FIRM DYNAMICS AND RESIDUAL INEQUALITY IN OPEN ECONOMIES

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Abstract
Wage inequality between similar workers has been on the rise in many rich countries. Recent empirical research suggests that heterogeneity in firm characteristics is crucial to understand wage dispersion. Lower trade costs as well as labor and product market reforms are considered critical drivers of inequality dynamics. We ask how these factors affect wage dispersion and how much of their effect on inequality is attributable to changes in wage dispersion *between* and *within* firms. To tackle these questions, we incorporate directed job search into a dynamic model of international trade where wage inequality results from the interplay of convex adjustment costs with firms' different hiring needs along their life cycles. Fitting the model to German linked employer-employee data for the years 1996-2009, we find that firm heterogeneity explains about half of the surge in inequality. The most important mechanism is tougher product market competition driven by domestic product market deregulation and, indirectly, by international trade. (JEL: F12, F16, E24)

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