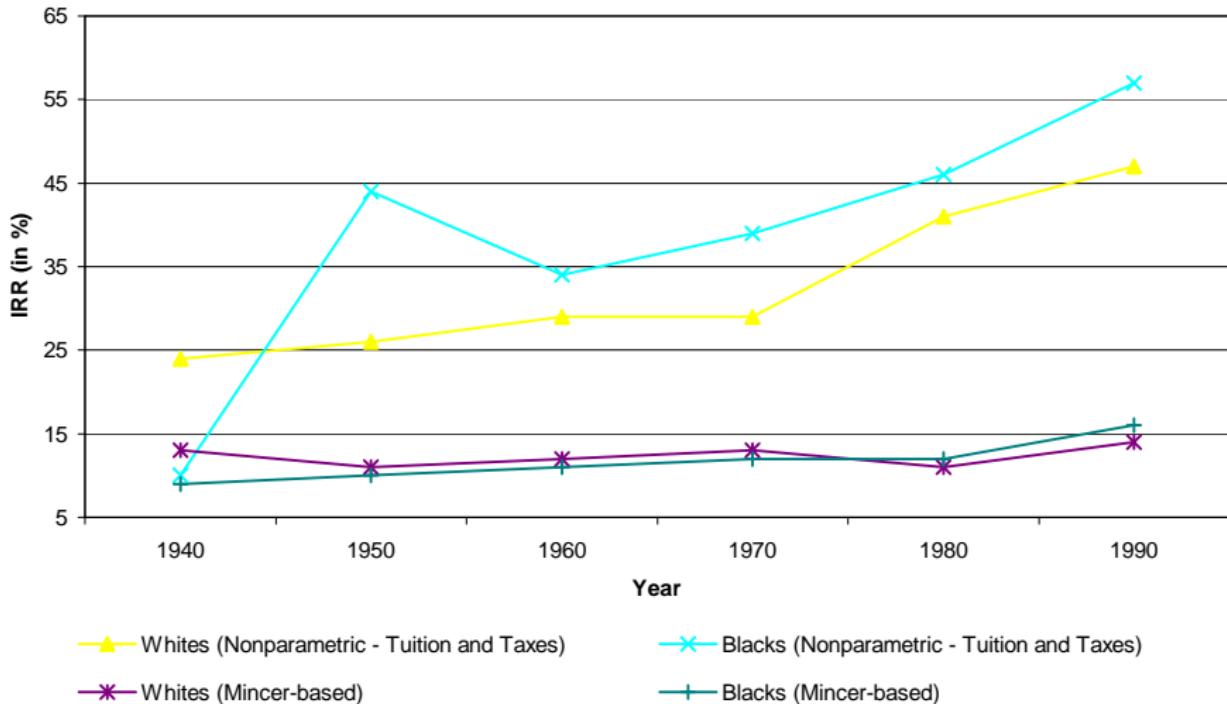
**Figure 4a: Average College Tuition Paid (in 2000 dollars)**



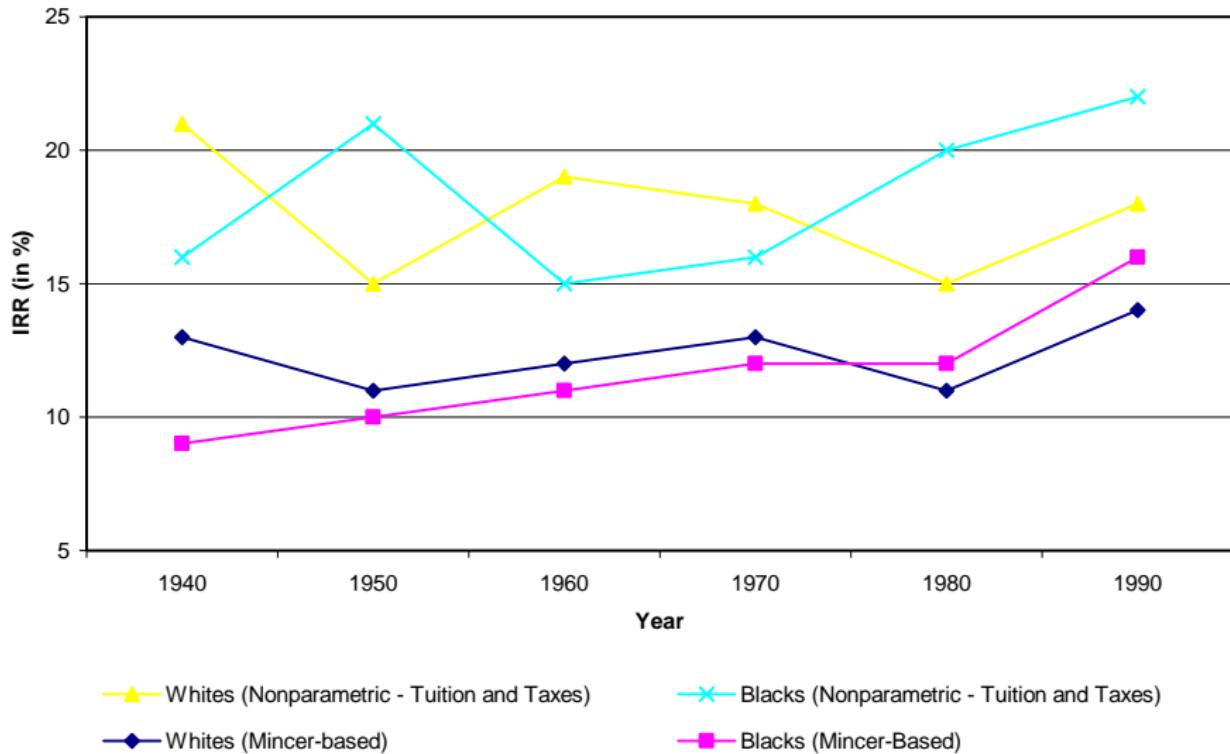
**Figure 4b: Marginal Tax Rates**  
**(from Barro & Sahasakul, 1983, Mulligan & Marion, 2000)**



**Figure 5: IRR for High School Completion (White and Black Men)**



**Figure 6: IRR for College Completion (White and Black Men)**

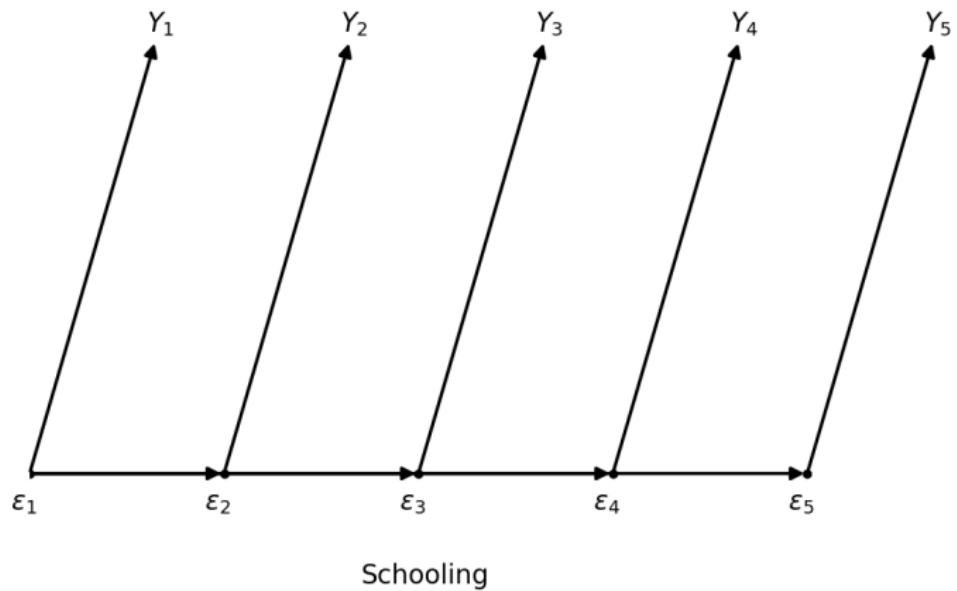


# **True rate of return**

Suppose there is uncertainty about net earnings conditional on  $s$  and actual lifetime earnings for someone with  $s$  years of schooling are:

$$Y_s = \underbrace{\left[ \sum_{x=0}^T (1+r)^{-x} Y(s, x) \right]}_{\bar{Y}_s} \epsilon_s$$

Figure: Model structure



The decision problem for a person with  $s$  years of schooling given the sequential revelation of information is to complete another year of schooling if

$$Y_s \leq \frac{E_s(V_{s+1})}{1+r}.$$

So the value of schooling level  $s$ ,  $V_s$ , is

$$V_s = \max \left\{ Y_s, \frac{E_s(V_{s+1})}{1+r} \right\}$$

for  $s \leq \bar{s}$ . At the maximum schooling level,  $\bar{s}$ , after all information is revealed, we obtain  $V_{\bar{s}} = Y_{\bar{s}} = \bar{Y}_{\bar{s}}\epsilon_{\bar{s}}$ .

The endogenously determined probability of going on from school level  $s$  to  $s + 1$  is

$$p_{s+1,s} = \Pr\left(\epsilon_s \leq \frac{E_s(V_{s+1})}{(1+r)\bar{Y}_s}\right),$$

where  $E_s(V_{s+1})$  may depend on  $\epsilon_s$  because it enters the agent's information set.

Thus, the expected value of schooling level  $s$  as perceived at current schooling  $s-1$  is:

$$E_{s-1}(V_s) = \underbrace{(1 - p_{s+1,s})\bar{Y}_s E_{s-1}\left(\epsilon \mid \epsilon \geq \frac{E_s(V_{s+1})}{(1+r)\bar{Y}_s}\right)}_{\text{direct return}} + \underbrace{p_{s+1,s} \left(\frac{E_{s-1}(V_{s+1})}{1+r}\right)}_{\text{option value}}.$$

## Objects of interest

- ▶ Option value

$$O_{s,s-1} = E_{s-1}[V_s - Y_s]$$

- ▶ True rate of return

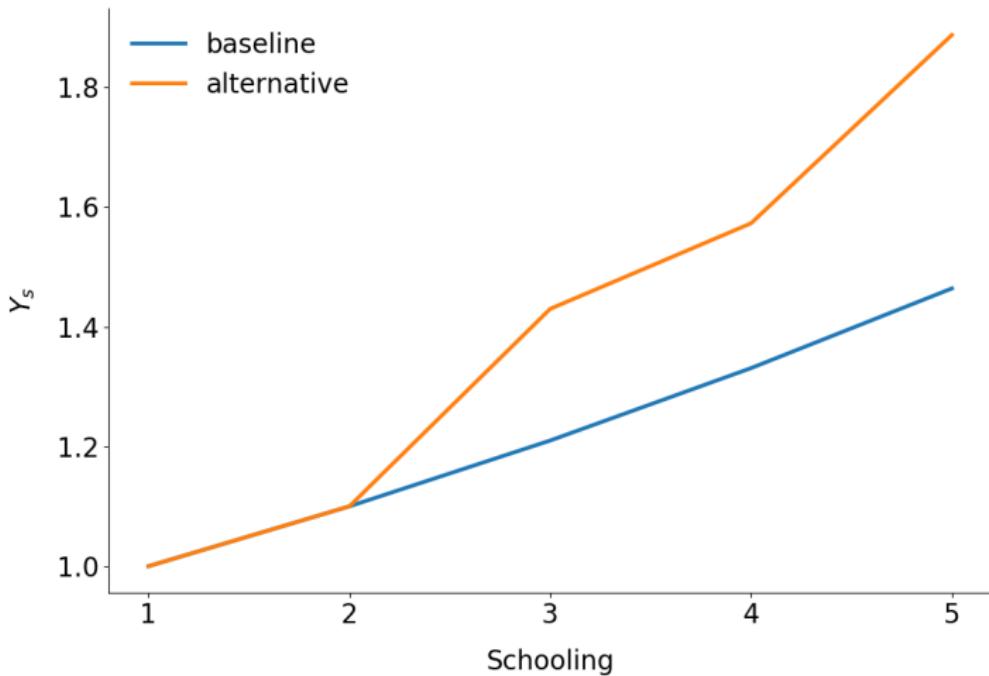
$$R_{s,s-1} = \frac{E_{s-1}[V_s] - Y_{s-1}}{Y_{s-1}}$$

## **Model specification**

$$\ln(\epsilon_s) \sim \mathbb{N}(0, \sigma) \quad r = 0.1$$

$$Y_{s+1} = (1 + \rho_{s+1})Y_s \quad \sigma = 0.1$$

Figure: Scenarios



We can analyze this model in a Jupyter Noteboook. Visit

<http://bit.ly/2skwwli>

for the implementation.

Figure: Option values and uncertainty

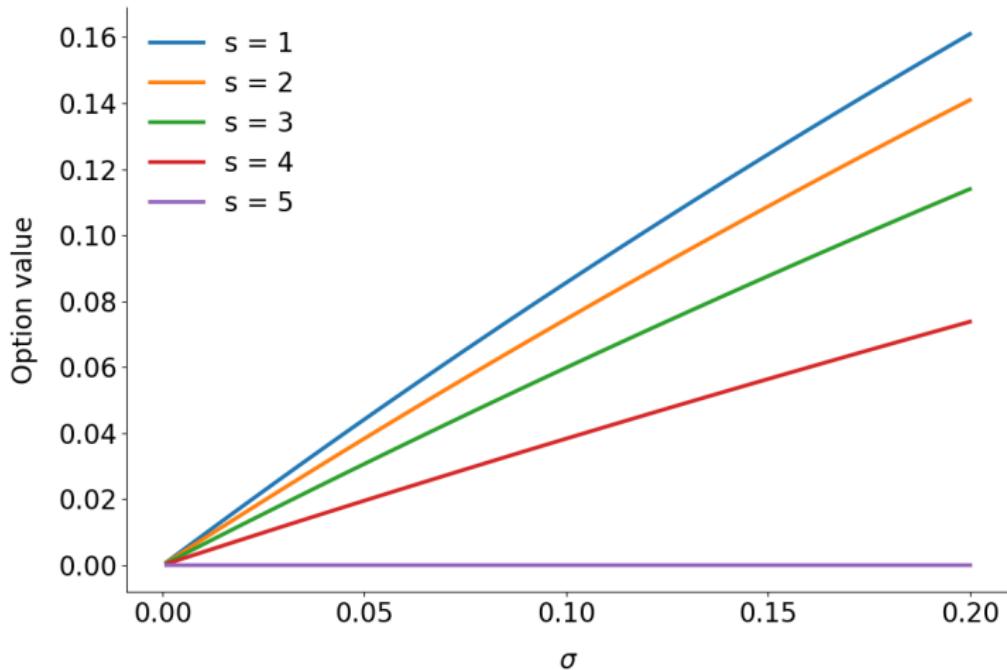
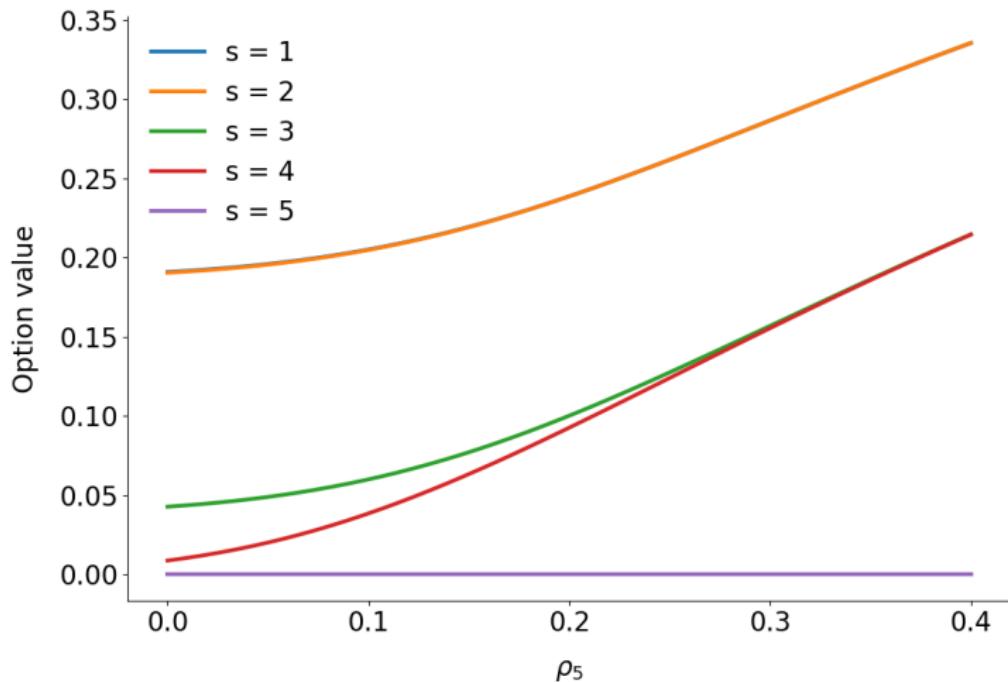


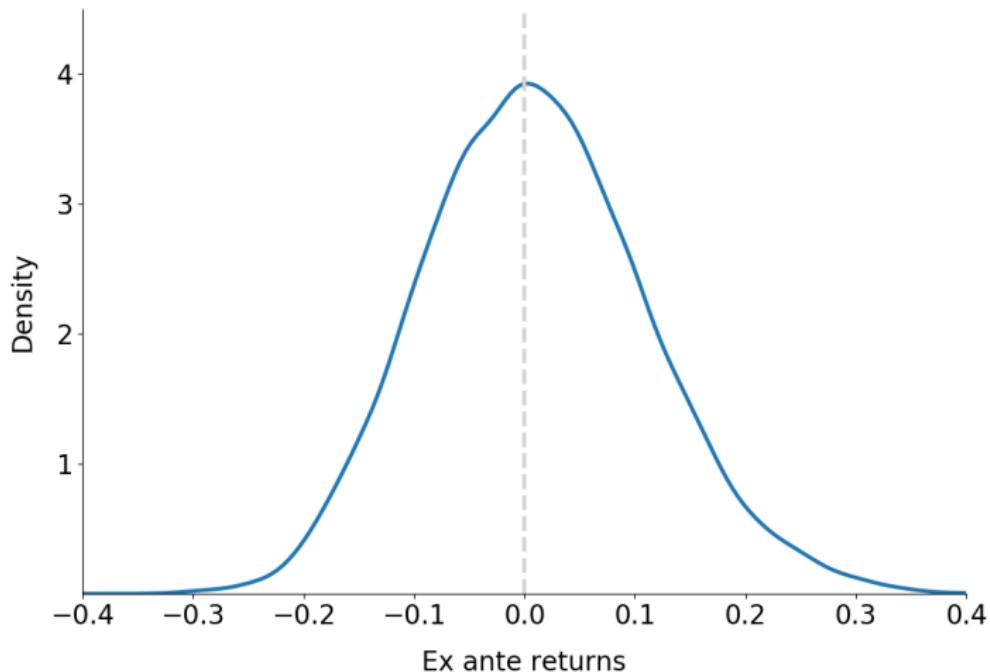
Figure: Option values and sheepskin effects



## **Key features**

- ▶ The convergence of  $O_{5,4}$  and  $O_{4,3}$  follows from the additional benefits of obtaining 5 years of schooling as we increase the growth rate  $\rho_5$ . It simply dominates the increase going from three to four years of schooling parameterized by  $\rho_4$ .

Figure: Returns



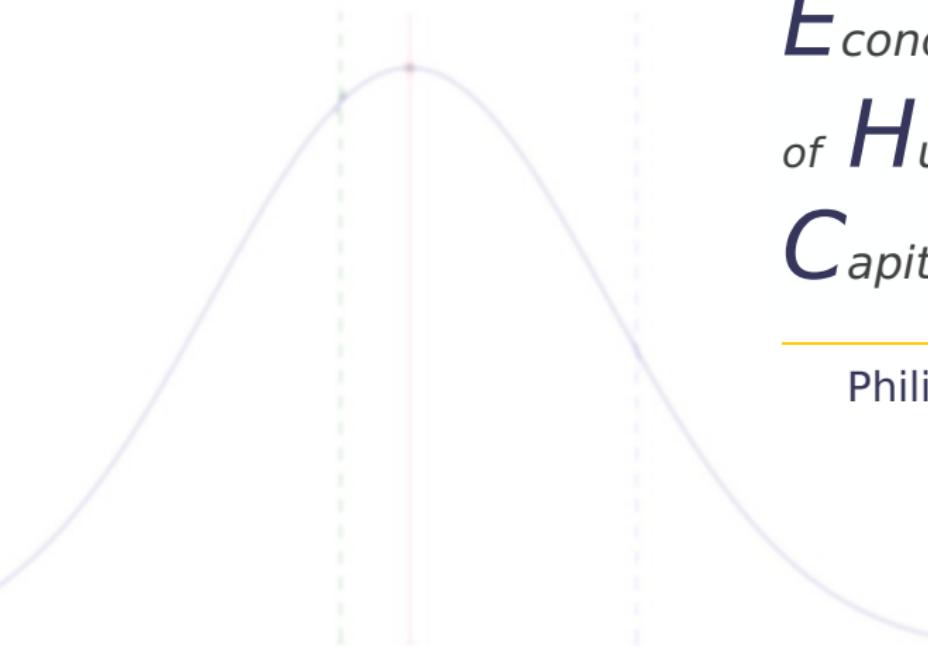
# **Conclusion**

# **Appendix**

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# Economics of Human Capital

Multidimensionality of skills

Philipp Eisenhauer

# **Introduction**

## Multidimensionality of skills

- ▶ Heckman, J. J., Stixrud, J., & Urzua, S. (2006). The effects of cognitive and noncognitive abilities on labor market outcomes and social behavior. *Journal of Labor Economics*, 24(3), 411–482.
- ▶ Eisenhauer, P., Heckman, J. J., & Mosso, S. (2015). Estimation of dynamic discrete choice models by maximum likelihood and the simulated method of moments. *International Economic Review*, 56(2), 331–357.

# The Effects of Cognitive and Noncognitive Abilities on Labor Outcomes and Social Behavior

James Heckman

University of Chicago and American Bar Foundation

Jora Stixrud and Sergio Urzua

University of Chicago

The Chicago Workshop on Black-White Inequality

Chicago

April 21, 2006

# Introduction

- Although the importance of cognitive skills for success in a variety of dimensions of social and economic life is well established, the importance of noncognitive skills has largely been overlooked.
- In the 1970's, Marxist economists documented the importance of noncognitive traits in the workplace (Bowles; Gintis; Edwards).
- Early work by Peter Muesser reported in Jencks (1979) found that skills such as industriousness, perseverance, and leadership have significant influences on wages – comparable to estimated effects of schooling, IQ, and parental socioeconomic status – even after controlling for standard human capital variables.

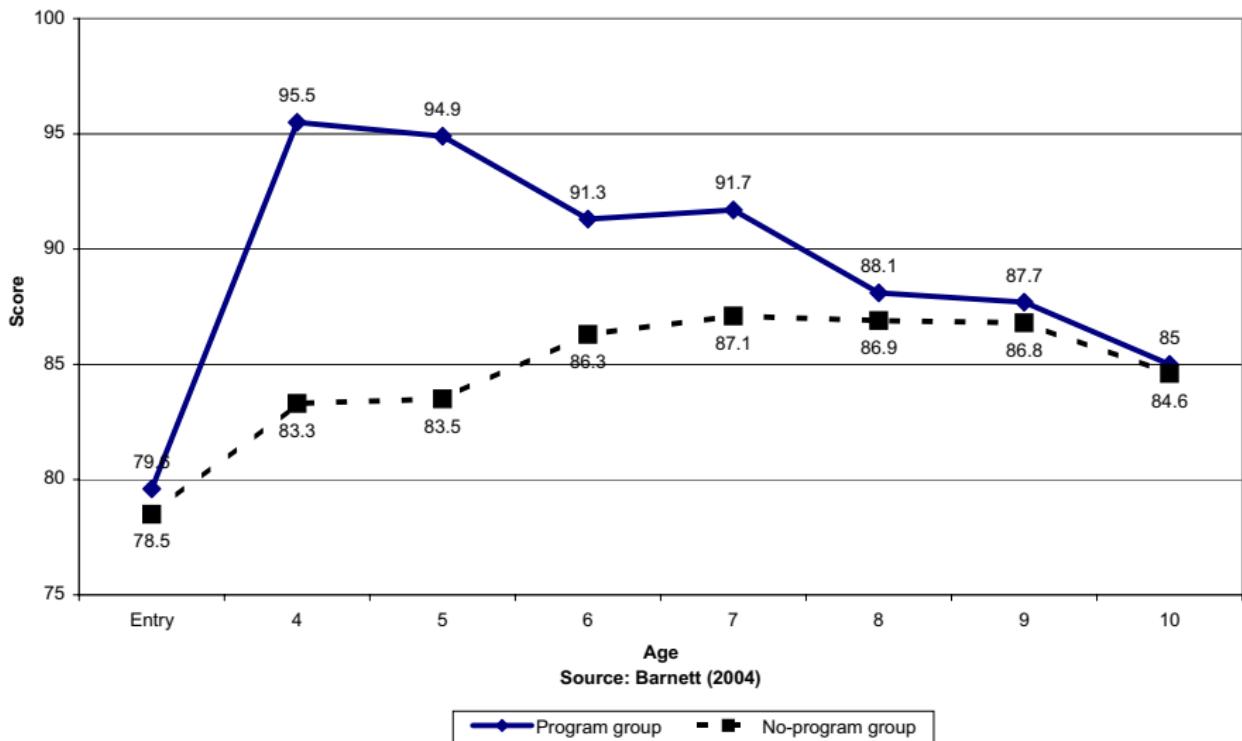
- Osborne (2000) studies the effect of personality and behavioral traits on wages of females.
- Bowles, Gintis, and Osborne (2001) present a model in which non-cognitive skills are rewarded by employers, in the form of increased wages. In their model, employee preferences that allow their employer to induce greater effort at a lower cost are termed incentive enhancing. If, for example, costlessly enforceable contracts for labor services are unavailable, then incentive enhancing preferences will be valued by the employer, and may be rewarded as such.
- Examples of incentive enhancing preferences are: a low time discount rate (i.e., greater future orientation), high degree of self-directedness and personal efficacy, a predisposition to truth-telling, a low disutility of effort, a high marginal utility of income, identification with the objectives of a firm's owners and managers, a tendency of helpful (non-disruptive) behavior toward other employees, and a high sense of shame at being without a job or receiving handouts.

- Heckman and Rubinstein (2001) use evidence from the General Education Development (GED) testing program (an exam-certified alternative high school degree) to demonstrate the quantitative importance of non-cognitive skills. GED recipients have the same cognitive ability as high school graduates that do not go onto college, as measured by scores on the Armed Forces Qualifying Test (AFQT). However, once cognitive ability is controlled for, GED recipients earn the same, have lower hourly wages, and obtain lower levels of schooling than high school dropouts. Some other factor must account for this striking difference, and the authors identify this as noncognitive skill.
- Heckman, LaFontaine and Urzua (2004) show that GEDs have higher turnover rates, are more likely to drop out of the army and post secondary schooling, and are less likely to persevere in many tasks than HS dropouts.

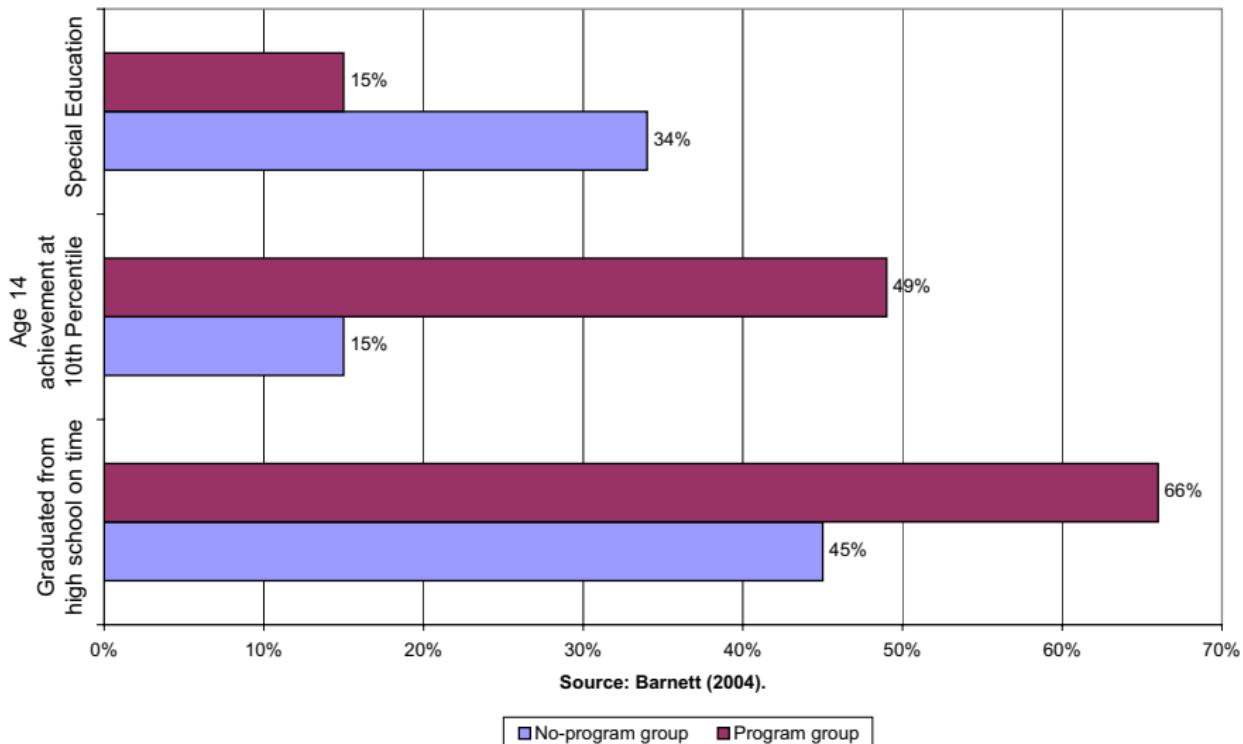
- Carneiro and Heckman (2002), and Heckman and Masterov (2004) argue that parents play an important role in producing both the cognitive and non-cognitive skills of their children, and more able and engaged parents have greater success in doing so. Because cognitive and non-cognitive abilities are shaped early in the lifecycle, differences in these abilities are persistent, and both are crucial to the social and economic success of an individual, gaps among income and racial groups begin early and persist.
- **Early interventions**, such as enriched childcare centers coupled with home visitations, have been successful in alleviating some of the initial disadvantages of children born into adverse conditions. The success of these interventions has primarily been due not to their success in improving the cognitive skills (IQ) of these children, but rather to their success in boosting non-cognitive skills and increasing child motivation.

- The Perry Preschool Program, an enriched early childhood intervention evaluated by random assignment where treatments and controls are followed to age 40, did not boost IQ but raised achievement test scores, schooling and social skills.
- Raised noncognitive skills but not cognitive skills, at least as measured by IQ.
- Effects were not uniform across gender groups (Heckman, 2004).
- See the evidence in Cunha, Heckman, Lochner and Masterov (2005).

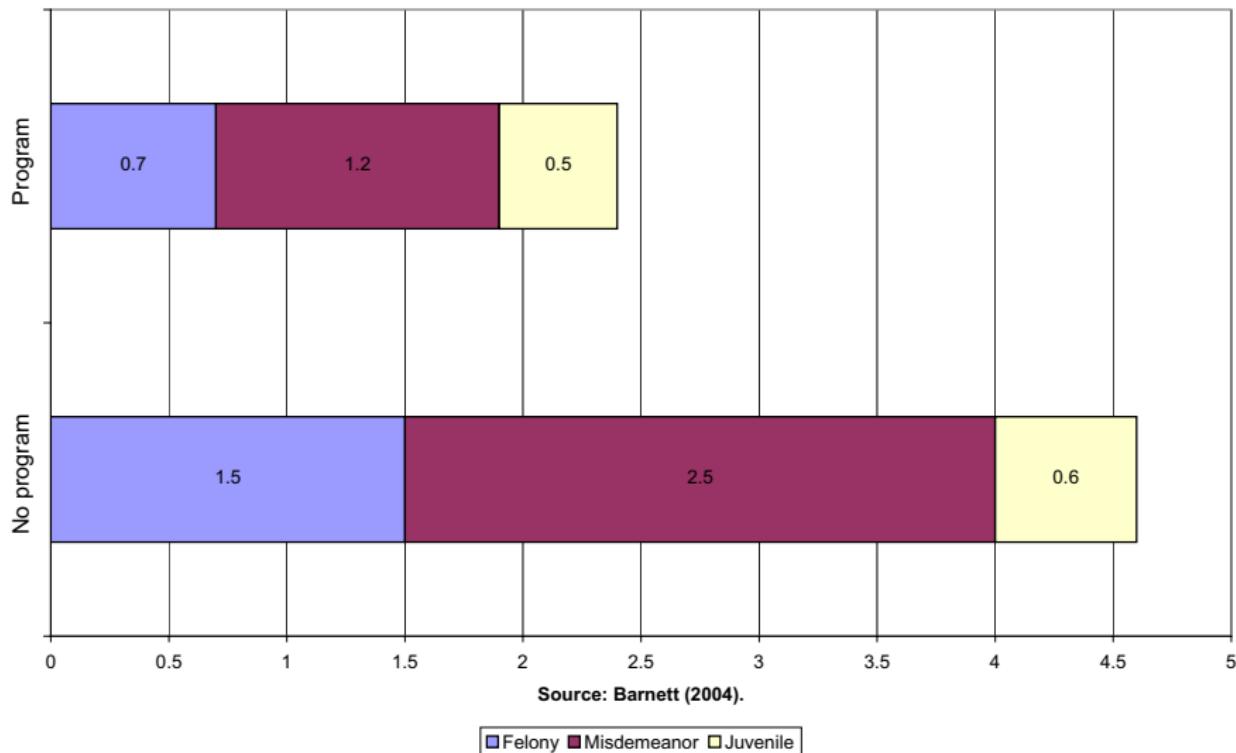
**Figure 1A**  
**Perry Preschool IQ Over Time**



**Figure 1B**  
**Perry Preschool: Educational Effects**



**Figure 1C**  
**Perry Preschool: Arrests Per Person by Age 27**



## Problems with the Recent Literature and Our Solution

- Naive regressions of earnings on test scores (cognitive and noncognitive) are problematic.
- Problem is reverse causality: Schooling may cause both earnings and test scores.
- The recent literature notes that schooling and age may influence cognitive measures and corrects for the effect of schooling on ability (Hansen, Heckman and Mullen, 2004).
- Age at test and schooling levels differ among individuals in our samples. It is necessary to account for the fact that our test measures are not directly comparable across people as they reflect different input levels.
- The test scores we use are corrected for the fact that different individuals have different amounts of schooling at the time they take the test.
- Our analysis generalizes Hansen, Heckman and Mullen (2004).

- We allow for common factors explaining wages and schooling to account for correlated risky behavior across youth (Biglan, 2004).
- We broaden previous analyses and explain wages, schooling and a variety of social behaviors from a low-dimensional set of factors.
- Start with cognitive tests to get the main idea of our procedure, and provide an intuition for how we secure identification.

# 1 Relationship Between Ability and Schooling: An Introduction

- $T(s_T)$  is the test score of a person with  $s_T$  years of schooling at the date of the test.  $S$  is final schooling level.
- Test is taken at schooling level  $s_T$ .  $X$  are other determinants. We suppress them to simplify the notation.

Latent ability  $f$  (IQ)

Test score  $T(s_T)$ :

$$T(s_T) = \mu(s_T) + \lambda(s_T)f + \varepsilon(s_T) \quad (1.1)$$

Assume that  $\varepsilon(s_T)$  is independent of  $f$ .  
 $f$  and  $\varepsilon(s_T)$  are assumed to have zero means.

$\mu(s_T)$  in equation (1.1) is the effect of schooling that is uniform across latent ability levels

$\lambda(s_T)$  is the effect of schooling on revealing or transforming latent ability  $f$ .

The marginal causal effects of changing schooling from  $s'_T$  to  $s_T$  on levels and slopes are

$$\mu(s_T) - \mu(s'_T) \text{ and } [\lambda(s_T) - \lambda(s'_T)] f$$

The empirical literature on cognitive ability recognizes the problem of reverse causality. (Herrnstein and Murray, 1994, Neal and Johnson, 1996, and Winship and Korenman, 1997)

Assumes  $\mu(s_T) = s_T\beta$  (linearity).

Uses instruments (Neal and Johnson, 1996) or proxies (Herrnstein and Murray, 1994; Winship and Korenman, 1997) to solve for endogeneity problems. Both methods are controversial.

## 2 Simple Idea Motivating How to Control for Endogeneity of Schooling on Test Scores

(Hansen, Heckman and Mullen, 2004)

- We observe Test at the date of the test ( $S_T$ ).
- The agent has  $S_T$  years of schooling at the date of the test ( $S_T = s_T$ ).
- The agent completes schooling and has final schooling  $S = s$ .
- We have panel data and follow the person after taking the test.
- Suppose we observe test score for a person with  $S = s$ ,  $S_T = s_T$ .

- Then if

$$\begin{aligned} T(S, S_T) &= \mu(s_T) + U(S, S_T) \\ E(T(S, S_T) \mid S_T = s_T, S = s) &= \mu(s_T) + E(U(S, S_T) \mid S = s, S_T = s_T) \end{aligned}$$

where it is assumed

$$E(U(S, S_T) \mid S = s, S_T = s_T) = E(U(S, S_T) \mid S = s)$$

(All selection controlled by conditioning on final schooling)

- Form Contrasts

$$\begin{aligned} & E(T(S, S_T) \mid S = s, S_T = s_T) - E(T(S, S_T) \mid S = s, S_T = s'_T) \\ &= \mu(s_T) - \mu(s'_T) \end{aligned}$$

Get “Effects,” e.g.

$$\mu(s_T) = s_T\beta$$

- We identify  $\beta$ .
- This is a “Matching” type of assumption.
- We can relax it using a semiparametric model (Hansen, Heckman and Mullen, 2004).
- They show that both approaches produce very similar estimates.

### 3 Extensions of the Model

- We extend the model to have two factors:

$$\begin{array}{ll} f^C & \text{Cognitive} \\ f^N & \text{Noncognitive} \end{array}$$

Using these factors, we can explain a variety of outcomes:

1. Schooling attainment
2. Wages given schooling
3. Wages overall
4. Work experience
5. Occupational choice
6. Social behaviors and risky correlated behaviors:
  - (a) Crime and incarceration
  - (b) Teenage pregnancy
  - (c) Drug use
  - (d) Smoking

- We use test scores on both cognitive and noncognitive skills to proxy the latent factors.
- We account for measurement error. (Produces a downward bias in *OLS*).
- We adjust for effect of schooling on test scores. (Produces an upward bias in *OLS*).

## 4 Our Model Approximates an Explicit Economic Model of Preferences and Behavior

Our model is an approximation to a simple life cycle model of youth and adult decision making over horizon  $\bar{T}$ .

- Let consumption and labor supply at period  $t$  be  $c(t)$  and  $l(t)$ , respectively.  $c(t)$  can be a vector of choices by agent.
- Utility  $U(c(t), l(t), \eta)$ , where the  $\eta$  are preference parameters.
- Time preference rate  $\rho$ .
- Human Capital in period  $t$  is  $h(t)$ . Its time rate of change is  $\dot{h}(t)$ .

$$\dot{h}(t) = \varphi(h(t), I(t), \tau)$$

$\tau$  are productivity parameters,  $I(t)$  is investment at  $t$ , and  $h(t)$  denotes the rate of change of the human capital stock.

- The initial condition is  $h(0)$ .

Wages at period  $t(Y(t))$  are given by human capital and productivity traits  $\theta$ :

$$Y(t) = R(h(t); \theta).$$

- Perfect credit markets at interest rate  $r$
- Law of motion for assets at period  $t(A(t))$ , given initial condition  $A(0)$  and ignoring taxes, is

$$\dot{A}(t) = Y(t)h(t)l(t) - P(t)'c(t) + rA(t)$$

- Agent maximizes

$$\int_0^{\bar{T}} \exp(-\rho t) U(c(t), l(t), \eta) dt$$

subject to initial conditions and dynamic constraints

- Cognitive and noncognitive skills can affect:

$$\begin{aligned} \text{preferences } \eta &= (\eta(f^C, f^N), \rho = \rho(f^C, f^N)), \\ \text{human capital productivity } \tau &= \tau(f^C, f^N), \\ \text{and direct market productivity } \theta &= (\theta(f^C, f^N)) \end{aligned}$$

- We examine how factors are priced out in different schooling markets.
- The factors also affect initial endowments:

$$\begin{aligned} h(0) &= h_0(f^C, f^N) \\ A(0) &= A_0(f^C, f^N) \end{aligned}$$

- Our econometric model is a linear-in-the-parameters approximation to the more general model.
- Underway is a more explicit structural model.
- Will talk about this at the end.

## 5 Data

National Longitudinal Survey of Youth (NLSY79). The NLSY is a representative sample of young Americans between the ages of 14 and 21 at the time of the first interview in 1979. We use the random sample of 6111 noninstitutionalized civilian youths.

The NLSY collects information on parental background, schooling decisions, labor market experiences, cognitive and noncognitive test scores and other behavioral measures of these individuals on an annual basis.

## **5.1 Cognitive Test Scores: (ASVAB)**

The following tests are used in our analysis: (i) arithmetic reasoning, (ii) word knowledge, (iii) paragraph comprehension, (iv) numerical operations, and (v) coding speed.

## **5.2 Non-Cognitive Measures**

### **5.2.1 Rotter Internal-External Locus of Control Scale**

The Rotter Internal-External Locus of Control Scale, collected as part of the 1979 interviews, is a four-item abbreviated version of a 23-item forced choice questionnaire adapted from the 60-item Rotter scale developed by Rotter (1966). The scale is designed to measure the extent to which individuals believe they have control over their lives, i.e., self-motivation and self-determination, (internal control) as opposed to the extent that the environment (i.e., chance, fate, luck) controls their lives (external control).

### **5.2.2 Rosenberg Self-Esteem Scale**

The Rosenberg Self-Esteem Scale, measures an individual's degree of approval or disapproval toward himself.

## 6 Traditional OLS Results

- To benchmark our analysis, we present traditional reduced form results of the effects of cognitive and non-cognitive skills on educational attainment, wages, smoking, going to jail, and teenage pregnancy.
- They assume that test scores are perfect proxies and they ignore problems arising from reverse causality.

Table 1 - Estimated Coefficients from Log Wage Regressions

NLSY79 - Males and Females at Age 30 <sup>(a)</sup>

Variables <sup>(b)</sup>	Males		Females	
	(A)	(B)	(A)	(B)
GED	0.017 (0.048)		-0.002 (0.056)	
High School Graduate	0.087 (0.035)		0.059 (0.044)	
Some College	0.146 (0.044)		0.117 (0.052)	
2yr College Graduate	0.215 (0.058)		0.233 (0.058)	
4yr College Graduate	0.292 (0.046)		0.354 (0.054)	
AFQT <sup>(c)</sup>	0.121 (0.016)	0.1900 (0.013)	0.169 (0.017)	0.251 (0.014)
ATTITUDES <sup>(d)</sup>	0.042 (0.011)	0.052 (0.012)	0.028 (0.013)	0.041 (0.013)
Constant	2.558 (0.057)	2.690 (0.050)	2.178 (0.063)	2.288 (0.052)

Notes: (a) We exclude the oversample of blacks, hispanics and poor whites, the military sample, and those currently enrolled in college; (b) The model includes includes a set of cohort dummies, local labor market conditions (unemployment rate), the region of residence, and race. The column A presents the estimates obtained from OLS. Column B presents the results from an OLS model in which the schooling dummies are excluded; (c) the cognitive measure represents the standardized average over the ASVAB scores (arithmetic reasoning, word knowledge, paragraph comprehension, numerical operations and coding speed); (d) The Non-cognitive measure is computed as a (standardized) average of the Rosenberg self-esteem scale and Rotter internal-external locus of control. Standard errors in parentheses.

- Both cognitive and non-cognitive measures are found to significantly affect wages, educational attainment, work experience and behavioral outcomes. Interesting gender differences also emerge.
- Such gender differences are a major finding of the intervention response literature (Heckman, 2004).
- Reduced form results are problematic because of measurement error and reverse causality (simultaneity).

## 7 A Model of Schooling and Wages

- We posit the existence of two underlying factors representing latent cognitive and non-cognitive ability. Let  $f^C$  and  $f^N$  denote the levels of latent cognitive and non-cognitive abilities.
- The levels of an individual's factors may result from some combination of inherited ability, the quality of the environment provided by his parents, early effort on his part, and the effects of any early interventions.
- Our sample starts at age 14 so we cannot investigate the effects of early environments in this study. We take  $f^C$  and  $f^N$  as initial conditions.
- We show some results from a project with Flavio Cunha at the end of this paper. This analysis starts at early ages and shows the determinants of skill formation over the life cycle.

- We assume that levels of both abilities are known by each individual but not by the researcher, and that they are fixed by the time the individual makes his schooling choice.
- We assume that latent abilities are mutually independent, and both determine the individual's wage and schooling decision.
- This does not mean that the manifest abilities are independent.

## 7.1 A Hedonic Model for Wages

- We assume that different schooling levels are priced differently in the labor market (Hedonic model).
- Both latent abilities (jointly with observable variables) determine log wages  $\ln Y_s$

$$\ln Y_s = \beta_{Y,s} X_Y + \alpha_{Y,s}^C f^C + \alpha_{Y,s}^N f^N + e_{Y,s} \quad \text{for } s = 1, \dots, \bar{S},$$

where

$$e_{Y,s} \perp\!\!\!\perp (f^N, f^C, X_Y).$$

- “ $\perp\!\!\!\perp$ ” denotes independence.
- We determine how factors are priced out in different schooling markets,  $s = 1, \dots, \bar{S}$ .

## 7.2 The Schooling Model

Let  $s^*$  denote this optimal schooling level as a choice among utilities in different states:  $I_j$ ,  $j = 1, \dots, \bar{S}$ .

$$s^* = \arg \max_{s=\{1, \dots, \bar{S}\}} \{I_1, \dots, I_{\bar{S}}\}.$$

where

$$I_s = \beta_s X_s + \alpha_s^C f^C + \alpha_s^N f^N + e_{S,s} \quad \text{for } s = 1, \dots, \bar{S} \quad (7.1)$$

is a reduced form net utility, where

$$e_{S,s} \perp\!\!\!\perp (f^N, f^C, X_s).$$

From (7.1)

$$D = \begin{cases} 1 & \text{if } I_1 = \max \{I_1, \dots, I_{\bar{S}}\} \\ & \vdots \\ \bar{S} & \text{if } I_{\bar{S}} = \max \{I_1, \dots, I_{\bar{S}}\}. \end{cases}$$

- $D$  indicates the schooling decision of the individual.

## 7.3 The Measurement System and Identification of the Model

- Identification of the above model can be directly established using the strategy developed in Carneiro, Hansen, and Heckman (2003).
- Our identification strategy assumes the existence of a set of cognitive and noncognitive measures (test scores). It assumes the existence of two sets of variables (each with at least two elements) measuring cognitive and non-cognitive skills. Each set is exclusively devoted to its respective latent ability. Latent cognitive ability is only allowed to affect scores on cognitive measures, and latent non-cognitive is only allowed to affect scores on non-cognitive measures.
- The specification pursued here makes the interpretation of  $f^C$  and  $f^N$  as cognitive and non-cognitive abilities more transparent.

- We address the potential problem of reverse causality between schooling and test scores and schooling and attitude scales.
- The observed measures may not be fully informative about the actual skills of the individuals, since they may be influenced by the schooling level at the moment of the test.
- They may also depend on school quality and family environment.

- Denote by  $s_T$  the schooling level at the moment of the test ( $s_T = 1, \dots, \bar{S}_T$ ), the model for the cognitive measure  $C_i$  ( $i = 1, \dots, n_C$ ) is

$$C_i(s_T) = \beta_{C_i}(s_T)X_C + \alpha_{C_i}(s_T)f^C + e_{C_i}(s_T)$$

with  $i = 1, \dots, n_C$ ,  $s_T = 1, \dots, \bar{S}_T$  and

$$e_{C_i}(s_T) \perp\!\!\!\perp (f^C, X_C) \text{ and } e_{C_i}(s_T) \perp\!\!\!\perp e_{C_j}(s'_T)$$

for all  $C_i$  and  $C_j$  in  $C$  and schooling levels  $s_T$  and  $s'_T$  such that  $C_i \neq C_j$  and  $s_T \neq s'_T$ .

- $\alpha_{C_i}(s_T)$  and  $\beta_{C_i}(s_T)$  can also depend on many other determinants of family and environment.

