Higher and higher? Performance pay and wage inequality in Germany

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Performance pay is of growing importance to the wage structure as it applies to a rising share of employees. This trend has been observed in several industrialized countries over the past decades (Lemieux et al., 2009). A parallel trend has been that of growing wage inequality (Autor et al., 2008). This prompts the following research question: How is the rise in wage inequality related to the growing use of performance pay schemes?

Performance pay has been found to contribute strongly to growing wage inequality in the US mainly in the top of the wage distribution (Lemieux et al., 2009; Heywood and Parent, 2009). For Germany, this relation has not been studied yet. The case of Germany is interesting because its wage structure follows the international trends in growing wage dispersion (Dustmann et al., 2009) and the increasing use of performance pay schemes (Pannenberg and Spiess, 2009). At the same time, the labor market has experienced dramatic shifts from strong rigidity to more flexibility (Fitzenberger et al., 2011). These shifts rendered “Germany’s jobs miracle” (Krugman, 2009) possible, that took place on the German labor market during the Great Recession (Möller, 2010). Still, the dramatic growth in wage inequality in Germany remains in parts unresolved. Several explanations are possible, one of which is skill-biased technological change (“SBTC”, Katz and Autor, 1999; Autor et al., 2003). However, Antonczyk et al. (2009) find that changes in the tasks cannot explain the growing wage dispersion in Germany. Deunionization can explain only a small part of it (Antonczyk et al., 2010) while differences between industries and establishments play a large role (ibid., Card et al., 2012). Can performance pay provide the missing explanation for rising wage inequality?

In order to analyze this question empirically, data from the German Socio-Economic Panel Study (SOEP) for the period 1984 to 2009 are employed. “Performance-pay jobs” are defined as those job matches that have rewarded profit-sharing, premiums or bonuses at least once in the past. The data shows that the share of performance pay jobs has increased steadily over the considered
time period by more than 20 percentage points. At the same time, wage inequality, as measured by the 90-10 differential grew by more than 21 log points over the period of 20 years (12 log points at the interquartile range). In order to analyze the relation between these two trends, a sequential decomposition method is employed. This captures the contributions of different components of the wage distribution and separates them from one another. In addition, this method has been extended to the context of quantile regressions so that results for the entire distribution of wages are obtained (Machado and Mata, 2005, Chernozhukov et al., 2008). By means of this sequential decomposition method, the following research question can be analyzed: How would the wage structure have developed, had the incidence of pay for performance not increased?

The corresponding results show that the growing use of performance pay did not contribute to the growth in wage dispersion. Still, there has been a small but significant upward shift in the wage distribution due to the growing use of performance pay. The magnitude of this shift is around one log point which explains about 11% of wage growth at the median. The growth in wage inequality is instead explained by changes in the characteristics of the workforce (particularly in the top half of the wage distribution) and returns to these characteristics (particularly in the bottom half). Finally, as more employees receive pay for performance, wage inequality grows within performance pay jobs – but even more so within those job matches that do not reward performance. The returns to observed characteristics increased more within performance pay jobs than within non-performance pay jobs. The wage difference between both types of jobs grew over time but remained flat.

The cause for growing wage inequality in Germany is not the growing use of variable pay schemes, as the present analysis has shown. Thus, the underlying causes for the described trends need further investigation.

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* For a closer analysis please refer to Higher and higher? Performance pay and wage inequality in Germany, in SOEPpapers on Multidisciplinary Panel Data Research Vol. 476.
References


