Abstract

The year 1997 was a turning point in the labor market in Japan. In that year, the attitudes of enterprise unions and stock markets toward downsizing began to change, which resulted in an increase in the probability of dismissal, even among unionized workers. In this study, we first present theoretical predictions on the impact of this increased probability of dismissal on the wage response to the business cycle by applying shirking theory. The higher the probability of dismissal, as is typical for low earners, the more likely that shirking theory becomes applicable, while for those whose probability of dismissal is potentially small or almost zero (e.g., high earners), shirking theory does not fit. We find that the change in 1997 weakened the relationship between the business cycle and the wages of low earners compared with beforehand; on the contrary, the change in the wage response to the business cycle for high earners was only very small. Second, our empirical exercises using the Firpo, Fortin, and Lemieux decomposition method show that wages became less pro-cyclical for low earners after 1997 compared with before and unchanged for high earners. Given these different responses between low and high earners, the 1997 structural change in the labor market contributed to shrinking wage inequality in recessions thereafter. Our theoretical and empirical evidence provides a valuable insight into why recent wage growth is sluggish, even with a labor shortage.