- Likewise, if we denote by  $s_T$  the schooling level at the moment of the test ( $s_T = 1, \dots, \bar{S}_T$ ), the model for the non-cognitive measure  $N_i$  ( $i = 1, \dots, n_N$ ) is

$$N_i(s_T) = \beta_{N_i}(s_T)X_N + \alpha_{N_i}(s_T)f^C + e_{N_i}(s_T)$$

with  $i = 1, \dots, n_N$ ,  $s_T = 1, \dots, \bar{S}_T$  and

$$e_{N_i}(s_T) \perp\!\!\!\perp (f^N, X_N) \text{ and } e_{N_i}(s_T) \perp\!\!\!\perp e_{N_j}(s'_T)$$

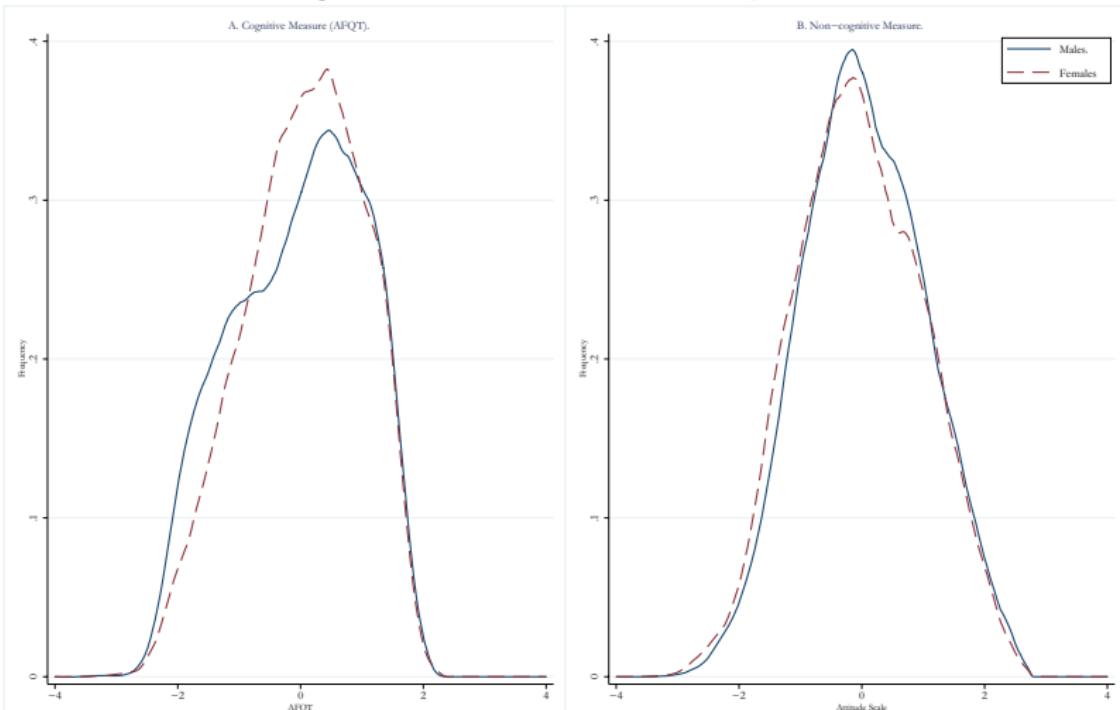
for all  $N_i$  and  $N_j$  in  $N$  and schooling levels  $s_T$  and  $s'_T$  such that  $N_i \neq N_j$  and  $s_T \neq s'_T$ .

- $\alpha_{N_i}(s_T)$  and  $\beta_{N_i}(s_T)$  can also depend on background features and schooling.
- There are no natural units for latent ability. Therefore, for some  $C_i$  ( $i = 1, \dots, n_C$ ) and  $N_j$  ( $j = 1, \dots, n_N$ ) we set  $\alpha_{C_i} = \alpha_{N_i} = 1$ .
- This extends traditional factor analysis by having endogenous loadings  $(\alpha_{C_i}(s_T), \alpha_{N_i}(s_T))$

## 8 Evidence on the Importance of Cognitive and Noncognitive Skills

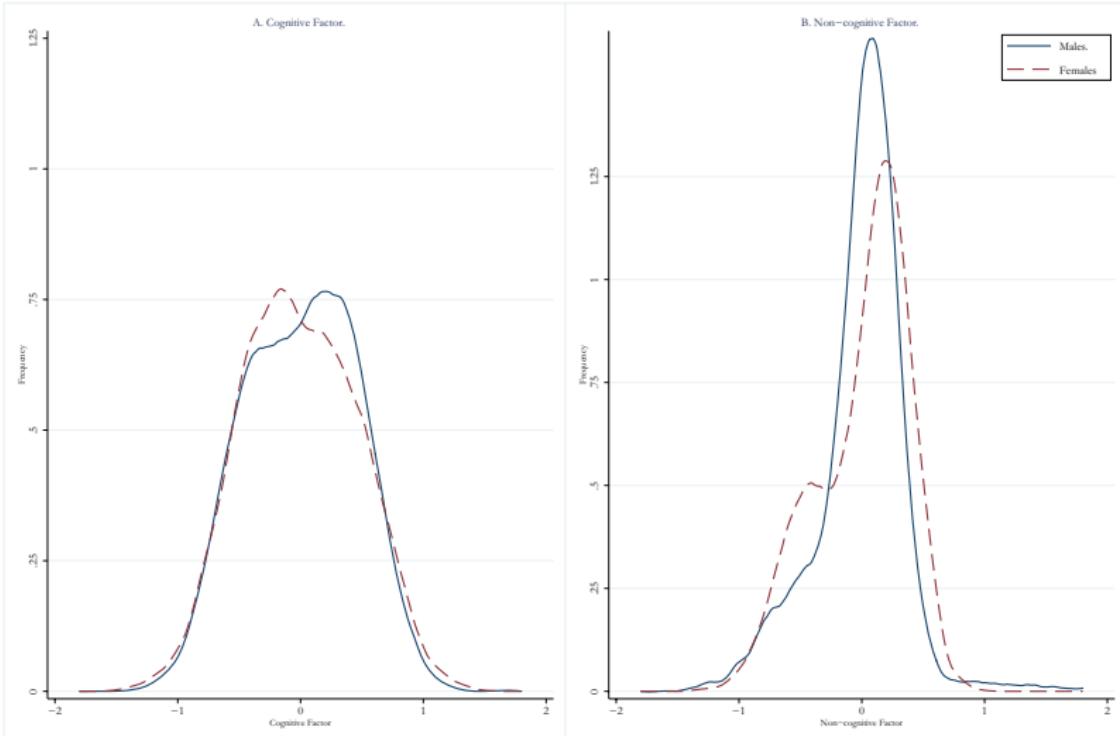
- We use a robust semiparametric approach to estimation.
- We make no distributional assumptions.
- Our evidence argues strongly against normality.
- Male distributions more variable; higher right tail in male cognitive distributions.
- Thicker lower tail for male noncognitive distributions.

Figure 2A. Distribution of Test Scores by Gender



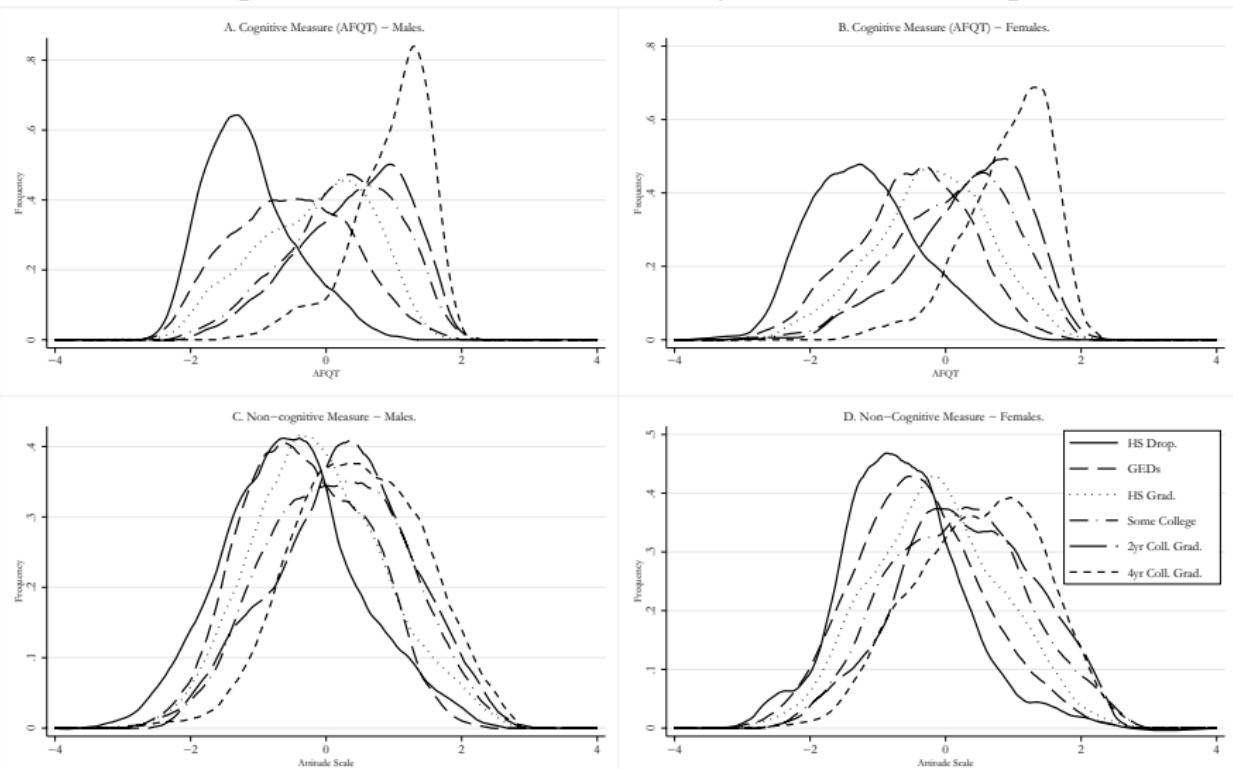
Notes: The AFQT is the mean raw score computed using ASVAB tests. The Attitude Scale is the average raw score between the Rosenberg scale of Self-Steem and the Rotter scale of internal-external locus of control.

Figure 2B. Distribution of Factors by Gender



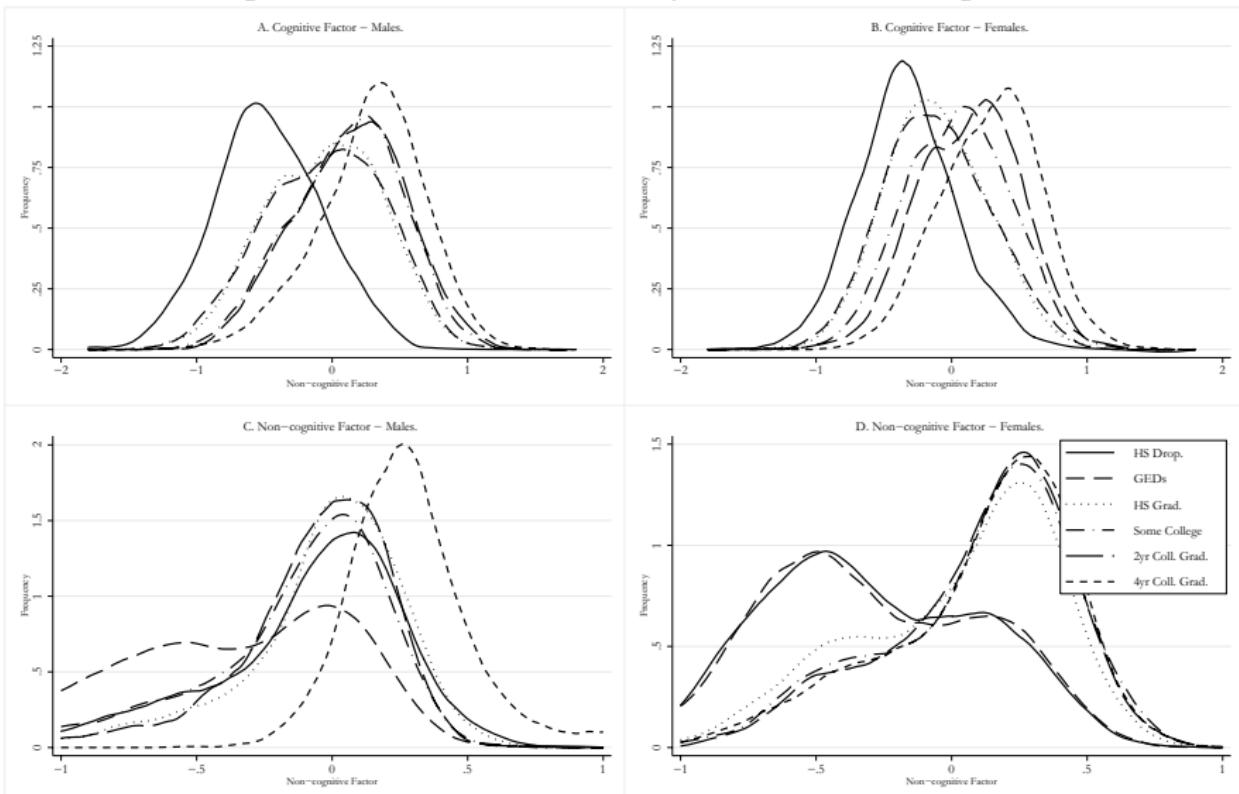
Notes: The factors are simulated from the estimates of the model. The simulated data contain 19,600 observations.

Figure 3A. Distribution of Test Scores by Gender and Schooling Level



Notes: The cognitive measure represents the standardized average over the ASVAB scores (arithmetic reasoning, word knowledge, paragraph comprehension, numerical operations and coding speed). The Noncognitive measure is computed as a (standardized) average of the Rosenberg self-esteem scale and Rotter internal-external locus of control. The schooling levels represent the observed schooling level by age 30 in the NLSY79 sample (See Appendix A for details).

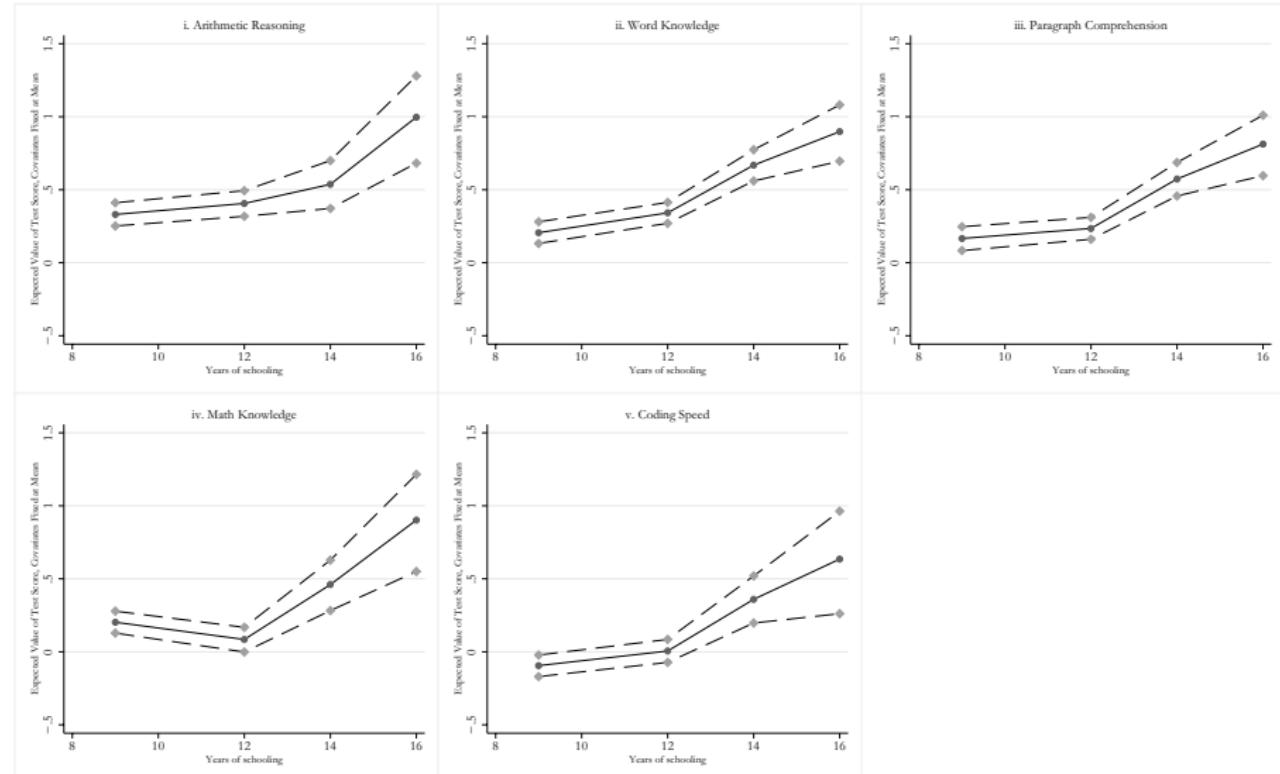
Figure 3B. Distribution of Factors by Gender and Schooling Level



Notes: The factors are simulated from the estimates of the model. The schooling levels represent the predicted schooling level by age 30. These schooling levels are obtained from the structure and estimates of the model and our sample of the NLSY79 (See Appendix A for details). The simulated data contain 19,600 observations.

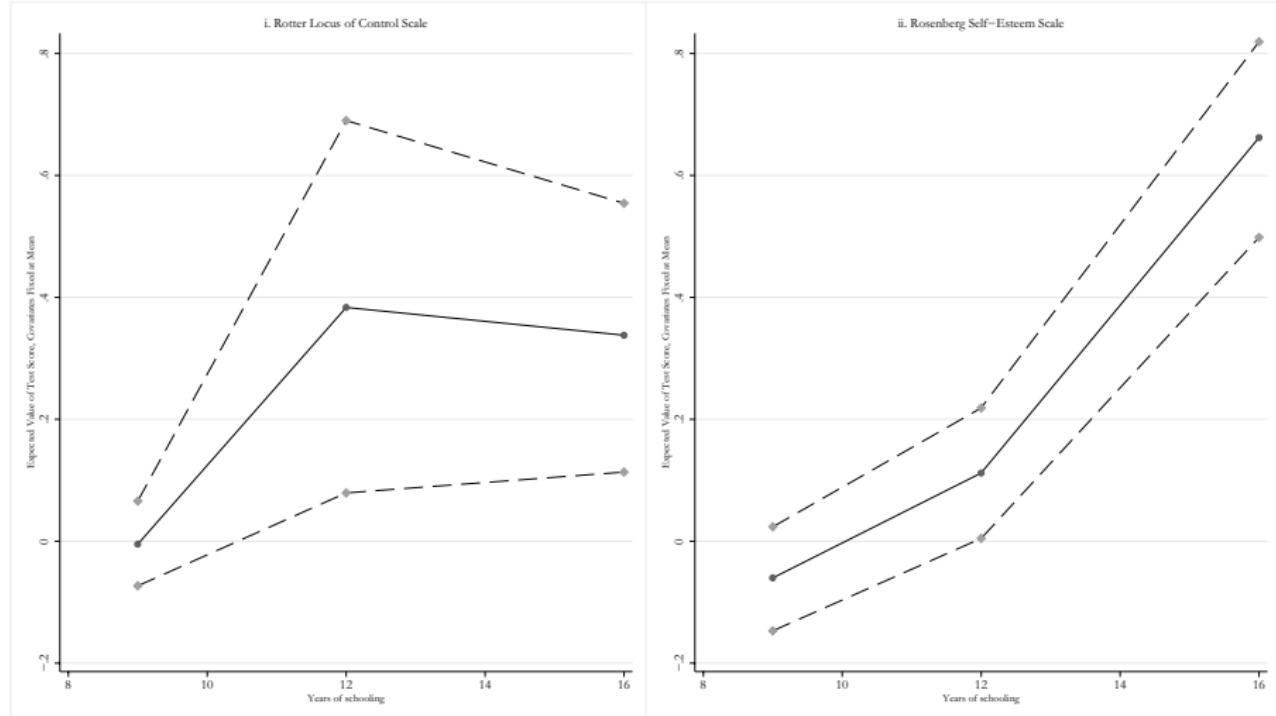
# The Effect of Schooling on Test Scores

Figure 4A. Effect of schooling on ASVAB Components for person with average ability  
with 95% confidence bands--Males



Notes: We standardize the test scores to have within-sample mean 0, variance 1. The model is estimated using the Age 30 NLSY79 Sample (See Appendix A for details).

Figure 4B. Effect of schooling on Noncognitive scales for person with average ability  
with 95% confidence bands—Males



Notes: The locus of control scale is based on the four-item abbreviated version of the Rotter Internal–External Locus of Control Scale. This scale is designed to measure the extent to which individuals believe they have control over their lives through self-motivation or self-determination (internal control) as opposed to the extent that the environment controls their lives (external control). The Self-Esteem Scale is based on the 10-item Rosenberg Self-Esteem scale. This scale describes a degree of approval or disapproval toward oneself. In both cases, we standardize the test scores to have within-sample mean 0 and variance 1, after taking averages over the respective sets of scales. The model is estimated using the Age 30 NLSY79 Sample (See Appendix A for details).

# Evidence From The Semiparametric Model

## Results for Wages

Figure 5A. Mean Log Wages by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

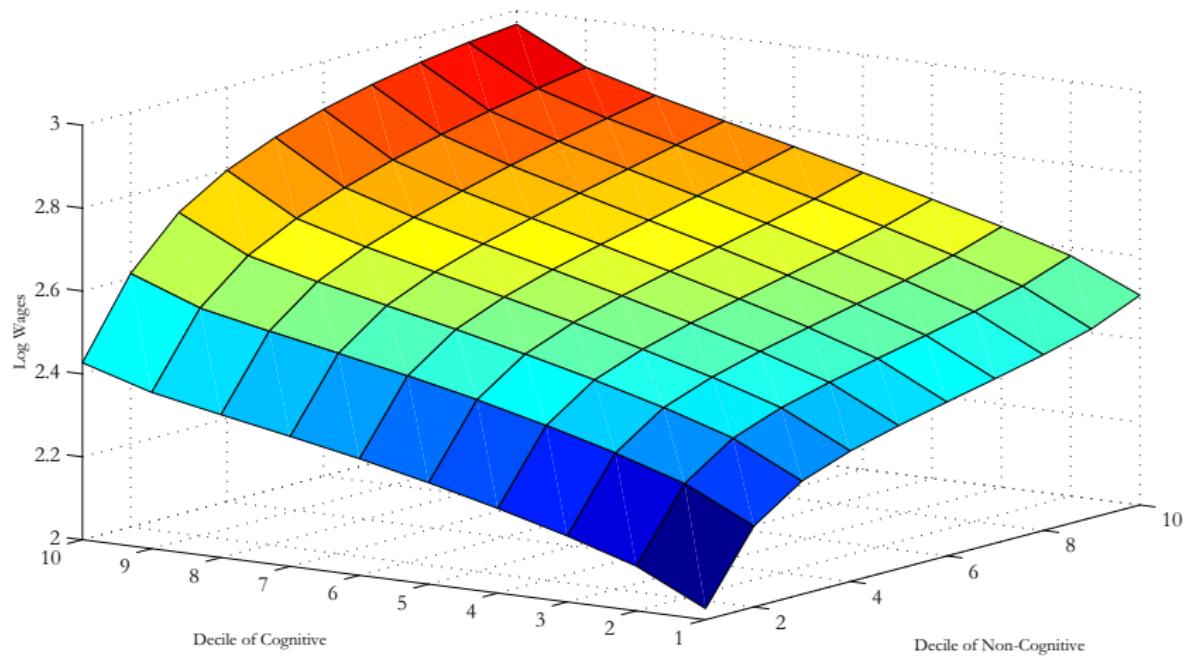
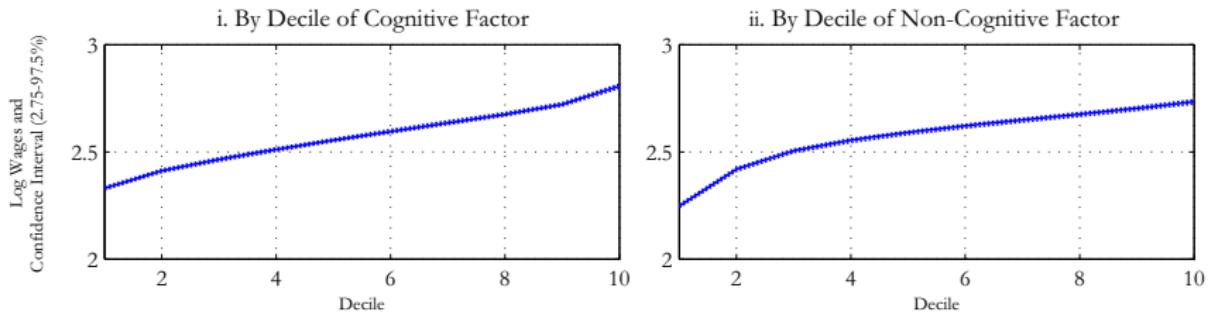


Figure 5B. Mean Log Wages by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 6A. Mean Log Wages by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

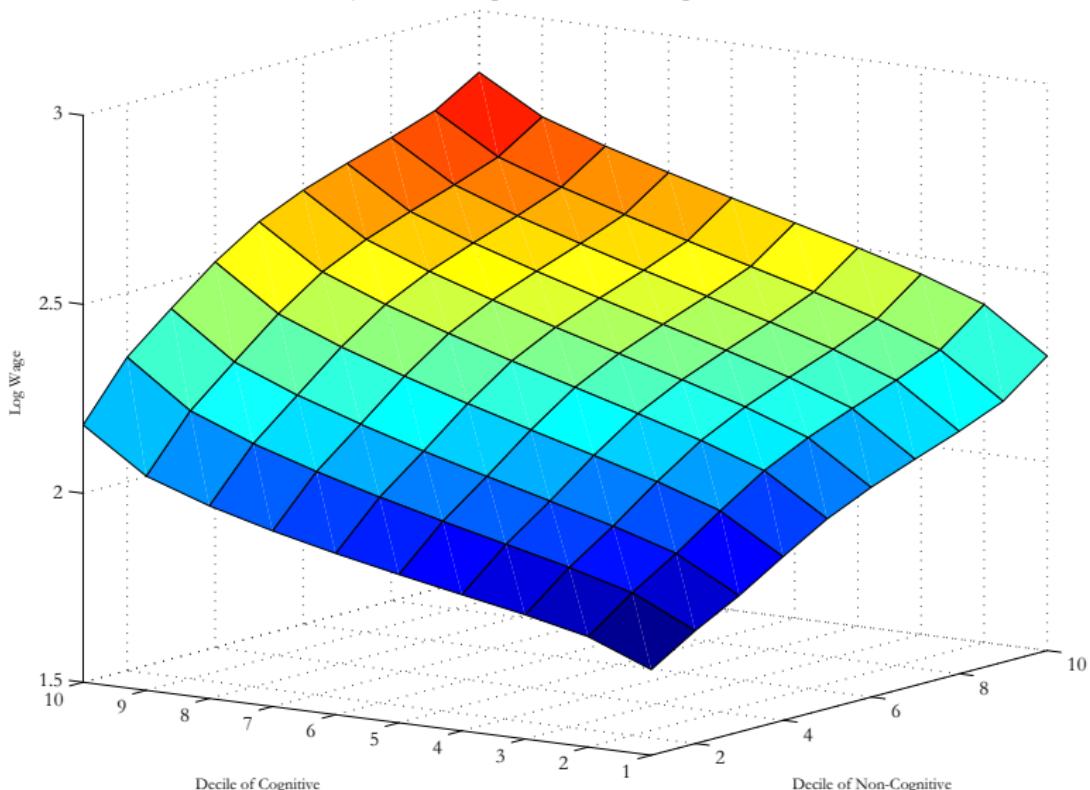
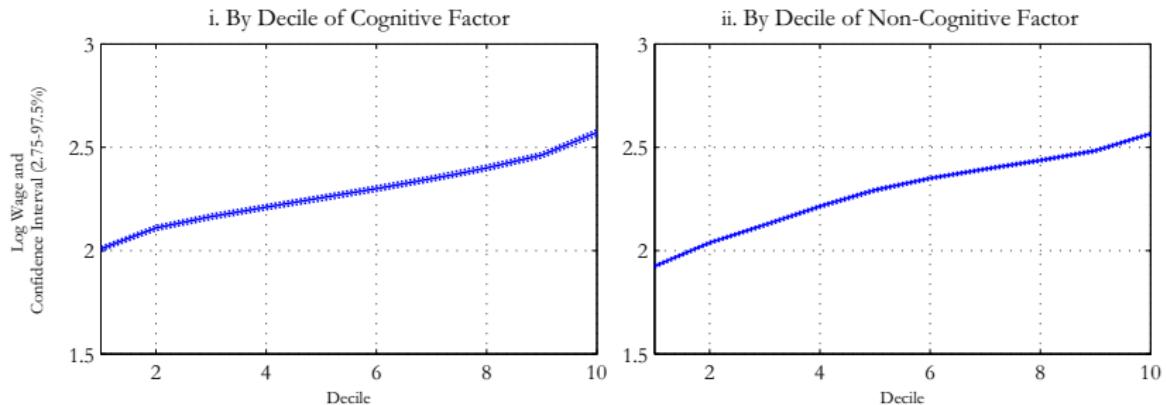


Figure 6B. Mean Log Wages by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

# Results for Wages

By Schooling Level

(Hedonic Markets)

Figure 7A. Mean Log Wages of High School Dropouts by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

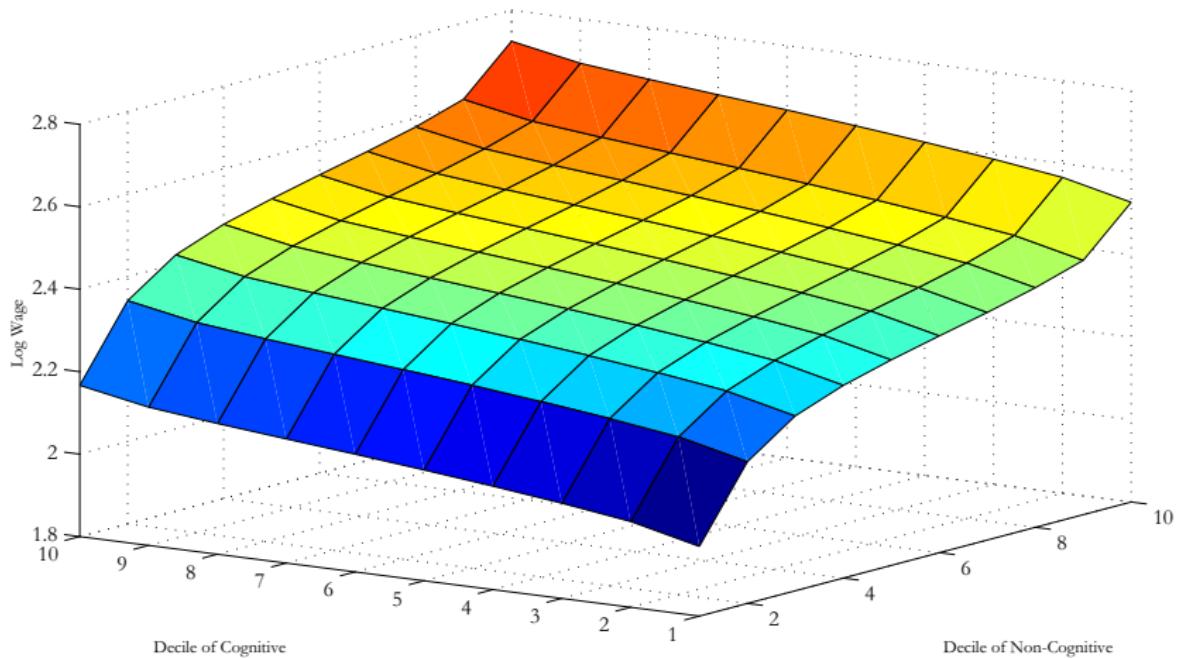
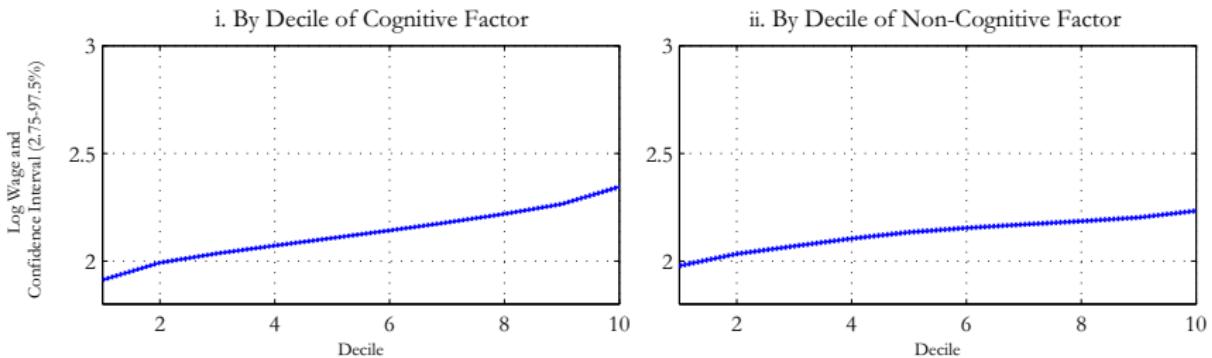


Figure 7B. Mean Log Wages of High School Dropouts by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 8A. Mean Log Wages of GEDs by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

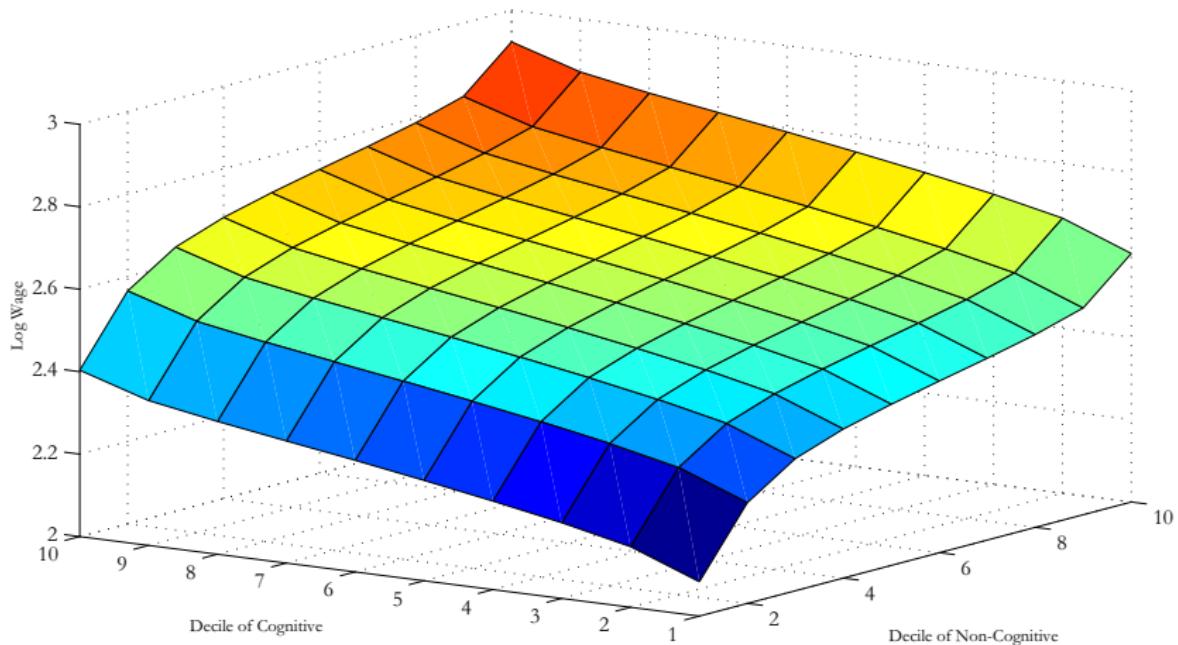
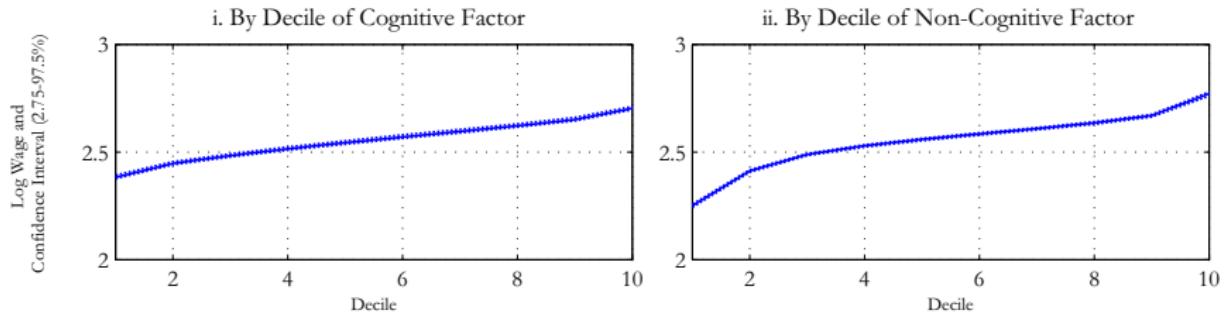


Figure 8B. Mean Log Wages of GEDs by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 9A. Mean Log Wages of GEDs by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

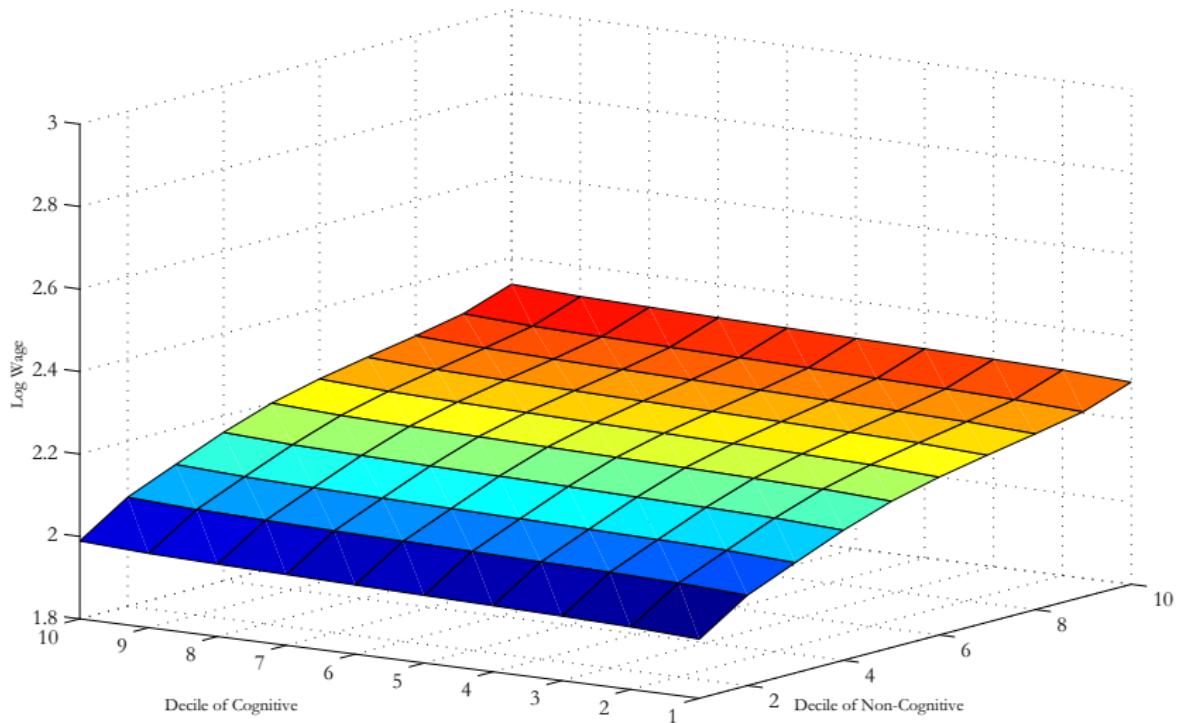
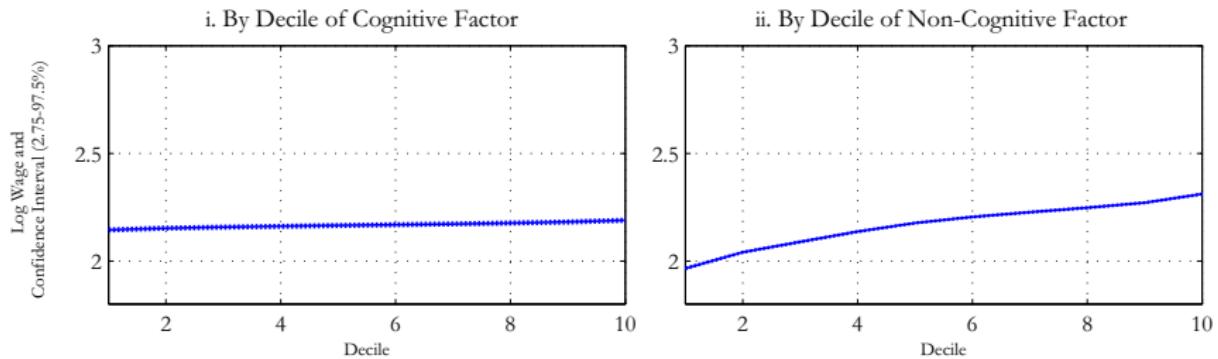


Figure 9B. Mean Log Wages of GEDs by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 10A. Mean Log Wages of High School Graduates by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

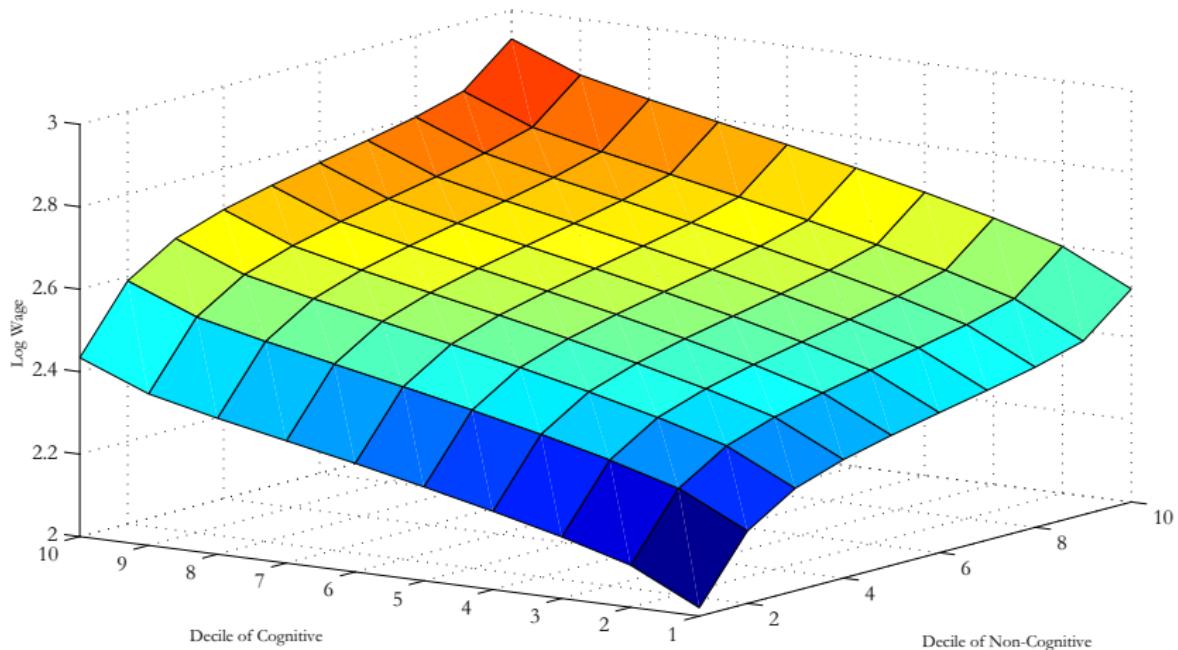
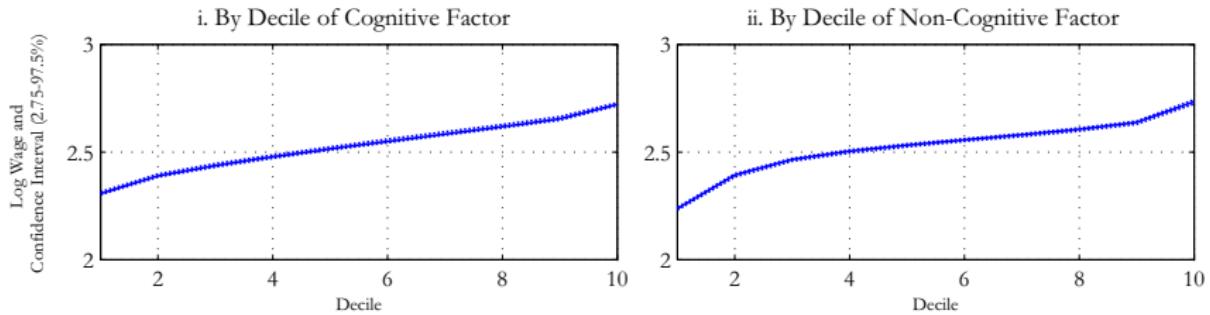


Figure 10B. Mean Log Wages of High School Graduates by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 11A. Mean Log Wages of 2-yr College Graduates by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

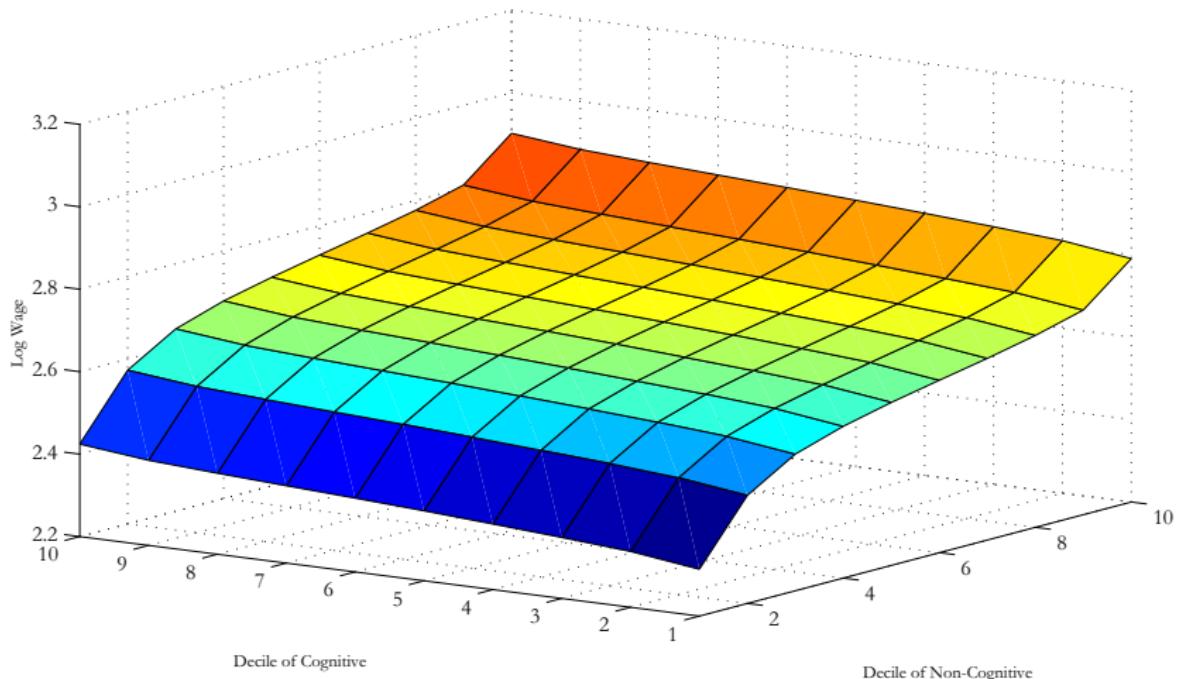
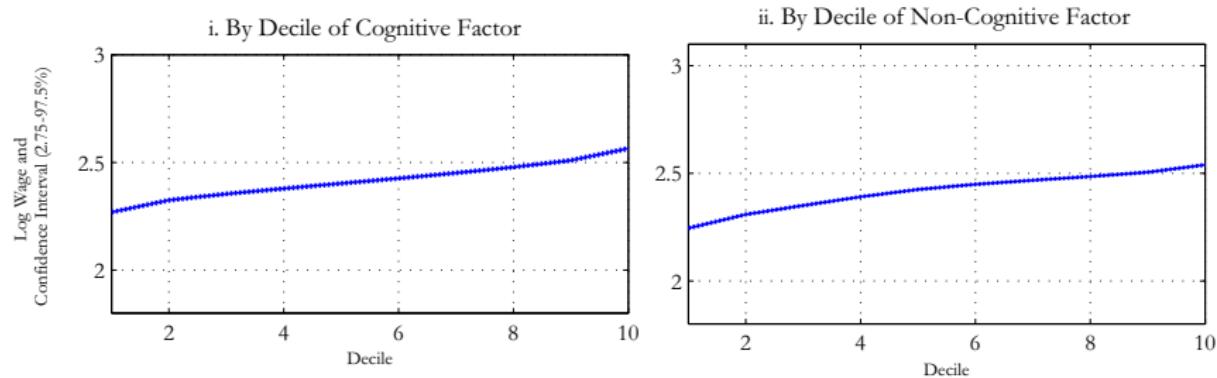


