Senior Project

Department of Economics

"The Racial Income Gap and Intergenerational Mobility"

Evelyn Kirkendall

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Advisor: Dr. Francesco Renna

Abstract:

This paper employs 1979-2014 National Longitudinal Survey of Youth data (NLSY79) to estimate the impact of intergenerational income inequality on the black-white income gap. The income differential could be attributed in part to the hindered progress of black families' income across generations. Some income class warfare has become apparent in the last United States's (US) presidential election of 2017, and the plight experienced by lower income black Americans has demonstrated that existing socioeconomic policies are insufficient to aid their advancement. Two intergenerational income elasticities are estimated, one for black families and one for white families. The Blinder-Oaxaca decomposition is used to determine the income gap and extent of IGE's effect. The income differential is estimated to be 0.64. IGE significantly impacts the explained and unexplained portions of the income gap. Labor market policies should target employer discrimination against parent income to decrease the difference.

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I. Introduction

Some racial tensions exist between black and white Americans because of unequal access to greater wealth and opportunities that prevent racial groups from equality (Wilson 2011, Mazumder 2014). An existing difference in pay divides blacks and whites, and this is known as the black-white income gap. Discrimination alone does not cause the gap, but it does contribute. Race continues to be a barrier to economic opportunity despite some economic reprieve after the Civil Rights movement. Economists have found that Americans have low intergenerational income mobility, and mobility of blacks can be lower than whites. This difference may prevent blacks from earning equal income with whites. Blacks have not been improved their income mobility over the past hundred years (Mazumder 2014). The black-white income gap and stagnant intergenerational mobility encourages economists to analyze why these patterns continue in the United States.

Intergenerational mobility is an indicator a country's economic opportunity, and mobility is the defining feature of the American Dream. Americans have long believed that they can determine their wealth separately from their parents. Low upward mobility affects both races at low income levels, but blacks face an even larger disadvantage. Several reasons could explain the setback to blacks' income mobility relative to whites. They have not had the same opportunities for as long as white people due to slavery in America and its residual effects. Black families have inherited less endowments. Some effects such as discrimination and segregation may explain some of the prevailing inequality. Businesses, political policies, and society can implement explicit or implicit elements to suppress economic opportunities for black families. Regional differences in political and societal structure may institutionalize socioeconomic differences. There are multiple ways to address the issues of income inequality, and research into

all explanations of the gap between blacks and whites could allow more precise policies to address these systemic problems.

Income discrimination may be influenced by intergenerational mobility because employers may value the income of white families more than black families. This influences the income that their children will earn. Comparing income and mobility between groups can help economists and policymakers comprehend the mechanisms of economic opportunity. A common measure of mobility is the coefficient, intergenerational income elasticity (IGE). This will be estimated through a Mincer equation. This paper seeks to identify how much the income gap and possible discrimination are influenced by the IGEs of black and white families by using the Oaxaca decomposition. Sometimes, the inequality of mobility across generations is a proposed reason for the income gap and discrimination, but this is one of the first studies to analyze that relationship. It provides more specific information on the effect of mobility rather than a side-by-side comparison of the races.

II. Literature Review

Estimation of the income gap varies from study to study depending on the focus of the study. General perception is that most of the income gap, estimated around 0.20, can be mostly explained by occupation, skills, and ability (Heckman 1998). Employer discrimination alone does not account for the black-white income gap. One way to estimate the gap is the Oaxaca decomposition. It also identifies the explained and unexplained portion of the income differential. The amount that a variable explains the income gap is due to their difference in skills or endowments; and the amount that the variable leaves unexplained reveals its contribution to labor market discrimination. Using the Oaxaca decomposition and data from the Bureau of Labor Statistics's Current Population Survey (CPS), Kamara (2015) found that whites

are paid significantly higher hourly wages in comparison with blacks or Hispanics. The wage gap for Hispanics was due to skill differential, but employer discrimination was the primary cause for the black-white wage gap.

