Rising Inequality and Falling Labor Share: The Role of Wage Contracts

Cynthia L. Doniger (Federal Reserve Board)

I study trends in labor share and earnings inequality in the context of an on-the-job search model featuring heterogeneous wage contracts. In the model, a shift toward employment contracts with upwardly-renegotiable wages implies a decrease in labor share and an increase in inequality. Using the German social security register, I assess the ability of this mechanism to account for trends in inequality and labor share observed in that country. I find a secular trend toward upwardly flexible wage contracts which accelerates in the 2000's matching the observed series for inequality and labor share over the same horizon. Further, I show that industries in which the incidence of upward wage revisions increases most also experience larger increases in inequality and larger declines in labor share.