Figure 11B. Mean Log Wages of 2-yr College Graduates by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 12A. Mean Log Wages of 4-yr College Graduates by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

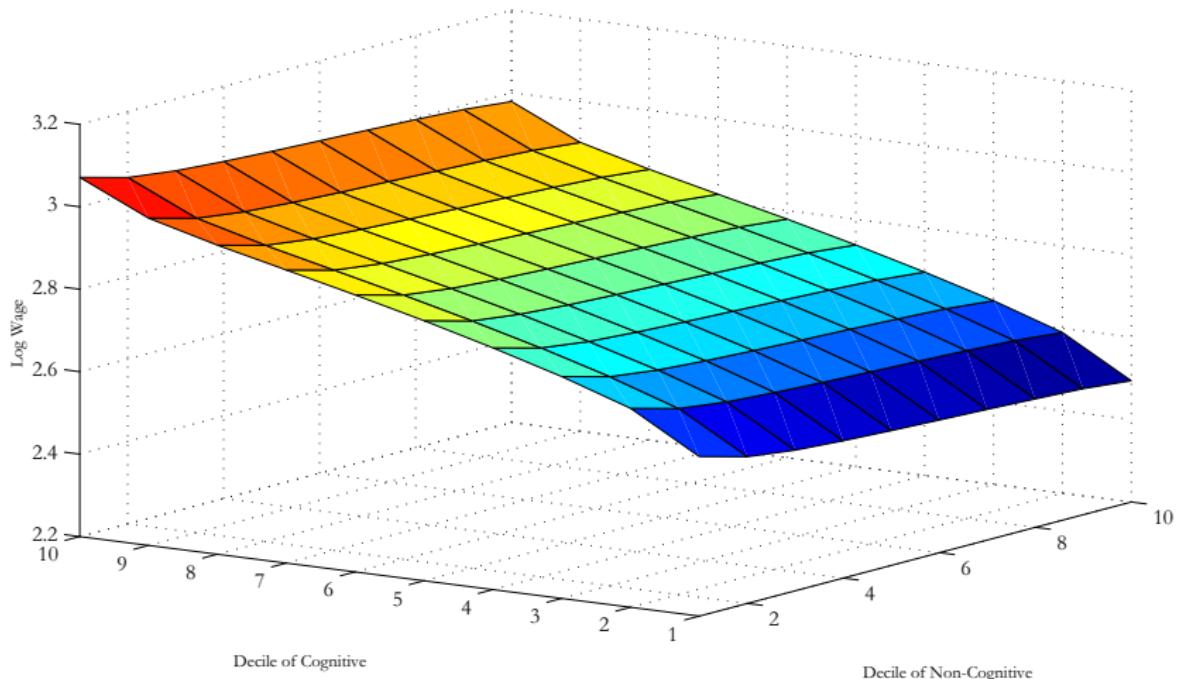
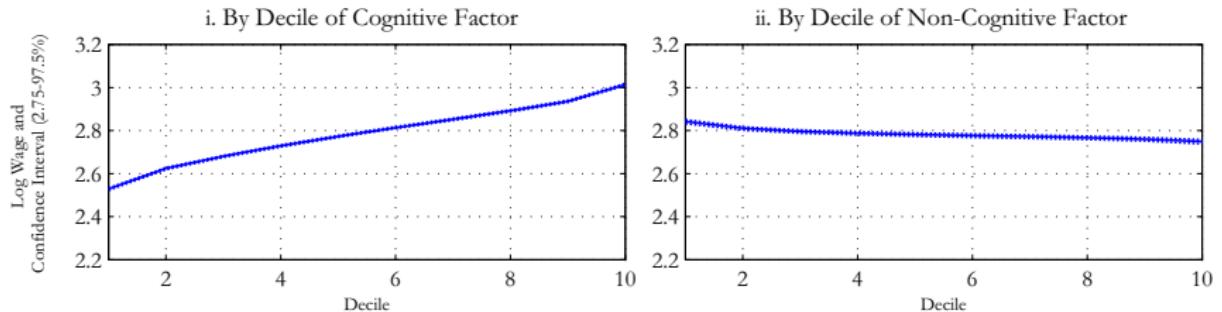


Figure 12 B. Mean Log Wages of 4-yr College Graduates by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 13 A. Mean Log Wages of 4-yr College Graduates by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

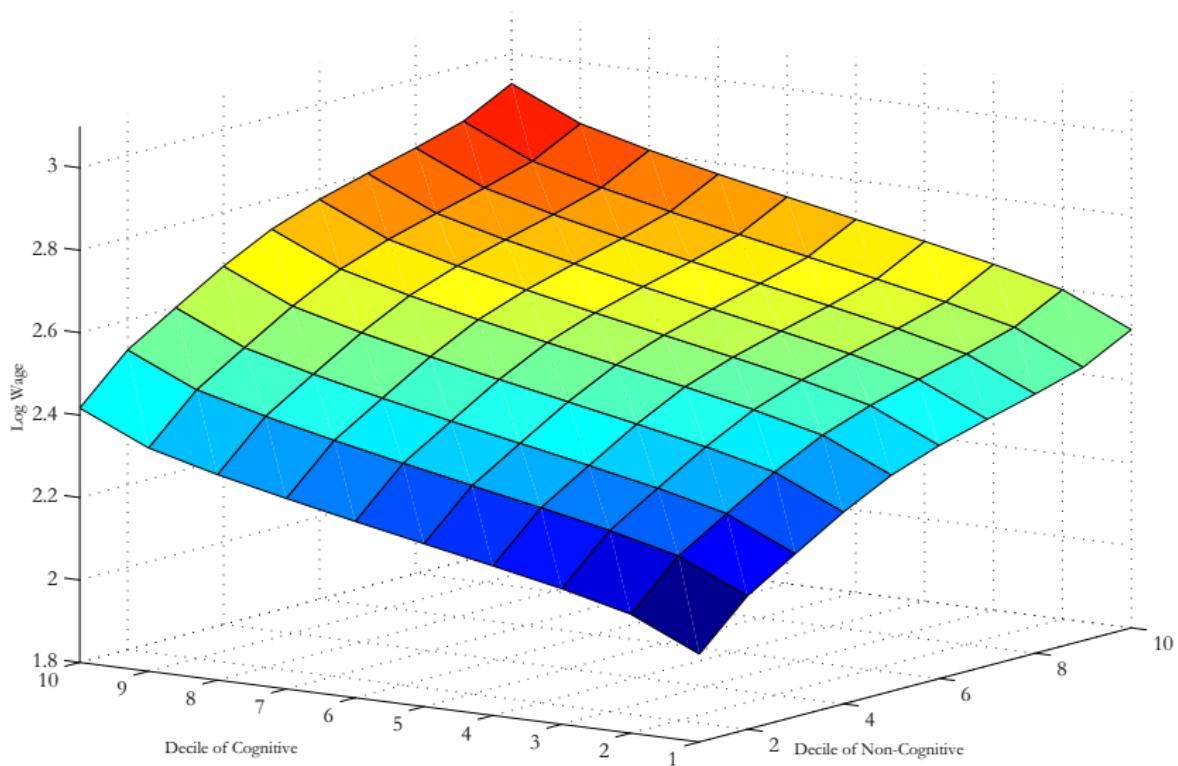
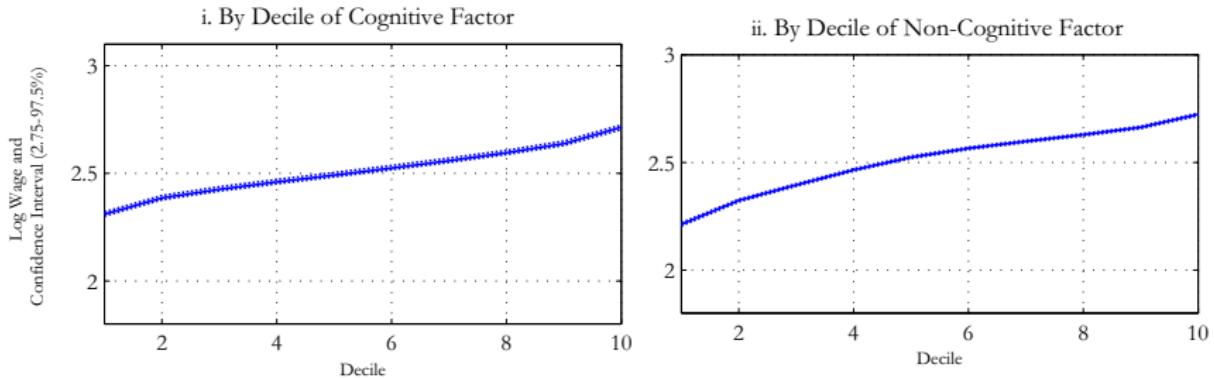


Figure 13 B. Mean Log Wages of 4-yr College Graduates by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

# Results for Other Outcomes

Figure 14A. Probability of Employment by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factor

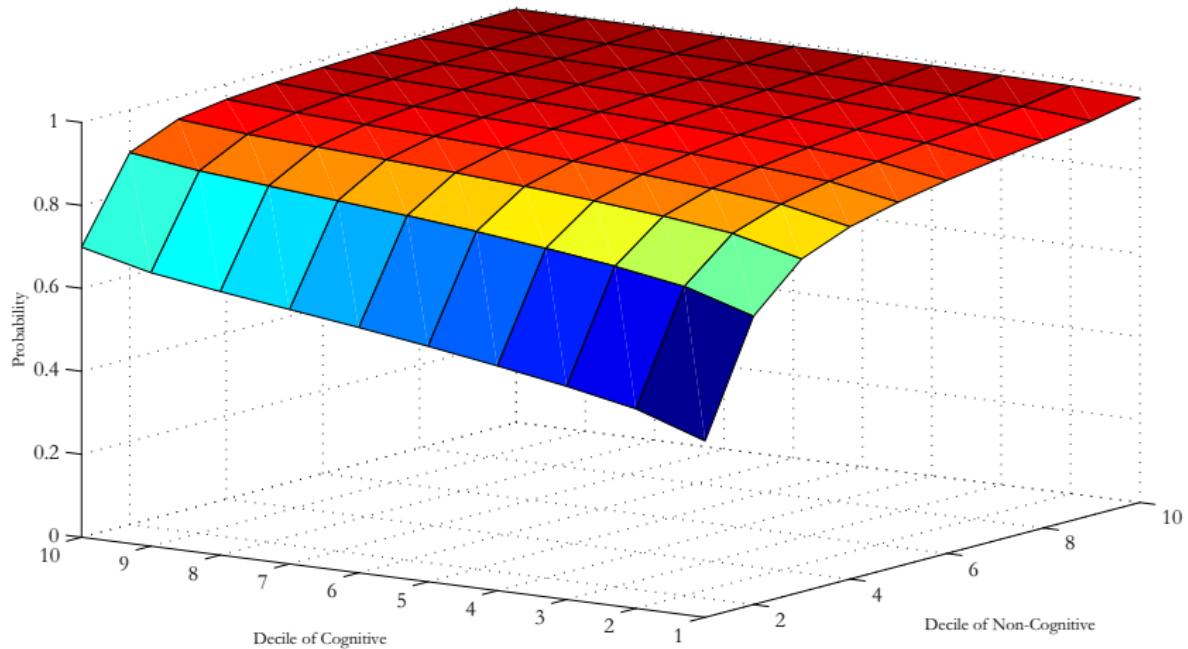
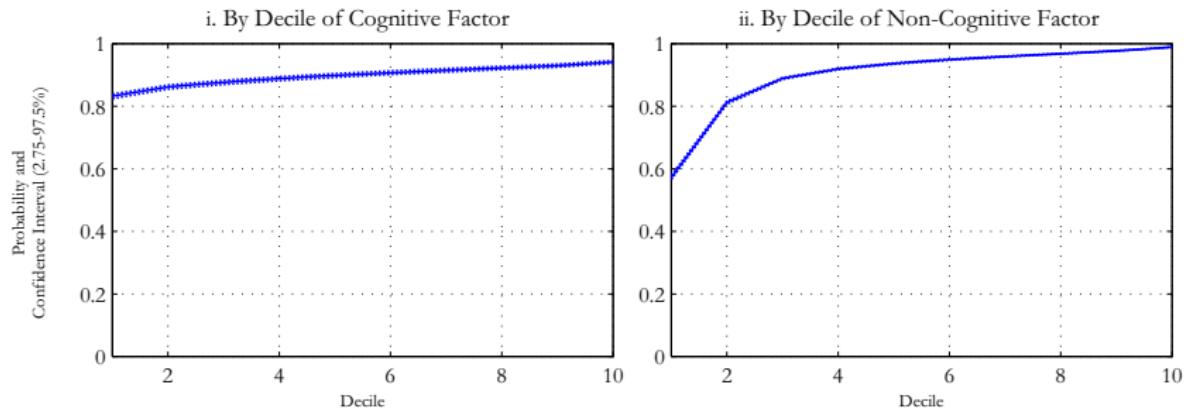


Figure 14B. Probability of Employment by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 15A. Probability of Employment by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factor

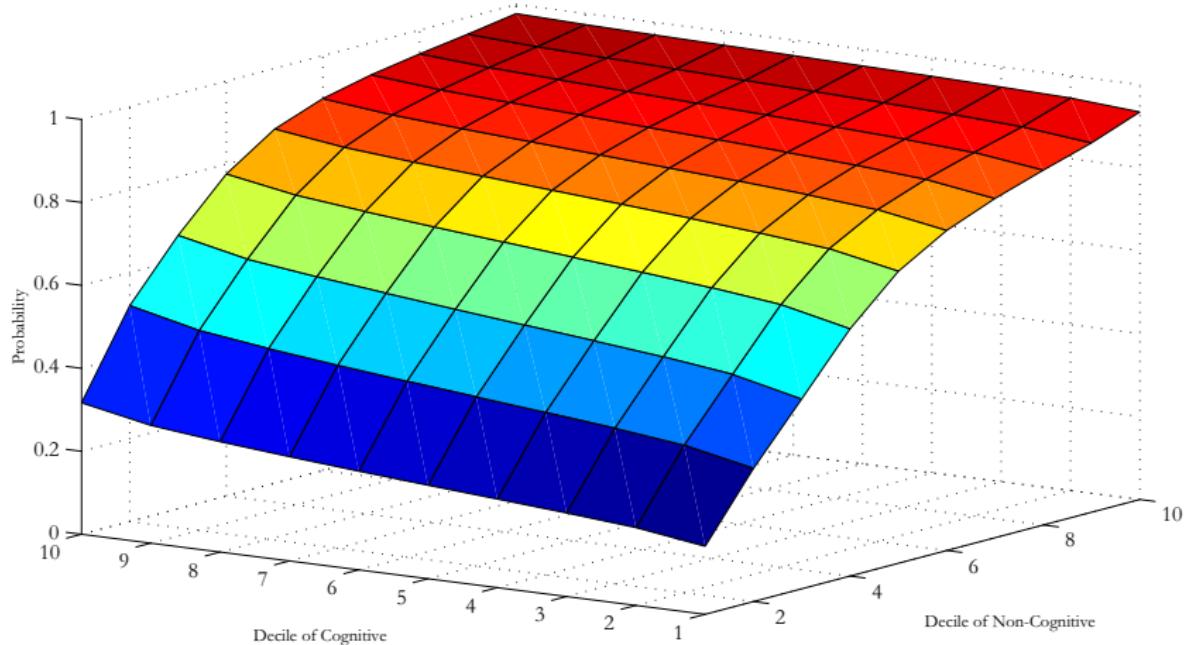
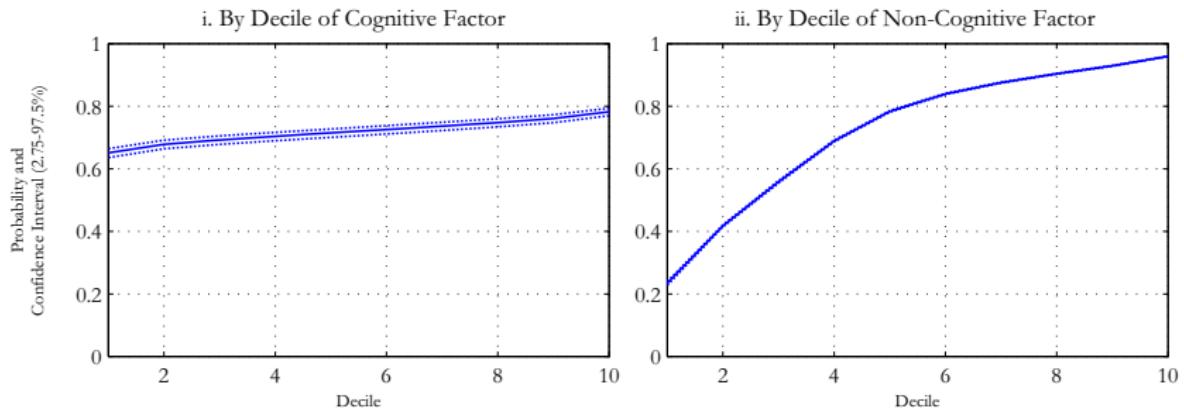


Figure 15B. Probability of Employment by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 16A. Mean Work Experience of High School Dropouts by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

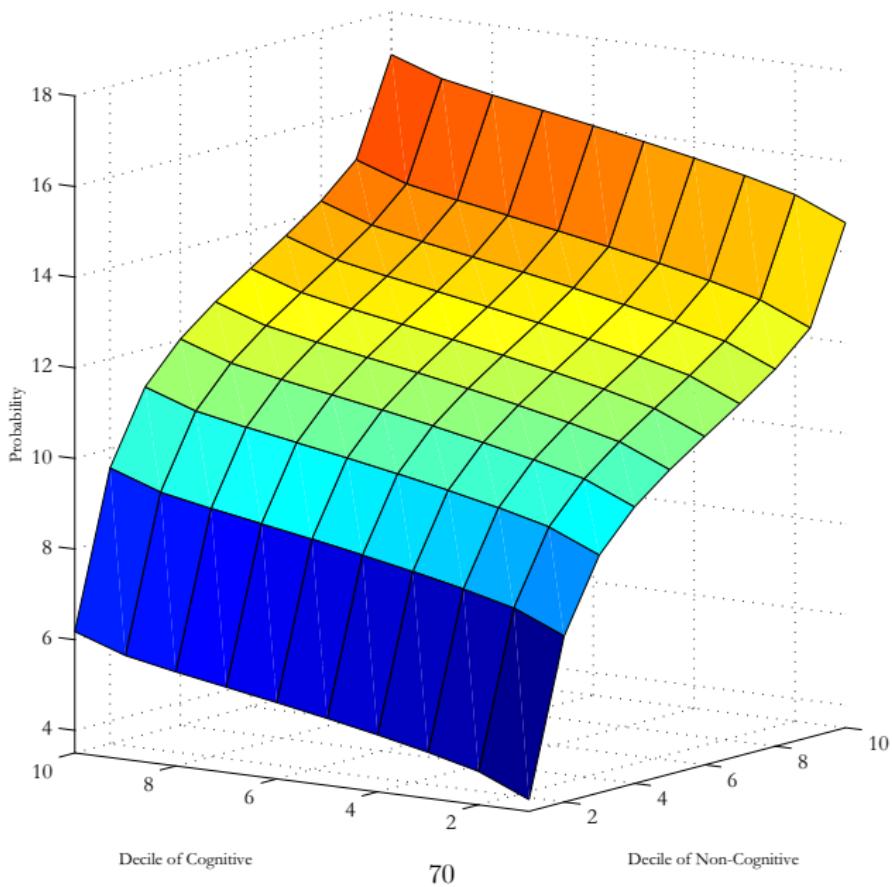
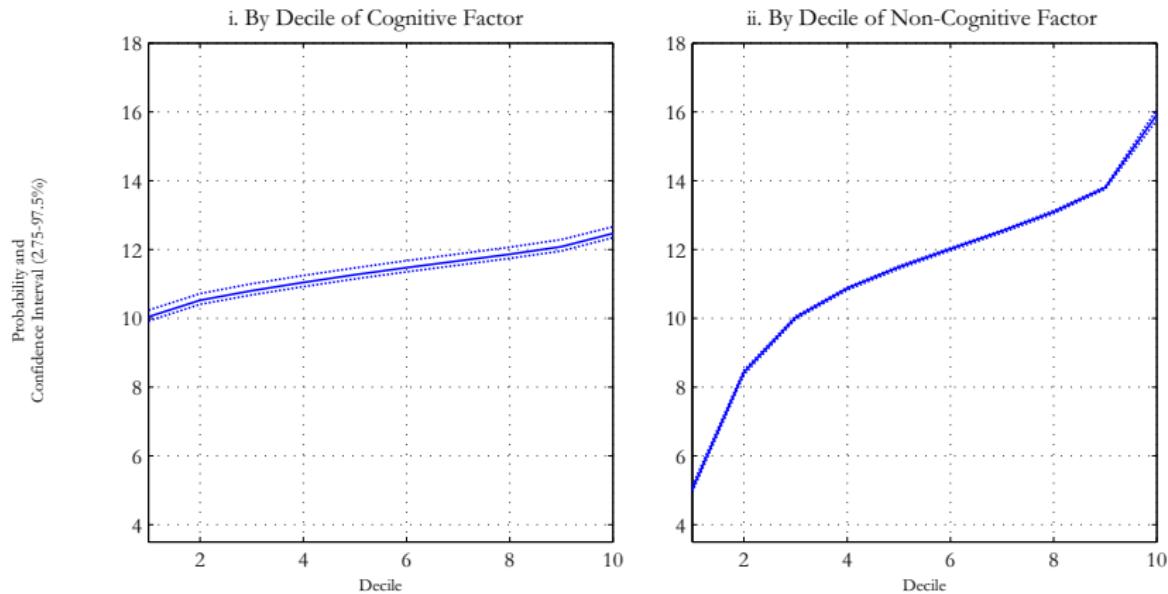


Figure 16B. Mean Work Experience of High School Dropouts by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 17A. Mean Work Experience of High School Graduates by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

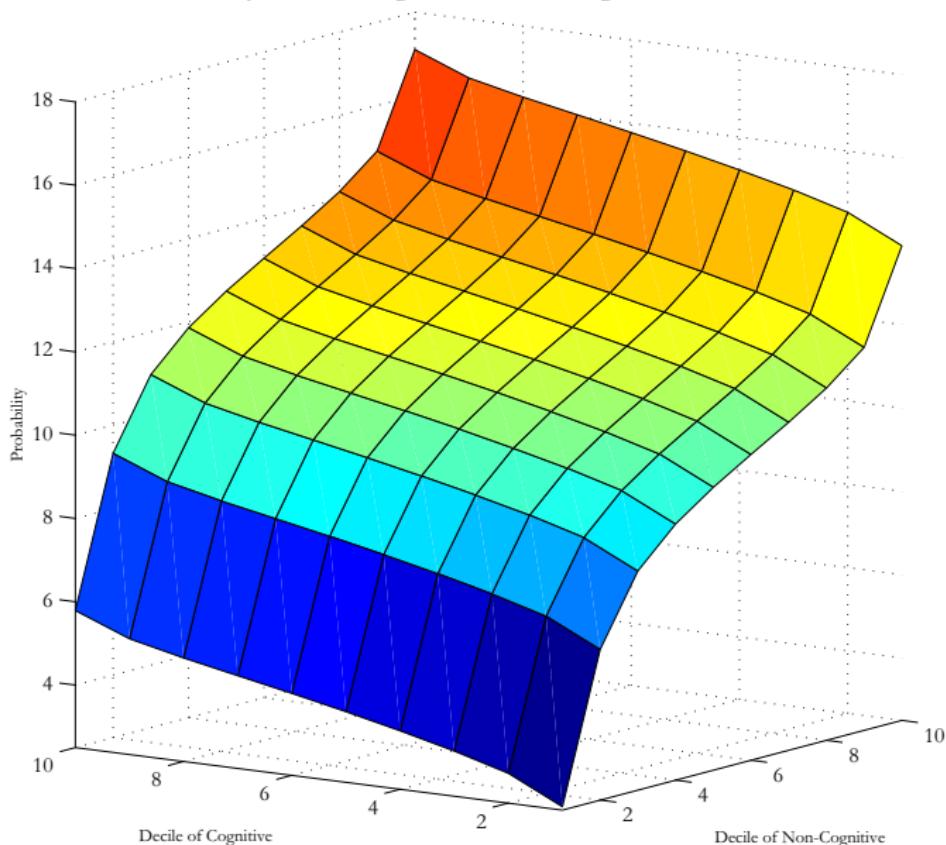
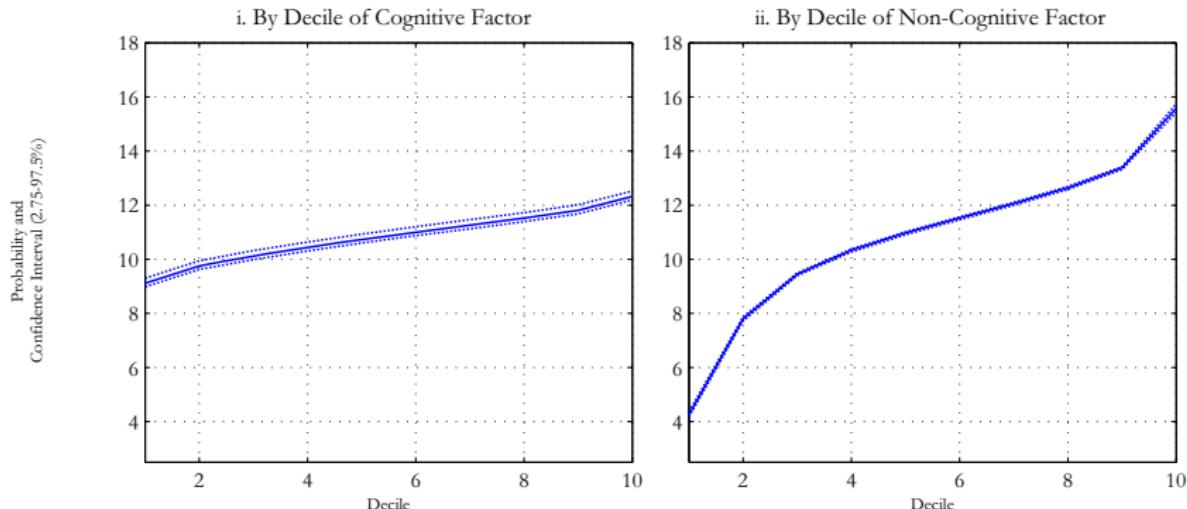


Figure 17B Mean Work Experience of High School Graduates by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 18A. Mean Work Experience of 4-yr College Graduates by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

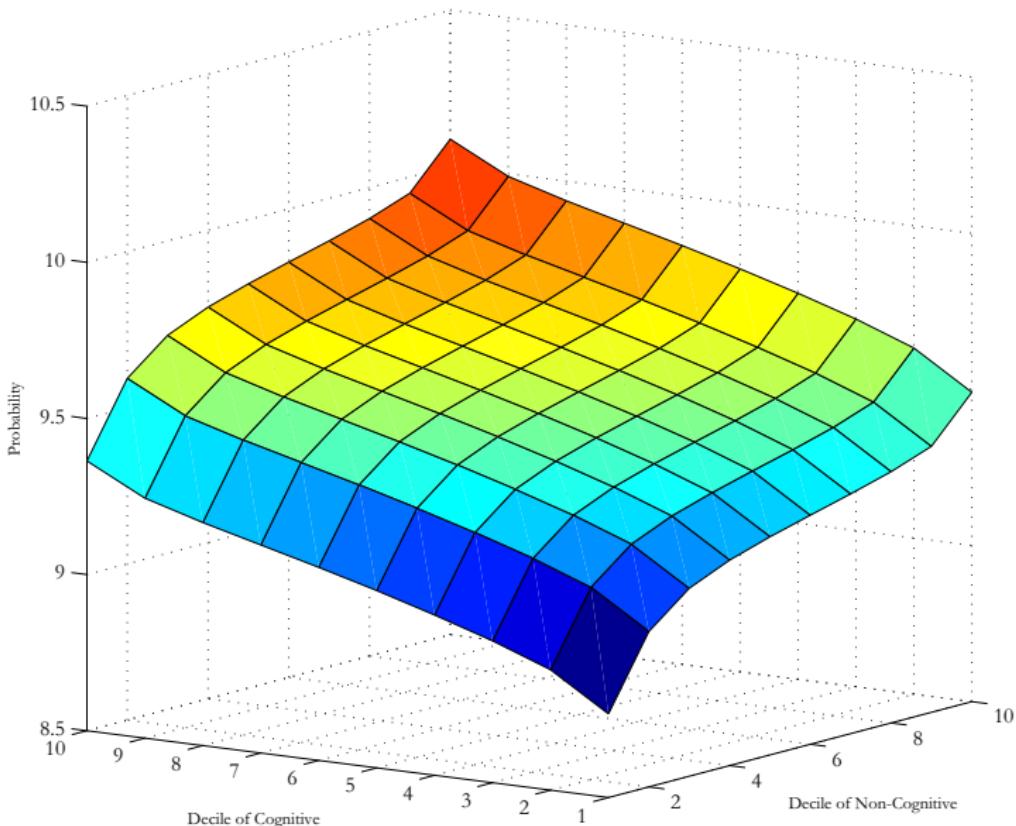
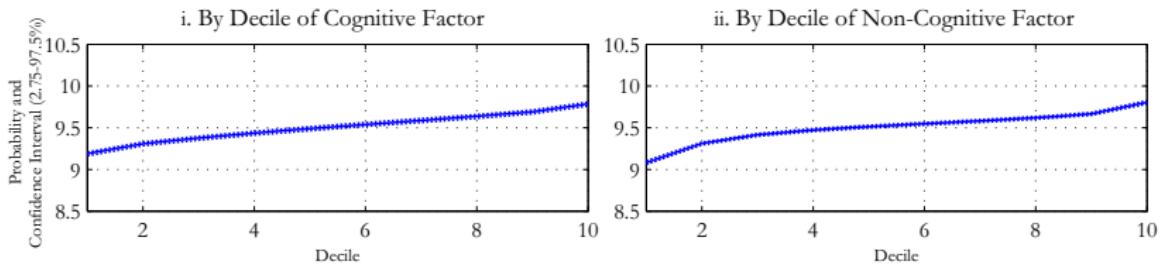


Figure 18B. Mean Work Experience of 4-yr College Graduates by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 19A. Mean Work Experience of 4-yr College Graduates by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

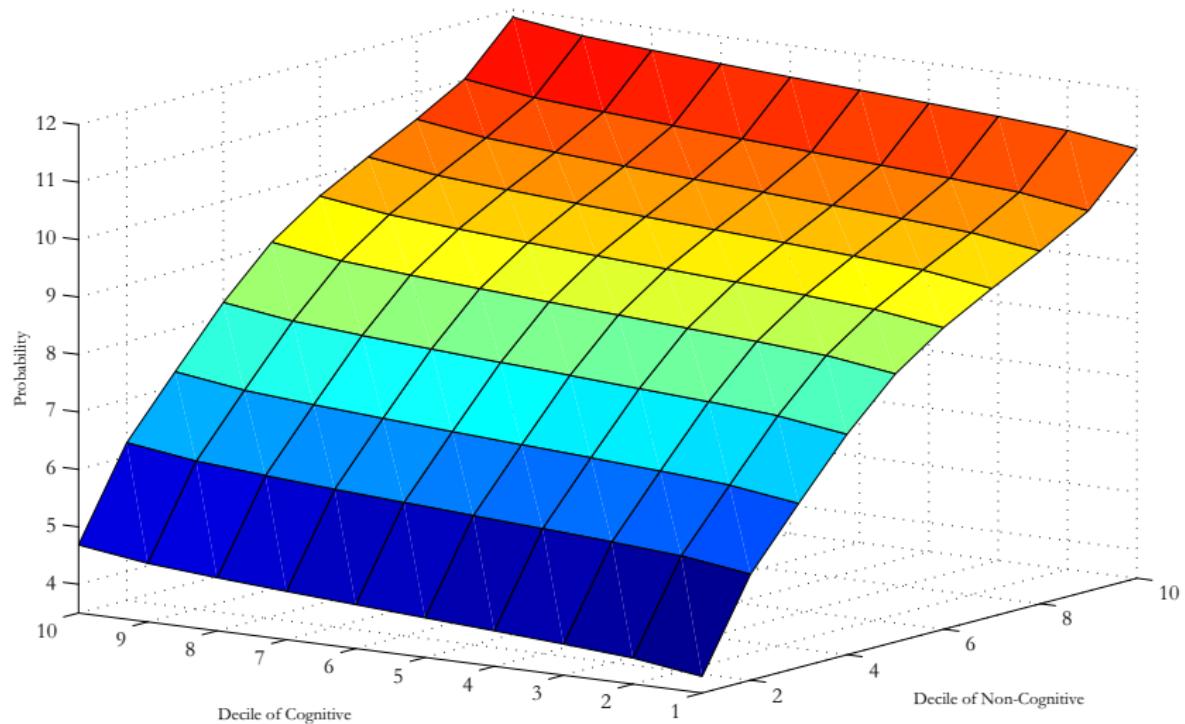
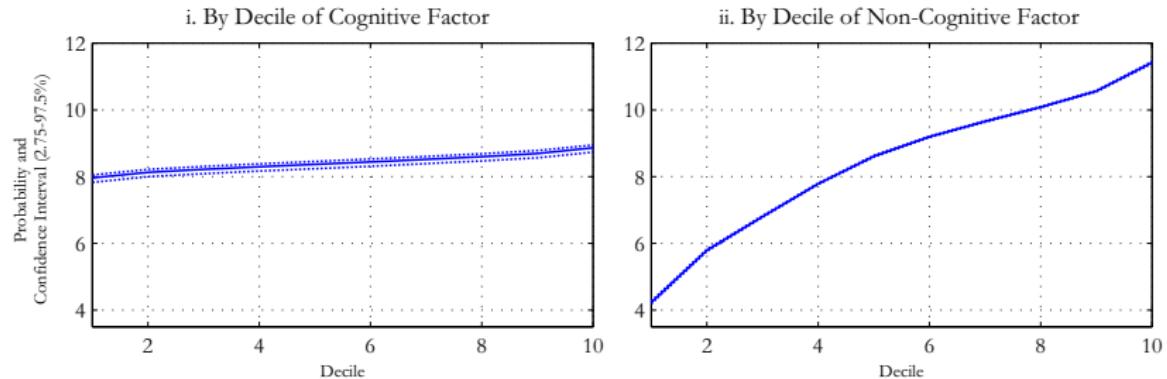


Figure 19B. Mean Work Experience of 4-yr College Graduates by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 20A. Probability Of Being a White Collar Worker by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factor

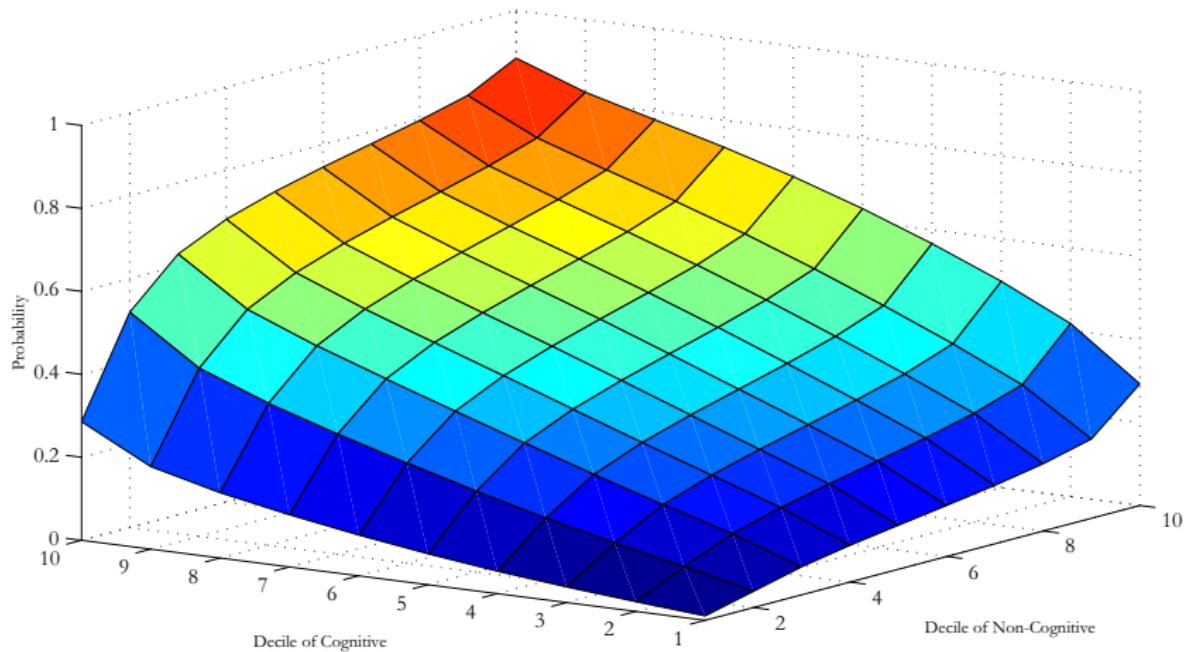
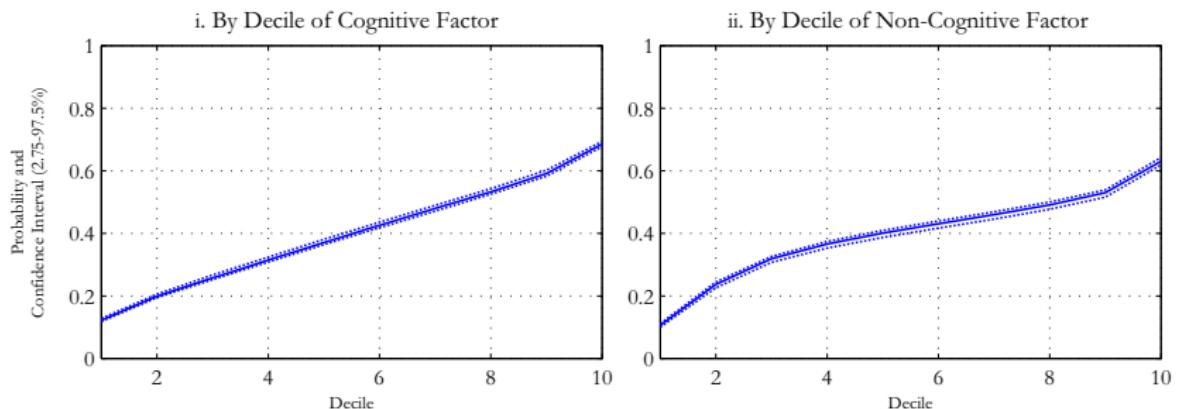


Figure 20B. Probability Of Being a White Collar Worker by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 21A. Probability of Being a High School Dropout by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

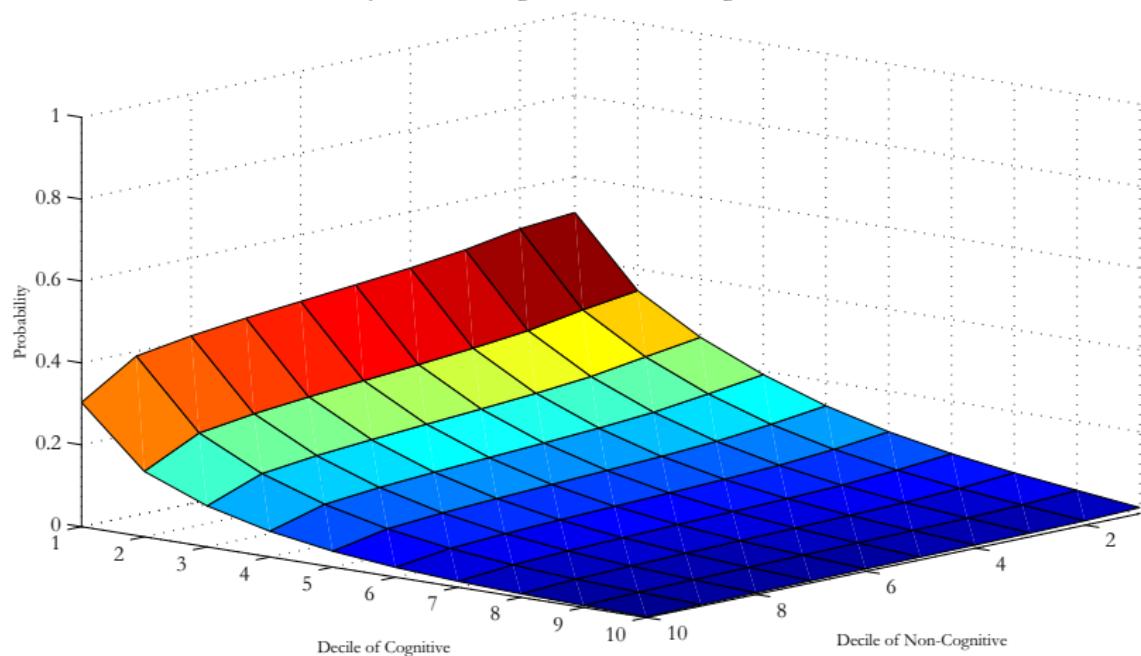
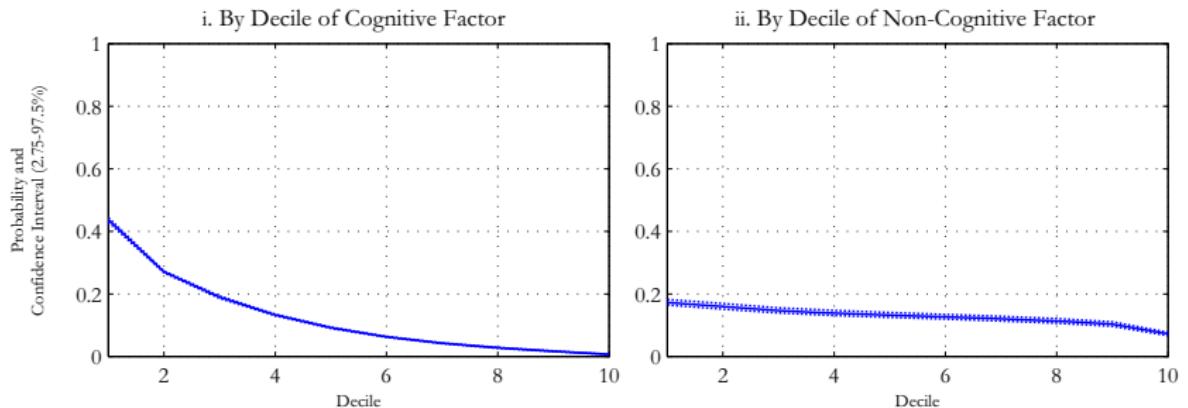


Figure 21B. Probability of Being a High School Dropout by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 22 A. Probability of Being a GED by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

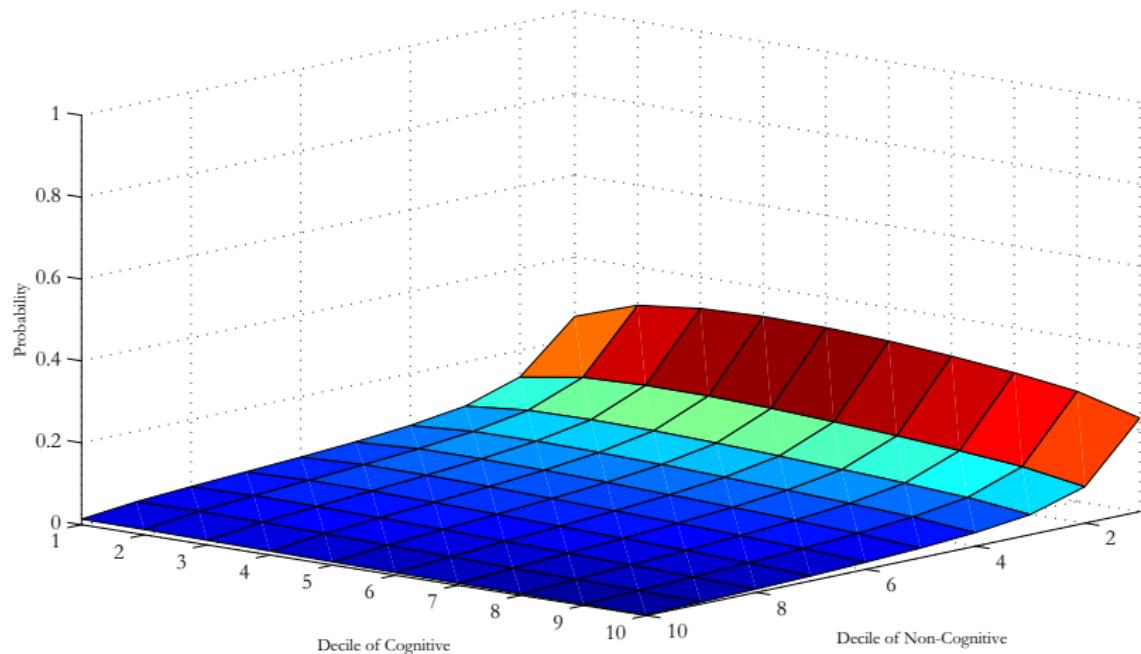
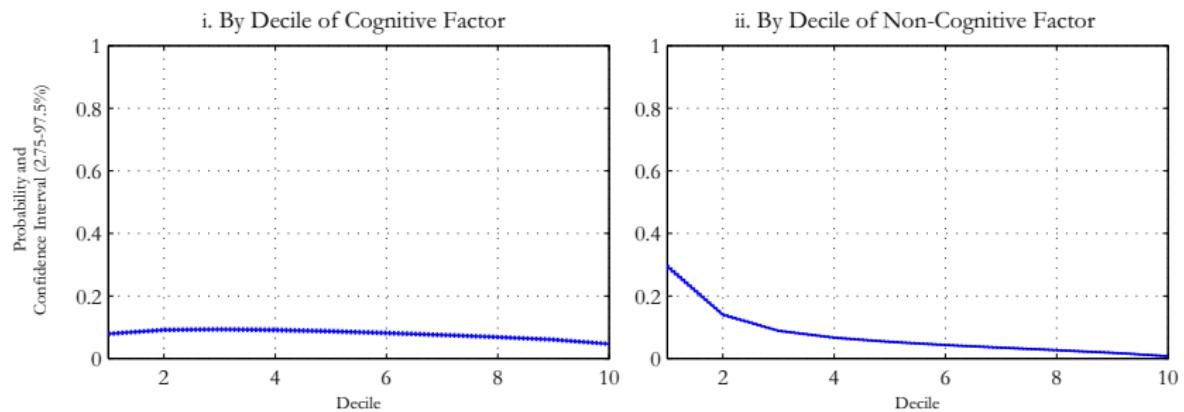


Figure 22 B. Probability of Being a GED by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 23 A. Probability of Being a 2-yr College Graduate by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