The Mincer equation explains income as a function of the person's human capital; it includes measures of skills and abilities. Estimating IGE in a Mincer equation is a common approach to estimate the level of intergenerational mobility in an economy (e.g., Becker 1986, Chetty 2014, Dahl 2008, Solon 2002). To estimate IGE, one regresses the log income of the parents on the log income of the child. The coefficient on log income of the parents is the IGE. When it is one, intergenerational mobility does not exist as the child's income is completely predicted by their parents' income. An estimate of zero indicates complete income mobility, so the child earns an income without effects from their parents' income. IGE is sensitive to sample and income specifications.

Studies tend to differ in their estimates of IGE because of IGE sensitivity. The number of years in the average lifetime income or ages when average income was observed change the coefficient estimate. Two reasons for the variation are the effects of life-cycle and attenuation biases. Life-cycle bias can mislead the analysis when the average income is not representative of the person's lifetime earnings. Attenuation bias is caused by errors in the independent variable(s) that cause the slope of the regression to go to zero. To limit these biases, economists attempt to identify the "best" representative specifications for average income when the income for the entire lifetime is not available for parents and children. Older studies tend to find lower IGE in contrast to newer studies, and some of this is due to the above-mentioned biases (Dahl 2008, Solon 2002). Another possibility for the changing IGE estimates is that intergenerational mobility is decreasing over time. Mazumder (2008) estimated an IGE for each decade between

1950 and 2000. IGE rises from 0.336 to 0.571 from 1950 to 2000. He used a cross-sectional data set from the decennial Censuses' Integrated Public Use Microdata Series (IPUMS) from 1940 to 2000.

Most economic studies of intergenerational mobility incorporate the human capital model as theorized by Becker (1986). The fundamental idea of the human capital theory is that parents pay for their children to acquire skills and abilities of value to the economy. Human capital is a factor of laborer productivity. It can also be used as a signal for employers. As a parent's income increases, they have more money to spend on their child. With a high quality of life and education, children of wealthier parents have leverage to attain an income and wealth independent of their parents. When parents are well-endowed, their children are less able to make significant changes to their situation. Children with less-endowed parents can more significantly change their parents' situation. When a group or country regresses to the mean of mobility, the difference in child-parent income decreases. Thus, regression to the mean establishes income equality.

In his paper, Becker analyzed and summarized multiple studies that used IGE. He included a large number of studies with varying IGE estimations. Most relevant to this discussion is his review of Robert Hauser's findings on Wisconsin high school graduates comparing the IGEs of younger and older blacks and whites. Becker concluded that younger blacks regressed to the mean slower than older blacks did. He speculates that labor market discrimination affects the speed of regression to the mean, and that is why younger blacks regress more slowly. One limitation to this research was that the responses of older blacks had greater response error in the data.

Borjas (1992) also used IGE to analyze US mobility. In this analysis he developed the ethnic capital theory as an off-shoot of the human capital theory. The ethnic capital theory suggests that the ethnic and racial parental background may be considered a human capital externality. He used data from the General Social Surveys (GSS) and the NLSY79. He focused on first-, second-, and third-generation immigrants and found that children with one immigrant parent had a lower IGE than children with two ethnic parents. He concluded that skills and income earned persists across generations. Then, he looks at sample of black families, and he showed that the ethnic capital model estimated IGE higher and more accurately than a normal human capital theory model. Disregarding the role of ethnic capital causes IGE estimation to overpredict progress of blacks. Borjas's speculations for the difference in natives and ethnic families' IGE include discrimination, among other institutional issues.

Dahl used Social Security Administration data in his study of mobility and IGE (1998). He ran several regressions to find the income specifications that best identify lifetime income of the son and father. He included in his study father and daughter estimates of IGE. His findings underlined the sensitivity of IGE to income specifications. The average age at which he determines is the best for measure the son's average income is 35 to 37 because he finds that they are less under the influence of lifecycle bias. He uses the age range of 20 to 55 to calculate the father's average life income to minimize lifecycle and attenuation biases. This specification provided an estimated IGE of about 0.5, with estimates ranging from 0.30 to 0.63 depending on the type sample selection. Including military persons changes the IGE as well. He estimated the IGE for fathers and their daughters and for fathers and their sons, and he found that daughters have greater mobility than sons.

