

## Skills or Formal Education - What Drives Income and Employment Participation?

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Economic theory views (perceived) productivity as a main determinant for remuneration as well as the realization of job-matches. Formal education can increase individual abilities and competences and therefore improve productivity as well as labour market outcomes. The role of formal education and individual competences is not obvious from a theoretical point of view. Does higher education lead to higher wages by improving individual ability or are more able people more likely to enjoy higher education in order to signal their (on average) higher abilities on the labour market?

Our empirical results confirm on the one hand the positive relation between formal education as well as individual abilities and labour market outcomes. At the same time we find a high degree of educational inheritance in Austria. Our simulation results show that individual competences can only partly compensate for lacking higher formal educational degrees. Given the distribution of competences between people with different formal educational levels we find that those with low educational levels can only compensate approximately one third of the observed wage difference if they would dispose of the average competence level of the next higher education level. This underlines that wage differences are to a high degree determined by formal qualifications. In general these differences can hardly be compensated by individual ability. Especially those who comprise of poor initial endowments can compensate these income differences even less than those with more favorable initial endowments.

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