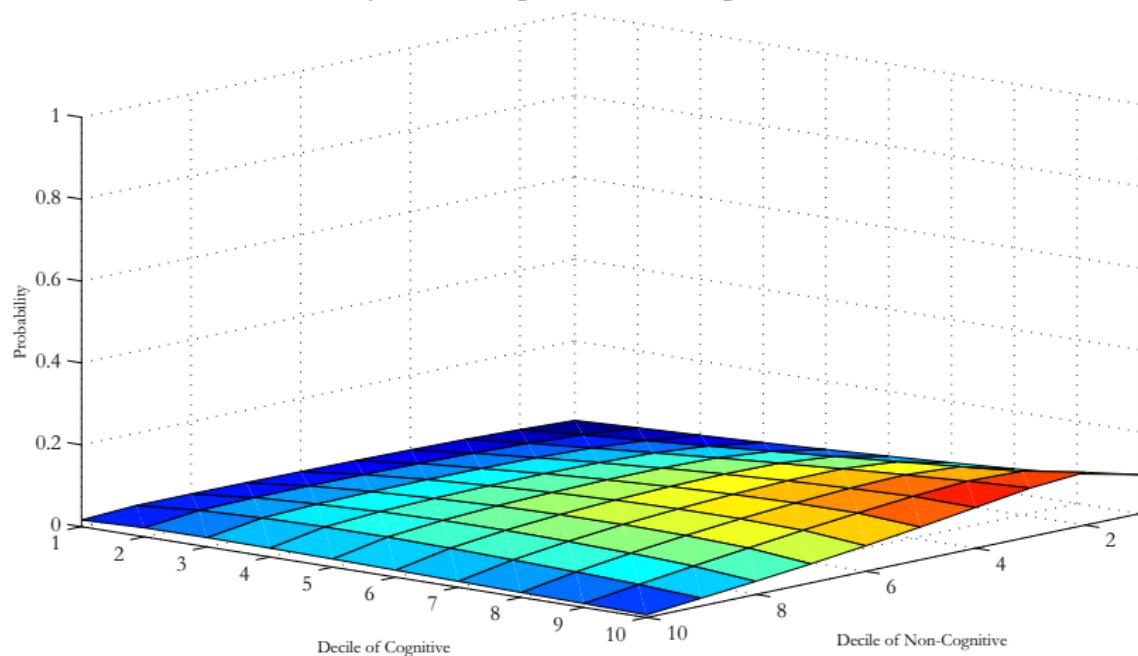
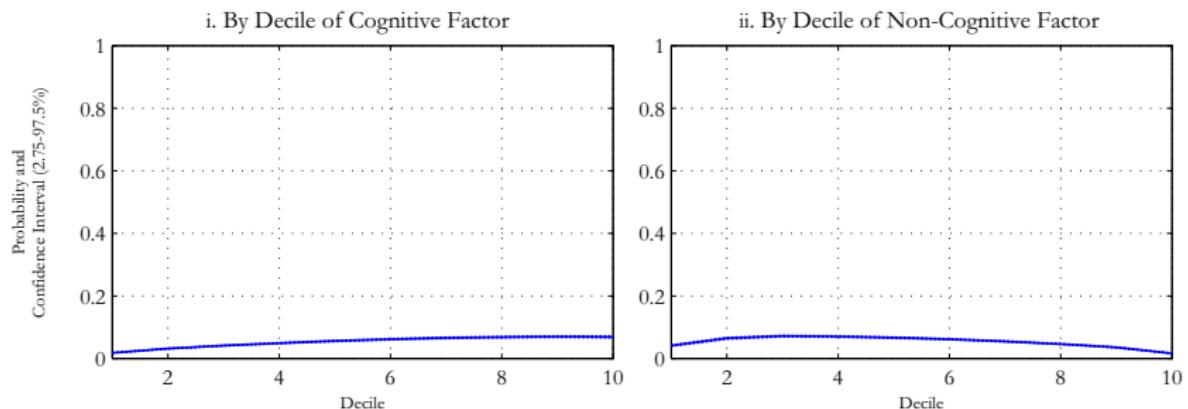


Figure 23 B. Probability of Being a 2-yr College Graduate by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 24 A. Probability of Being a 2-yr College Graduate by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

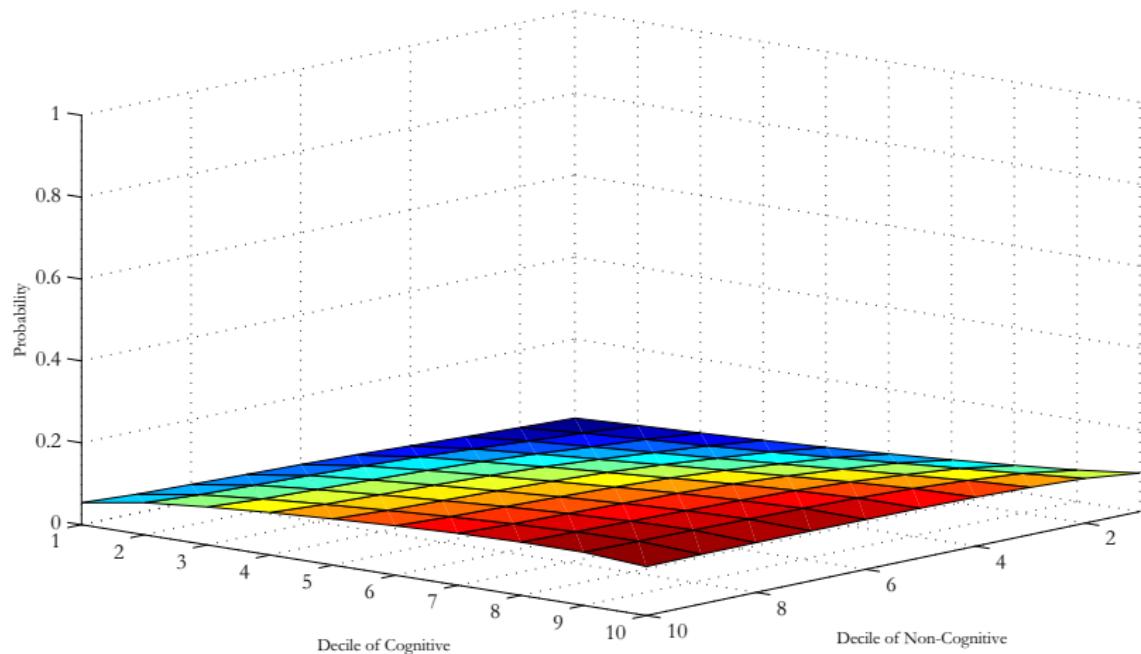
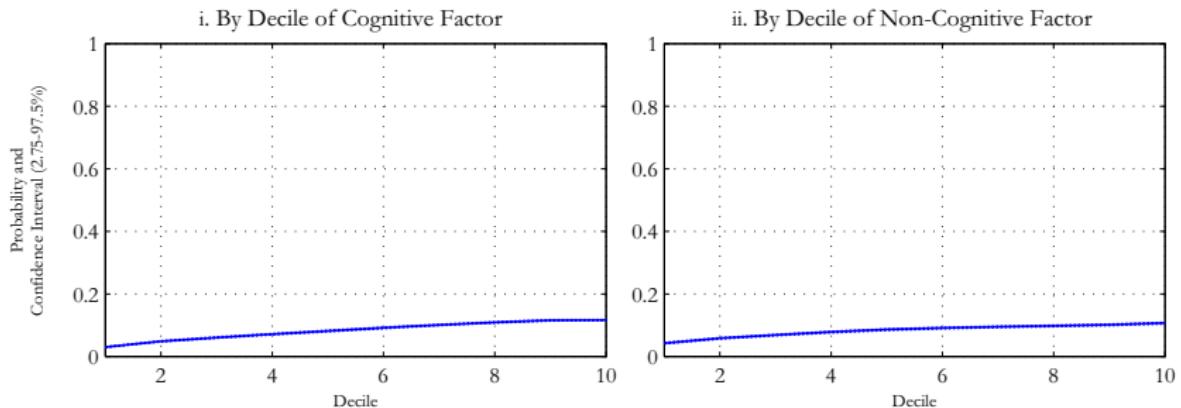


Figure 24B . Probability of Being a 2-yr College Graduate by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 25A. Probability of Being a 4-yr College Graduate by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factors

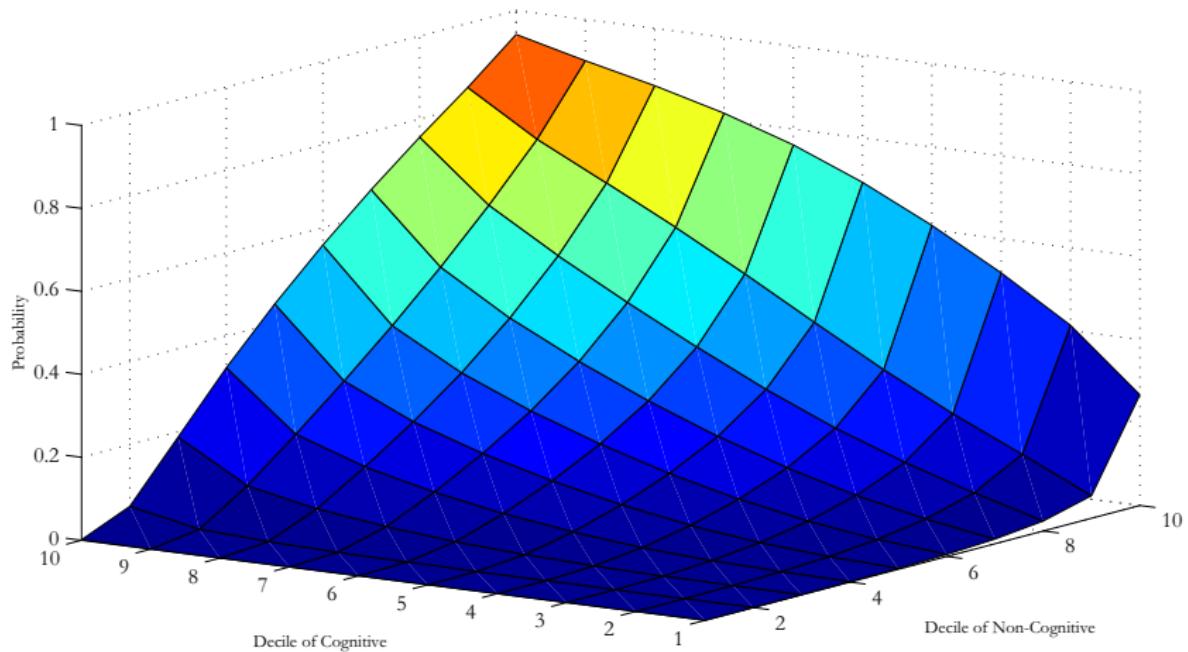
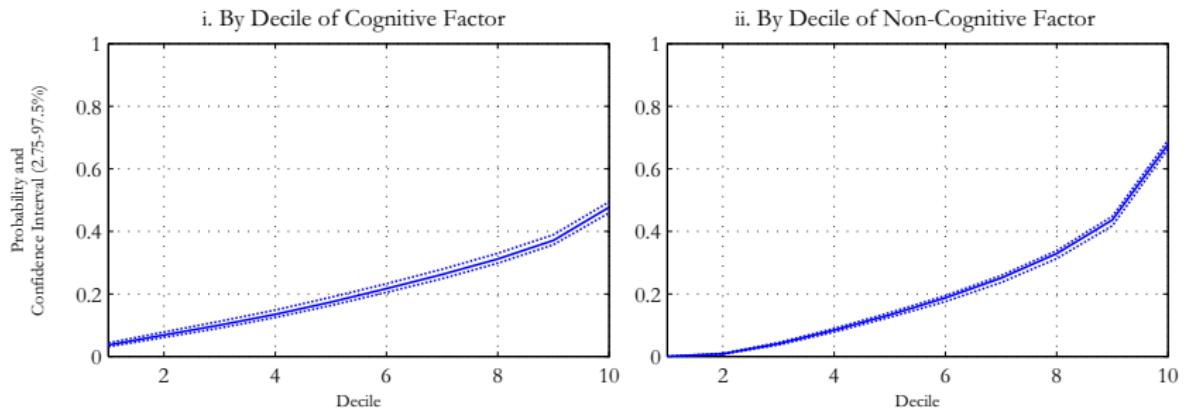


Figure 25 B. Probability of Being a 4-yr College Graduate by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 26 A. Probability of Being a 4-yr College Graduate by Age 30 - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

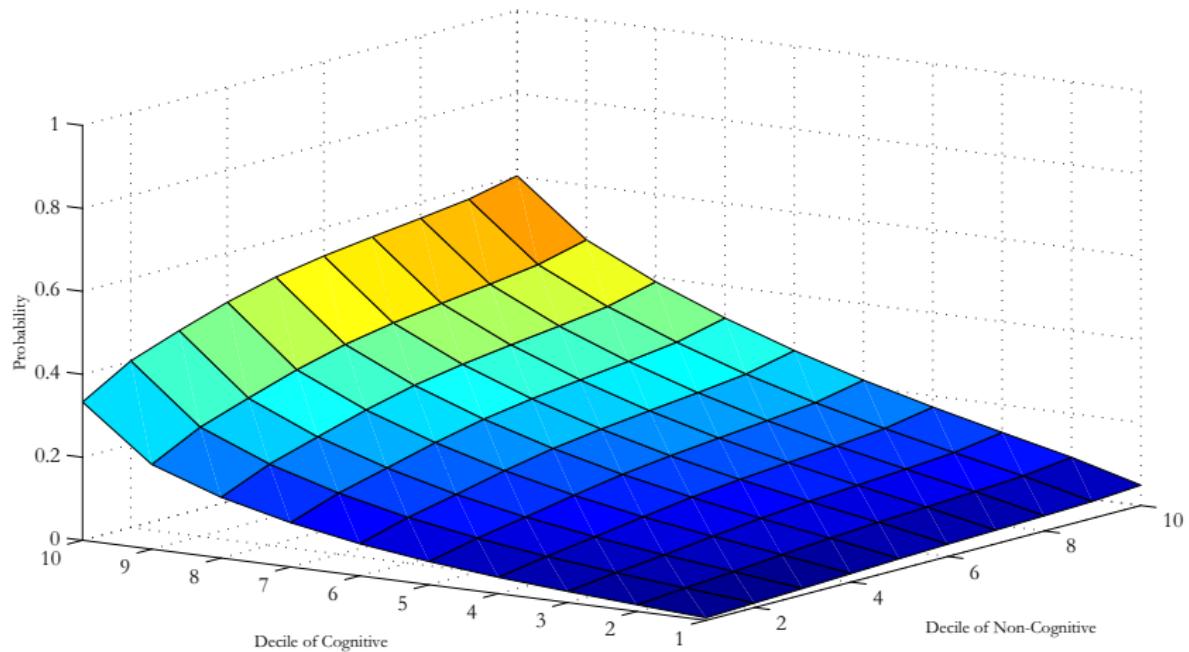
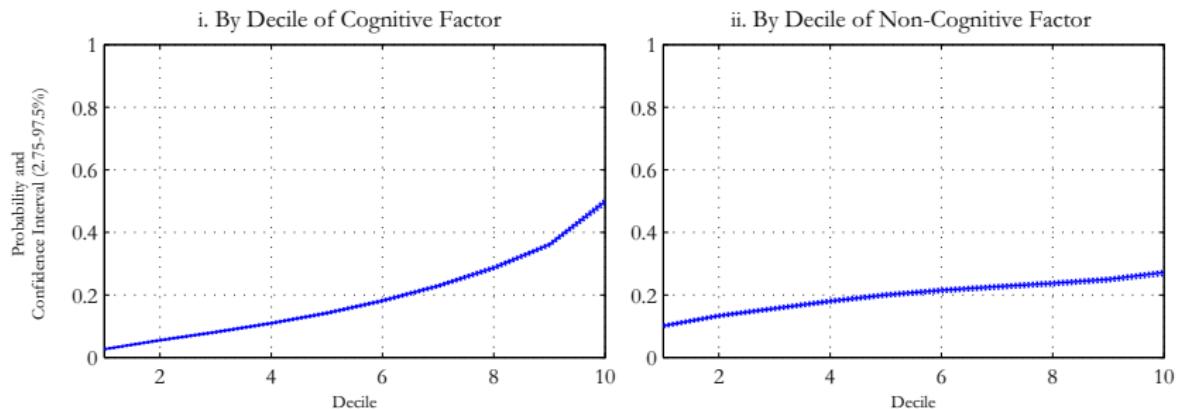


Figure 26 B. Probability of Being a 4-yr College Graduate by Age 30 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 27 A. Probability Of Daily Smoking By Age 18 - Males  
i. By Decile of Cognitive and Non-Cognitive Factor

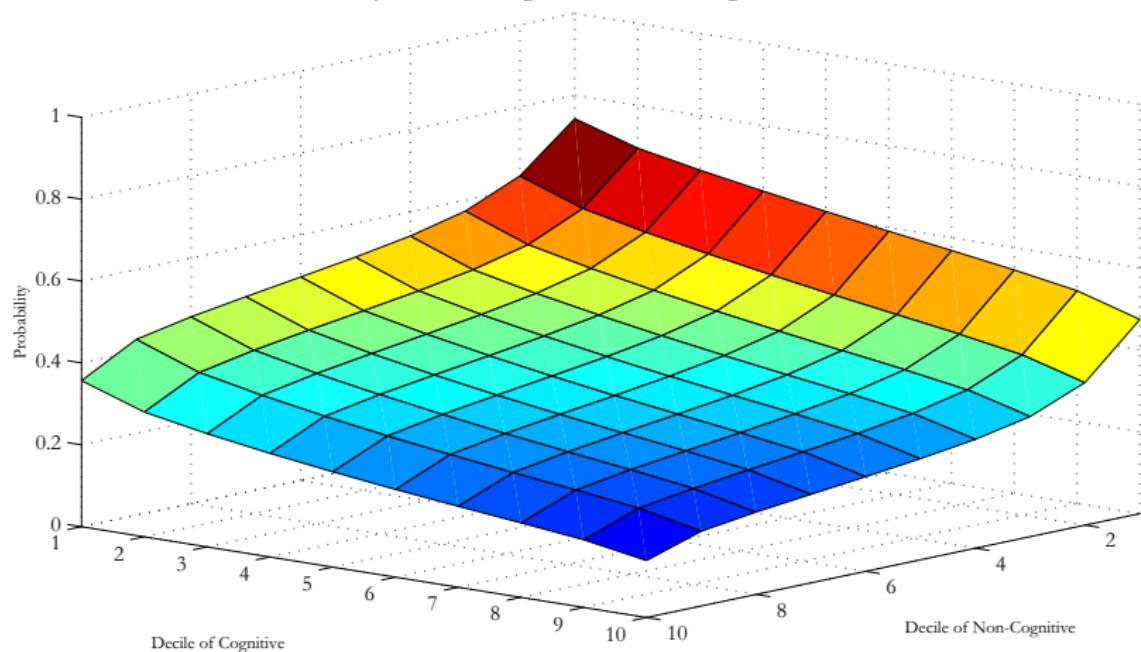
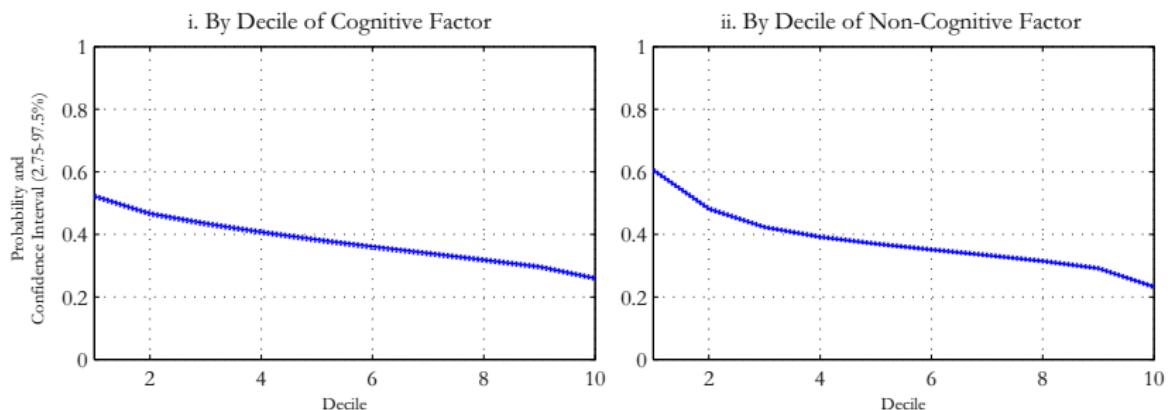


Figure 27 B. Probability Of Daily Smoking By Age 18 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 28 A. Probability Of Daily Smoking By Age 18 - Females  
i. By Decile of Cognitive and Non-Cognitive Factor

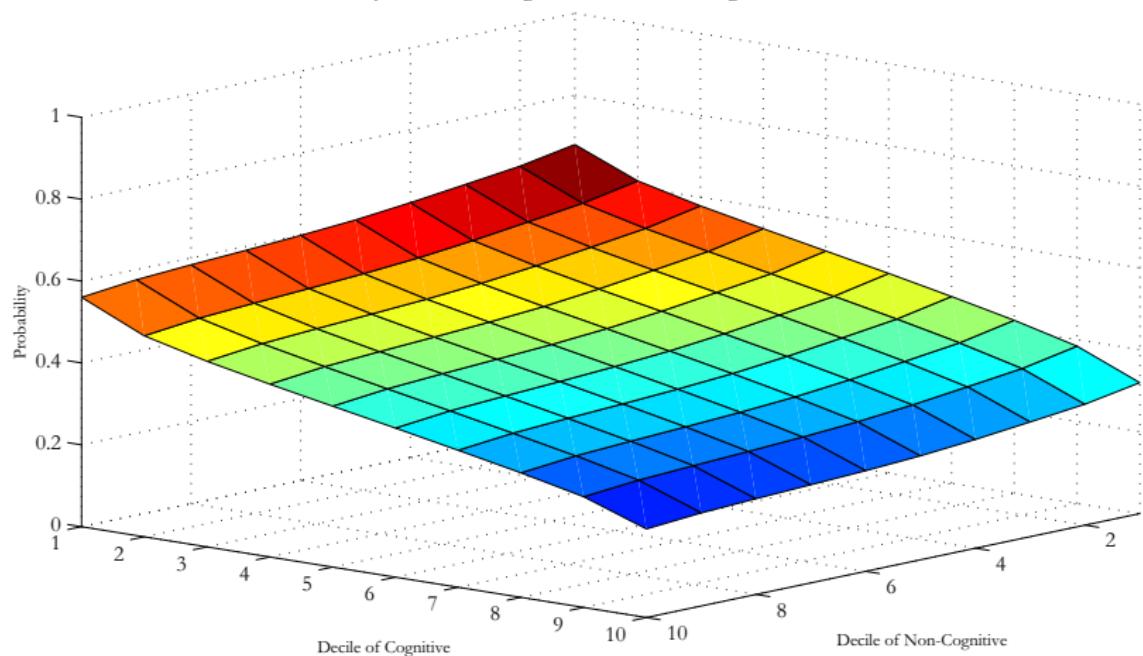
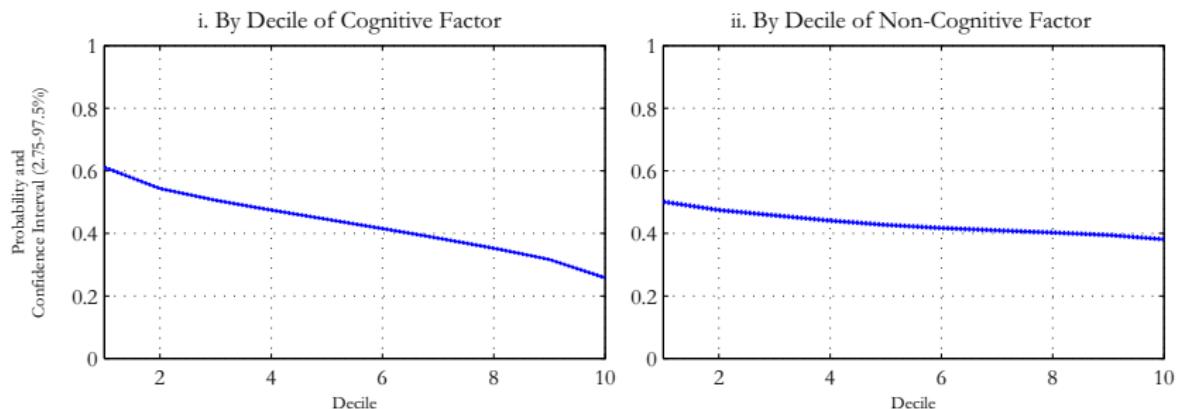


Figure 28 B. Probability Of Daily Smoking By Age 18 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 29 A. Probability of Smoking Marijuana during the Year 1979 - Males  
i. By Decile of Cognitive and Non-Cognitive Factor

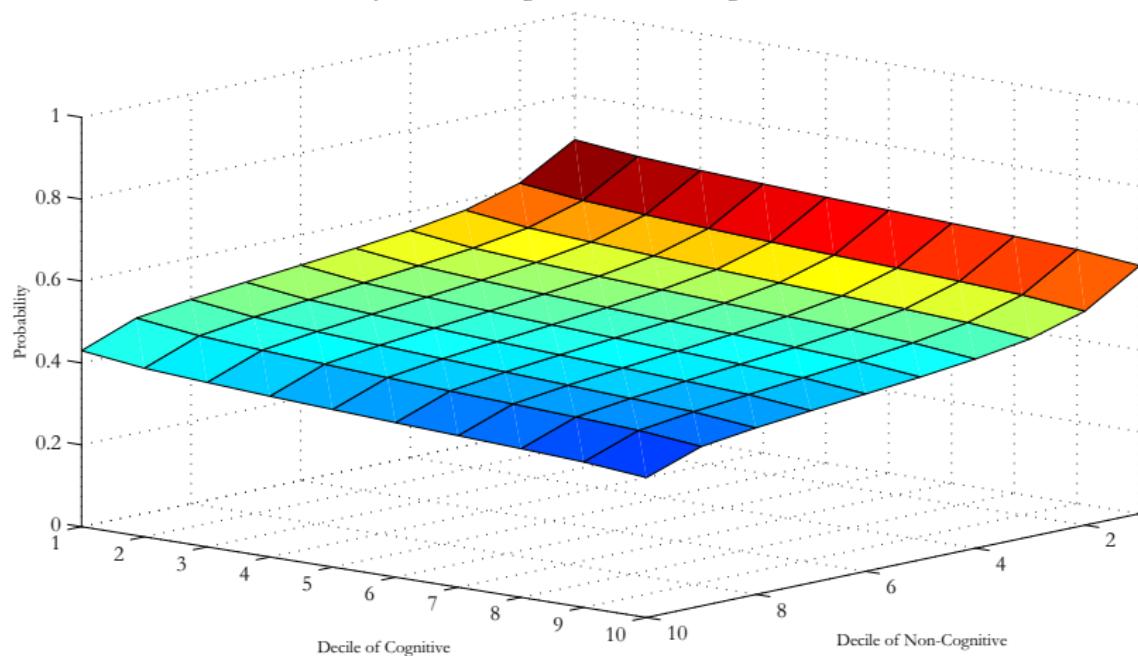
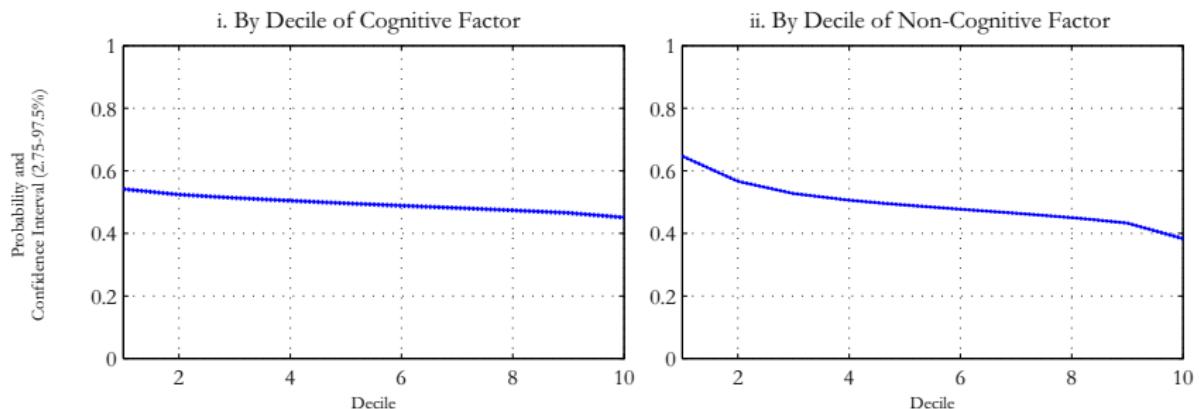


Figure 29 B Probability of Smoking Marijuana during the Year 1979 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 30 A. Probability of Smoking Marijuana during the Year 1979 - Females  
i. By Decile of Cognitive and Non-Cognitive Factor

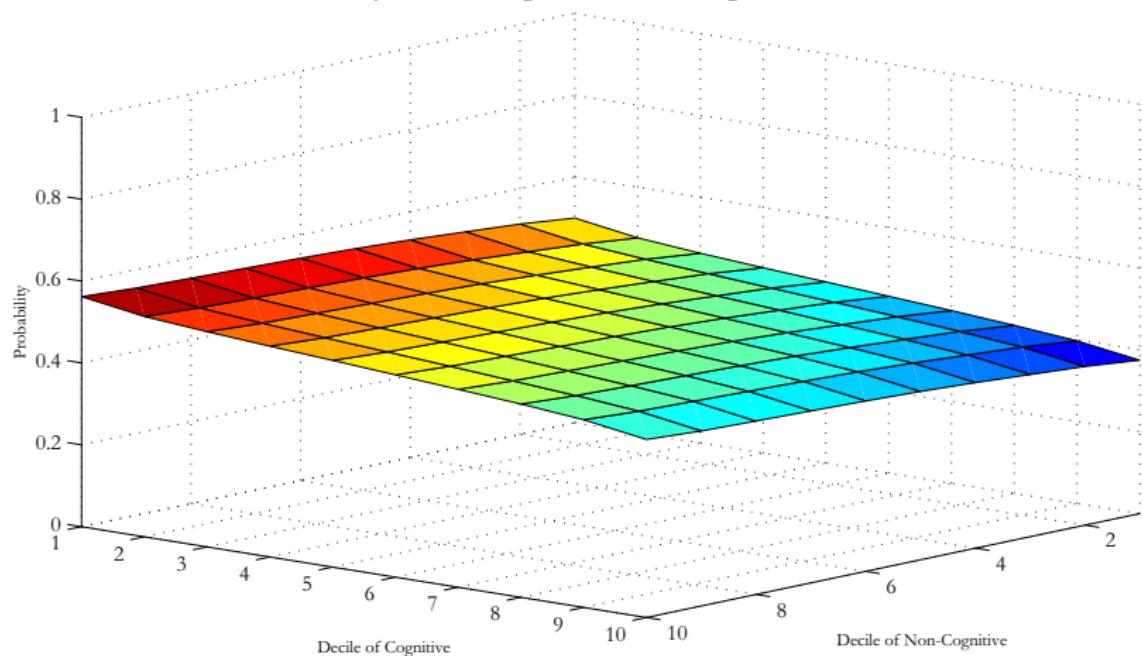
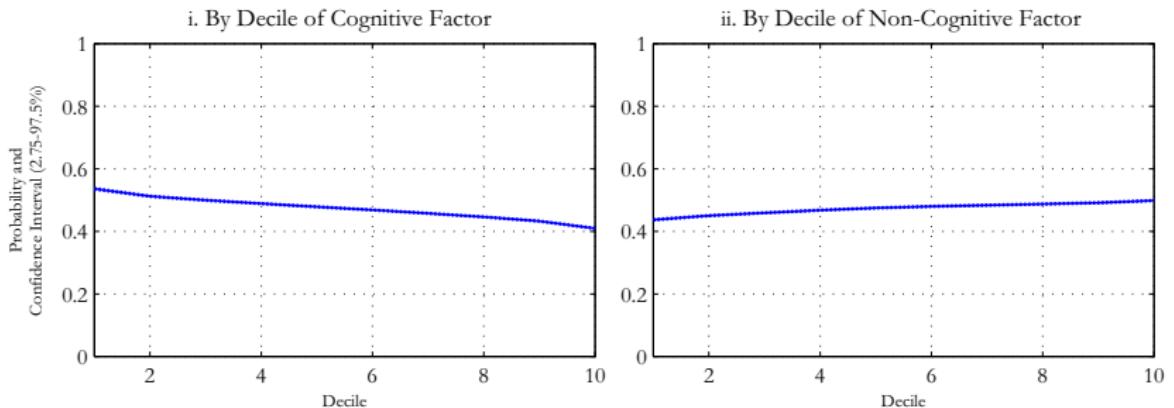


Figure 30 B. Probability of Smoking Marijuana during the Year 1979 - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 31 A. Probability of Participating in Illegal Activities during the Year 1979- Males  
i. By Decile of Cognitive and Non-Cognitive Factor

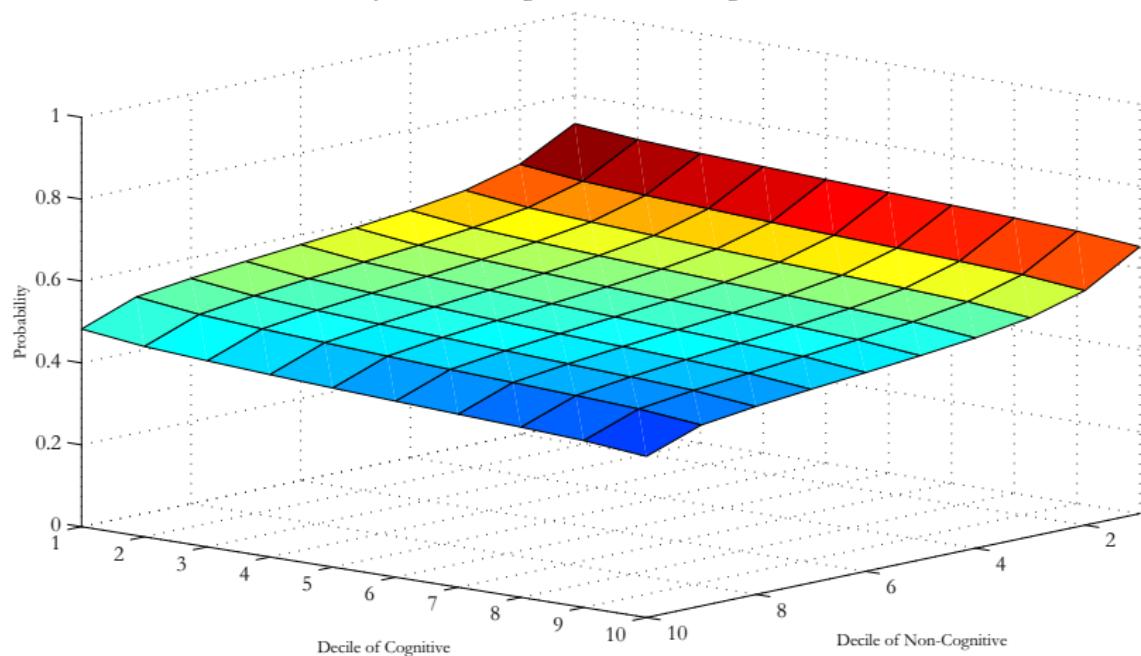
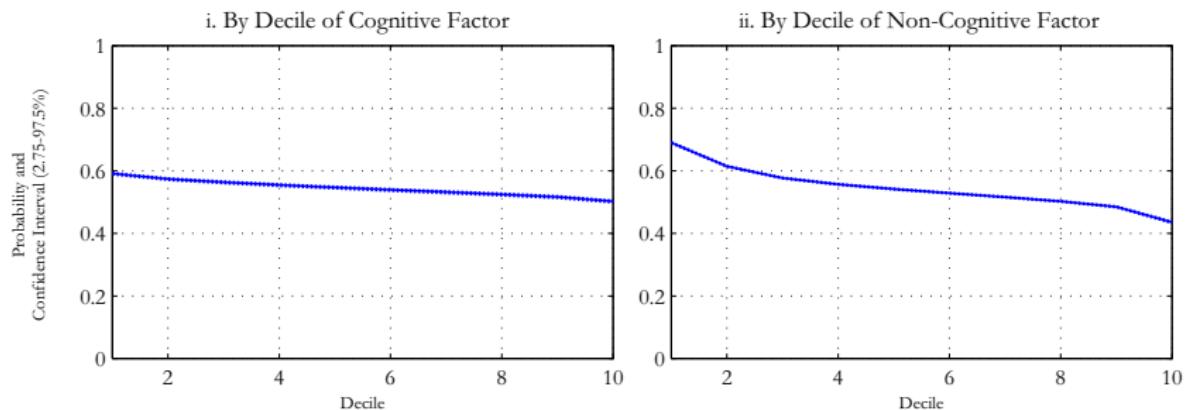


Figure 31 B. Probability of Participating in Illegal Activities during the Year 1979- Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 32 A. Probability of Incarceration by Age 30 - Males  
i. By Decile of Cognitive and Non-Cognitive Factor

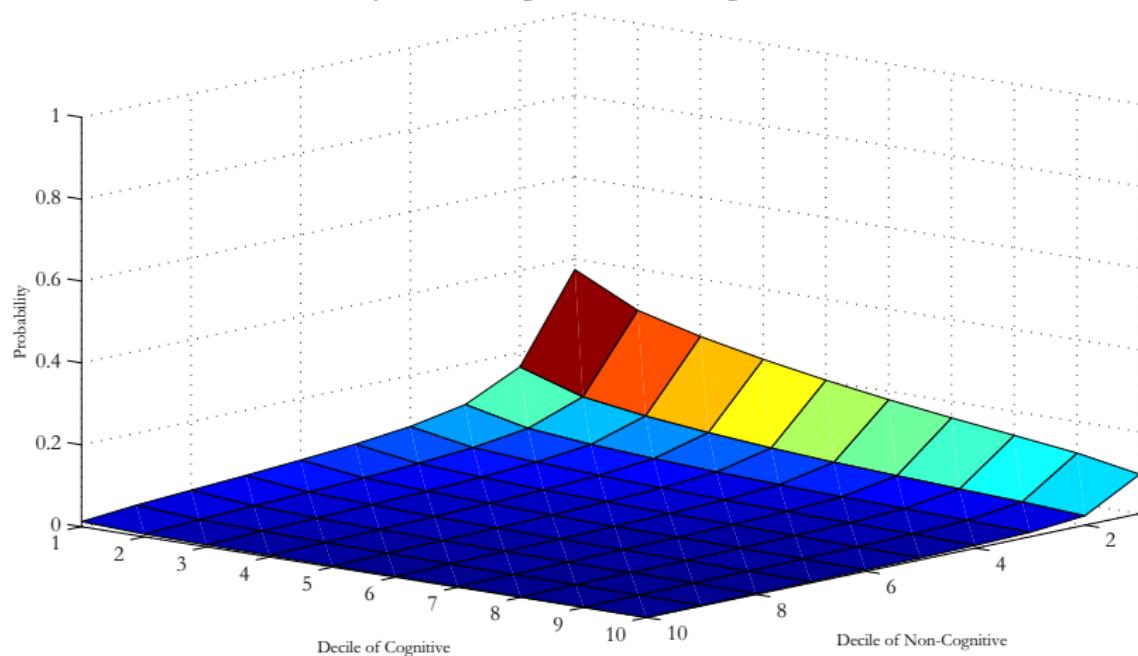
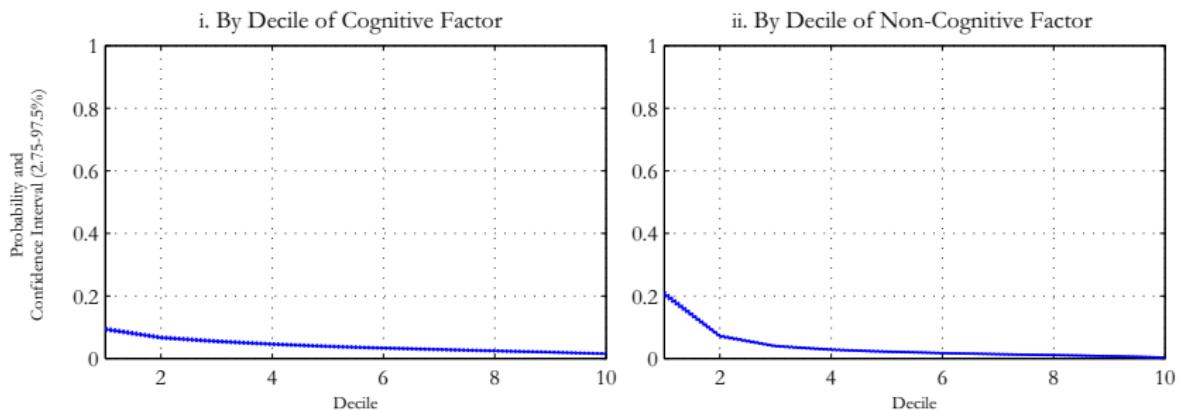


Figure 32B . Probability of Incarceration by Age 30 - Males



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

Figure 33 A. Probability Of Being Single With Child - Females  
i. By Decile of Cognitive and Non-Cognitive Factors

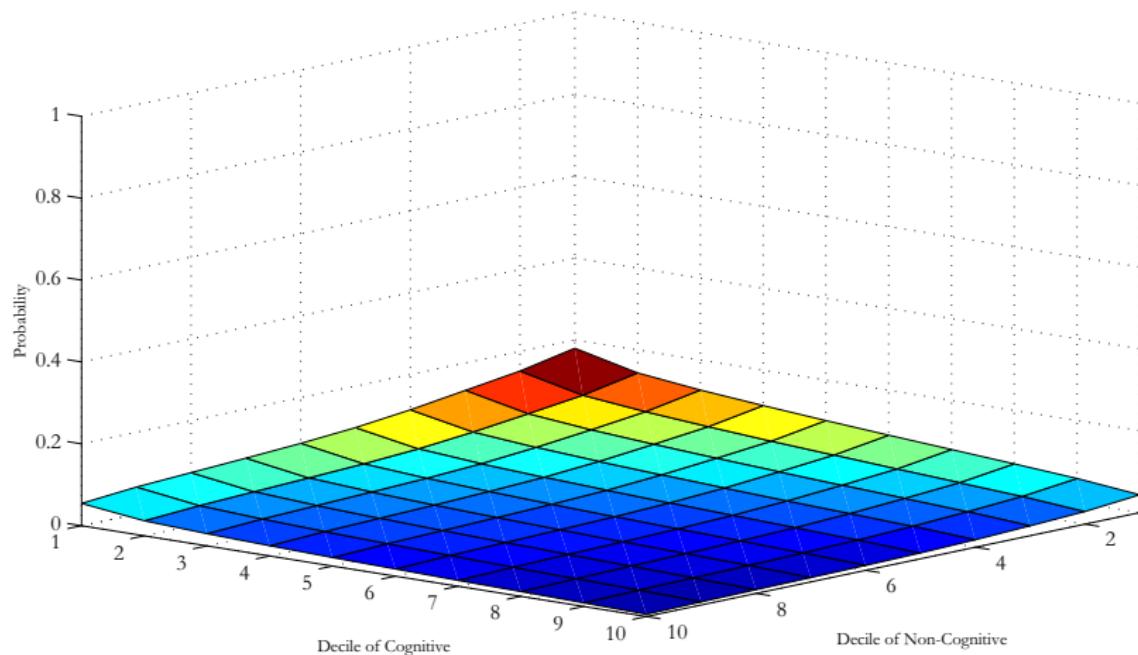
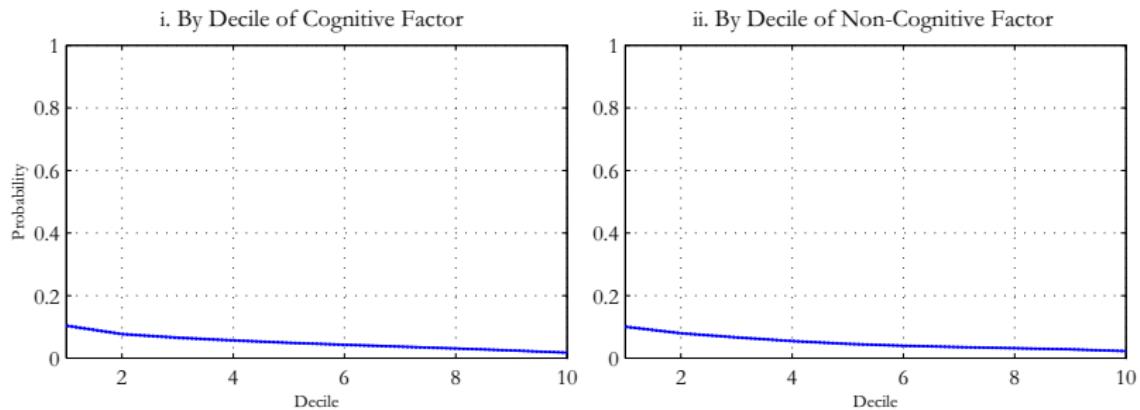


Figure 33 B. Probability Of Being Single With Child - Females



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (50 draws).

## 9 How Important is the assumption that

$$f^C \perp\!\!\!\perp f^N ?$$

- First, observed cognitive and noncognitive test scores can be highly correlated even if factors are not  
(through  $\beta_N(s_T, X)$ ,  $\beta_C(s_T, X)$ ,  $\alpha_N(s_T, X)$ ,  $\alpha_C(s_T, X)$ ).
- $C$  and  $N$  are not highly correlated.
- Adjusting for background, the correlation weakens greatly.

## 10 Where Do Skills Come From?: The Technology of Skill Formation

(Cunha and Heckman, 2005: Technology of Skill Formation, first draft, 2003).

- Using CNLSY data, we estimate determinants of cognitive and noncognitive skills over the life cycle.
- $f_t^C$  denotes the cognitive factor at period  $t$ .
- $f_t^N$  denotes the noncognitive factor at period  $t$ .
- $f_t^{IC}$  denotes the investment in the cognitive skills at period  $t$ .
- $f_t^{IN}$  denotes the investments in noncognitive skills at period  $t$ .

- The dynamic factor model is described by:

$$f_{t+1}^C = \gamma_1^C f_t^C + \gamma_2^C f_t^N + (1 - \gamma_1^C - \gamma_2^C) f_t^{IC} + \eta_{t+1}^C$$

$$f_{t+1}^N = \gamma_1^N f_t^C + \gamma_2^N f_t^N + (1 - \gamma_1^N - \gamma_2^N) f_t^{IN} + \eta_{t+1}^N$$

$$f_{t+1}^{HOME} = \gamma_1^{IC} f_t^C + \gamma_2^{IC} f_t^N + \gamma^I f_t^{HOME} + \eta_{t+1}^{IC}$$

- The estimated equation coefficients are (using CNLSY data):

$$f_{t+1}^C = 0.516 f_t^C + 0.483 f_t^N + 0.001 f_t^{IC} + \eta_{t+1}^C, \quad var(\eta_{t+1}^C) = 0.036$$

$$f_{t+1}^N = 0.98 f_t^N + 0.02 f_t^{IN} + \eta_{t+1}^N, \quad var(\eta_{t+1}^N) = 0.00184$$

$$\begin{aligned} f_{t+1}^{HOME} &= -0.01 f_t^C + 0.036 f_t^N + 0.8074 f_t^{HOME} + \eta_{t+1}^{HOME}, \\ var(\eta_{t+1}^{HOME}) &= 0.0042 \end{aligned}$$

- So, more noncognitive skill today increases the stock of cognitive skills tomorrow, but the reverse effect of cognitive skills on noncognitive skills is practically nonexistent.