Geography and political systems influence the IGE gap. A study found that racial differences in income mobility vary across cities and regions (Chetty 2014). Chetty divided the entire US into commuting zones and estimated each zone and region's intergenerational mobility using IGE and intergenerational rank association (IRA). IRA is similar to the IGE only the rank of each person's income is used. He defined commuting zones as metropolitan areas. To study race, he predicted the percentage of blacks or whites within a certain zip code. The study concluded that five factors were significant in determining mobility, one of which was racial segregation. Racially segregated communities have lower mobility for both blacks and whites if there is a larger population of blacks.

Chetty concluded that high income mobility is also correlated with less income inequality, greater social capital, better primary schools, and better family stability. These are environmental factors, and controlling for them may explain the difference in IGE. In general, the Southeast has the lowest mobility, and the rural Midwest and the mountain West exhibit the highest mobility. Additionally, some areas of the US have higher mobility than Canada and Denmark have. This is another indication that there is not one generalizable estimate of the IGE for a country. Measurement of intergenerational mobility should be tailored to specific groups of people within a country. It is likely inaccurate to describe an entire country using a single measure of intergenerational mobility. Rather, Chetty recommends that a sample is segmented into different socioeconomic groups for an accurate picture possible of the income equality.

In another paper on this subject, Mazumder (2014) used transition matrices to measure intergenerational mobility. Transitional probabilities of relative income status and directional rank probability answer more specific questions regarding the nature of mobility. He used the NSLY79 data in conjunction with the US Census Bureau's Survey of Income and Program

Participation (SIPP) data. He shows the rate of is dramatically lower for blacks compared to whites. For example, blacks who received 14 years of education have about 16% less mobility than whites with the same educational background. This result suggests that improvements in education may not affect the racial gap significantly. When comparing skills, there is some correlation that a higher score on the Armed Forces Qualification Test (AFQT) correlates with greater upward mobility. Additionally, he found that family structure has little to do with downward mobility, with the exception that single parentage decreases the likelihood of upward mobility more significantly for blacks than for whites. These factors represent a person's accumulation of human capital and their earned income.

Previous economic literature explores several aspects of intergenerational mobility with regards to income inequality, but decomposing the income gap using IGE has been undertaken by few economists. Most of the literature that breaks down racial discrepancy has been accomplished by comparing IGEs or incomes. This does not sufficiently answer to the nature of the relationship between IGE and income differential, or how much IGE differential explains discrimination. IGE's role in the income gap is a new and developing concept.

III. Theoretical Model

Following prior literature, the relevant theories of human capital and discrimination imply that IGE could affect wage discrimination (Dahl 2008, Heckman 1998). These theories were developed by Becker in 1986 and 1957, respectively, though economists continue to expound upon them. According to the human capital theory, skills and ability are capital in which workers, their parents, and the public can invest. These investments positively influence productivity of the laborer in the economy. Thus, parents' income influences the income of the children. An economy that provides equal opportunity to children enables each generation to

determine their income level regardless of family background or wealth. A child's income independent of their parents' income signals complete intergenerational mobility and greater economic equality. Differences of mobility between races arise when outside forces such as discrimination prevent equal opportunity. If skills are similar, intergenerational mobility and regression to the mean should be similar for all races.

One possible reason for the income gap is racial discrimination. The modern theory of discrimination distinguishes three types of discriminatory behaviors with regards to respective income and wealth. Employers discriminate when they prefer or dislike a certain racial group. Employee and customer discrimination occur when they prefer to work or interact with or not with a certain racial group. The last type is statistical discrimination, which is when a company acts on statistically proven differences in productivity between races. Statistical discrimination is acceptable because the behavior maximizes profits, but the other types of discrimination are not economically efficient.

The income differential between blacks and whites may be influenced by how a person's family income and background is perceived to add to the worker's expected productivity. Parental income can affect the productivity of a worker. A child's income can also be effected by how their employer values their parents' income due to their personal bias against their race. For example, an employer that prefers whites to blacks, despite them having similar family incomes and human capital, would be discriminating against blacks if they paid blacks less income. Because a parent's income can be an important determinant of their child's income, discrimination against income mobility may increase the income gap.

