

ABSTRACT

The canonical supply and demand framework of competitive labor markets can be used to explain the bulk of observed time trends and much of cross-country variation in wage gaps between education levels. Carneiro and Lee (2011) argued that previous literature using this framework had overstated the increase in educated labor supply by implicitly assuming unchanging pre-college ability levels, because increases in the share of college graduates dilute the average quality of college students. We use data on Finnish military conscripts' cognitive and non-cognitive test results, matched with later life completed education and labor market outcomes. We find that positive cohort trends in both cognitive and non-cognitive ability dampen and even reverse any such dilution in graduate quality. These cohort trends in skills have, along with increasing educational attainment, reduced earnings gaps between education levels. Despite the increase in their supply, the returns to social skills increase over time, which points to a large increase in the demand for social skills. By contrast, the returns to cognitive skills have been on decline. Similar cohort trends in cognitive ability (aka "the Flynn effect") have been documented around the world, so our findings are suggestive for other countries as well.