Table 2A  
 Correlation Matrix  
 Dynamic Factor Model - White Children / CNLSY-1979  
 Initial Covariance - Assumed

	Cognitive	Noncognitive	Home
Cognitive	1.0000	0.0000	0.0000
Noncognitive	0.0000	1.0000	0.0000
Home	0.0000	0.0000	1.0000

Correlation Matrix  
 Dynamic Factor Model - White Children / CNLSY-1979  
 Period 2 = Children aged between 7 and 8

	Cognitive	Noncognitive	Home
Cognitive	1.0000	0.1370	0.0023
Noncognitive	0.1370	1.0000	0.0341
Home	0.0023	0.0341	1.0000

Table 2B

Correlation Matrix			
Dynamic Factor Model - White Children / CNLSY-1979			
Period 3 = Children aged between 9 and 10			
	Cognitive	Noncognitive	Home
Cognitive	1.0000	0.0992	0.0016
Noncognitive	0.0992	1.0000	0.0313
Home	0.0016	0.0313	1.0000

Correlation Matrix			
Dynamic Factor Model - White Children / CNLSY-1979			
Period 4 = Children aged between 11 and 12			
	Cognitive	Noncognitive	Home
Cognitive	1.0000	0.0879	0.0012
Noncognitive	0.0879	1.0000	0.0295
Home	0.0012	0.0295	1.0000

Table 2C

Covariance Matrix  
Dynamic Factor Model - White Children / CNLSY-1979  
Period 5 = Children aged between 13 and 14

	Cognitive	Noncognitive	Home
Cognitive	1.0000	0.0848	0.0010
Noncognitive	0.0848	1.0000	0.0288
Home	0.0010	0.0288	1.0000

# 11 Conclusion

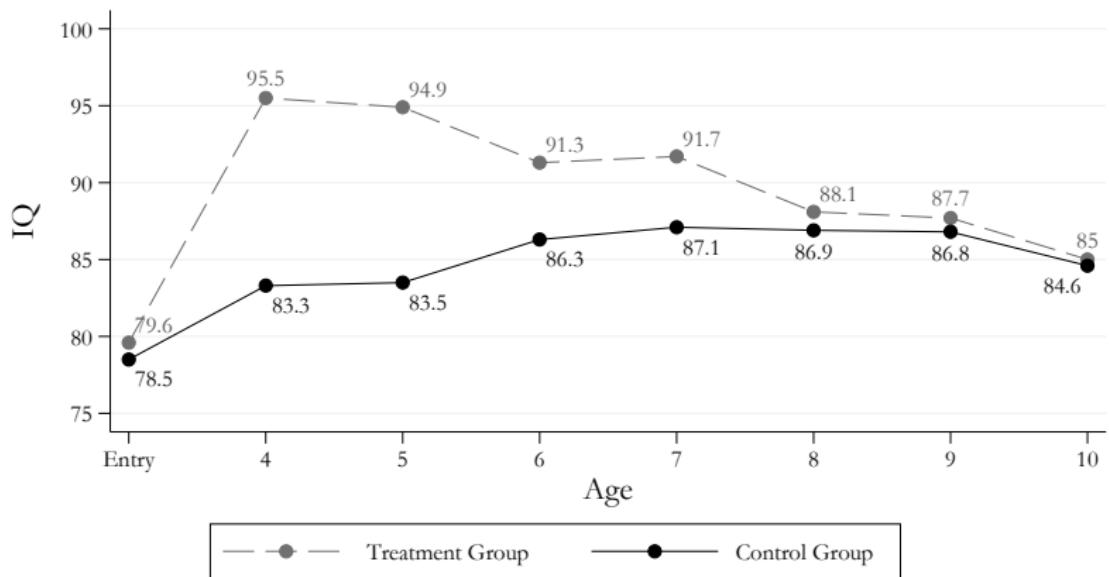
- Low dimensional model for two latent abilities explains a diverse array of behaviors controlling for reverse causality and selection
- We move beyond looking only at effects of cognitive and noncognitive skills on wages.
- For many dimensions of behavior, noncognitive ability is more important than, or as important as (in the sense of effects of movements from the top to the bottom of the distribution) cognitive ability.
- Noncognitive ability affects acquisition of skills and a variety of behaviors as well as market productivity as measured by wages.
- Cognitive ability affects market productivity, skill acquisition and a variety of behaviors.

- Schooling affects both cognitive and noncognitive skills.
- Existence of multiple skills alters signalling theory which is based on assuming a single ability.
- Single crossing property is violated.
- Araujo, Gottlieb and Moreira (2004) developed this theory in response to our evidence on the GED.
- They explore implications of the GED as a mixed signal. GEDs have higher cognitive skills than dropouts, but lower noncognitive skills than graduates.
- One interpretation of high “psychic costs” found in the recent literature, is that it represents noncognitive ability.
- High psychic costs explain sluggish response of schooling to increases in wages.
- Race differences. Evidence that noncognitive components are very important in determining the wages of blacks.

- Some evidence that multiple noncognitive factors required to fit the data.
- Cunha and Heckman (2006) relax independence of factors in a dynamic model of skill formation.
- They show that noncognitive skills promote cognitive skill formation but not vice versa.

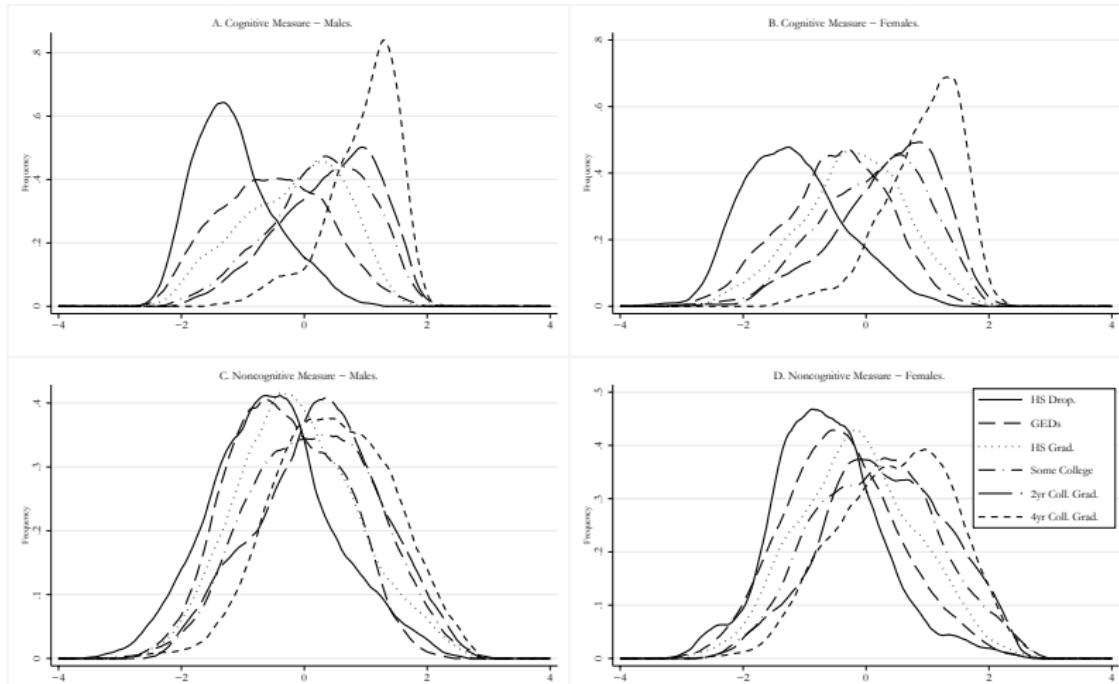
Figure 1

Perry Preschool Program: IQ, by Age and Treatment Group



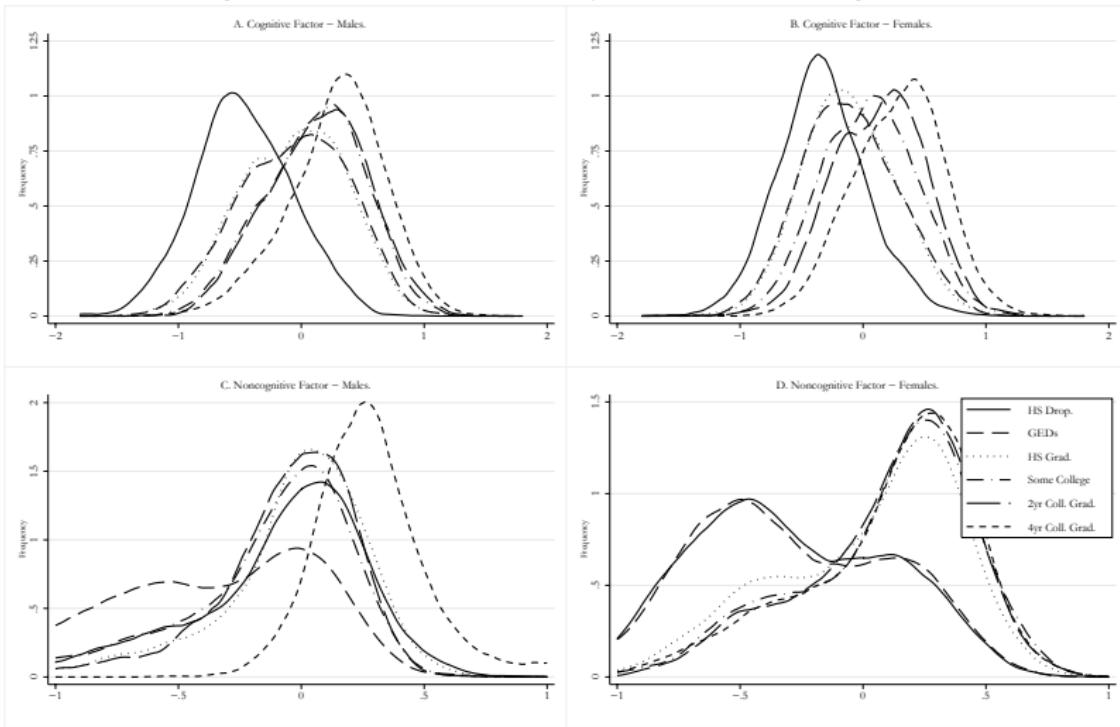
Source: Perry Preschool Program. IQ measured on the Stanford-Binet Intelligence Scale (Terman & Merrill, 1960). Test was administered at program entry and each of the ages indicated.

Figure 2. Distribution of Test Scores by Gender and Schooling Level



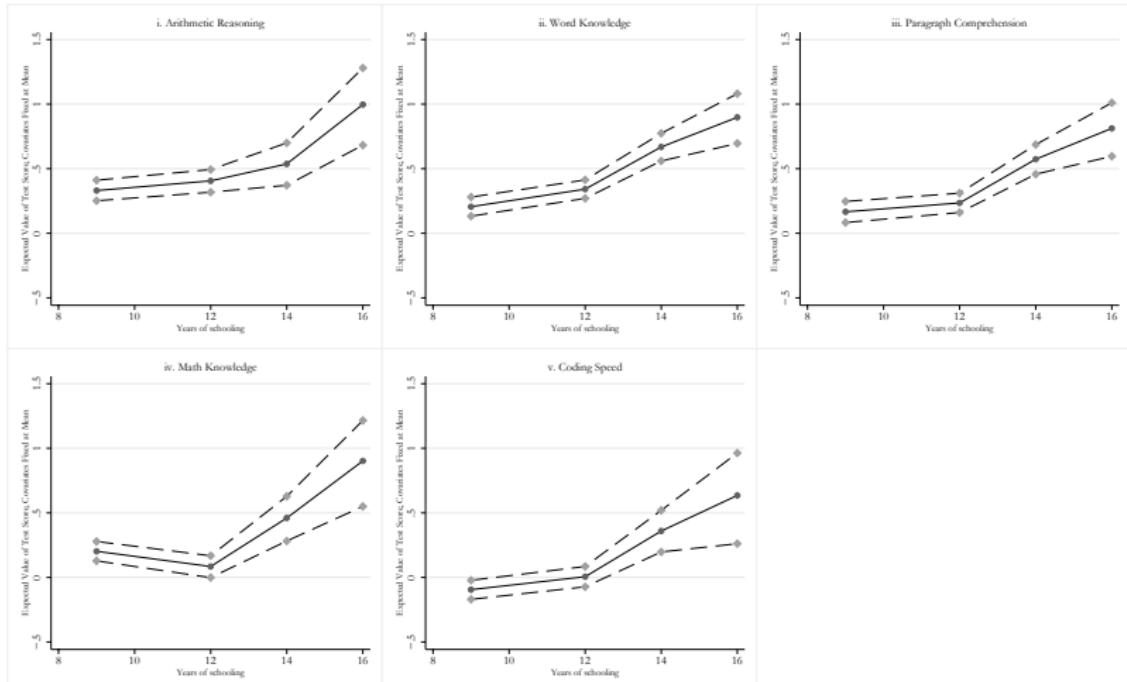
Notes: The cognitive measure represents the standardized average over the ASVAB scores (arithmetic reasoning, word knowledge, paragraph comprehension, numerical operations and coding speed). The noncognitive measure is computed as a (standardized) average of the Rosenberg Self-Esteem Scale and Rotter Internal-External Locus of Control Scale. The schooling levels represent the observed schooling level by age 30 in the NLSY79 sample (See Web Appendix A for details).

Figure 3. Distribution of Factors by Gender and Schooling Level



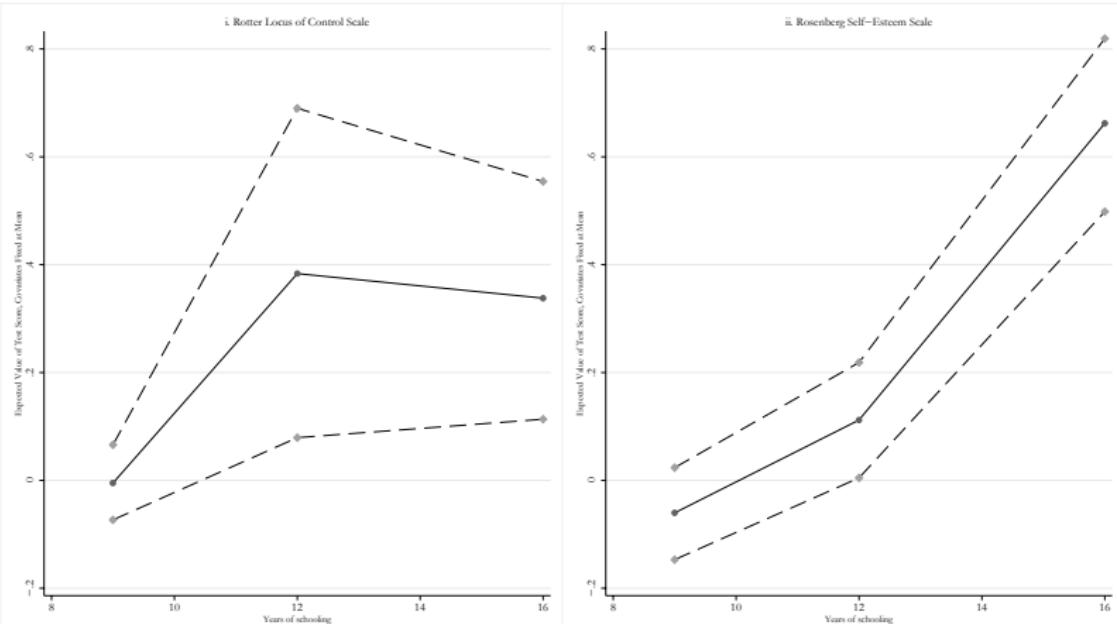
Notes: The factors are simulated from the estimates of the model. The schooling levels represent the predicted schooling level by age 30. These schooling levels are obtained from the structure and estimates of the model and our sample of the NLSY79 (See Web Appendix A for details). The simulated data contain 19,600 observations.

Figure 4A. Effect of schooling on ASVAB Components for person with average ability  
with 95% confidence bands—Males



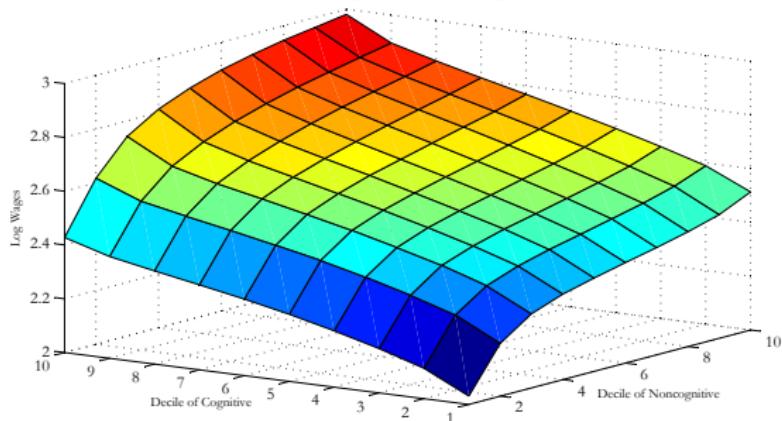
Notes: We standardize the test scores to have within-sample mean 0, variance 1. The model is estimated using the Age 30 NLSY79 Sample (See Web Appendix A for details).

Figure 4B. Effect of schooling on Noncognitive scales for person with average ability  
with 95% confidence bands—Males

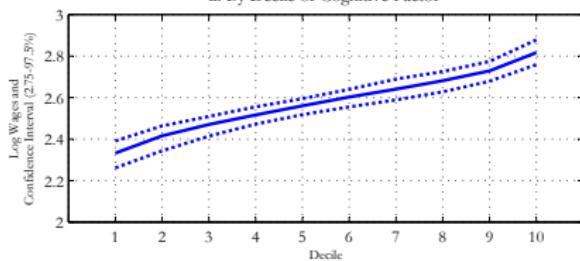


Notes: The locus of control scale is based on the four-item abbreviated version of the Rotter Internal–External Locus of Control Scale. This scale is designed to measure the extent to which individuals believe they have control over their lives through self-motivation or self-determination (internal control) as opposed to the extent that the environment controls their lives (external control). The self-esteem scale is based on the 10-item Rosenberg Self-Esteem Scale. This scale describes a degree of approval or disapproval toward oneself. In both cases, we standardize the test scores to have within-sample mean 0 and variance 1, after taking averages over the respective sets of scales. The model is estimated using the Age 30 NLSY79 Sample (See Web Appendix A for details).

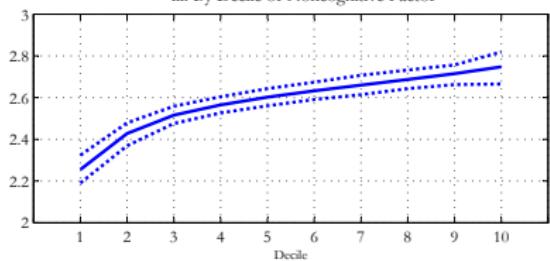
Figure 5A. Mean Log Wages by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

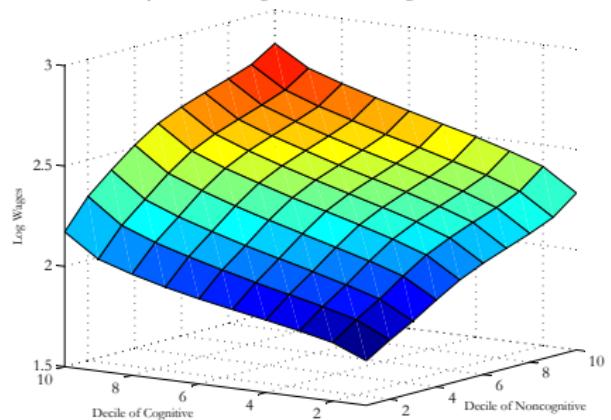


iii. By Decile of Noncognitive Factor

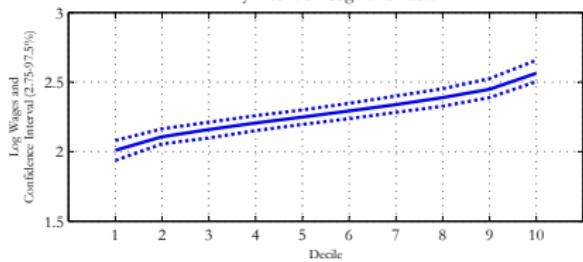


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

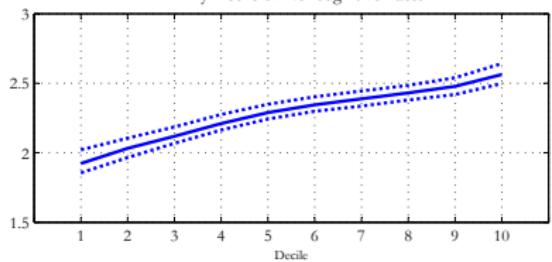
Figure 5B. Mean Log Wages by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

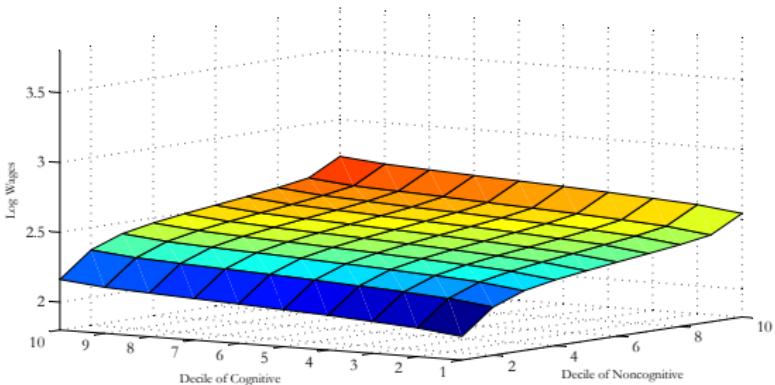


iii. By Decile of Noncognitive Factor

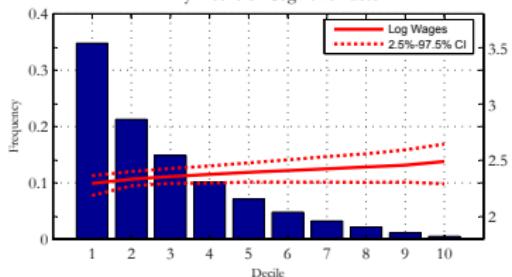


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

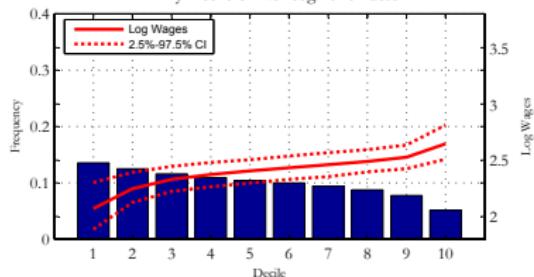
Figure 6A. Mean Log Wages of High School Dropouts by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

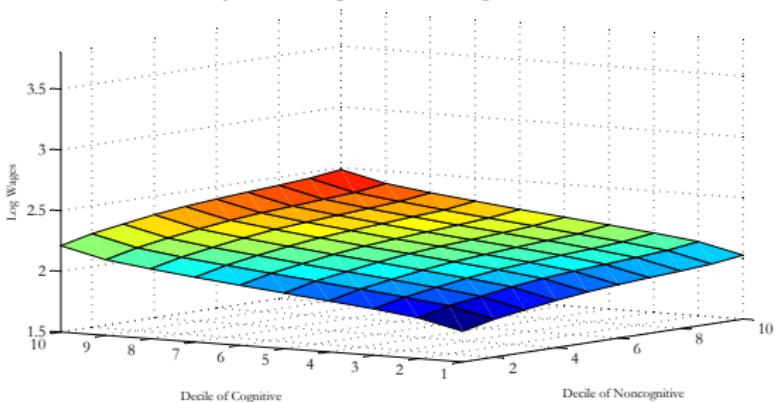


iii. By Decile of Noncognitive Factor

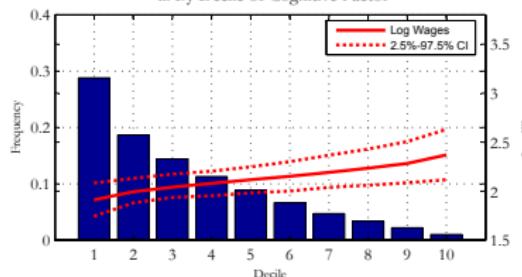


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

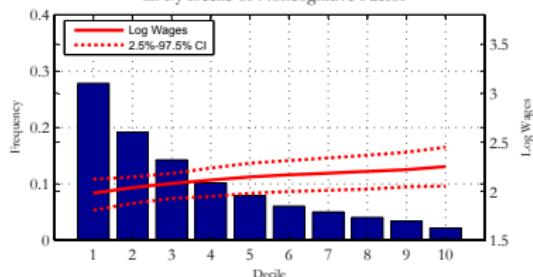
Figure 6B. Mean Log Wages of High School Dropouts by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

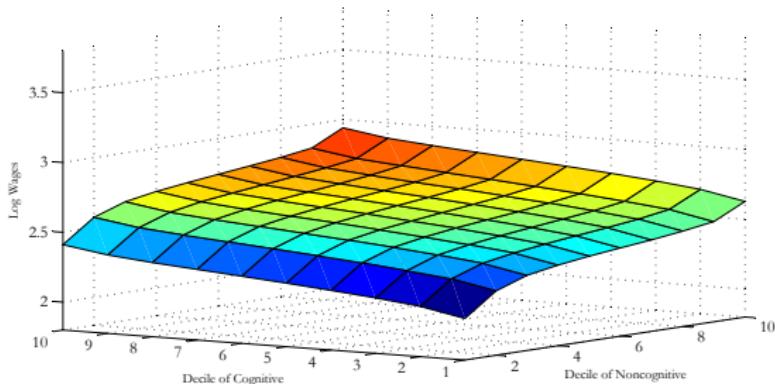


iii. By Decile of Noncognitive Factor

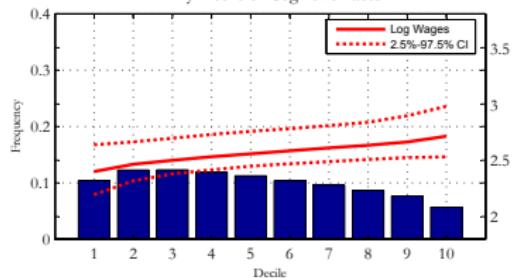


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

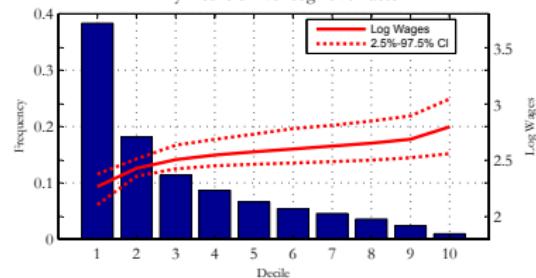
Figure 7A. Mean Log Wages of GEDs by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

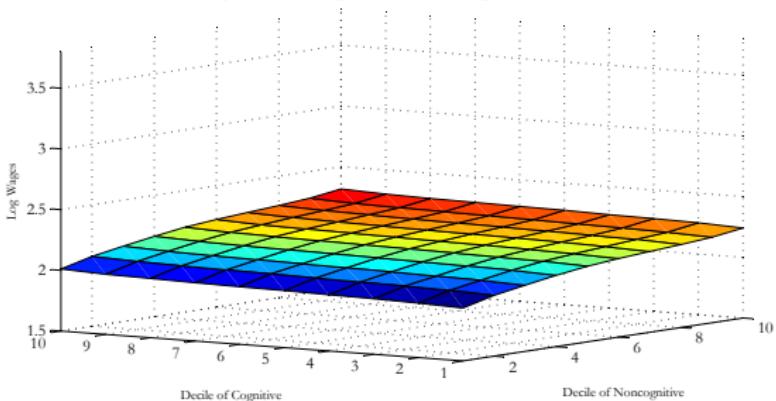


iii. By Decile of Noncognitive Factor

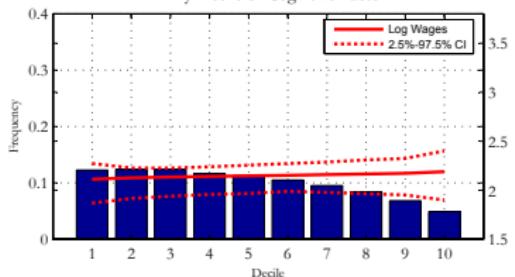


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

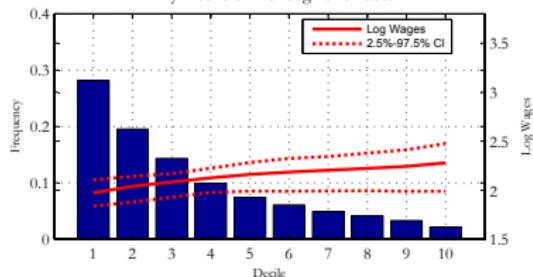
Figure 7B. Mean Log Wages of GEDs by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

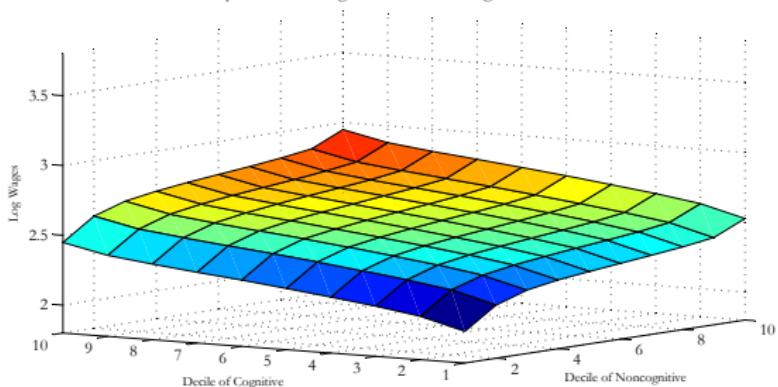


iii. By Decile of Noncognitive Factor

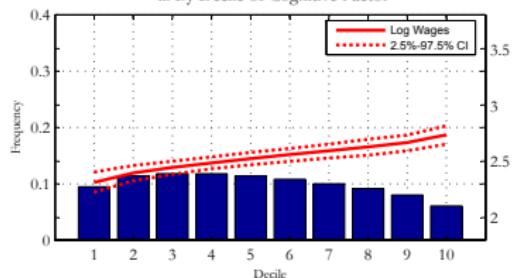


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

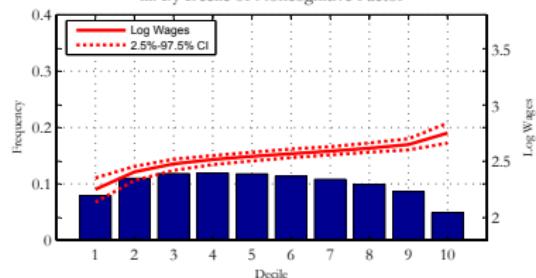
Figure 8A. Mean Log Wages of High School Graduates by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

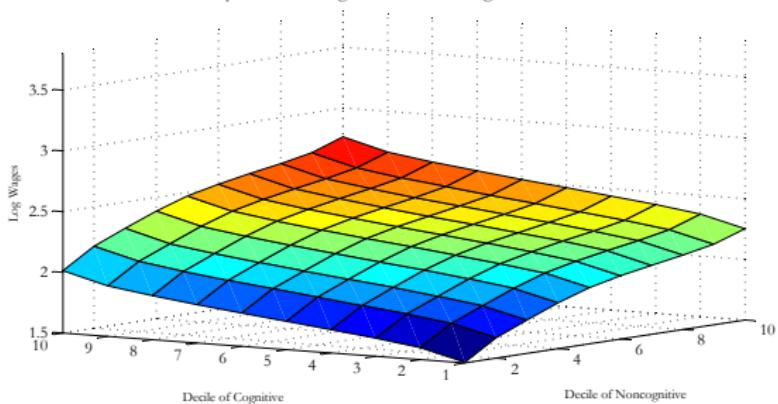


iii. By Decile of Noncognitive Factor

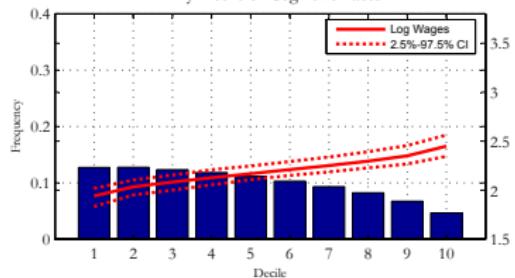


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

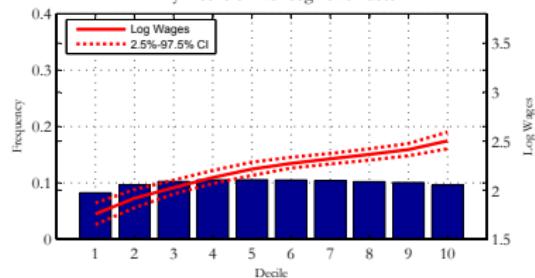
Figure 8B. Mean Log Wages of High School Graduates by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

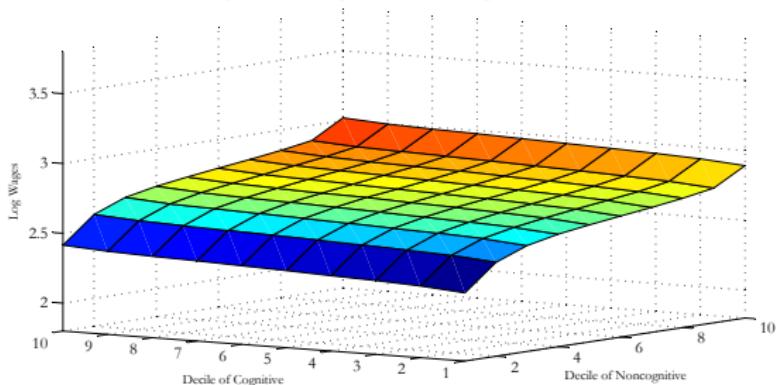


iii. By Decile of Noncognitive Factor

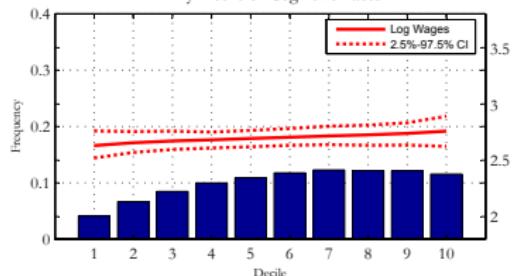


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

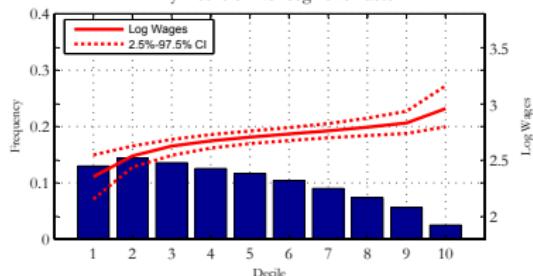
Figure 9A. Mean Log Wages of Some College Attenders by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

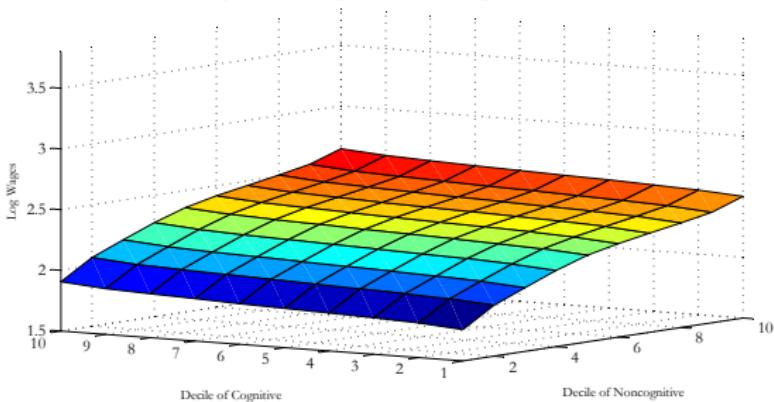


iii. By Decile of Noncognitive Factor

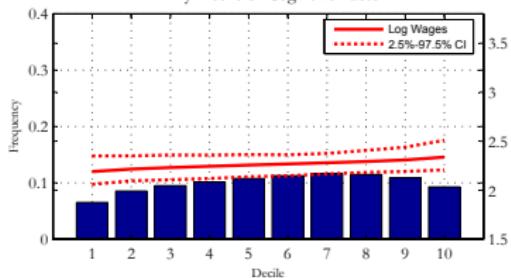


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

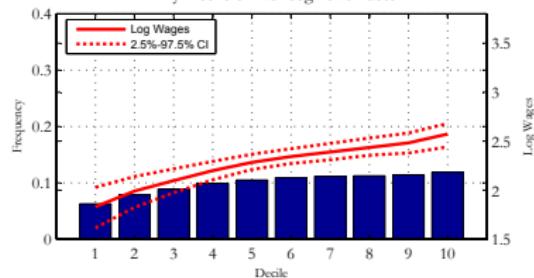
Figure 9B. Mean Log Wages of Some College Attenders by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

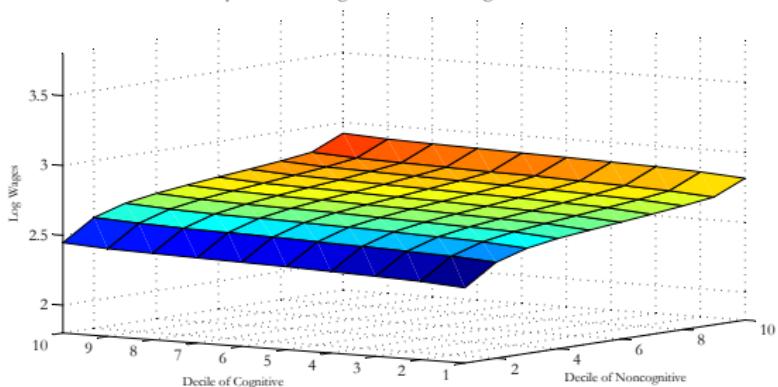


iii. By Decile of Noncognitive Factor

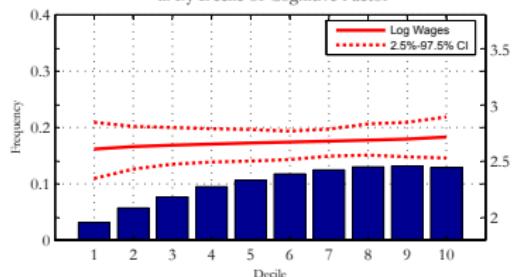


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

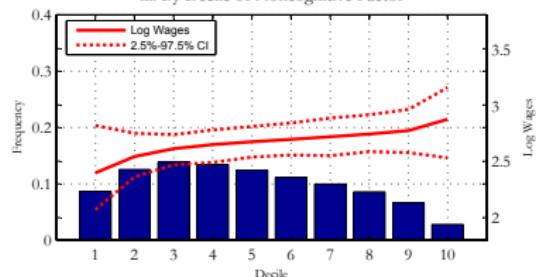
Figure 10A. Mean Log Wages of 2-yr College Graduates by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

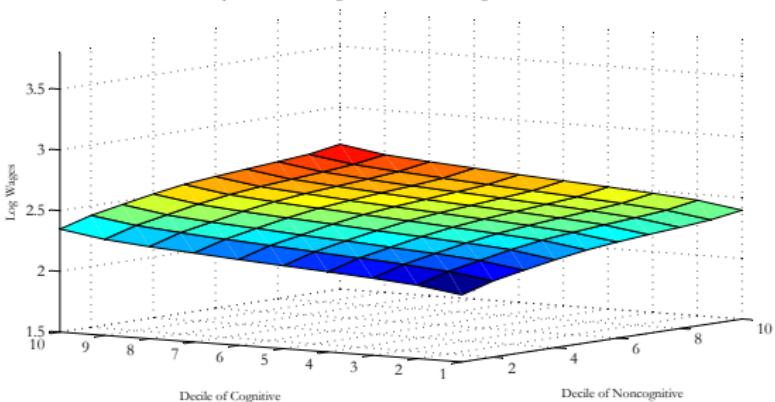


iii. By Decile of Noncognitive Factor

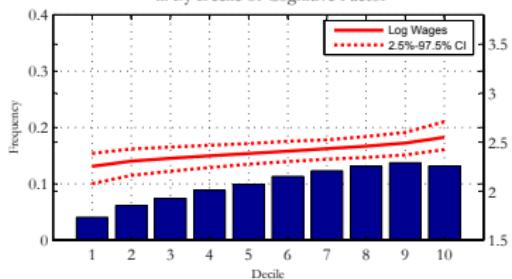


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

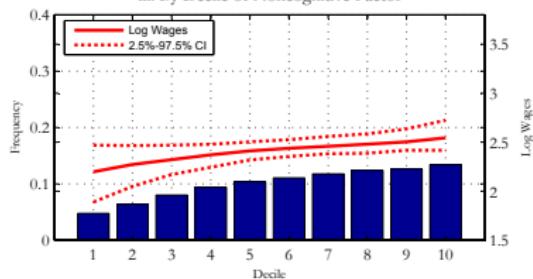
Figure 10B. Mean Log Wages of 2-yr College Graduates by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

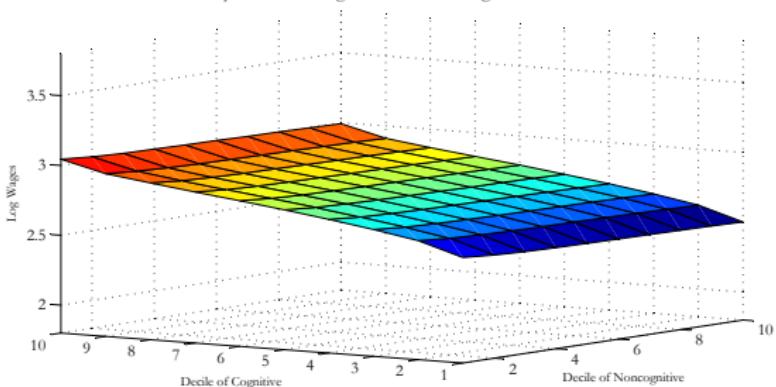


iii. By Decile of Noncognitive Factor

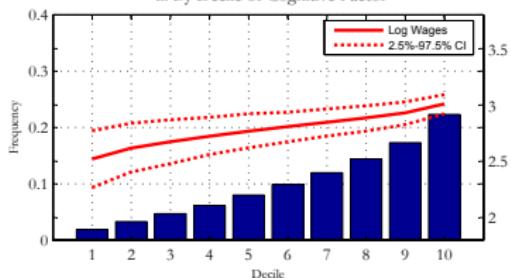


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

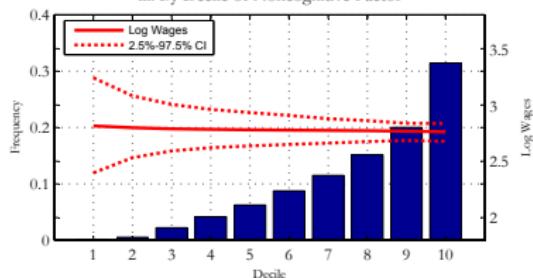
Figure 11A. Mean Log Wages of 4-yr College Graduates by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

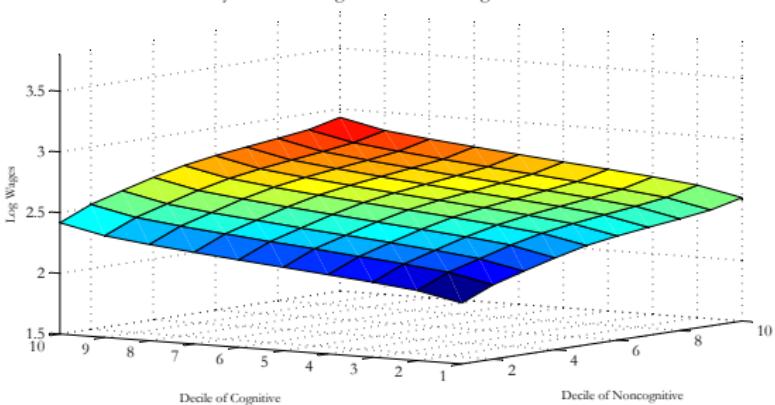


iii. By Decile of Noncognitive Factor

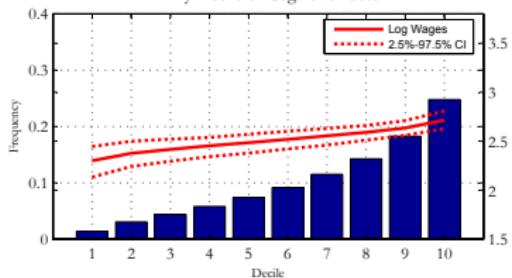


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

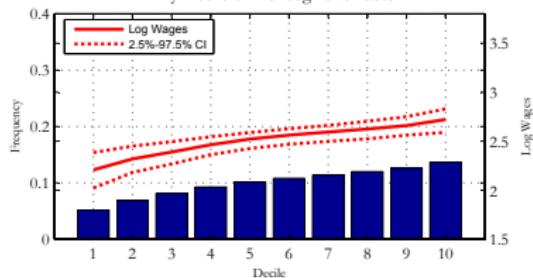
Figure 11B. Mean Log Wages of 4-yr College Graduates by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

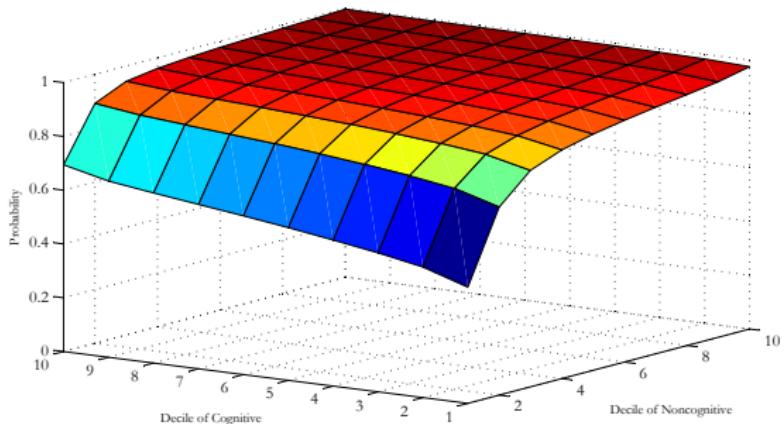


iii. By Decile of Noncognitive Factor

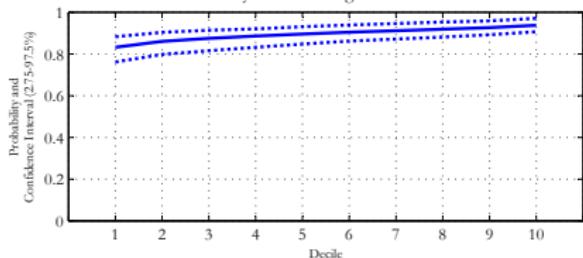


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

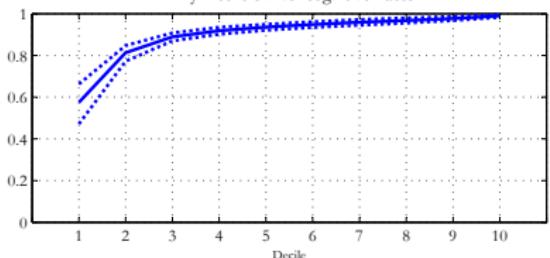
Figure 12A. Probability of Employment at Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

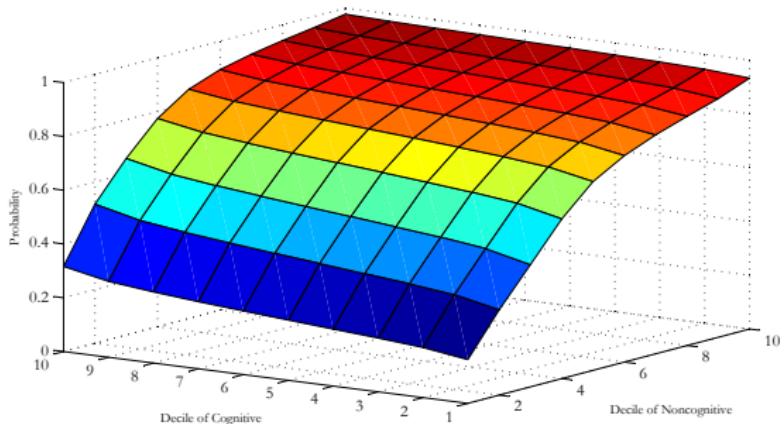


iii. By Decile of Noncognitive Factor

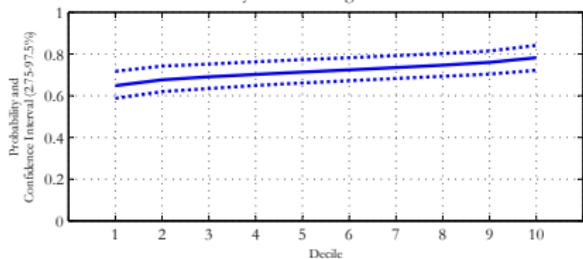


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable.  
 The confidence intervals are computed using bootstrapping (200 draws).

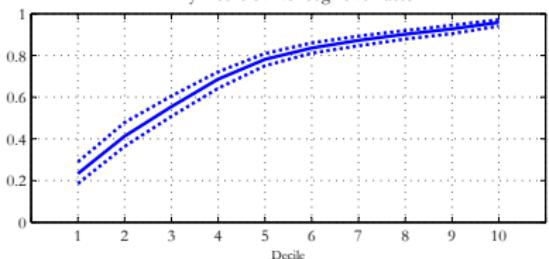
Figure 12B. Probability of Employment at Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

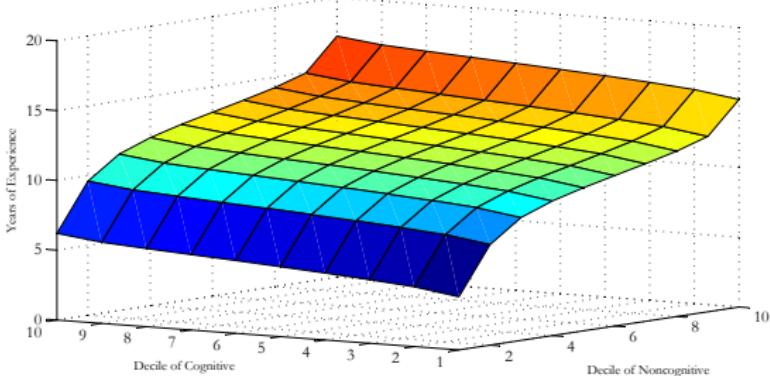


iii. By Decile of Noncognitive Factor

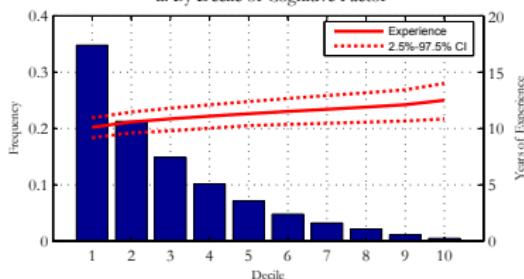


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable.  
 The confidence intervals are computed using bootstrapping (200 draws).

