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Performance pay, trade and inequality

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# PERFORMANCE PAY, TRADE AND INEQUALITY\*

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## Abstract

This paper introduces moral hazard into a general equilibrium model with heterogeneous firms to study wage inequality between homogeneous workers. Optimal performance pay contracts yield non-degenerate wage distributions among co-workers, enabling the analysis of two conceptually distinct, and empirically relevant, dimensions of wage dispersion: between-firm and within-firm inequality. The latter remains virtually unexplored in the literature. As an application, I characterize analytically the impact of trade liberalization on within-firm inequality, highlighting a new channel through which international trade can contribute to residual wage dispersion. To motivate the theory, I show that the model is consistent with cross-firm empirical patterns in residual wage dispersion and performance pay using nationally representative, matched employer-employee data from Canada.

JEL codes: F16, J31, J33.

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