IV. Data and Methodology

The dataset used for this analysis is the NLSY79. It is commonly used to study race and intergenerational mobility because few, easily accessible datasets include a well-defined race variable. The data set will be split into two in the following way: one for black people and one for white people. The log child represent that of sons and daughters, and the log parent income may include mothers and/or fathers. Appendix A contains the variables considered in the model. An additional regression model for each data set will be run to control single mothers. The variables will be discussed in this section. Variables and income specifications are taken from Mazumder's 2014 study since he also used the NLSY. The representations of lifetime income will be created for parents and their daughters and/or sons in their late thirties and forties. A child's average net income is estimated from the years 1997 to 2005.

The sons and daughters are between the age of 39 and 48. The parental net family's average income will be taken from the years 1978 to 1980 when the children were living at home. This ensures that a significant number of observations in the sample. Parents are between the ages of 31 and 67, so they are about the same age as the kids to compare their average incomes. Observations in which income earned for parents or children were all zero or missing were dropped. They are outliers, and they could skew the results. Income is adjusted for inflation to 2004 dollars using the Consumer Price Index. Sons and daughters were combined because the net family income could be earned by a mother and/or father. Gender does not need to be controlled. The sample of children will include only those who lived with their parents during the first two years of the survey and who also remained in the survey until adulthood.

Theory and previous research predicts that these variables are significant to the model. As a person earns more skills, experience, and ability as measured by education of the child (EDU_R), experience (EXP), and AFQT scores (AFQT81), they can earn higher income since

they are more productive. Therefore, all the coefficients on the variables, including the intercept, should be positive except for experience-squared (EXP2). EXP2 is negative because a person stops gaining experience as they grow older, which results in their income increasing at a decreasing rate according to the age-earnings profile. Previous literature recommends a measure of fertility and a dummy variable indicating marriage status to control for family structure. This study includes a control for children of two-parent households because they may earn and hence invest more than single parent households.

The IGE for each race is found within a Mincer equation that regresses log parent income, skills, and ability on log child income. Then, the Oaxaca decomposition will reveal the income gap, and how much parental income explains or does not explain the difference. The log-log model to estimate the Mincer equation is below:

$$(1) \qquad Y_i = \alpha + \beta_1 * X_i + \beta_2 * Z_i + \varepsilon_i$$

Equation (1) estimates the relationship between the log child income (Y_i) with the log parent income (X_i) as IGE (β_1). β_1 denotes the mobility between generations. Z_i denotes the other variables included in the model. β_2 represents their coefficients. Four regressions will be estimated, for the black and white data sets and then two for the single mother control. The model with the best R-squared and explanatory power will be chosen for the decomposition of the racial income gap.

The Oaxaca decomposition will determine the extent to which IGE and the other variables contribute to the income gap. It uses the coefficients from the Mincer equations and the means of their respective variables to estimate the following equation:

$$(2) \qquad Y_w - Y_b = \beta_w [X_w - X_b] + [\alpha_w - \alpha_b + (\beta_w - \beta_b)(X_b)]$$

The difference in white and black income is illustrated on the left-hand side. The first half of the right-hand side shows how much of the gap is explained by differences in endowments. The second half of the equation shows how much of the difference in income is unexplained by difference in skills. This could indicate possible discrimination. X_w and X_b represent the means of each variable for whites and blacks, and β_w and β_b represent their respective coefficients found in Equation (1). The decomposition will show how much each variable contributes to a difference in endowments and a difference due to possible discrimination.

V. Results

First, the OLS regression results will be discussed, and then the Oaxaca decomposition will be explained. Table 1 presents the results of the OLS regressions for blacks and whites. Number of observations were 1,793 for the black regression and 2,753 for the white regression. There is some disparity between the number of observations. Both models explain about a fifth of the variance when predicting log child income according to their R-squared. Table 2 shows the results for the two-parent income control. It detracted from the R-squared values, and the black-white regressions are less comparable with a difference of more than 1,000 observations. It explained less about log child income, and black and white regressions are more difficult to compare with such a large difference in observations. The only other obvious difference is that blacks' IGE is lower and whites' IGE is higher in Table 2. Table 1 regressions provide more comparable black and white samples. Its results are the focus of the following analysis, and they will be used in the decomposition.