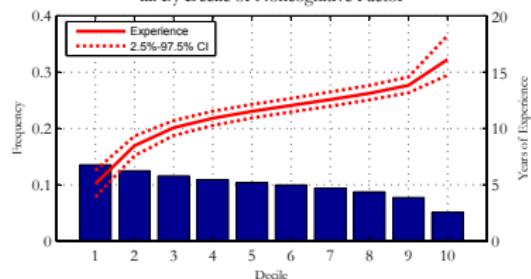
Figure 13A. Mean Work Experience of High School Dropouts by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

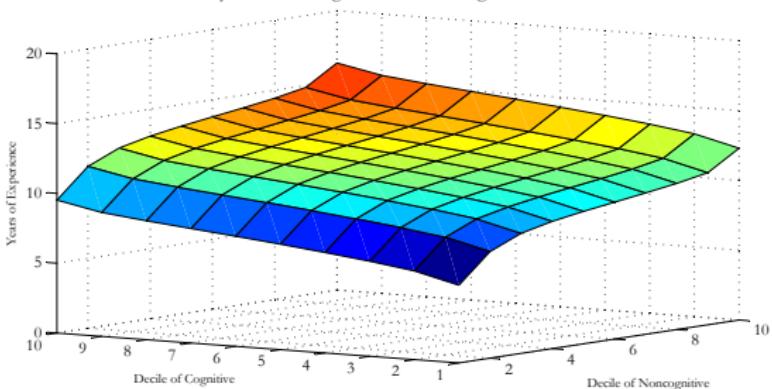


iii. By Decile of Noncognitive Factor

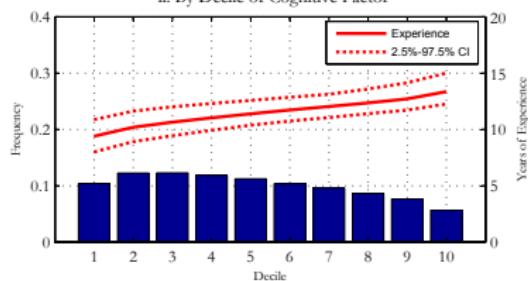


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

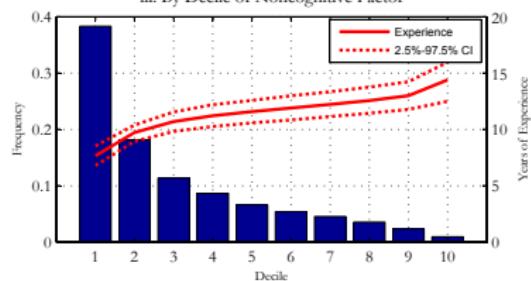
Figure 13B. Mean Work Experience of GEDs by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

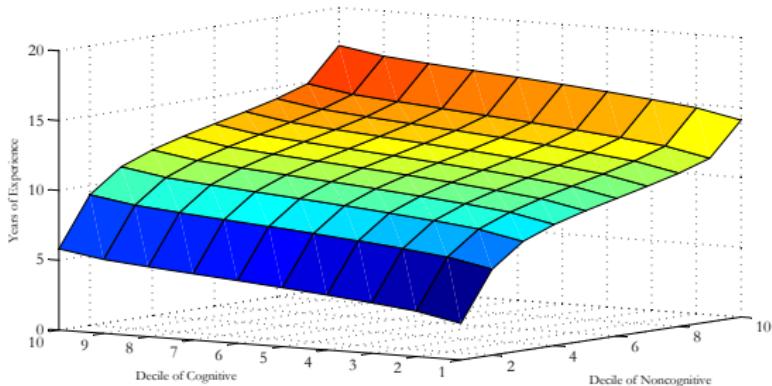


iii. By Decile of Noncognitive Factor

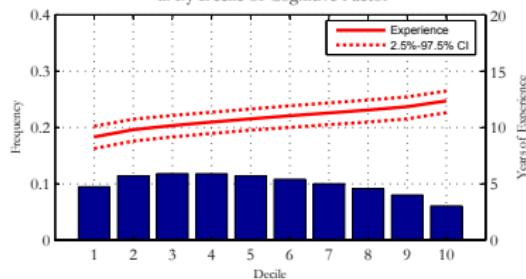


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

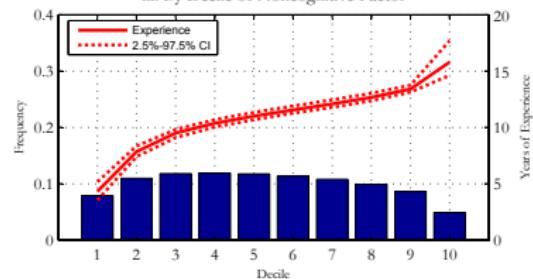
Figure 13C. Mean Work Experience of High School Graduates by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

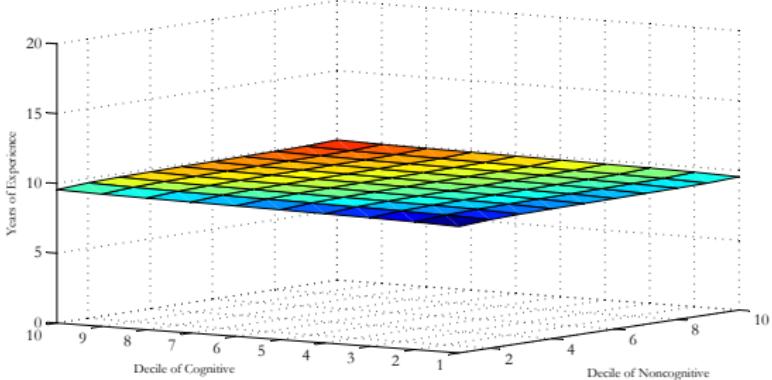


iii. By Decile of Noncognitive Factor

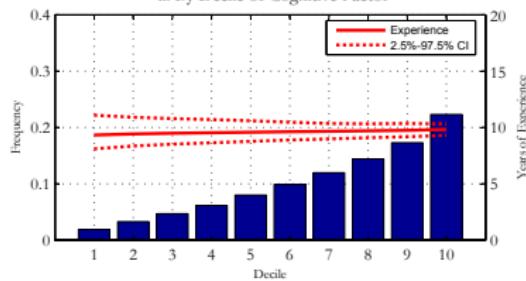


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

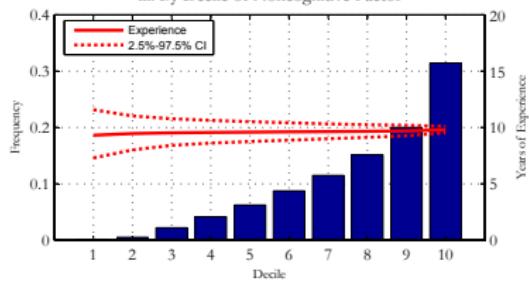
Figure 13D. Mean Work Experience of 4-yr College Graduates by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

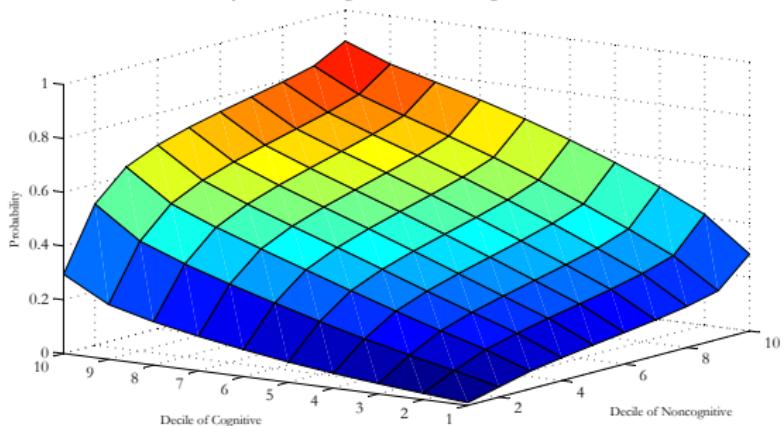


iii. By Decile of Noncognitive Factor

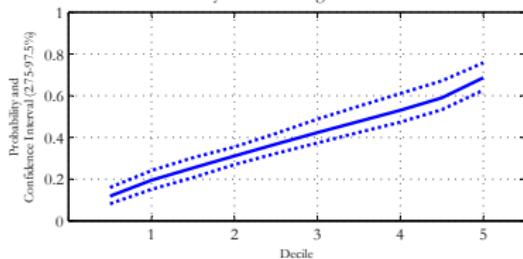


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws). Frequency indicates proportion of individuals with the indicated level of education whose abilities lie in the indicated decile of the distribution.

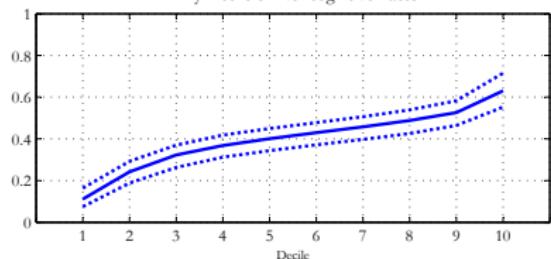
Figure 14A. Probability Of Being a White Collar Worker by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

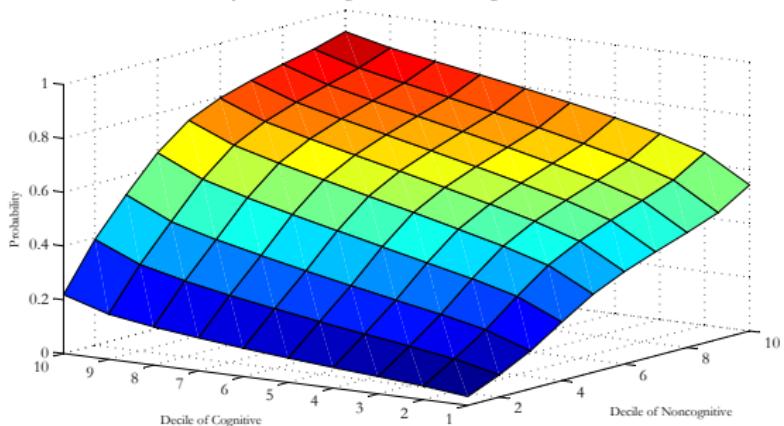


iii. By Decile of Noncognitive Factor

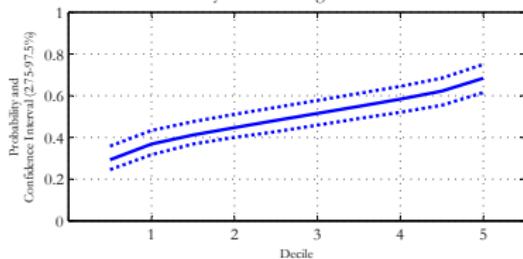


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

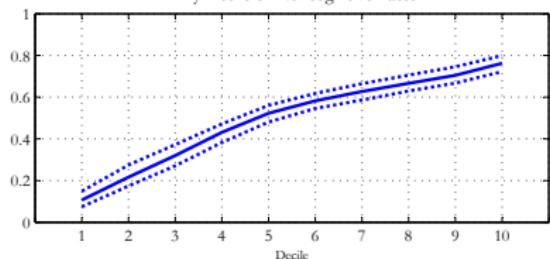
Figure 14B. Probability Of Being a White Collar Worker by Age 30 - Females  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

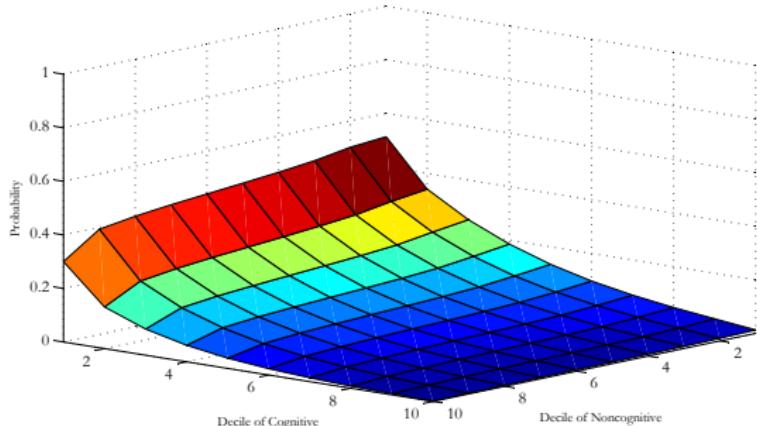


iii. By Decile of Noncognitive Factor

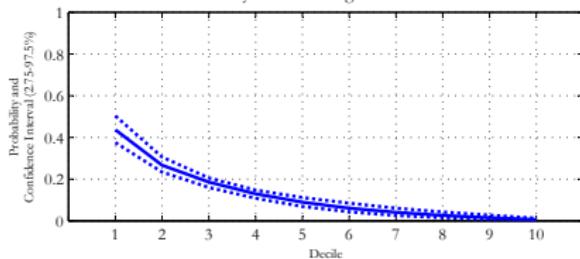


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

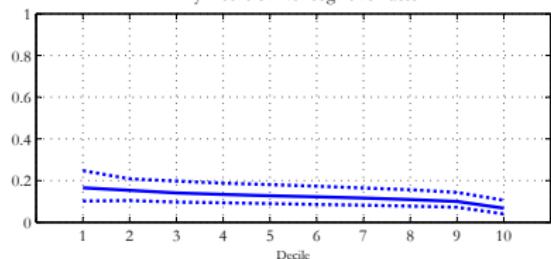
Figure 15. Probability of Being a High School Dropout by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

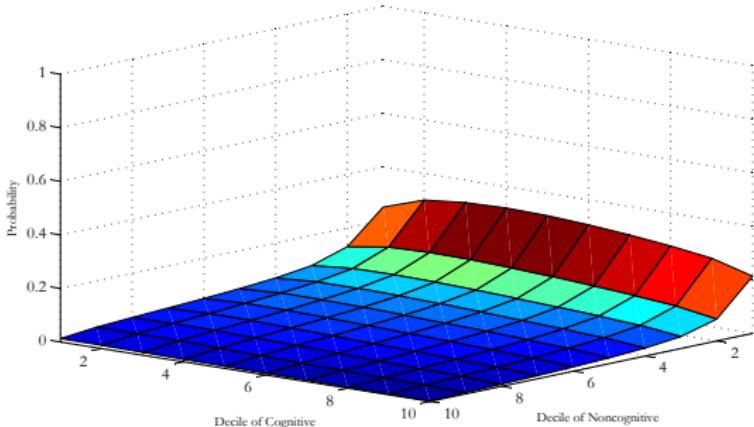


iii. By Decile of Noncognitive Factor

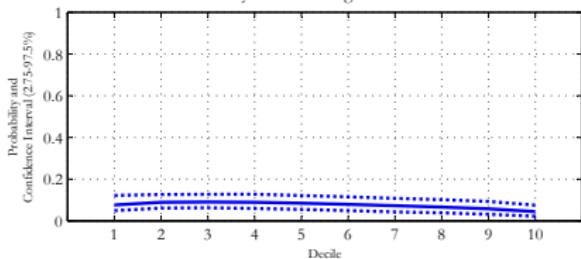


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

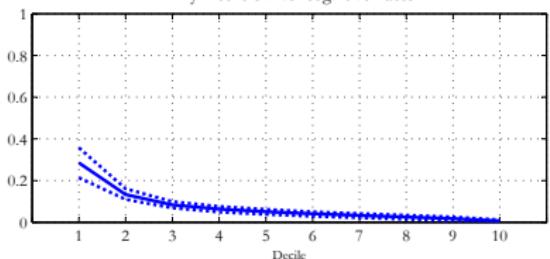
Figure 16. Probability of Being a GED by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

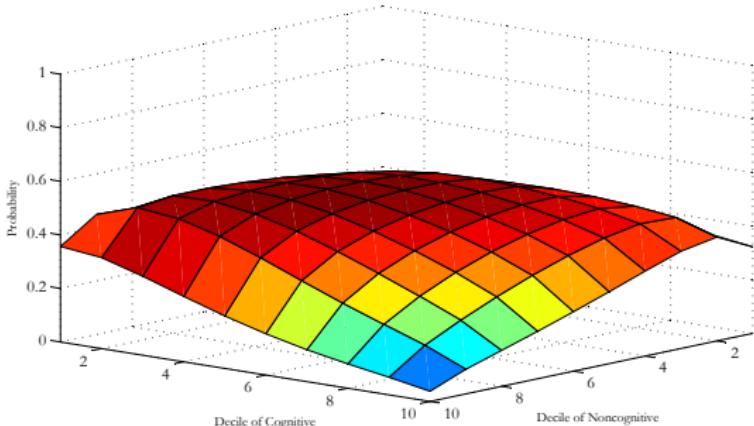


iii. By Decile of Noncognitive Factor

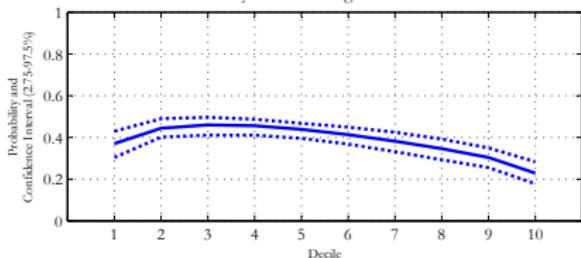


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable.  
 The confidence intervals are computed using bootstrapping (200 draws).

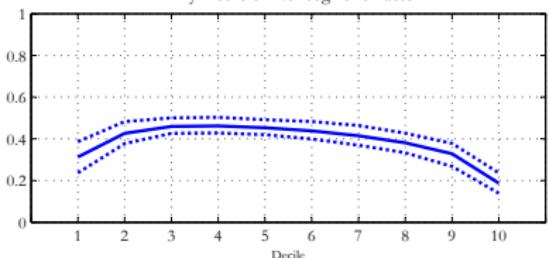
Figure 17. Probability of Being a High School Graduate by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

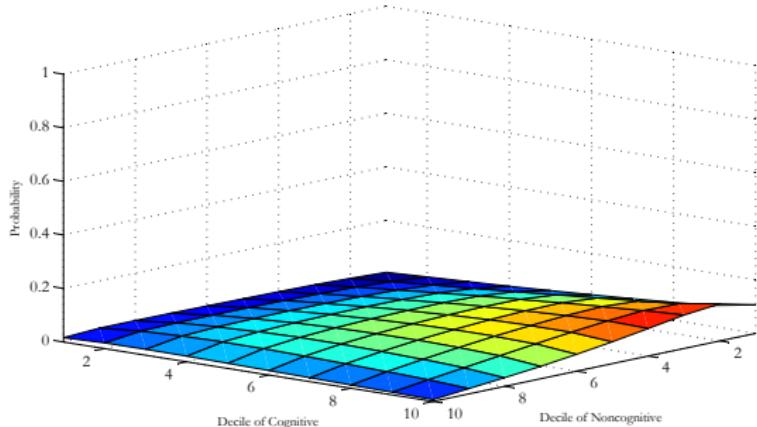


iii. By Decile of Noncognitive Factor

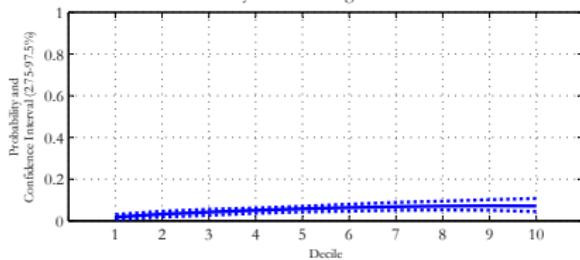


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

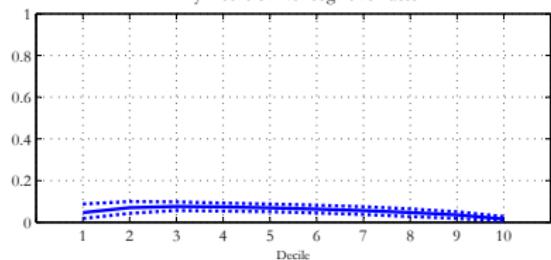
Figure 18. Probability of Being a 2-yr College Graduate by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

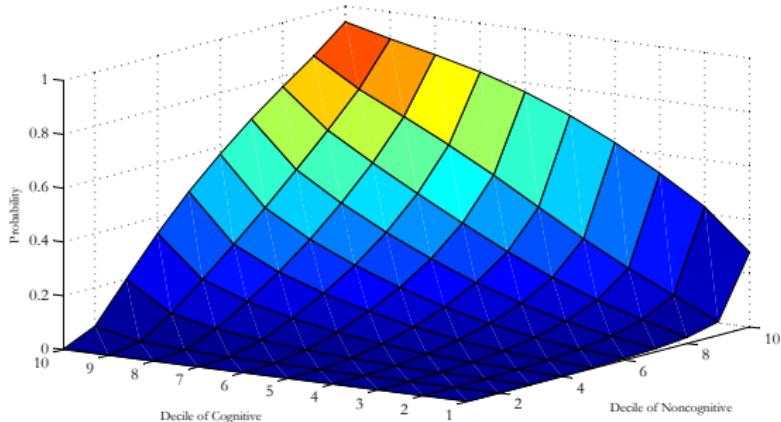


iii. By Decile of Noncognitive Factor

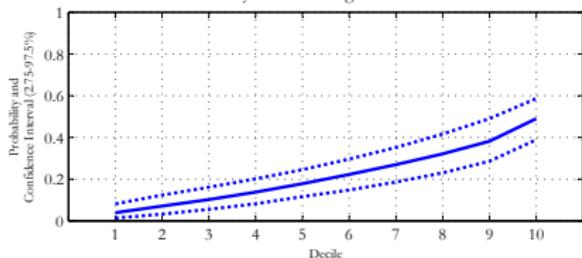


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable.  
 The confidence intervals are computed using bootstrapping (200 draws).

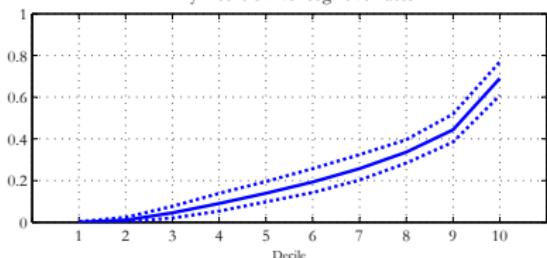
Figure 19. Probability of Being a 4-yr College Graduate by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

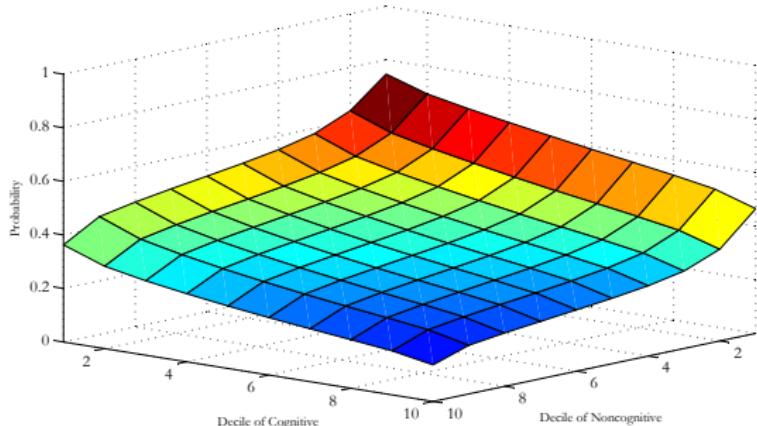


iii. By Decile of Noncognitive Factor

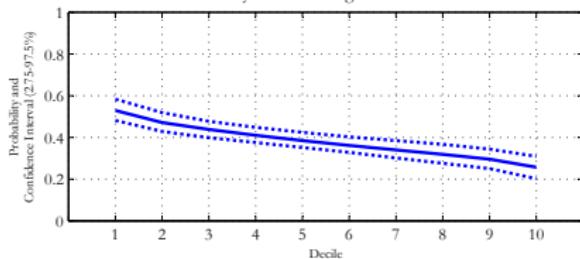


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

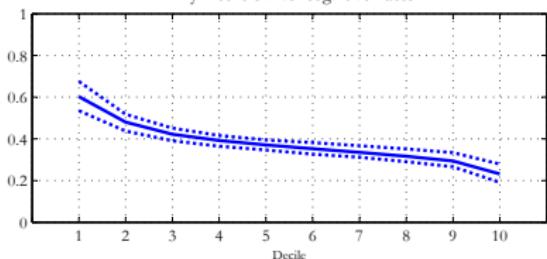
Figure 20A. Probability Of Daily Smoking By Age 18 - Males  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

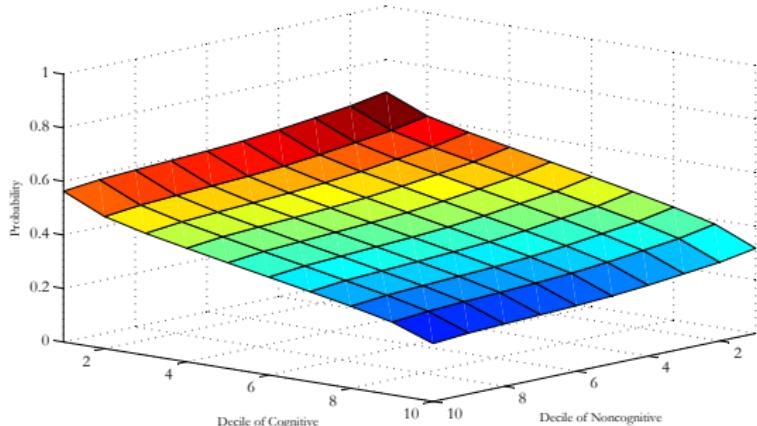


iii. By Decile of Noncognitive Factor

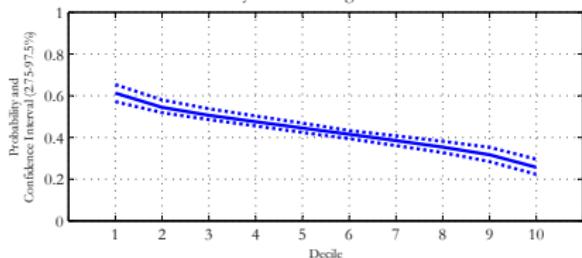


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

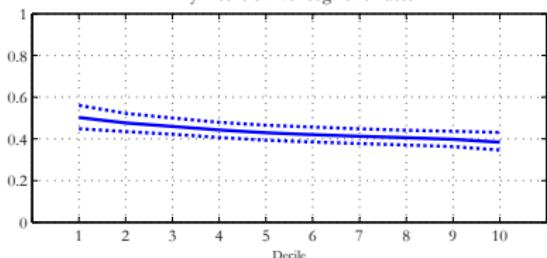
Figure 20B. Probability Of Daily Smoking By Age 18 - Females  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

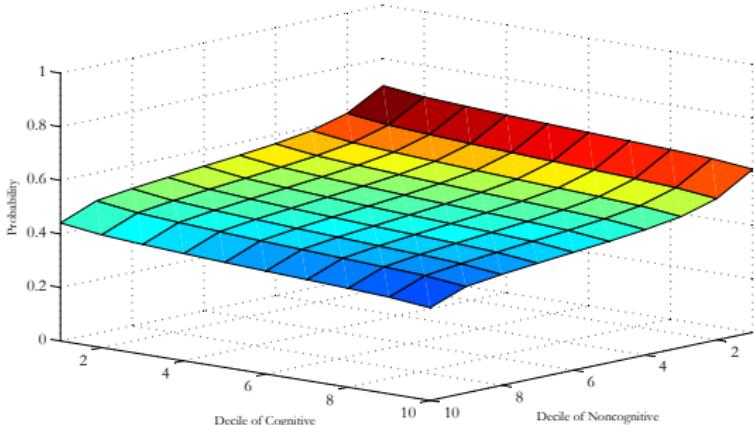


iii. By Decile of Noncognitive Factor

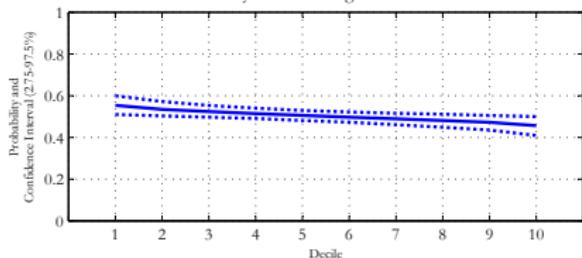


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable.  
 The confidence intervals are computed using bootstrapping (200 draws).

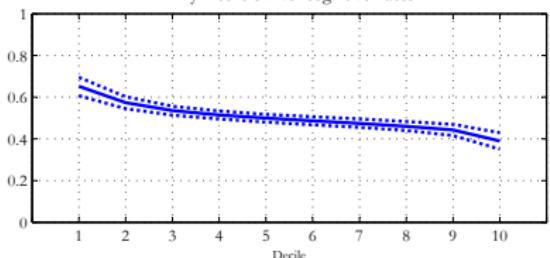
Figure 21. Probability of Smoking Marijuana during the Year 1979 - Males  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

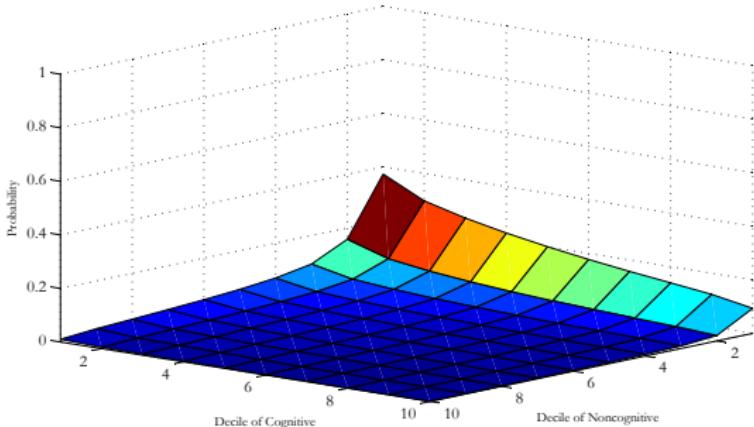


iii. By Decile of Noncognitive Factor

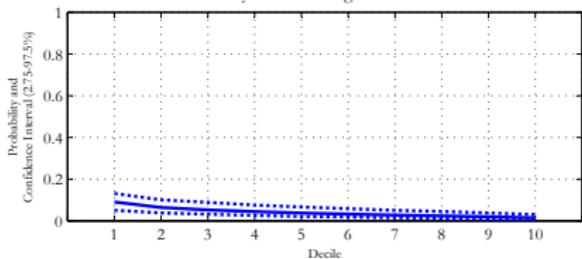


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

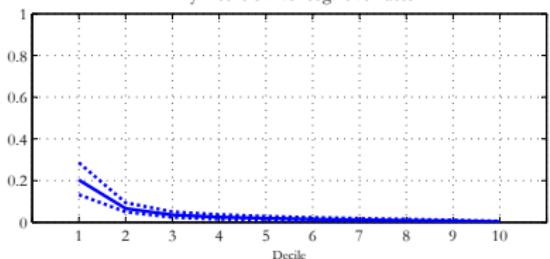
Figure 22. Probability of Incarceration by Age 30 - Males  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

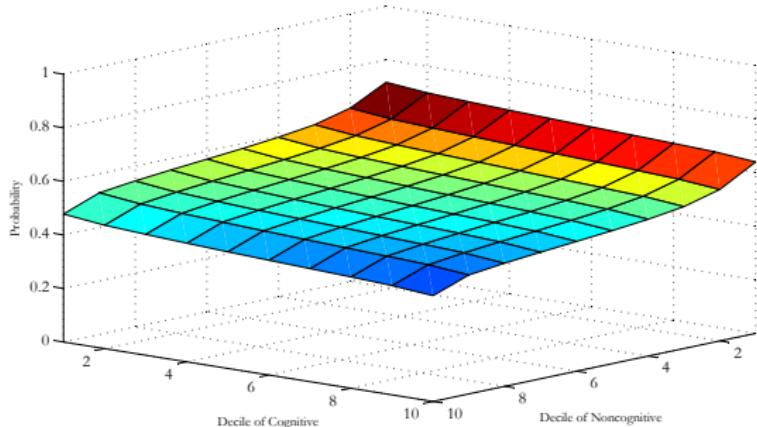


iii. By Decile of Noncognitive Factor

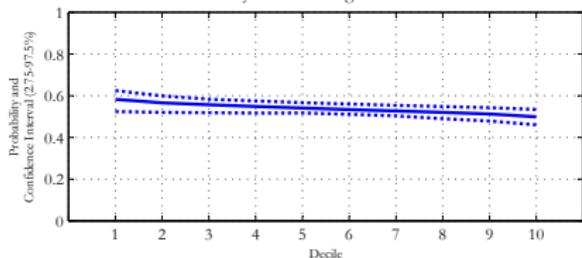


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

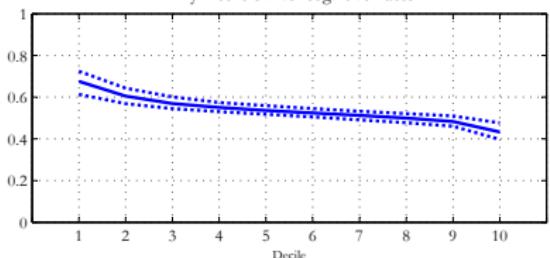
Figure 23. Probability of Participating in Illegal Activities during the Year 1979- Males  
 i. By Decile of Cognitive and Noncognitive Factor



ii. By Decile of Cognitive Factor

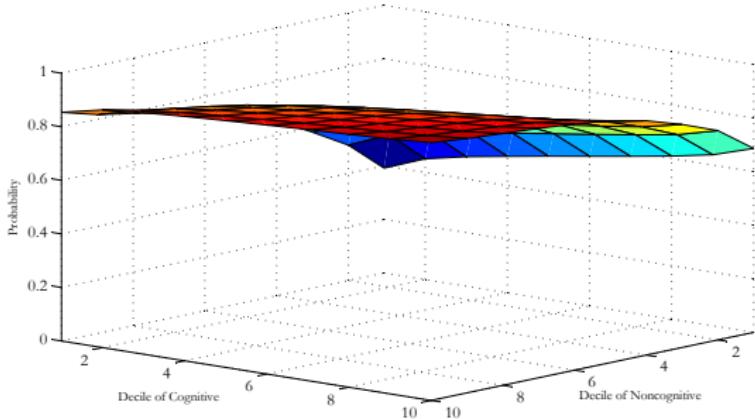


iii. By Decile of Noncognitive Factor

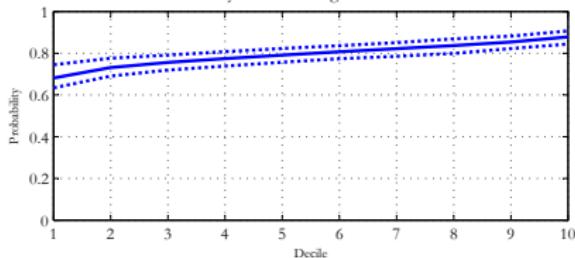


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable.  
 The confidence intervals are computed using bootstrapping (200 draws).

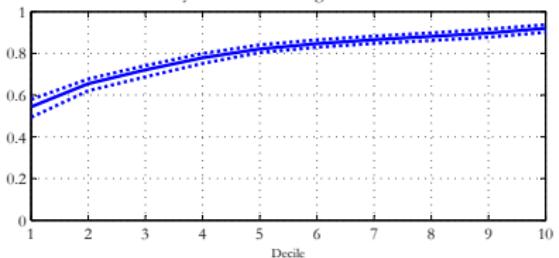
Figure 24. Probability Of Being Single With No Child at Age 18 - Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor

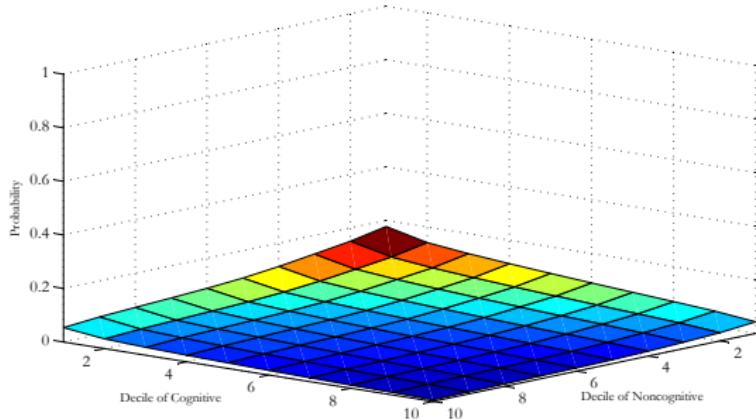


iii. By Decile of Noncognitive Factor

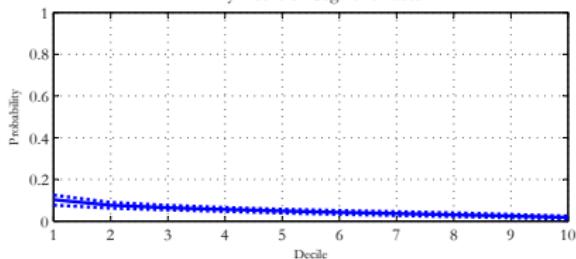


Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

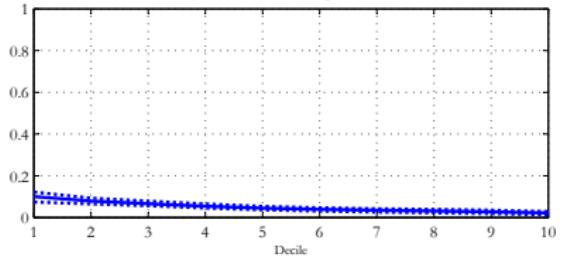
Figure 25. Probability Of Being Single With Child at Age 18- Females  
 i. By Decile of Cognitive and Noncognitive Factors



ii. By Decile of Cognitive Factor



iii. By Decile of Noncognitive Factor



Notes: The data are simulated from the estimates of the model and our NLSY79 sample. We use the standard convention that higher deciles are associated with higher values of the variable. The confidence intervals are computed using bootstrapping (200 draws).

# Estimation of Dynamic Discrete Choice Models by Maximum Likelihood and Simulated Method of Moments

**Fit** structural model to  
*observed* data.

$$\xrightarrow{\text{---}} \hat{\psi}^{obs}$$

**Simulate** synthetic dataset  
using estimates.

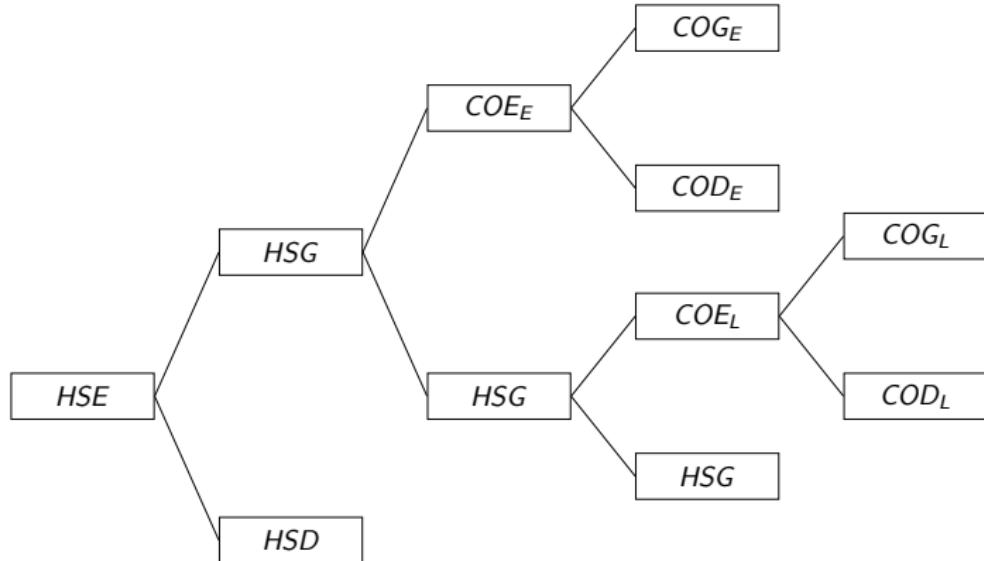
Compare

**Fit** structural model to  
*synthetic* data.

$$\xrightarrow{\text{---}} \hat{\psi}^{syn}$$

# Model

Figure: Decision Tree



## Agent Behavior

- ▶ Objective
- ▶ Constraints
  - ▶ Institution
  - ▶ Information

## Value Function

$$V(s | \mathcal{I}(s)) = Y(s) +$$

$$\max_{s' \in \Omega(s)} \left\{ \frac{1}{1+r} \left( -C(s', s) + \mathbb{E}[V(s' | \mathcal{I}(s')) | \mathcal{I}(s)] \right) \right\}$$

## Policy Function

$$s' = \begin{cases} \hat{s}' & \text{if } \mathbb{E}[V(\hat{s}') | \mathcal{I}(s)] - C(\hat{s}', s) > \mathbb{E}[V(\tilde{s}') | \mathcal{I}(s)] \\ \tilde{s}' & \text{otherwise} \end{cases}$$

## Objects of Interest

- ▶ Net Return
- ▶ Gross Return

## Net Return

$$NR(\hat{s}', \tilde{s}', s) = \frac{\mathbb{E} [V(\hat{s}') - V(\tilde{s}') \mid \mathcal{I}(s)] - C(\hat{s}', s)}{\mathbb{E} [V(\tilde{s}') \mid \mathcal{I}(s)]}$$

## Gross Return

$$GR(\hat{s}', \tilde{s}', s) = \frac{\mathbb{E} [\tilde{V}(\hat{s}') - \tilde{V}(\tilde{s}') \mid \mathcal{I}(s)]}{\mathbb{E} [\tilde{V}(\tilde{s}') \mid \mathcal{I}(s)]}$$

## Parametrization

- ▶ Benefits
- ▶ Costs
- ▶ Measurements

## Functional Forms

$$Y(s) = X(s)' \beta_s + \theta' \alpha_s + \epsilon(s) \quad \forall s \in \mathcal{S}$$

$$C(\hat{s}', s) = Q(\hat{s}', s)' \delta_{\hat{s}', s} + \theta' \varphi_{\hat{s}', s} + \eta(\hat{s}', s) \quad \forall s \in \mathcal{S}^c$$

$$M(j) = X(j)' \kappa_j + \theta' \gamma_j + \nu(j) \quad \forall j \in M$$

## Distributions of Unobservables

$$\theta \sim \mathcal{N}(0, \sigma_\theta) \quad \forall \theta \in \Theta$$

$$\epsilon(s) \sim \mathcal{N}(0, \sigma_{\epsilon(s)}) \quad \forall s \in \mathcal{S}$$

$$\eta(\hat{s}', s) \sim \mathcal{N}(0, \sigma_{\eta(\hat{s}', s)}) \quad \forall s \in \mathcal{S}^c$$

$$\nu(j) \sim \mathcal{N}(0, \sigma_{\nu(j)}) \quad \forall j \in \mathcal{M}$$

## Individual Likelihood

$$\int_{\Theta} \left[ \underbrace{\prod_{j \in M} f(M(j) \mid D, \theta; \psi)}_{\text{Measurement}} \times \right. \\ \left. \prod_{s \in S} \left\{ \underbrace{f(Y(s) \mid D, \theta; \psi)}_{\text{Outcome}} \underbrace{\Pr(G(s) = 1 \mid D, \theta; \psi)}_{\text{Transition}} \right\}^{1\{s \in \Gamma\}} \right] dF(\theta)$$

# Results

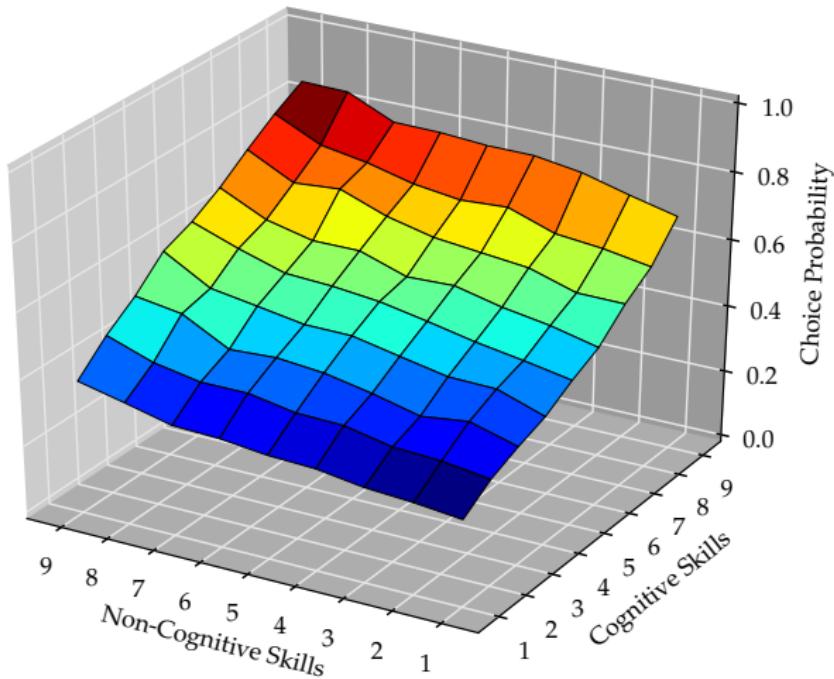
Table: Cross Section Model Fit

State	Average Earnings		State Frequencies	
	Observed	ML	Observed	ML
High School Graduates	4.29	3.84	0.30	0.32
High School Dropouts	2.29	2.59	0.17	0.14
Early College Graduates	6.73	7.46	0.29	0.29
Early College Dropouts	4.55	3.87	0.12	0.12
Late College Graduates	4.84	6.22	0.06	0.07
Late College Dropouts	4.89	4.88	0.06	0.06

## Objects of Interest

- ▶ Choice Probabilities
- ▶ Gross Return
- ▶ Net Return
- ▶ Schooling Attainment

