

The Search for Compensating Differentials: Is There a Pot of Gold After All?

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Abstract

Although the idea of compensating differentials has a long intellectual history, previous empirical work has had difficulty in confirming the theory. This paper uses a new data set consisting of the occupational averages of over two hundred job characteristics and finds strong support for the theory. In particular, a one standard deviation increase in the effort required on a job is associated with a 12% increase in wages. Similarly, occupations that involve additional responsibility offer higher wages, as do jobs that offer less long-term opportunity. On the other hand, workers value, as evidenced by their willingness to pay for them through wage reductions, physically pleasant and safe working conditions, intellectually challenging work, smaller workplaces and occupations providing better personal relations and more opportunity to interact with others. The result suggests two particular difficulties with most previous attempts to isolate compensating wage differentials. First, the high noise-to-signal ratio in micro-level data, especially when individual observations for working conditions are not available, introduces a high degree of random variation into estimated compensating effects, making the reconciliation of findings across different studies problematic. Second, the imposition of rigid functional forms combined with the omission of critical variables, as has been almost universal in works in this area, can produce serious specification biases. When these problems are overcome, it appears that the market provides significant compensating differentials for both desirable and undesirable job characteristics.