The intercept, education, IGE, and the AFQT score are all significant and positive. An additional unit of each predicts a percentage increase in the log child income. This follows the human capital theory. Experience was positive, but it and experience-squared were not significant to this model. Experience-squared for the white regression positively affects child

income, which is counter to theory. However, it increases log income by an insignificant amount for either race, so it does not impact the results. A glance at the intercepts reveals that blacks earn less income than whites, all else equal. This is consistent with expectations from prior literature and the summary statistics in the appendix. A percent change in education adds 12 percent to the income of blacks, and it increases a white person's income by about 10 percent. The coefficient of AFQT scores reveal that every 10 percentage points achieved increases child income by 9 percent for blacks, and child income increases by 6 percent for whites. These variables have a greater effect on black income than white income. Blacks tend to earn more income than whites from an additional unit of skill or ability because they start off with a lower income. To earn similar income with whites, blacks must have greater human capital.

Both IGEs are low and close to each other. Blacks are slightly more mobile with an IGE of 0.16, while white IGE is 0.18. Consequently, blacks have slightly greater intergenerational income mobility than whites. The IGE coefficient indicates that, for every one percent parental income increases, child income is predicted to increase by 16 percent for blacks, and to increase by 18 percent for whites. Blacks' earned income does not reflect their parents' income as much as white children's income does. This could be because black parents of that generation were less endowed, so their children have greater room to rise or fall. Overall, there is some evidence that America may be more mobile than other recent studies found, but these estimates are not completely representative of the US.

The results of the Oaxaca decomposition are shown in Table 3. Decomposing the gap finds an income difference of 64 percent. A black person earns 40 cents in income for every white person's dollar. The 'Total' column indicates how much of the income gap is explained or unexplained. Half of the income gap is explained by skills, and the other half is unexplained.

This allows that possible discrimination creates almost half of the income inequality. Employers and economic policies may prevent blacks from earning similar incomes as whites. The decomposition further explains that the intercept difference is 0.83. This means that blacks earn less income than whites when only accounting for race.

The income gap was further decomposed by the contribution of each variable. Significantly to the hypothesis, log parent income affects the income differential between blacks and whites. IGE accounts for about one-half of the gap and two-thirds of possible discrimination. One-third of the explained difference is due to the difference in IGE, and AFQT score accounts for about half of it. The effect of IGE is mostly unexplained and contributes to possible discrimination. The income of white families is valued 18 percent more than similar income of black families. This is a disadvantage to blacks achieving income equality. Discrimination against parental income prevents each generation from earning income equal to whites. Black Americans' intergenerational mobility may be slightly higher than whites' mobility, but it does not have the same value to discriminatory employers.

The table also shows that black people's education is valued 36 percent more than white people's education when controlling for the difference in years of education. The difference in the value of education decreases the gap mostly. Very little of the difference in experience is explained, and much of it is unexplained. The experience of black laborers is valued 115 percent higher than white experience. It closes some of the income gap, but it still reveals possible discrimination. This can be seen also in the table with respect to the AFQT scores, where blacks' ability again has higher value than whites' ability. The results of experience-squared show that, as whites and blacks grow older, whites earn 85 percent more log income than blacks because accumulated experience of white people amounts to greater value to those who discriminate.

The Oaxaca decomposition reveals that discrimination and differences in endowments affect the income gap equally. Some variables have greater effect than others, and IGE is one of them. Employers value blacks more than whites for having a certain amount of human capital. Blacks must prove through their human capital that they are worth the additional income. Whites achieve a higher income due to their race. This is understood in conjunction with the difference in intercepts. The results of the decomposition are the first of its kind, but there is room for improvement and expansion.

VI. Conclusion

The income gap is much larger than previously thought, and there is some statistical evidence that IGE contributes significantly to it. Intergenerational mobility does not help blacks improve or equalize their income with whites if discrimination prevails. The income gap could persist if employers discriminate against black people by paying whites more because of their parents' income. Additionally, black people should not have to increase their human capital to reach similar wealth of white people. Policies should be considered to enforce business practices that pay blacks and whites equally when considering parent income. Blacks and whites may have more income mobility from generation to generation than previously thought. Blacks may have better a IGE than whites because they have greater downward mobility overall, and they could have greater room to alter their parents' income.