Figure: Choice Probability, Early College Enrollment



**Figure: Gross Return, Early College Enrollment**

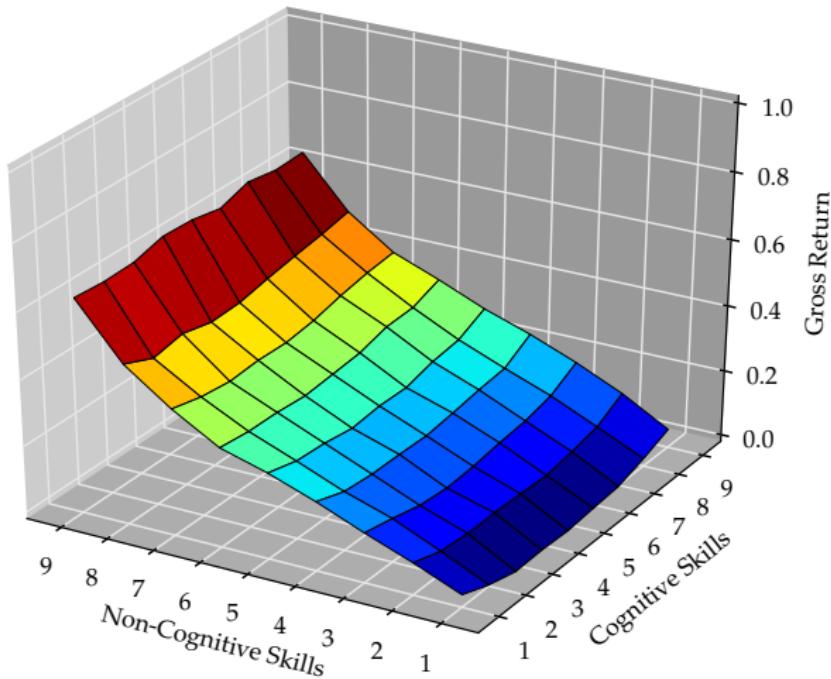


Figure: Net Return, Early College Enrollment

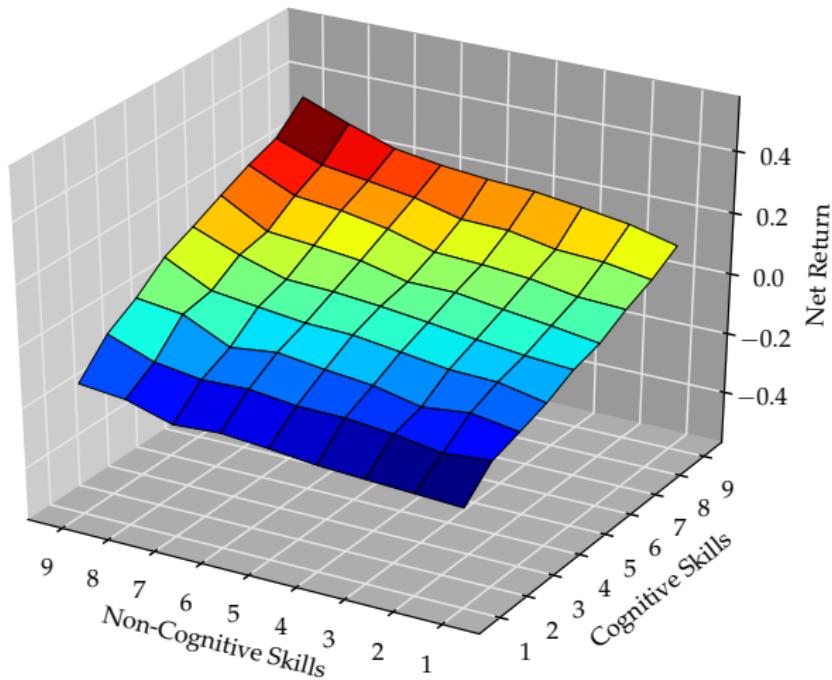
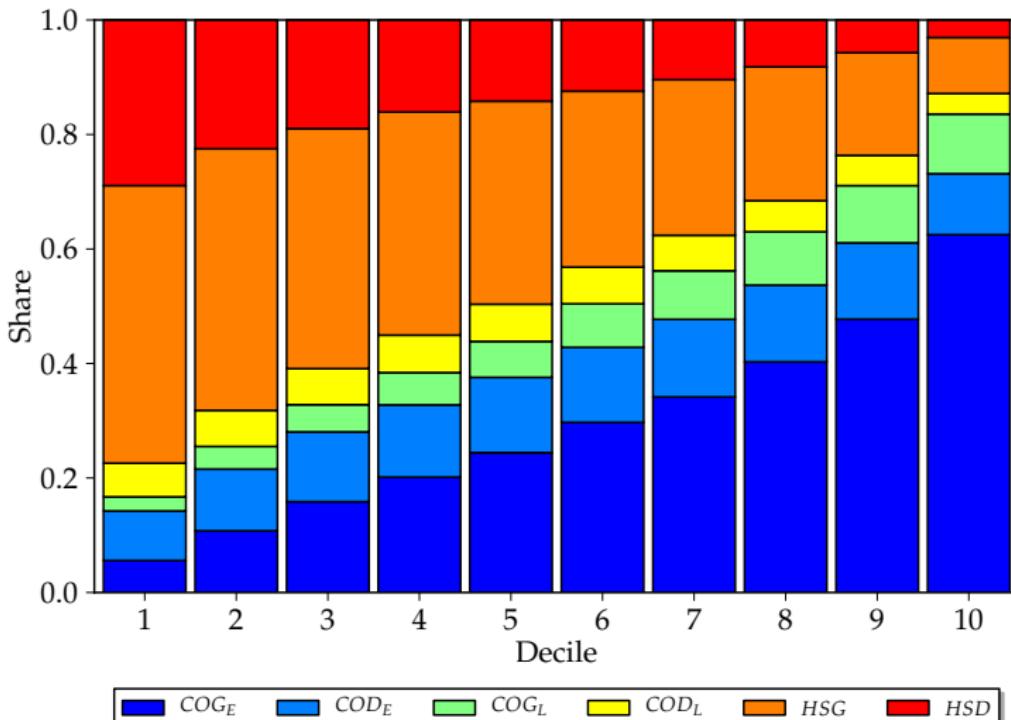
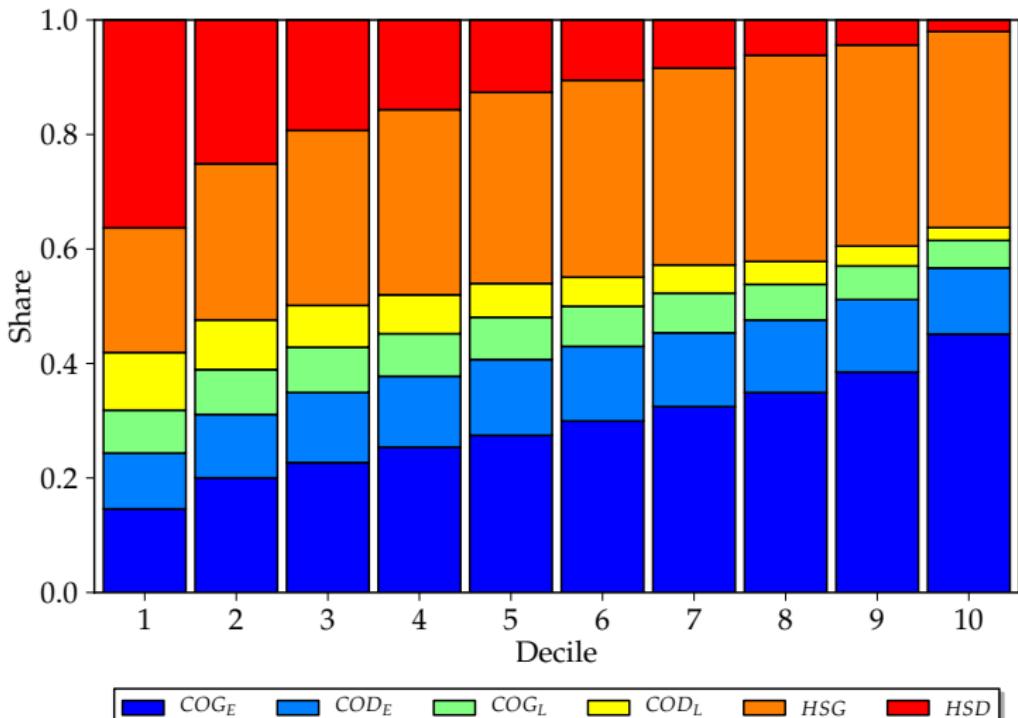


Figure: Schooling Attainment by Cognitive Skills



**Figure:** Schooling Attainment by Non-Cognitive Skills



# Monte Carlo Study

Synthetic Agents	5,000
Structural Parameters	192
Free Parameters	138

# Simulated Method of Moments

## Criterion Function

$$\arg \min_{\psi} \Lambda(\psi) = [\check{f} - \hat{f}(\psi)]' W^{-1} [\check{f} - \hat{f}(\psi)]$$

, where  $\hat{f}(\psi) = \frac{1}{R} \sum_{r=1}^R \hat{f}_r(u_r; \psi)$

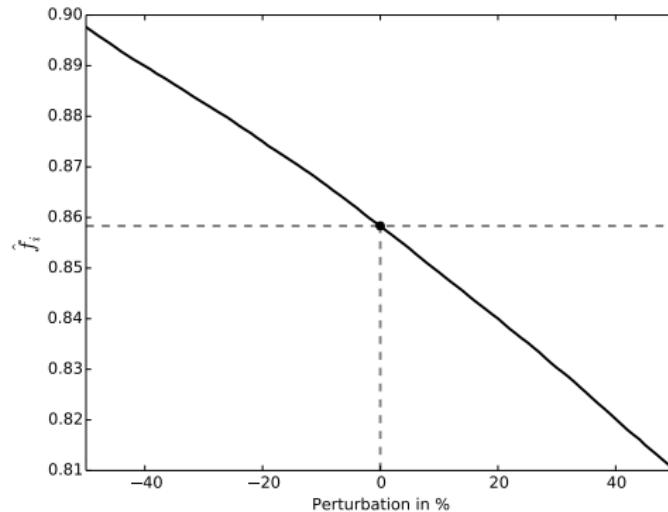
Number of Moments	250
Number of Replications	50
Weighting Matrix	Diagonal Matrix with Variances
Optimization Algorithm	TAO POUNDerS

## *Moment Conditions*

- ▶ Benefit Equations
  - ▶ Means
  - ▶ Standard Deviations
  - ▶ Ordinary Least Squares Models
- ▶ Cost Equations
  - ▶ State Frequencies
  - ▶ Linear Probability Models

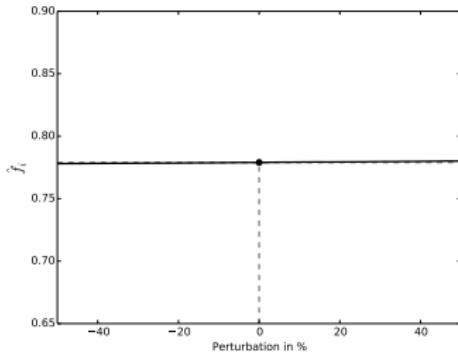
## *Parameter Perturbations*

**Figure:** Parameter Perturbation, Cost

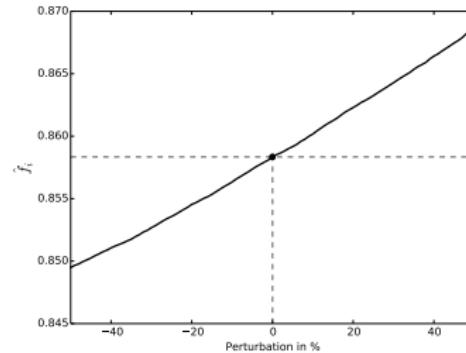


High School Graduation, State Frequency

**Figure:** Parameter Perturbation, Benefit



HS Graduates, Average Wages



HS Graduation, State Frequency

## *Model Fit*

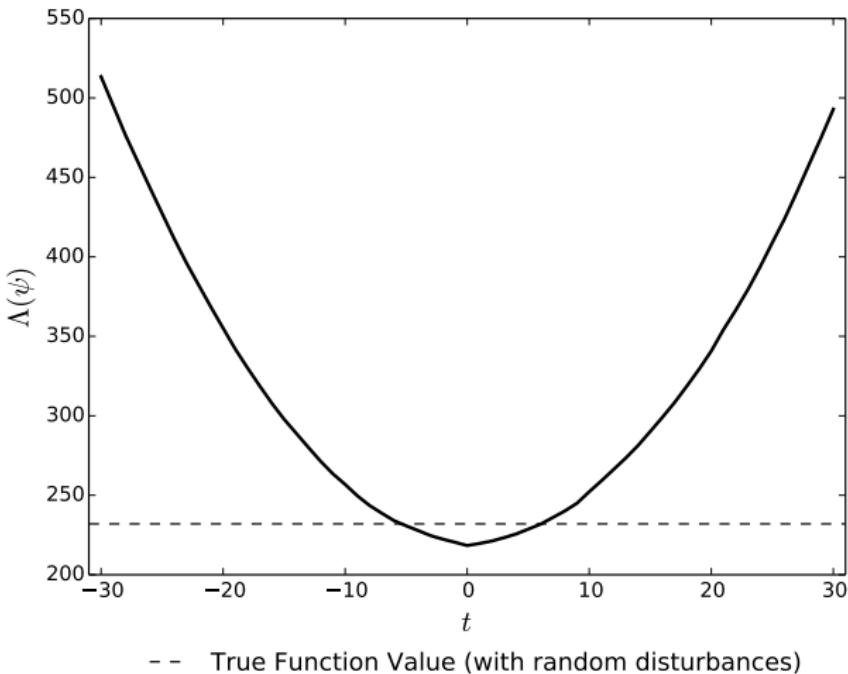
Table: Cross Section Model Fit

State	Average Earnings		
	True	ML	SMM
High School Graduates	3.87	3.87	3.86
High School Dropouts	2.51	2.52	2.53
Early College Graduates	6.80	6.78	6.86
Early College Dropouts	3.90	3.95	3.92
Late College Graduates	6.03	6.14	6.24
Late College Dropouts	5.10	5.07	5.08
RMSE		0.05	0.07

Table: Cross Section Model Fit

State	State Frequencies		
	True	ML	SMM
High School Graduates	0.32	0.32	0.33
High School Dropouts	0.14	0.14	0.13
Early College Graduates	0.29	0.29	0.29
Early College Dropouts	0.12	0.12	0.13
Late College Graduates	0.07	0.07	0.05
Late College Dropouts	0.06	0.06	0.07
RMSE	0.00	0.00	

Figure: Function Value



## *Economic Implications*

Table: Economic Implications

State	Gross Return		
	True	ML	SMM
High School Graduation	30%	41%	42%
Early College Graduation	88%	96%	96%
Late College Graduation	29%	28%	36%
RMSE		0.09	0.13

Table: Economic Implications

State	Net Return		
	True	ML	SMM
High School Graduation	63%	61%	212%
Early College Graduation	57%	51%	125%
Late College Graduation	14%	12%	38%
RMSE	0.05	0.75	

Table: Standard Deviations

$\hat{\sigma}_{\eta_{(\hat{s}', s)}}$			
State	True	ML	SMM
High School Graduation	0.27	0.24	0.85
Early College Graduation	0.61	0.59	1.49
Late College Graduation	0.61	0.59	1.49
RMSE	0.01	0.68	

# Tuning Parameters

- ▶ Moment Conditions
- ▶ Replications
- ▶ Optimization Algorithm

## *Moment Conditions*

**Table:** Set of Moments

Sets	<i>Dynamic (Panel) Moments</i>			<i>Cross Section Moments</i>
	Base	Alt. A	Alt. B	Base
<b>Benefit Models</b>				
Means	✓	✓	✓	✓
Standard Deviations	✓	✓	✓	✓
Ordinary Least Squares	✓	✓	✓	✓
Correlations			✓	
<b>Choice Models</b>				
State Frequencies	✓	✓	✓	✓
Linear Probability				
- cross section				✓
- dynamic	✓	✓	✓	
Probit				
- dynamic	✓	✓		
Correlations			✓	

**Table:** Set of Moments

Sets	<i>Dynamic (Panel) Moments</i>			<i>Cross Section Moments</i>
	Base	Alt. A	Alt. B	Base
<b>Overall Statistics</b>				
Number of Moments	250	339	545	222
Number of Replications	50	50	50	50
Weighting Matrix	Diagonal Matrix with Variances			
Optimization Algorithm	TAO POUNDeRS			
<b>Quality of Fit Measures</b>				
$\Lambda(\hat{\psi})$	218.32	277.80	447.60	632.07
$\Lambda(\psi^*)$	232.66	291.56	471.95	215.12

Table: Robustness of Economic Implications

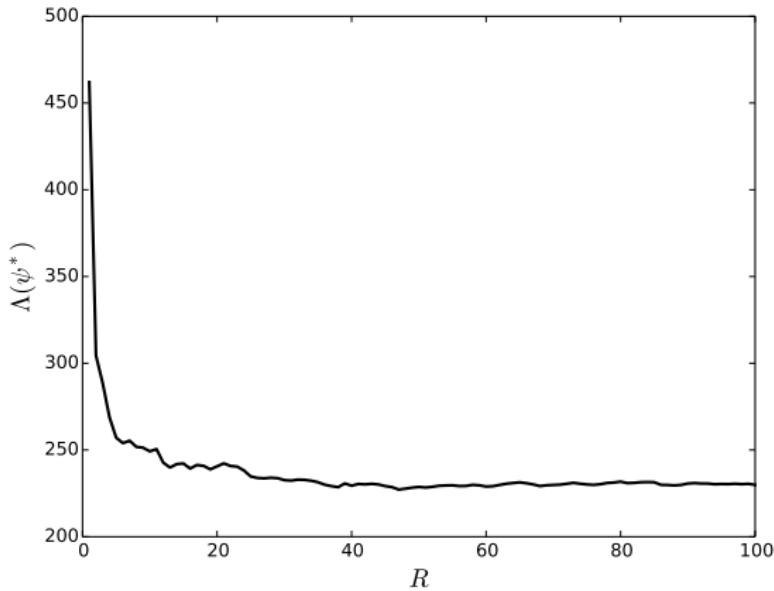
State	<i>Dynamic (Panel) Moments</i>			
	True	Base	Alt. A	Alt. B
Gross Return				
High School Graduation	30%	42%	37%	37%
Early College Graduation	88%	96%	72%	73%
Late College Graduation	29%	36%	18%	18%
Net Return				
High School Graduation	63%	212%	203%	194%
Early College Graduation	57%	125%	107%	112%
Late College Graduation	14%	38%	30%	35%

Table: Robustness of Economic Implications

State	<i>Cross Section Moments</i>	
	True	Base
Gross Return		
High School Graduation	30%	16%
Early College Graduation	88%	57%
Late College Graduation	29%	16%
Net Return		
High School Graduation	63%	215%
Early College Graduation	57%	79%
Late College Graduation	14%	26%

## *Replications*

**Figure:** Role of Replications



## *Optimization Algorithm*

# TAO POUNDerS

## Practical Optimization Using No Derivatives for Sums of Squares

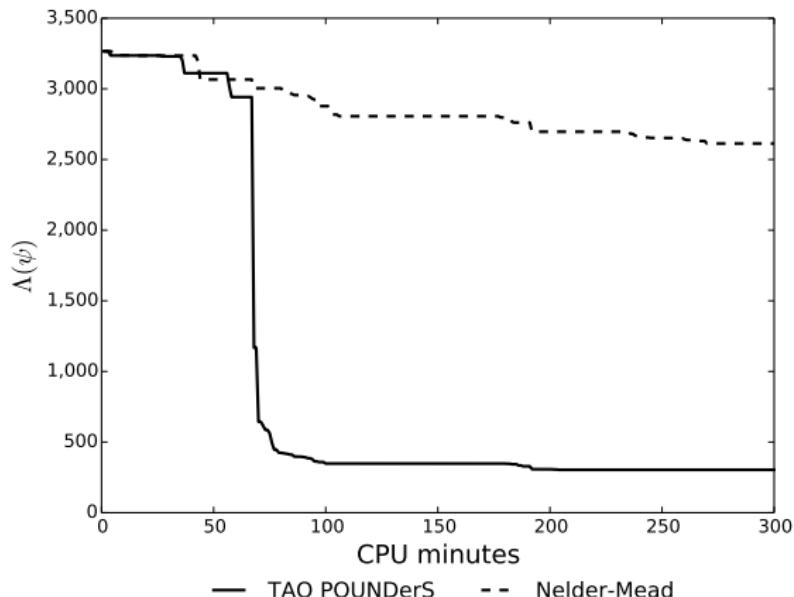
### *Nonlinear Least-Squares*

$$\Lambda(\psi) = \sum_{i=1}^I \bar{f}_i(\psi)^2 = \sum_{i=1}^I \left( \frac{\check{f}_i - \hat{f}_i(\psi)}{\hat{\sigma}_i} \right)^2$$

### *Derivative-Free Trust-Region Algorithm*

$$\min\{m_k(\psi) : \|\psi - \psi_k\|_\infty \leq \Delta_k\}$$

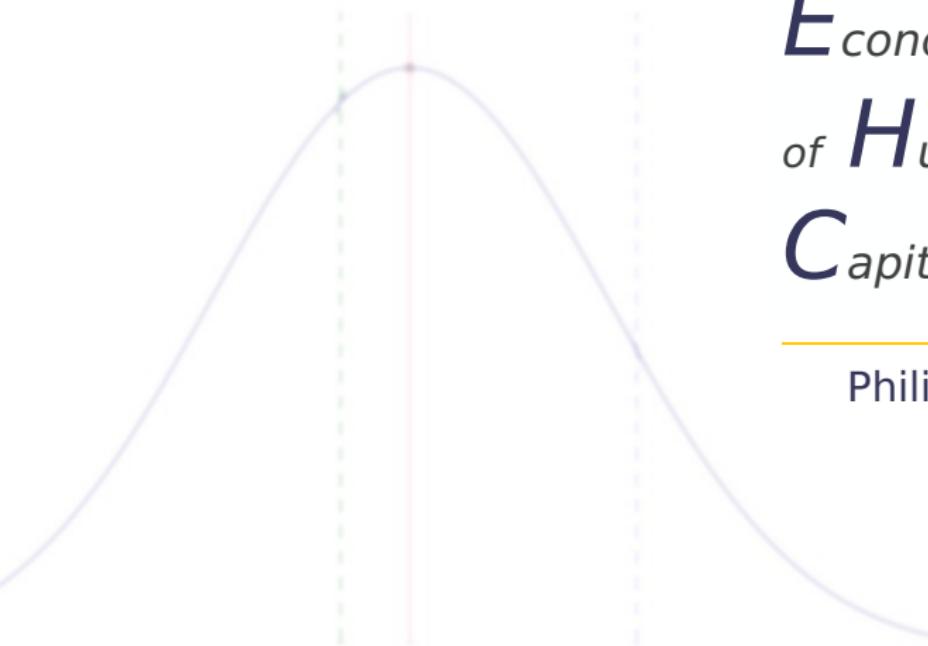
Figure: Optimization Algorithms



# **Appendix**

# *References*

- Becker, G. S. (1964). *Human capital* (1st ed.). New York City, NY: Columbia University Press.
- Eisenhauer, P., Heckman, J. J., & Mosso, S. (2015). Estimation of dynamic discrete choice models by maximum likelihood and the simulated method of moments. *International Economic Review*, 56(2), 331–357.
- Heckman, J. J., Stixrud, J., & Urzua, S. (2006). The effects of cognitive and noncognitive abilities on labor market outcomes and social behavior. *Journal of Labor Economics*, 24(3), 411–482.



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# Economics of Human Capital

Static model of educational choice

Philipp Eisenhauer

# **Introduction**



## **Heckman (2008) defines three policy evaluation tasks:**

- ▶ Evaluating the impact of historical interventions on outcomes including their impact in terms of well-being of the treated and the society at large.
- ▶ Forecasting the impact of historical interventions implemented in one environment in other environments, including their impact in terms of well-being.
- ▶ Forecasting the impacts of interventions never historically experienced to various environments, including their impact on well-being.

## **Econometrics of policy evaluation**

- ▶ is important
- ▶ is complicated
- ▶ is multifaceted

## **Numerous applications**

- ▶ labor economics
- ▶ development economics
- ▶ industrial economics
- ▶ health economics

## **Numerous effects**

- ▶ conventional average effects
- ▶ policy-relevant average effects
- ▶ marginal effects
- ▶ distributional effects
- ▶ effects on distributions

## **Numerous estimation strategies**

- ▶ instrumental variables
- ▶ (quasi-)experimental methods
- ▶ matching

# **Model**

## Generalized Roy model

Potential Outcomes

$$Y_1 = \mu_1(X) + U_1$$

$$Y_0 = \mu_0(X) + U_0$$

Observed Outcome

$$Y = DY_1 + (1 - D)Y_0$$

Choice

$$D = I[S > 0]$$

$$S = \mu_D(X, Z) - V$$

- ▶  $S$  is the overall surplus from treatment participation
- ▶  $V$  captures the individual's unobservable dislike of treatment

# *Individual Heterogeneity*

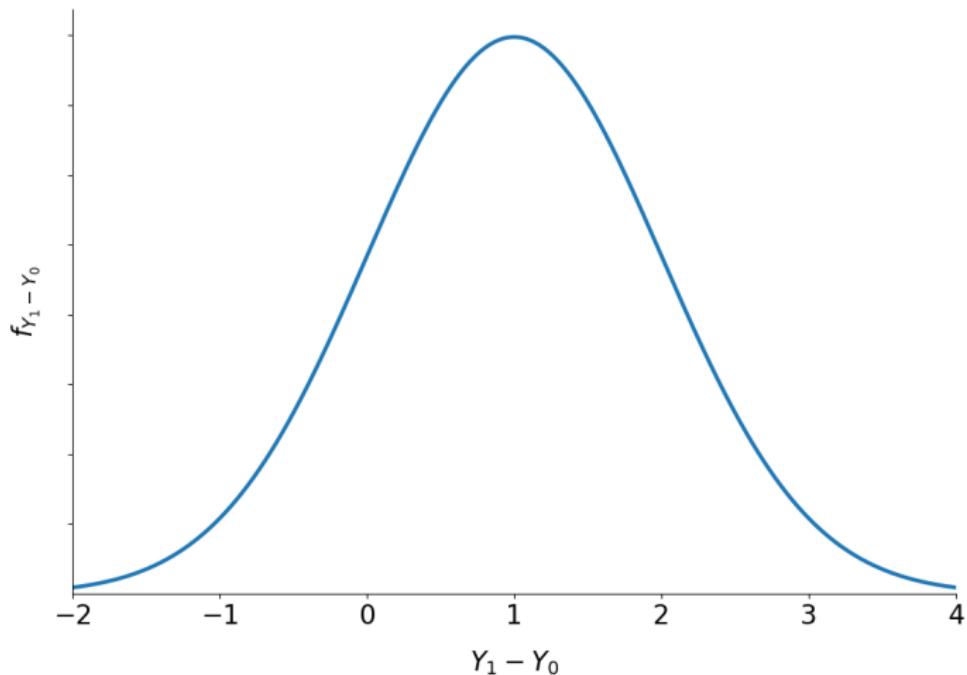
Individual-specific benefit of treatment

$$Y_1 - Y_0 = (\mu_1(X) - \mu_0(X)) + (U_1 - U_0)$$

## Sources of Heterogeneity

- ▶ Difference in observables
- ▶ Difference in unobservables
  - ▶ Uncertainty
  - ▶ Private information

Figure: Distribution of benefits



## Econometric problems

- ▶ **Evaluation problem**, we only observe an individual in either the treated or untreated state.
- ▶ **Selection problem**, individuals that select into treatment differ from those that do not.

## Essential Heterogeneity

**Definition:** Individuals select their treatment status based on gains unobservable by the econometrician. More formally,

$$Y_1 - Y_0 \not\perp D \quad | X = x.$$

⇒ consequences for the choice of the estimation strategy

# **Objects of interest**

## **Useful Notation**

$$P(X, Z) = \Pr(D = 1 \mid X, Z) = F_V(\mu_D(X, Z))$$

$$U_D = F_V(V)$$

Figure: First-stage unobservable

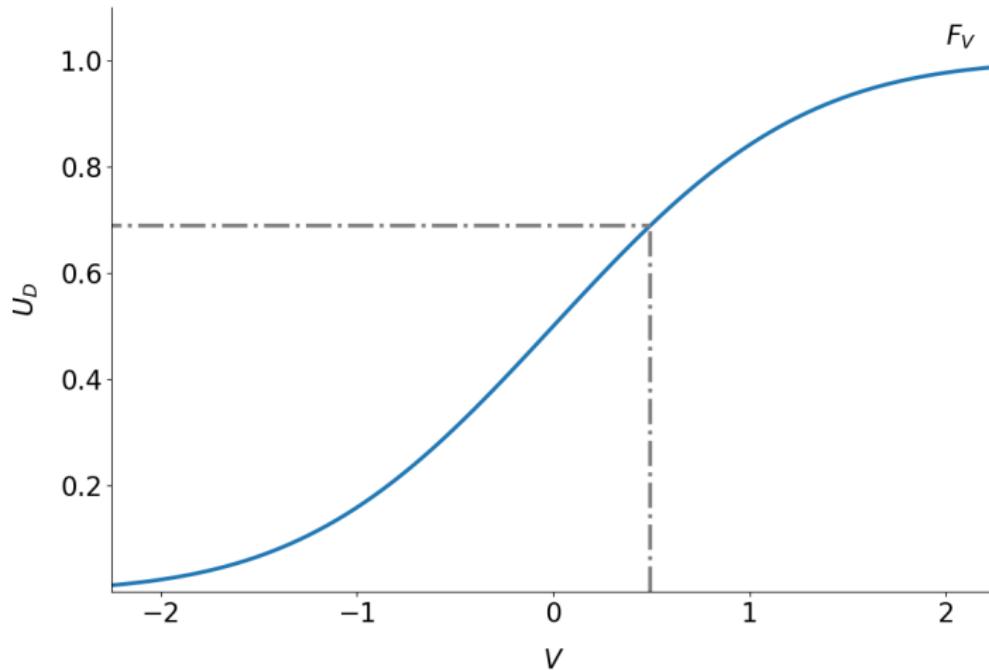


Figure: Support

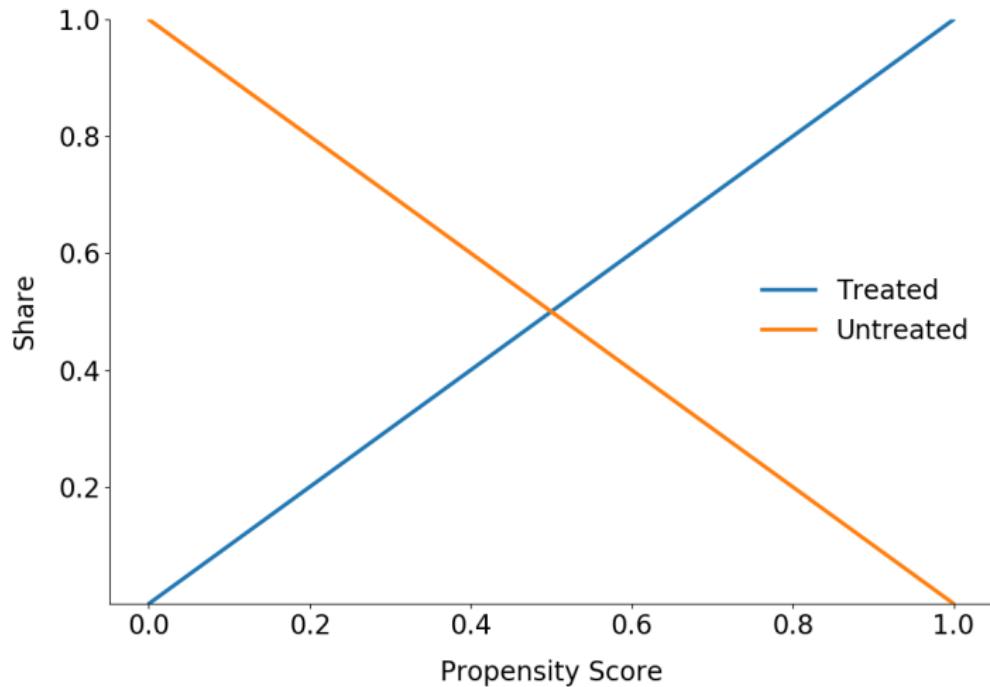
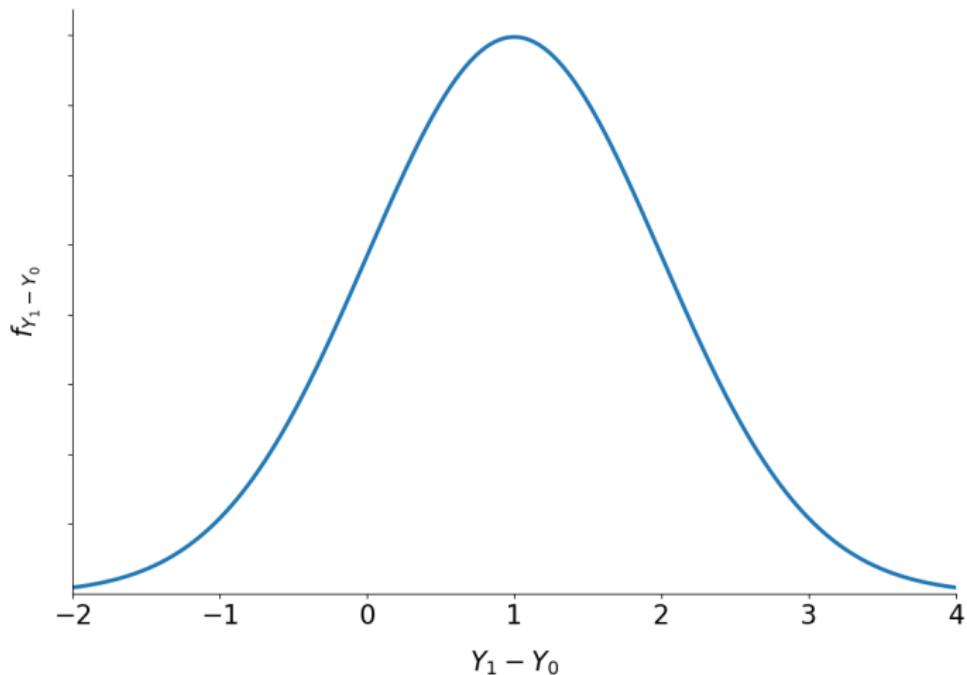
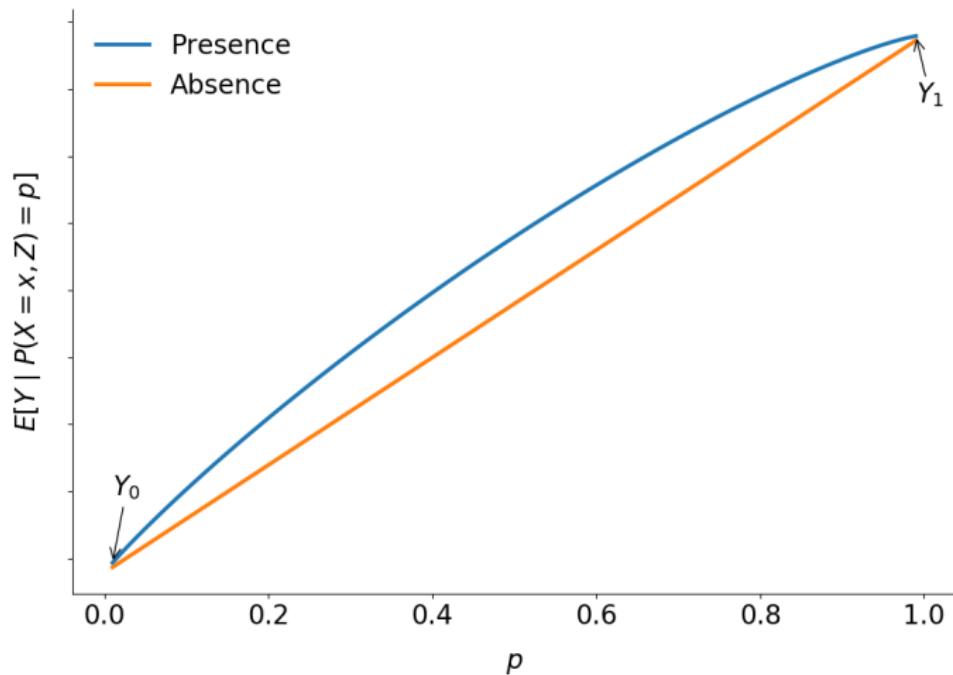


Figure: Distribution of benefits



**Figure:** Conditional expectation and essential heterogeneity



# *Conventional Average Treatment Effects*

## Conventional Average Treatment Effects

$$B^{ATE} = E[Y_1 - Y_0]$$

$$B^{TT} = E[Y_1 - Y_0 \mid D = 1]$$

$$B^{TUT} = E[Y_1 - Y_0 \mid D = 0]$$

⇒ correspond to *extreme* policy alternatives

## Selection Problem

$$E[Y | D = 1] - E[Y | D = 0] = \underbrace{E[Y_1 - Y_0 | D = 1]}_{B^{TT}} + \underbrace{E[Y_0 | D = 1] - E[Y_0 | D = 0]}_{\text{Selection bias}}$$

$$\begin{aligned}
 E[Y | D = 1] - E[Y | D = 0] &= \underbrace{E[Y_1 - Y_0]}_{B^{ATE}} \\
 &\quad + \underbrace{E[Y_1 - Y_0 | D = 1] - E[Y_1 - Y_0]}_{\text{Sorting on gains}} \\
 &\quad + \underbrace{E[Y_0 | D = 1] - E[Y_0 | D = 0]}_{\text{Sorting on levels}}
 \end{aligned}$$

- ▶ bias depends on the parameter of interest
- ▶ selection bias as sorting on levels

**Figure:** Distribution of effects with essential heterogeneity

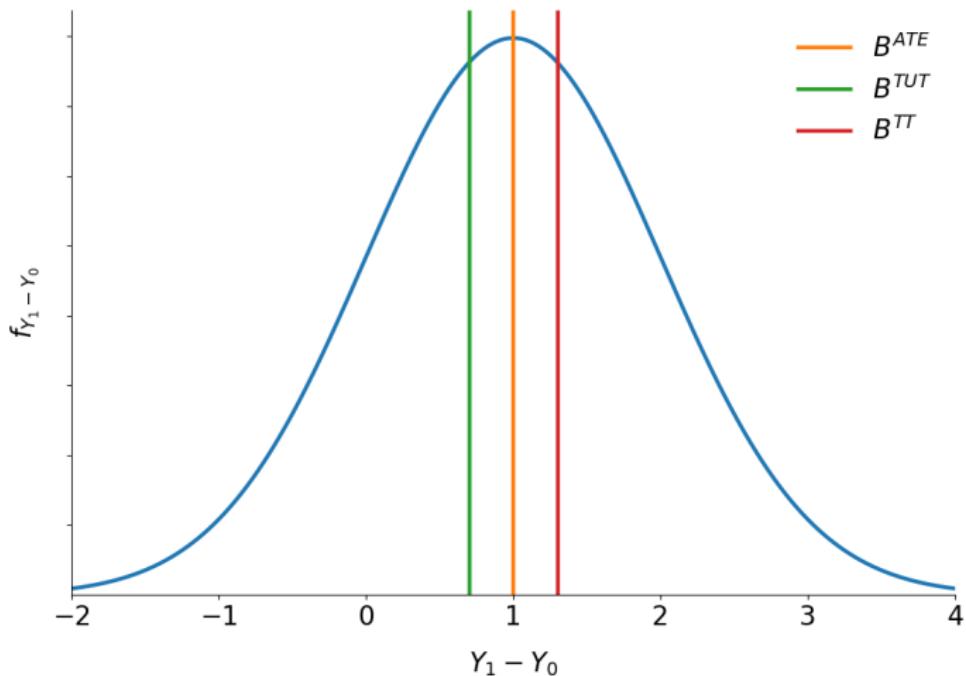
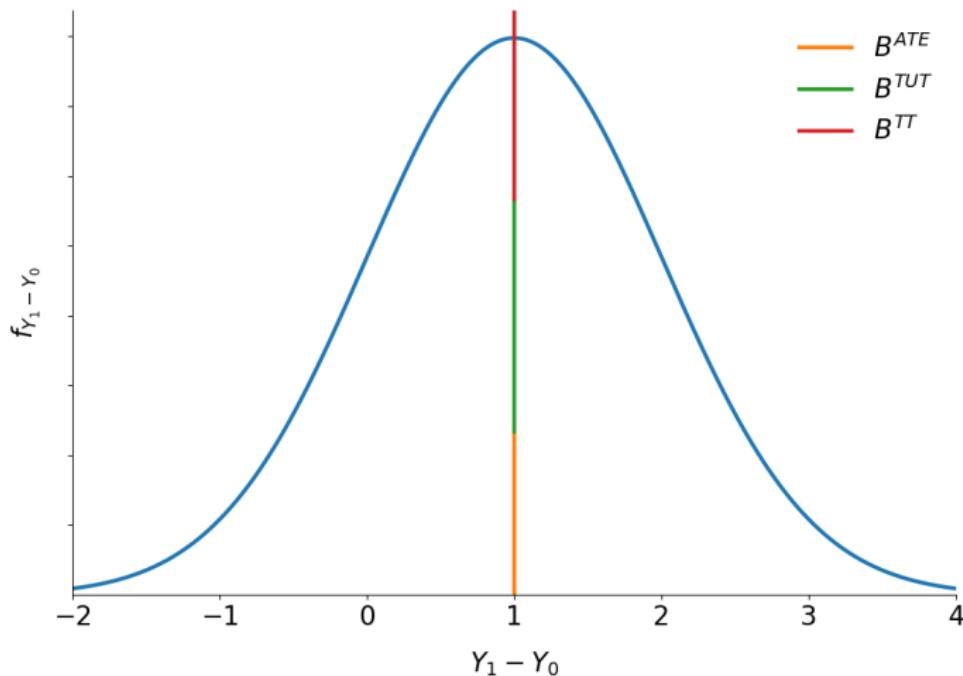


Figure: Distribution of effects without essential heterogeneity



# *Policy-Relevant Average Treatment Effects*

## Observed Outcomes

$$Y_B = D_B Y_1 + (1 - D_B) Y_0$$

$$Y_A = D_A Y_1 + (1 - D_A) Y_0$$

## Effect of Policy

$$B^{PTE} = \frac{1}{E[D_A] - E[D_B]} (E[Y_A] - E[Y_B])$$

## *Marginal Benefit of Treatment*

## Marginal Benefit of Treatment

$$B^{MTE}(x, u_D) = E[Y_1 - Y_0 \mid X = x, U_D = u_D]$$

**Intuition:** Mean gross return to treatment for persons at quantile  $u_D$  of the first-stage unobservable  $V$  or a willingness to pay for individuals at the margin of indifference.

Figure: Margin of indifference

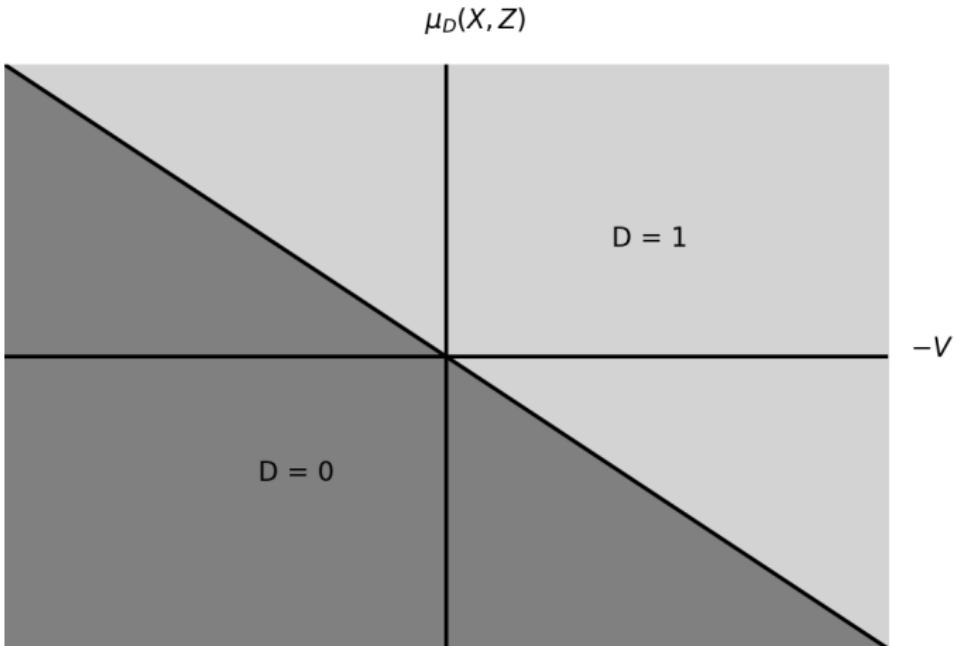
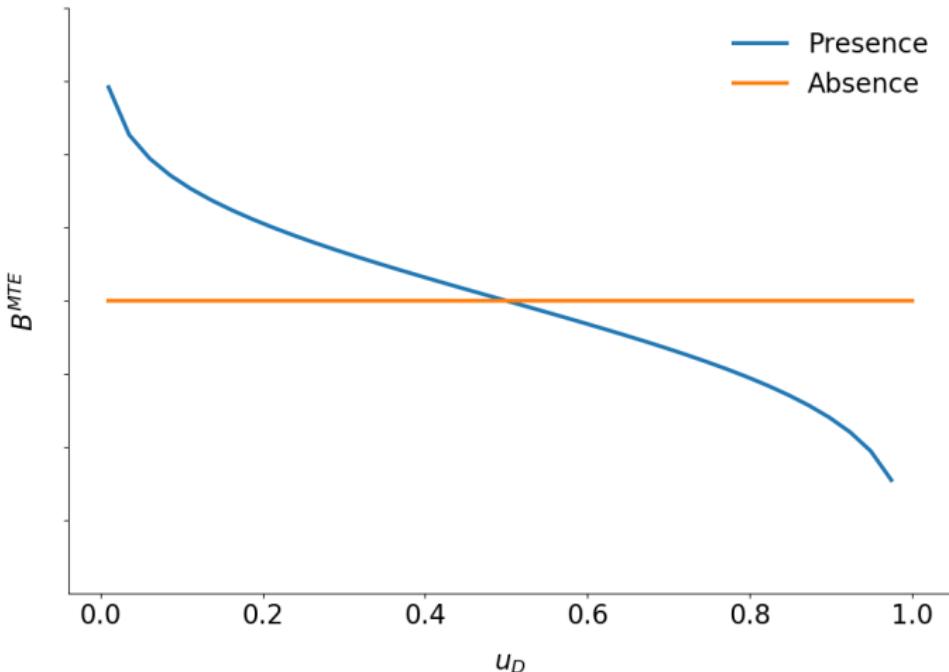


Figure:  $B^{MTE}$  and essential heterogeneity



**Effects of treatment as weighted averages** Parameter  $\Delta_j$ , can be written as a weighted average of the  $B^{MTE}(x, u_D)$ .

$$\Delta_j(x) = \int_0^1 B^{MTE}(x, u_D) \omega^j(x, u_D) du_D,$$

where the weights  $\omega^j(x, u_D)$  are specific to parameter  $j$  and integrate to one.

