

Mario Macis

University of Chicago

Wage Dynamics and Insurance

I consider an insurance model of the employment relationship with two-sided limited commitment. The model implies that wages should be insensitive to changes in outside opportunities as long as these do not make some outside option constraint binding. I derive empirically testable implications of the model, contrast them with those implied by alternative wage setting mechanisms (the spot market model, continual Nash bargaining and the insurance model with one-sided limited commitment), and test them using a large, matched employer-employee panel of male workers from Northern Italy spanning the period 1982-1997. The empirical results are supportive of the insurance model with two-sided limited commitment. Current wages are correlated with both the best and the worst realizations of outside options (proxied with the aggregate and local unemployment rate) since the start of tenure, even after controlling for current conditions. Cohort effects in wages do exist but disappear when substantial changes in outside opportunities occur. Finally, the responsiveness of wages to upward or downward, small or large changes in outside opportunities reveals asymmetries consistent with the predictions of the model.