This study paves the way for a new interest in the income gap. It provides evidence to suggest that studies should continue to examine income inequality with respect to intergenerational mobility. Some suggestions for further decompositions include identifying directional mobility in IGE within the income gap. Looking at within income groups or occupations could amplify effectual policy recommendations. Like some other studies, one can also adopt a method of predicting income from the occupations of parents and children rather

than using reported income. Additionally, this methodology could apply to the gender and the immigrant-native income gap.

There were some limitations to this study. Some issues are that IGE for blacks is lower than that of whites; and the estimated income gap is greater than prior literature expects. The NLSY79's self-reported income may have skewed the results. The number of years averaged for family income could be greater. Different income specifications may be required when using this data set. A recommendation would be to discard observations of people who earned zero income for three or more years, or narrowing the sample between the tenth and ninetieth percentile. This would reduce number of observations, but it may still provide more relevant and accurate estimates. Additionally, IRA may be a better method using this data considering the questionable reliability of income. Although it is good that the US seems to have decent mobility from this study, this is an inconclusive result as it runs counter to other papers. One last suggestion is to use a data set in which income is not self-reported. Regardless of these issues, this study reveals interesting questions and results for future studies regarding the relationship between income mobility and the income gap.

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Table 1. Black and White OLS Regression Results				
	Black		White	
Variables	Coefficients	T-Value	Coefficients	T-Value
Intercepts	6.27209	6.72***	7.11025	11.68***
LINC_P	0.16312	6.47***	0.18081	8.62***
EDU_R	0.12437	9.29**	0.09603	10.67***
EXP	0.06242	0.91	0.0144	0.33
EXP2	-0.00152	-1.08	-0.00006738	-0.07
AFQT81	0.00889	8.59***	0.00587	10.07***
R-Squared	0.2743		0.2596	
N	1793		2753	
Note: *** indicates significance at p=0.01. ** indicates significance at p=0.05.				

Table 2. OLS Regression Results for Two-Parent Income				
	Black		White	
Variables	Coefficients	T-Value	Coefficients	T-Value
Intercepts	5.77536	4.07***	7.236	10.42***
LINC_P	0.14599	3.85***	0.19194	7.94***
EDU_R	0.14027	7.66***	0.0918	9.18***
EXP	0.09503	0.9	0.00287	0.06
EXP2	-0.00201	-0.93	0.00011328	0.11
AFQT81	0.00836	5.88***	0.00549	8.67***
R-Squared	0.2655		0.2508	
N	990		2298	
Note: *** indicates significance at p=0.01. ** indicates significance at p=0.05.				

Table 3. Blinder-Oaxaca Decomposition		
Variables	Explained	Unexplained
Intercepts		0.8382
LINC_P	0.1254	0.1807
EDU_R	0.0638	-0.3589
EXP	-0.0122	-1.1552
EXP2	0.0026	0.8531
AFQT81	0.1776	-0.0728
Total	0.3571	0.2850
Total Wage Gap		0.642

Appendix A. Summary Statistics

Variable	Definition	Blacks			Whites		
		N	Mean	Standard Deviation	N	Mean	Standard Deviation
INC_R	Child's average income from years 1997 to 2005.	2,129	43,169.58	36,671.38	3,268	75,361.36	60,704.39
LINC_R	Log of the child's average income from years 1997 to 2005.	2,129	10.33	0.92	3,268	10.96	0.80
INC_P	Parents' average wages from years 1978 to 1980.	2,129	34,977.91	25,583.25	3,268	64,555.82	35,989.89
LINC_P	Log of the parents' average wages from years 1978 to 1980.	2,129	10.21	0.73	3,268	10.91	0.63
EDU_R	Years of education of the child.	2,050	12.664878	2.01	3,197	13.33	2.41
EXP	Measure of experience acquired by age.	1,832	24.057	2.92	2,842	23.21	3.18
EXP2	Measure of experience acquired by age, squared.	1,832	587.28	141.29	2,842	548.69	147.41
AFQT81	Armed Forces Qualification Test score in 1981.	2,071	24.10	20,965.98	3,141	54.36	27,619.67
SMOM	Child had a single mother, no father or step-father on household record in 1979.	2,129	0.45	0.50	3,268	0.17	0.37

Note: All variables are from the 1979 National Longitudinal Survey of Youth of the U.S. Bureau of Labor Statistics. All income was converted to 2004 dollars using the Consumer Price Index.