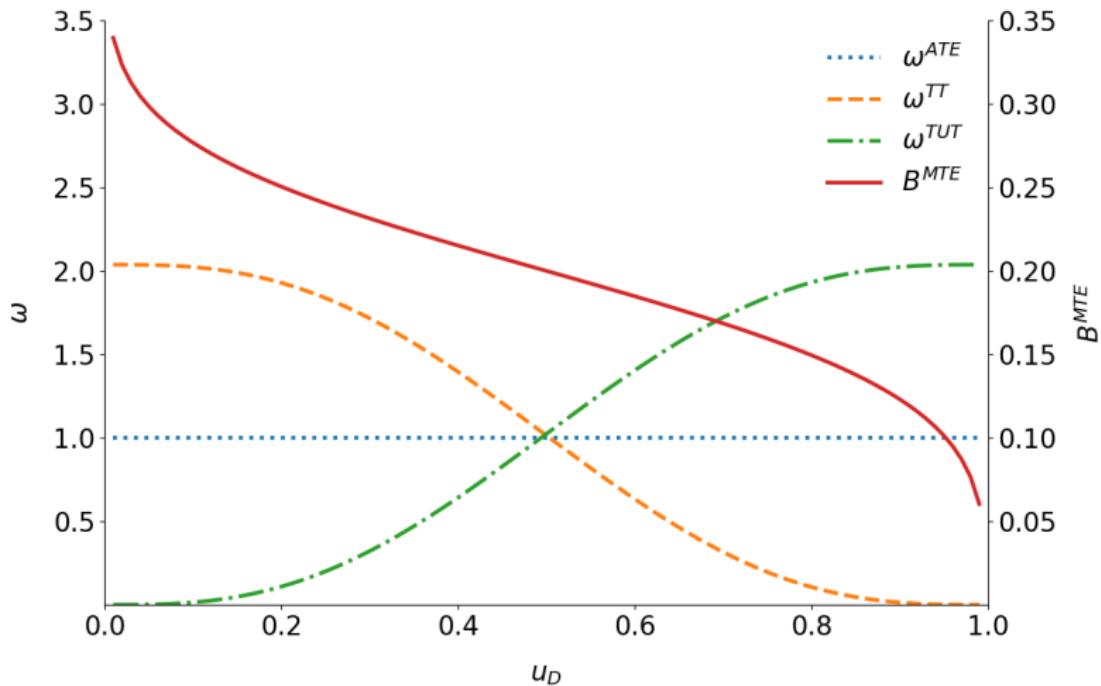
## Weights

$$\omega^{ATE}(x, u_D) = 1$$

$$\omega^{TT}(x, u_D) = \frac{1 - F_{P|X=x}(u_D)}{E[P | X = x]}$$

$$\omega^{TUT}(x, u_D) = \frac{F_{P|X=x}(u_D)}{E[1 - P | X = x]}$$

Figure: Effects of treatment as weighted averages



## *Local Average Treatment Effect*

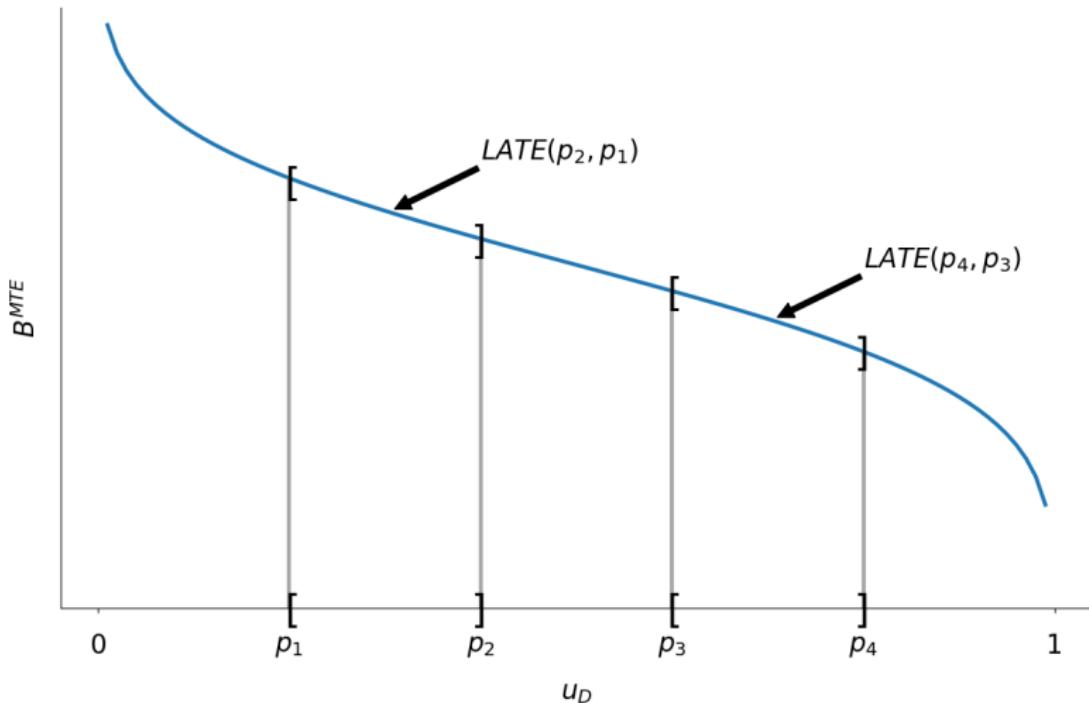
## **Local Average Treatment Effect**

- ▶ **Local Average Treatment Effect:** Average effect for those induced to change treatment because of a change in the instrument.  
⇒ instrument-dependent parameter
  
- ▶ **Marginal Treatment Effect:** Average effect for those individuals with a given unobserved desire to receive treatment.  
⇒ deep economic parameter

$$B^{LATE} = \frac{E[Y | Z = z] - E[Y | Z = z']}{P(z) - P(z')}$$

$$B^{LATE}(x, u_D, u_{D'}) = \frac{1}{u_D - u_{D'}} \int_{u_D}^{u_{D'}} B^{MTE}(x, u) du,$$

Figure: Local average treatment effect



## *Distributions of Effects*

## **Distrbutions of Effects**

- ▶ marginal distribution of benefits
- ▶ joint distribution of potential outcomes
- ▶ joint distribution of benefits and surplus

Figure: Distribution of benefits

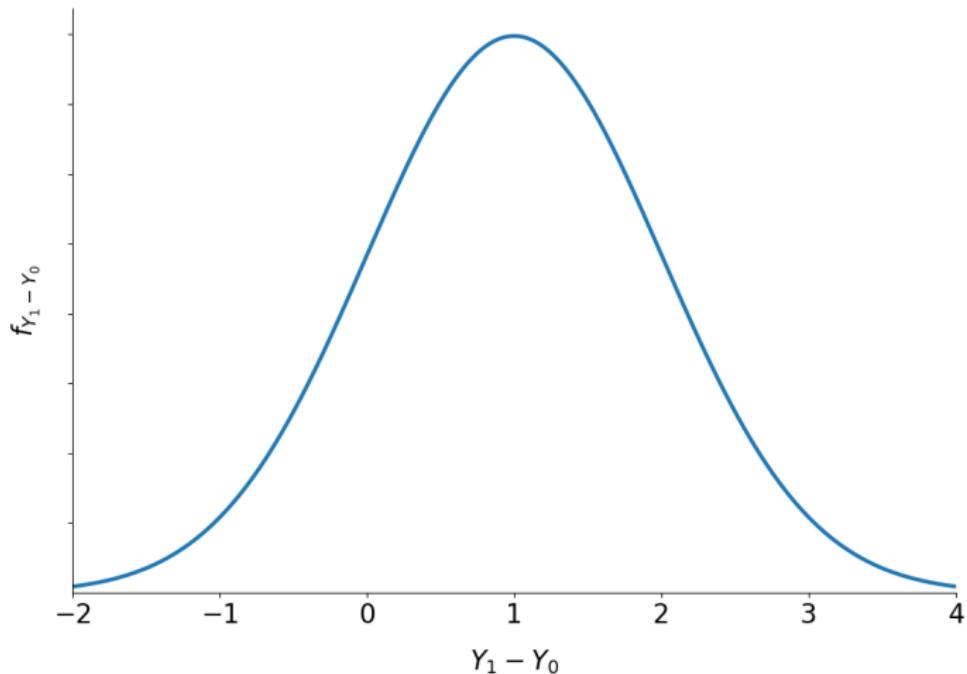


Figure: Distribution of potential outcomes

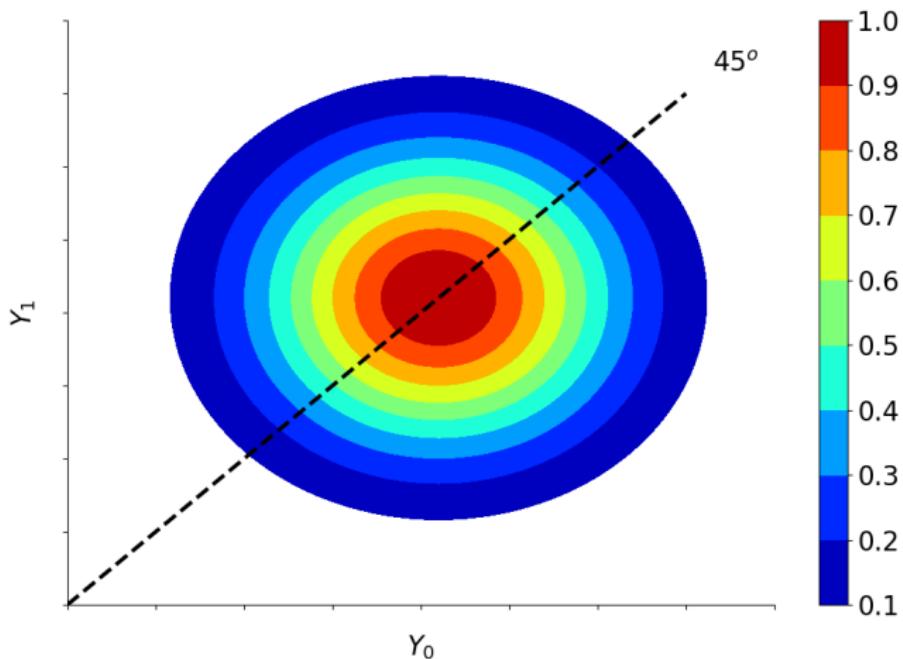
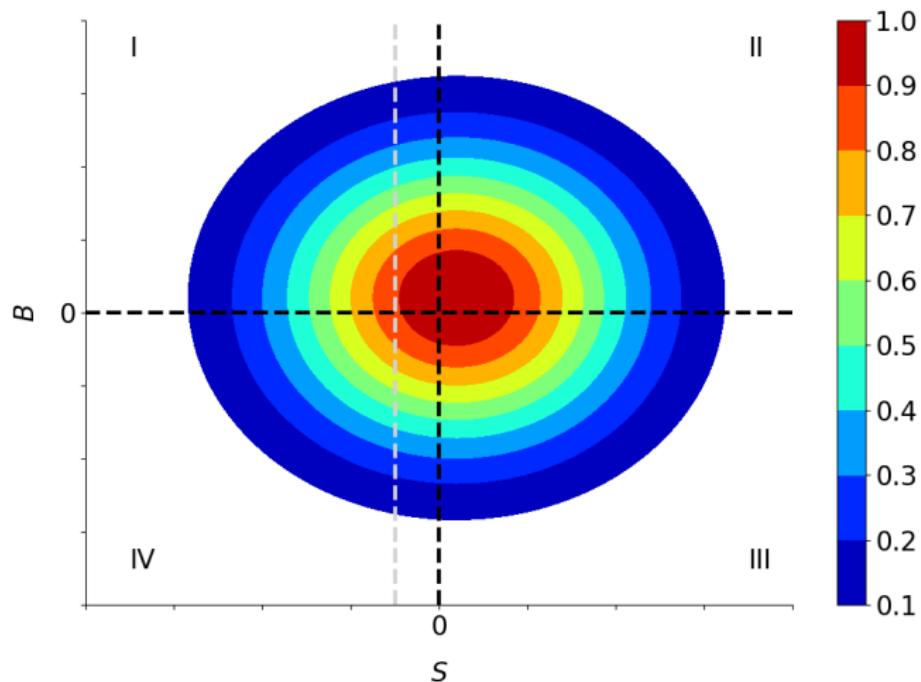


Figure: Distribution of benefits and surplus

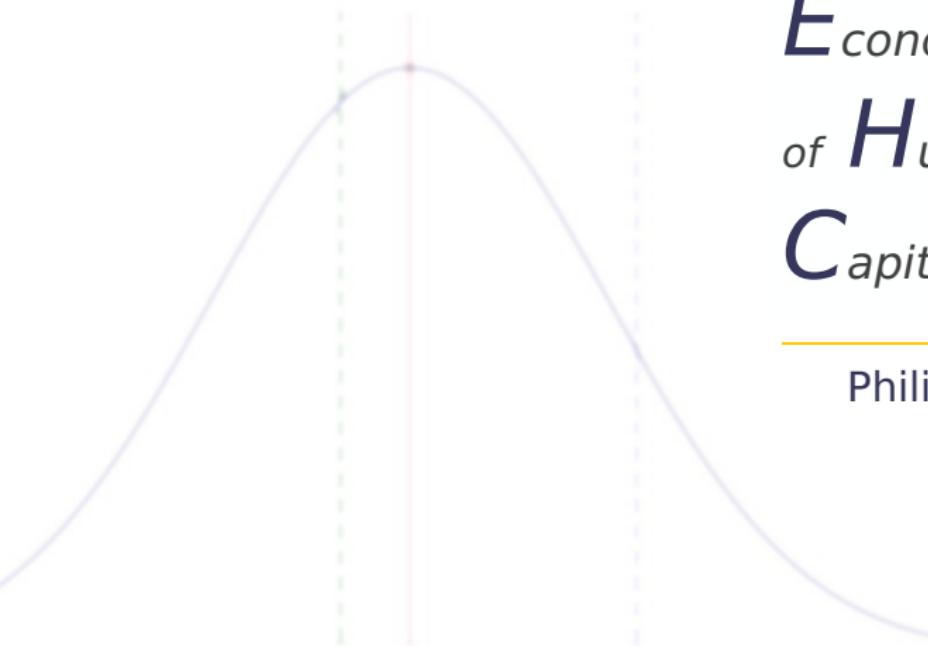


# **Conclusion**

# **Appendix**

# *References*

- Becker, G. S. (1964). *Human capital* (1st ed.). New York City, NY: Columbia University Press.
- Heckman, J. J. (2008). Schools, skills, and synapses. *Economic Inquiry*, 46, 289–324.



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# Economics of Human Capital

Dynamic model of human capital accumulation

Philipp Eisenhauer

# **Introduction**

We build on the following seminal paper:

- ▶ Keane, M. P., & Wolpin, K. I. (1997). The career decisions of young men. *Journal of Political Economy*, 105(3), 473–522.

## Roadmap

- ▶ Economic Model
- ▶ Mathematical Model
- ▶ Data
- ▶ Computational Model
- ▶ Results

# **Economic Model**

## Decision Problem

$t = 1, \dots, T$  decision period

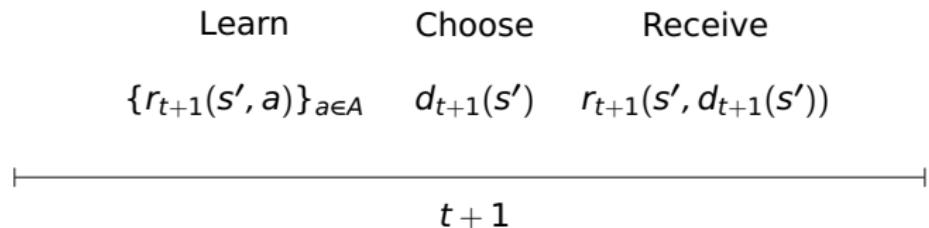
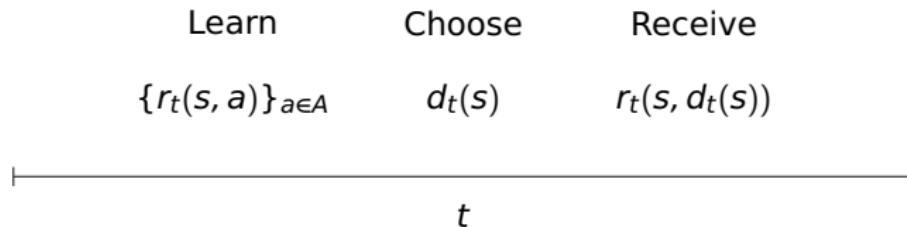
$s \in S$  state

$a \in A$  action

$d_t(s)$  decision rule

$r_t(s, a)$  immediate reward

## Timing of Events



$\pi = (d_1, \dots, d_T)$  policy

$h_t = (s_1, a_1, \dots, s_t)$  history

$\delta$  discount factor

$p_t(s, a)$  conditional distribution

## **Individual's Objective under Risk**

$$v_1^{\pi^*}(s) = \max_{\pi \in \Pi} E_s^\pi \left[ \sum_{t=1}^T \delta^{t-1} r_t(X_t, d_t(X_t)) \right]$$

# **Mathematical Model**

## Policy Evaluation

$$v_t^\pi(s) = \mathbb{E}_s^\pi \left[ \sum_{\tau=t}^T \delta^{\tau-t} r_\tau(X_\tau, d_\tau(X_\tau)) \right]$$

## Inductive Scheme

$$v_t^\pi(s) = r_t(s, d_t(s)) + \delta \mathbb{E}_s^\pi \left[ v_{t+1}^\pi(X_{t+1}) \right]$$

## Optimality Equations

$$v_t^{\pi^*}(s) = \max_{a \in A} \left\{ r_t(s, a) + \delta E_s^p \left[ v_{t+1}^{\pi^*}(X_{t+1}) \right] \right\}.$$

## Backward Induction Algorithm for MDP

**for**  $t = T, \dots, 1$  **do**

**if**  $t == T$  **then**

$$v_T^{\pi^*}(s) = \max_{a \in A} \{ r_T(s, a) \} \quad \forall s \in S$$

**else**

        Compute  $v_t^{\pi^*}(s)$  for each  $s \in S$  by

$$v_t^{\pi^*}(s) = \max_{a \in A} \left\{ r_t(s, a) + \delta E_s^p [v_{t+1}^{\pi^*}(X_{t+1})] \right\}$$

        and set

$$d_t^{\pi^*}(s) = \arg \max_{a \in A} \left\{ r_t(s, a) + \delta E_s^p [v_{t+1}^{\pi^*}(X_{t+1})] \right\}$$

**end if**

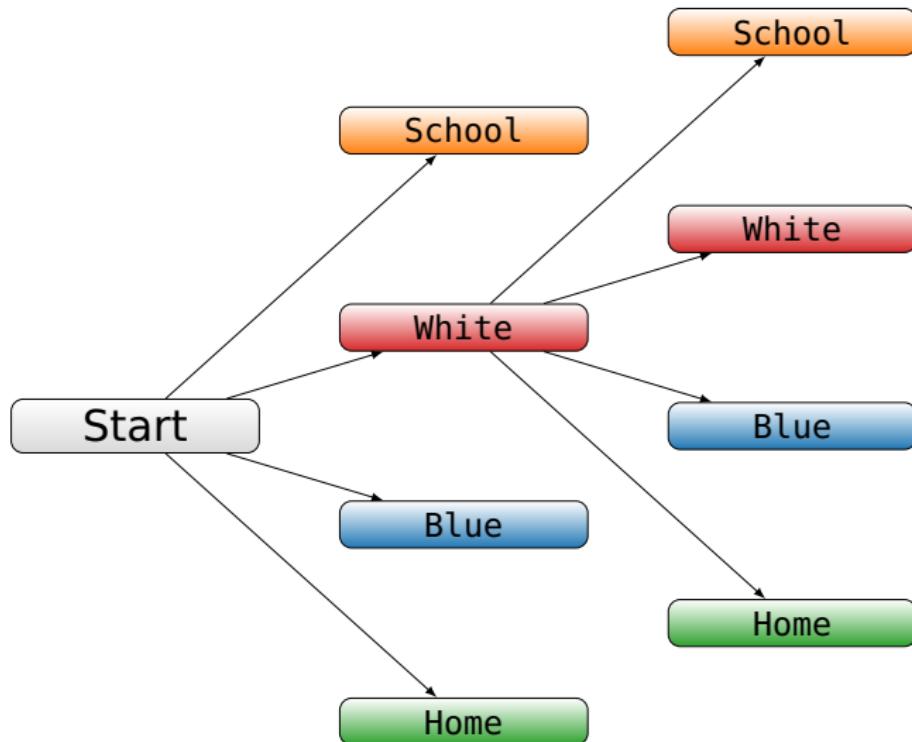
**end for**

# **Data**

## **National Longitudinal Survey of Youth (1979)**

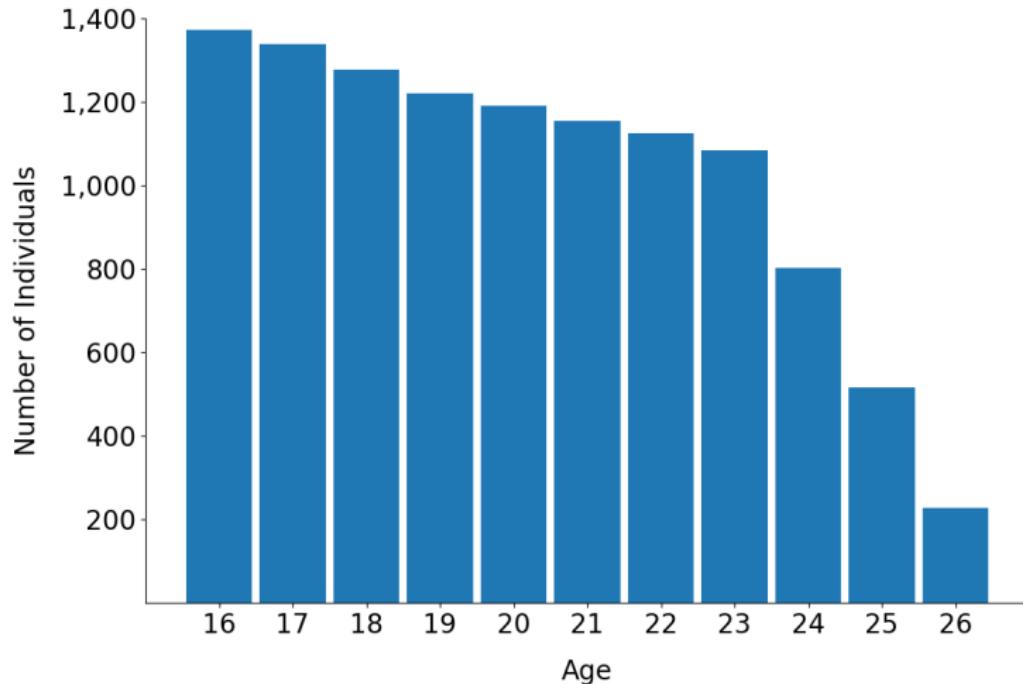
- ▶ 1,373 white males starting at age 16
- ▶ life-cycle histories
  - ▶ school attendance
  - ▶ occupation-specific work status
  - ▶ real wages

Figure: Decision Tree

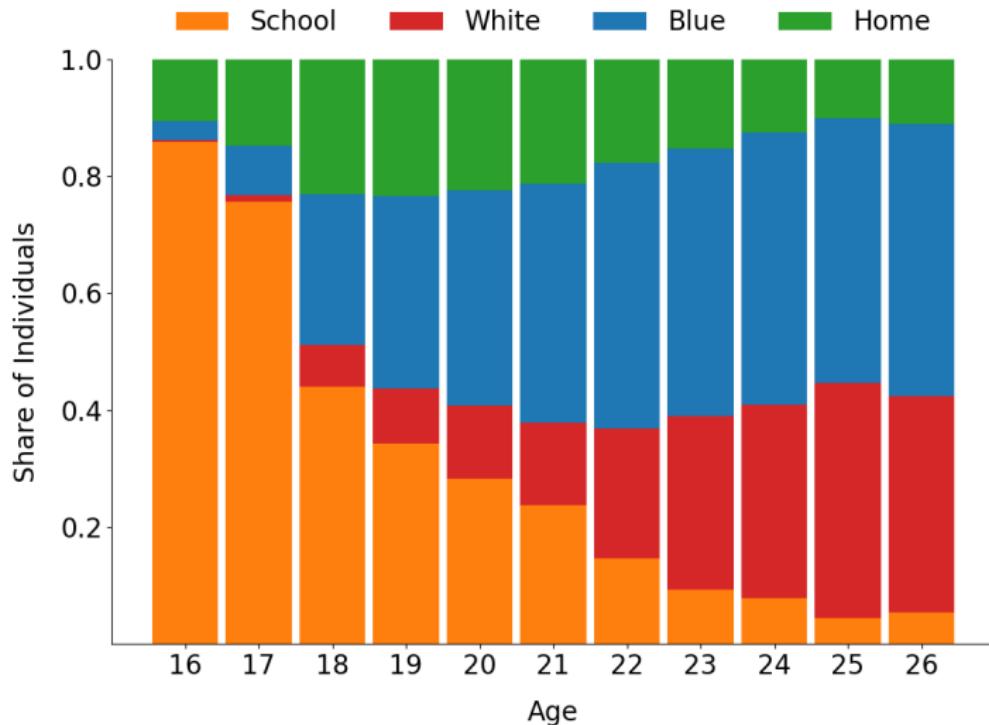


# *Descriptives*

Figure: Sample Size



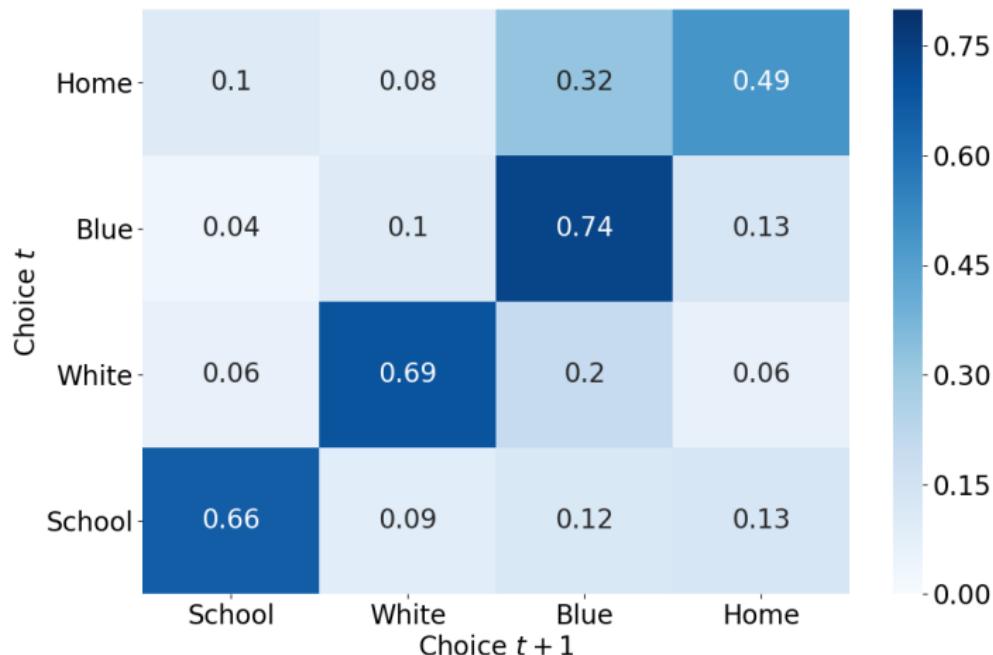
## Figure: Observed Choices



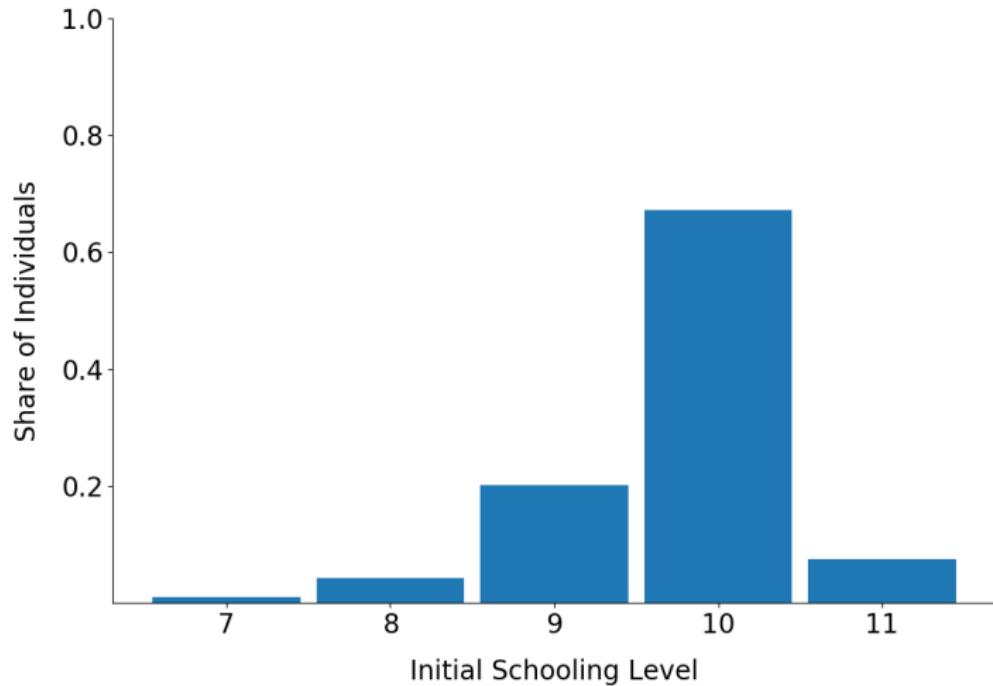
**Table:** Observed Real Wages

Age	<u>White</u>		<u>Blue</u>	
	Obs.	Mean	Obs.	Mean
16	2	.	26	10,287
20	128	5,499	349	14,432
25	201	16,540	222	21,991

## Figure: Observed Transitions



**Figure: Initial Schooling**



**Table:** Activities by Initial Schooling

Alternatives	<u>Initial Schooling</u>				
	7	8	9	10	11
School	0.69	0.86	2.48	3.37	2.83
White	0.08	0.38	0.65	1.36	2.04
Blue	3.69	3.62	3.05	2.40	1.98
Home	4.23	4.19	1.91	1.10	1.32
Total	8.69	9.05	8.09	8.24	8.17

## *Reduced-form Analysis*

## Table: Mincer Regressions

Log Real Wages		
Intercept	8.314***	8.329***
Schooling	0.086***	0.077***
<u>Work Experience</u>		
- linear	0.132***	0.125***
- squared	-0.005***	-0.003***
<u>Corrected AFQT</u>		
- linear	—	0.002***
Adj-R <sup>2</sup>	0.21	0.22
Observations	4,420	4,232

## Table: Mincer Regressions

	<u>Log Real Wages</u>	
	White	Blue
Intercept	7.748***	8.790***
Schooling	0.128***	0.044***
<u>Own Experience</u>		
- linear	0.146***	0.129***
- squared	-0.003	-0.005***
<u>Other Experience</u>		
- linear	0.096***	0.085***
- squared	0.002	-0.003
Adj-R <sup>2</sup>	0.28	0.17
Observations	1,468	2,952

## **Open Issues**

- ▶ distinction between ex ante and ex post returns
- ▶ role of psychic costs
- ▶ nonlinearities in the return
- ▶ role of uncertainty

# **Computational Model**

## Additional Structure

$t$  age

$k$  unobserved type

$x_{j,t}$  experience in occupation  $j$  at age  $t$

$a_t$  action at age  $j$

$g_t$  level of schooling at age  $t$

## Skill Production Function

$$e_{j,k,t} = \exp \{ e_{j,k,16} + \underbrace{\alpha_{j,1} g_t + \alpha_{j,2} I[g_t \geq 12] + \alpha_{j,3} I[g_t \geq 16]}_{\text{schooling}} \\ + \underbrace{\alpha_{j,4} x_{j,t} + \alpha_{j,5} x_{j,t}^2 + \alpha_{j,6} I[x_{j,t} > 0] + \alpha_{j,7} x_{j \neq j',t}}_{\text{work experience}} \\ + \underbrace{\alpha_{j,8} I[a_{t-1} \neq j]}_{\text{depreciation}} + \alpha_{j,9}(t - 16) + \alpha_{j,10} I[t < 18] + \epsilon_{j,t} \}$$

with  $j, j' = 1, 2$ ,  $k = 1, \dots, 4$ , and  $t = 16, \dots, 65$

## Labor Market

$$r_{j,k,t} = w_{j,k,t} + \underbrace{\kappa_1 I[g_t \geq 12] + \kappa_2 I[g_t \geq 16]}_{\text{common returns}} + \beta_{j,1} \\ + \underbrace{\beta_{j,2} I[x_{j,t} > 0, a_{t-1} \neq j] + \beta_{j,3} I[x_{j,t} = 0, a_{t-1} \neq j]}_{\text{entry cost}}$$

with  $w_{j,k,t} = r_j e_{j,k,t}$

## School

$$r_{3,k,t} = e_{3,k,16} + \underbrace{\gamma_1 I[g_t \geq 12] + \gamma_2 I[g_t \geq 16]}_{\text{monetary and psychic cost}} \\ + \underbrace{\gamma_3 I[a_{t-1} \neq 3, g_t \leq 11] + \gamma_4 I[a_{t-1} \neq 3, g_t \geq 12]}_{\text{reenrollment cost}} \\ + \gamma_5(t - 16) + \gamma_6 I[t \leq 18] + \underbrace{\kappa_1 I[g_t \geq 12] + \kappa_2 I[g_t \geq 16]}_{\text{common returns}} \\ + \epsilon_{3,t}$$

## Home

$$r_{4,k,t} = e_{4,k,16} + \zeta_1 I[18 \leq t \leq 20] + \zeta_2 I[t \geq 21] \\ + \underbrace{\kappa_1 I[g_t \geq 12] + \kappa_2 I[g_t \geq 16]}_{\text{common returns}} + \epsilon_{4,t}$$

## State Space

- ▶ at time  $t$

$$s_t = \{g_t, \{x_{j,t}\}_{j=1,2}, a_{t-1}, \{\epsilon_{j,t}\}_{j=1,\dots,4}\}$$

$$\bar{s}_t = \{g_t, \{x_{j,t}\}_{j=1,2}, a_{t-1}\}$$

- ▶ laws of motion

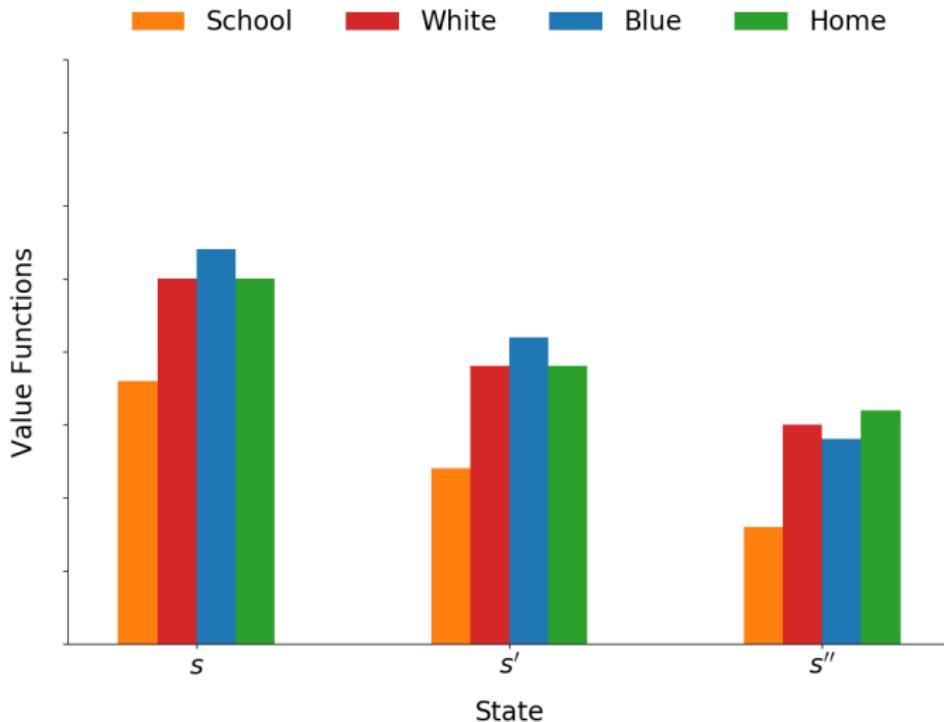
$$x_{j,t+1} = x_{j,t} + I[a_t = j] \quad \forall \quad j \in \{1, 2\}$$

$$g_{t+1} = g_t + I[a_t = 3]$$

## Distribution of shocks

$$[\epsilon_{1,t}, \epsilon_{2,t}, \epsilon_{3,t}, \epsilon_{4,t}]^T \sim \mathcal{N}_0(\mathbf{0}, \Sigma)$$

Figure: Value Functions



## **Computational Tool**

<https://respy.readthedocs.io>

- ▶ Technical Documentation
    - ▶ Numerical Methods, Source Codes, Test Suite
  - ▶ User Documentation
    - ▶ Tutorial
- ⇒ Transparency, Recomputability, and Extensibility

# **Conclusion**

# **Appendix**

# *References*

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# **Labor Economics: Human Capital**

## **Tutorial Session**

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# 1 Quiz

- (1) Consider the seminal model by [Spence \(1973\)](#) as presented in class. High productivity workers always prefer the option to signal their ability.
- (2) Based on the discussion in class, the option value of schooling is always strictly positive for all schooling transitions.
- (3) The accounting-identity model as presented in [Heckman, Lochner, & Todd \(2006\)](#) provides a justification for interpreting the Mincer coefficient as an internal rate of return.
- (4) A college tuition subsidy always leads to an increase in high school graduation rates regardless of the individual time preferences.
- (5) [Heckman, Stixrud, & Urzua \(2006\)](#) report that the effect of cognitive skills on social outcomes is always more pronounced than the effect of noncognitive skills.
- (6) [Keane & Wolpin \(1997\)](#) find that a basic model of human capital investment explains the observed investment patterns just as well as their extended model.
- (7) [Carneiro, Heckman, & Vytlacil \(2011\)](#) find that individuals make their schooling decisions in light of heterogeneous returns.
- (8) [Keane & Wolpin \(1997\)](#) point to heterogeneous schooling levels at age 16 as the main determinant of inequality in expected total lifetime utility.
- (9) [Heckman, Lochner, & Todd \(2006\)](#) compile several pieces of evidence that point towards a rejection of the standard Mincer regression model.
- (10) [Lagakos, Moll, Porzio, Qian, & Schoellman \(2018\)](#) find that wages increase substantially more over the life cycle in poor countries than in rich countries.
- (11) [Lagakos et al. \(2018\)](#) show that their core findings hold up regardless of whether they focus on part or full time male wage workers.
- (12) [Lagakos et al. \(2018\)](#) determine that differences in long-term contracts are an important driver of cross-country differences in life cycle wage growth.
- (13) [Lagakos et al. \(2018\)](#) determine that human capital or search frictions are promising explanations for the cross-country differences in life cycle wage growth.
- (14) [Keane & Wolpin \(1997\)](#) find that the predictions of life cycle choices from a static and dynamic model of human capital investments are in general agreement.
- (15) [Keane & Wolpin \(1997\)](#) find that a \$2,000 college tuition subsidy has a pronounced impact on the expected present value of lifetime utility.

- (16) Carneiro et al. (2011) report point estimates that the marginal benefit of treatment for the average individual remains positive when moving along the distribution of  $V$ .
- (17) Heckman, Lochner, & Todd (2006) restrict their analysis to the ex post return to school-ing.

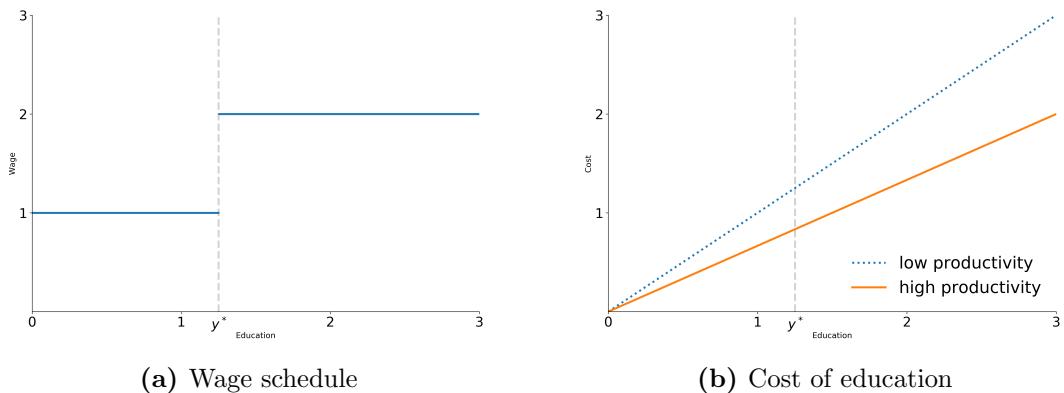
## 2 Introduction

Consider the motivating models of [Spence \(1973\)](#) and [Ben-Porath \(1967\)](#) as discussed in class.

- (1) For both models, provide a brief description of the question they are designed to address and their key ingredients. Provide two examples of important economic features that are missing from the formal analysis?

Consider the model developed in [Spence \(1973\)](#) in more detail. Figure 1 visualizes the information about the wage schedule and the cost of education in the parametrized model. Please assume throughout that employers belief that individuals with a level of education  $y^* \geq \frac{5}{4}$  have a high productivity.

**Figure 1:** Model parametrization

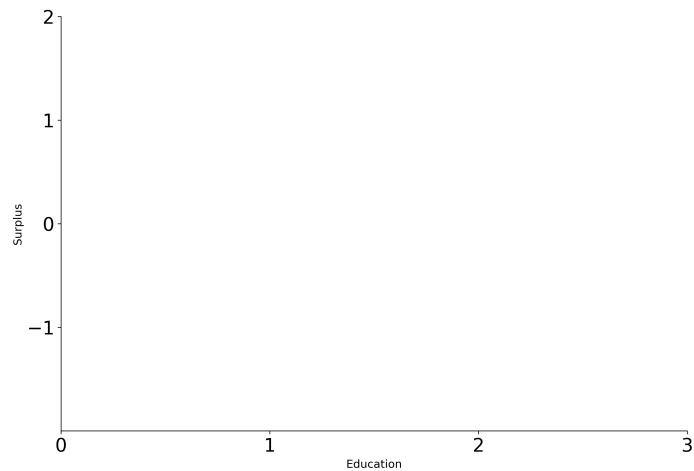


- (2) Write down the parametrization of the cost ( $c_L, c_H$ ) and wage ( $w_L, w_H$ ) functions for the high and low productivity individuals.
- (3) Complete Figure 2 by adding the surplus functions for each of the two groups over the specified range. Also, indicate the optimal level of schooling for each of the two groups.
- (4) Calculate the range of the separating schooling level  $y^*$  that confirms the employer's beliefs.

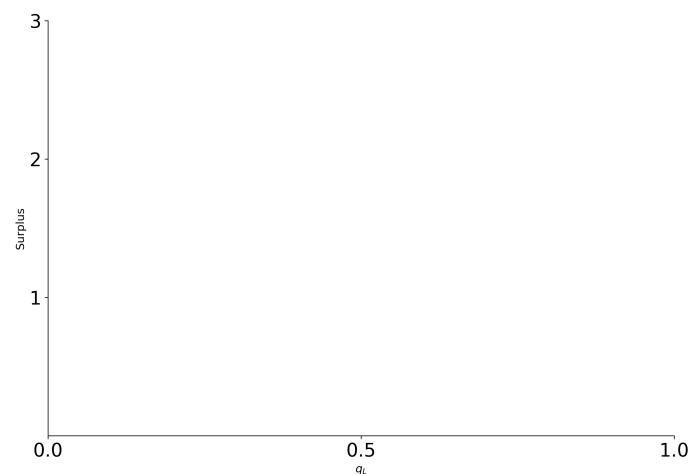
Now consider the case where individuals do not have the ability to signal their productivity and the share of individuals with low productivity is denoted by  $q_L$ .

- (5) What is the wage for each of the two groups in this scenario as a function of  $q_L$ ?
- (6) Complete Figure 3 by adding the surplus and wage for the two groups under the scenario where individuals are able to signal their ability and when they are not.

**Figure 2:** Surplus of education



**Figure 3:** Surplus and market structure



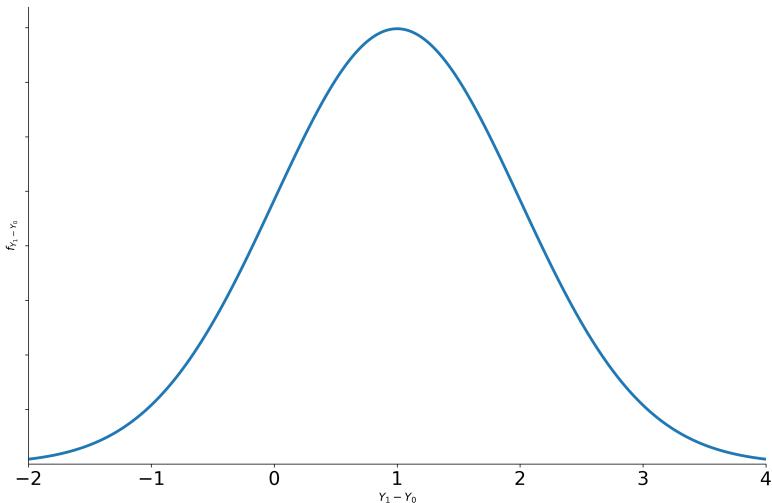
- (7) What scenario do high productivity individuals prefer, what does their assessment depend on, when exactly do they change their mind?

### 3 Static model of educational choice

Consider the framework of the generalized Roy model presented in class for the static analysis of educational choice.

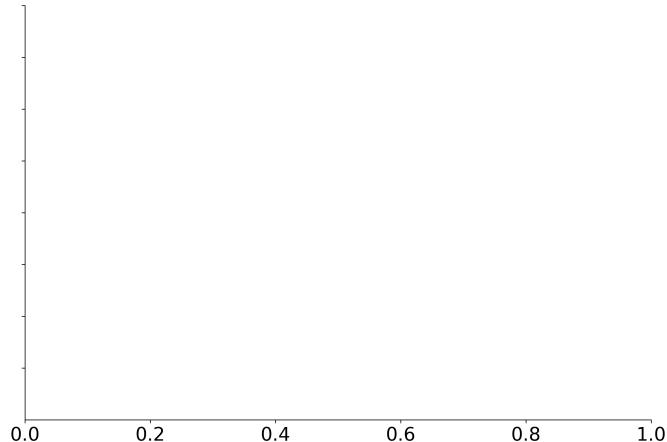
- (1) Write down and briefly describe the key equations of the model.
- (2) Formally define the conventional average treatment effects and describe their limited policy relevance. What is potentially lost by focusing on average effects instead of looking at the whole distribution of individual benefits?
- (3) Define and describe the concept of essential heterogeneity. How does its presence and absence affect the relationship between the conventional average treatment effect parameters. Please integrate the conventional average treatment effects in the absence of essential heterogeneity into Figure 4 which already shows a hypothetical distribution of individual-specific benefits.

**Figure 4:** Distribution of effects



- (4) Define and describe the marginal benefit of treatment. What exactly is the conditioning set? Complete the empty canvas below by sketching the marginal benefit of treatment in the presence and absence of essential heterogeneity. Ensure that both axes are properly labeled.
- (5) What are the main findings in [Carneiro et al. \(2011\)](#) on the marginal benefit of a college education?
- (6) Briefly outline the shortcomings of a static model of educational choice compared to a dynamic model.

**Figure 5:** Marginal benefit of treatment



Consider the following parameterization of the generalized Roy model presented in class for the static analysis of educational choice.

$$\begin{aligned} Y_1 &= 0.25 & D &= \mathbb{1}[0.50 > U] \\ Y_0 &= U \end{aligned}$$

Assume that  $U$  follows a uniform distribution between zero and one. Please be careful about correctly labeling all graphs that you decide to include in your answers.

- (1) Define the individual effect of treatment. What are the sources of heterogeneity in the model. What fraction of individuals have a positive benefit of treatment? How many do select into treatment?
- (2) Formally define the conventional average treatment effects and describe their limited policy relevance. How does the distribution of benefits for the model above look like? What is its exact range? Please mark the part of the distribution conditional on treatment status. Calculate the conventional effects of treatment.
- (3) Define and describe the concept of essential heterogeneity. Does the parameterized model exhibit essential heterogeneity? Please explain your answer.
- (4) Define and describe the marginal benefit of treatment  $B^{MTE}$ . How exactly does the  $B^{MTE}$  for the parameterized model above look like?

## 4 Dynamic model of educational choice

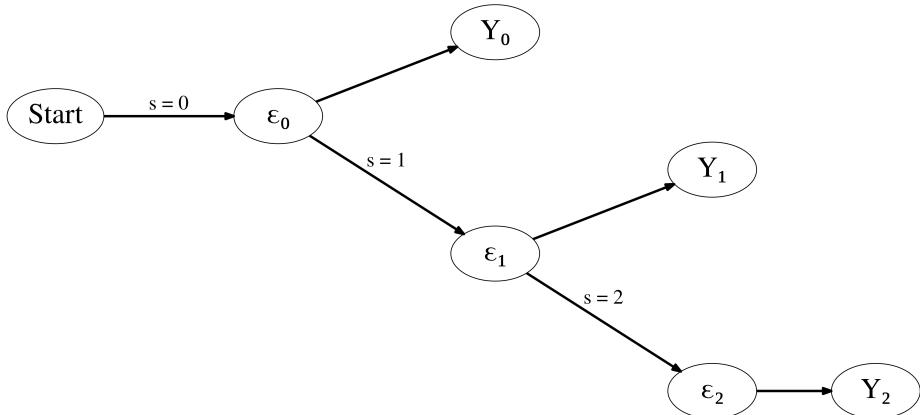
Please consider the standard setup of the Mincer returns as presented in class.

- (1) Please state and briefly describe the Mincer equation ([Mincer, 1974](#)). What are its key features? What important characteristics of schooling choices are lost when studying Mincer returns? What alternative return concepts exist?
- (2) [Heckman, Lochner, & Todd \(2006\)](#) derive several implications of the Mincer equation and put them to the empirical test. Please provide their formal statement and a brief verbal explanation.

Now please consider the sequential model of schooling decisions introduced in class to determine the true return to schooling.

Figure 6 shows the two period decision problem. Individuals enter the model without any schooling and can decide to pursue up to two additional years if they desire to do so. At any point, they can drop out of school and enter the labor market with the following earnings.

**Figure 6:** Decision problem



$$Y_0 = 0.5$$

$$Y_1 = 1.5 + \epsilon_1$$

$$Y_2 = 1.5$$

Note that not all earnings have a random component. In addition, there is no time-discounting and  $\epsilon_1$  follows a uniform distribution between zero and one.

- (4) What share of individuals will continue their schooling at each decision node? How does the final distribution of schooling levels look like?

- (5) Please provide the formal definition and a brief verbal explanation for the value  $V_s$  and true return  $R_{s,s-1}$  of a schooling level. For an individual entering the model, what is the value of no schooling  $V_0$  and the true return of the first year  $R_{1,0}$ ?
- (6) Please provide the formal definition and a brief verbal explanation of the option value of a schooling level. For an individual entering the model, what is the option value  $O_{1,0}$  of the first year of schooling?

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