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Modeling Life-Cycle Earnings Risk with Positive and Negative Shocks*

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Abstract

We estimate explicit age-varying distributions of idiosyncratic persistent and transitory earnings shocks over workers’ life-cycles using a German administrative data set. Large positive shocks, both transitory and persistent, are characteristic for the first eight years of the working life. After the age of 50, large negative shocks become a major source of earnings risk. Between the ages of 30 and 50, most shocks are small and transitory. Large persistent positive shocks that occur early in the working life help to rationalize large wealth and consumption shares of the top one percent in an incomplete markets model.

Keywords: Life-cycle, earnings risk, wealth dispersion, consumption inequality

1. Introduction

Individual earnings risk changes over the life-cycle. During the early stage of the working life, finding all-year-round employment and moving up the job-ladder are associated with large individual earnings fluctuations\textsuperscript{1} During prime-age (ages 30-50), workers settle into more stable employment and large earnings changes become less frequent. Once closer to retirement, periods of non-employment and losing a high-tenured job become major risks\textsuperscript{2}. Karahan and Ozkan (2013), Blundell et al. (2015), and López-Daneri (2016) study this age variation in terms of changing variances of idiosyncratic transitory and persistent earnings shocks. This paper also decomposes male earnings changes into transitory and persistent earnings shocks, but it goes beyond age-variations in the second moment of these shocks. In particular, it estimates explicitly age-varying distributions of positive and negative earnings shocks. We find that the probabilities to experience large positive and large negative earnings shocks vary

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\textsuperscript{1}See Topel and Ward (1992).

\textsuperscript{2}See Jung and Kuhn (2018).
substantially with age, and this age-variation furthers our understanding of households’ consumption
and savings decisions.

Using German administrative individual earnings data, we first document that moments of positive
and negative residual earnings growth behave very differently from each other over the life-cycle.
Positive residual earnings growth is relatively rare before the age of 30, but growth rates are large on
average and highly dispersed. The relatively frequent negative residual earning growth is small on
average leading to a positively skewed distribution of residual earnings growth. The average size and
the dispersion of positive residual earning growth fall throughout the life-cycle, and the average size
and the dispersion of negative residual earnings growth grow throughout the life-cycle. Brought by
less frequent large positive residual earnings growth and more frequent large negative residual earnings
growth, the distribution of residual earnings growth becomes negatively skewed from age 40 onwards.
After the age of 50, negative residual earnings growth is 10% larger on average and its variance is
60% larger than at age 25. In contrast, positive residual earnings growth is 70% smaller on average
and its variance is 70% smaller than at age 25. Finally, the first autocovariance of positive growth is
small relative to the first autocovariance of negative growth throughout the life-cycle.

Using simulated methods of moments, we estimate a parametric model that maps the distribution of
residual earnings growth into age-varying distributions of transitory and persistent earnings shocks.
We obtain these distributions explicitly by modeling shocks as a mixture of specified parametric
distributions, similar to Geweke and Keane (2000), Bonhomme and Robini (2010), and Guvenen et al.
(2016). To be specific, we parametrize residual log earnings as a mixture of three components that,
given our decomposition of the data, have a natural interpretation: a positive, a negative, and a mean-
zero component. The latter is a transitory normally distributed shock. In addition to this shock, with
age-varying probabilities, workers draw either an innovation to their positive component, an innovation
to their negative component, or no further shock. An innovation to the positive (negative) component
is a combination of a transitory and a persistent log-normally distributed shock. Hence, persistent
and transitory shocks are partially correlated in our model which deviates from the more standard
zero-correlation assumption in the literature. A positive correlation allows the model to be consistent
with the earnings dynamics occurring around two prominent (observable) persistent labor market
shocks: unemployment and job-to-job transitions. That is, earnings are lowest on average in the
year of an unemployment spell but return partially to their former level afterward (see also Jacobson
et al. (1993)). Similarly, average earnings are highest in the year of a job-to-job transition but reverse
somewhat thereafter. To capture the age-varying frequency and severity of these and other earnings
shocks, we allow the means and variances of the parametric shock distributions to vary with age.
These age variations in the shocks underlying the three components, together with the age-varying
sampling probabilities of the three components, allow the model to generate rich age-variants in the
overall distributions of transitory and persistent earnings shocks.

We find that at prime-age, most workers experience only small transitory shocks. At age 40, only 33%
of workers experience any persistent earnings shocks during a given year. These probabilities are much
higher, around 58 percent, at ages 25 and 55. Turning to the properties of these persistent shocks,
we find that the autocorrelations of persistent positive and persistent negative shocks are above 0.97,
i.e., these shocks are close to permanent. The probability to draw a positive persistent shock increases
from 11% at age 25 to 44% at age 55. Nevertheless, experiencing a positive persistent increase in log
earnings of more than 0.2 is 7 times more likely at age 25 than at age 55. The reason is that the
mean and the variance of persistent positive shocks are about 5 times larger at age 25 than at age 55.
Persistent negative shocks show the exact opposite life-cycle behavior of positive shocks. They are
small, have little dispersion, and occur with relatively high frequency early in life, and become rare,
large on average, and more dispersed late in life. To put these findings in perspective to the U-shaped

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3On average, earnings rise when young and decline when old. We study deviations from this predictable age pattern.
variance of persistent shocks over the life-cycle found by Karahan and Ozkan (2013), our results imply that the initial decrease is entirely driven by positive persistent shocks becoming less dispersed and the later increase is entirely driven by negative persistent shocks becoming more dispersed.

Transitory shocks to the positive and negative components are large and highly dispersed. On a life-time average basis, the variance of transitory negative shocks is 2.6 times larger than the variance of transitory positive shocks. Moreover, it is 11 times larger than the variance of persistent negative shocks. As a consequence, most large negative shocks are transitory. A negative change in log earnings of more than 0.2 is in 71% of the cases due to a transitory shock. The corresponding number for positive shocks is only 55%. The difference is even more pronounced early in life. At age 25, 94% of all negative changes in log earnings of more than 0.2 are the result of a transitory shock. In contrast, 50% of all positive changes in log earnings of more than 0.2 result from persistent shocks at age 25.

Next, we introduce this estimated earnings risk into an Aiyagari (1994) type model to study the implications of age-varying, non-normally distributed risk for consumption and savings decisions. We contrast the results to the widely used age-invariant risk model (AIRM) with mean-zero normally distributed transitory and persistent shocks. Compared to this latter model, the large but rare persistent positive shocks early in life imply, as in the data, a relatively high dispersion in the right tail of the cross-sectional earnings distribution. A few lucky workers, therefore, accumulate large wealth holdings for life-cycle purposes, particularly to finance consumption during retirement, and hold a relatively large share of the overall wealth. This channel has a strong amplification mechanism for cross-sectional wealth inequality because these shocks occur early in life; thus, they imply large cross-sectional differences in lifetime earnings. Compared to the AIRM, the share of wealth holdings by the top 1% more than doubles, bringing the model closer to the data.

Similar to wealth inequality, consumption inequality is more pronounced in the right tail of the cross-sectional distribution in our model than in the AIRM. That is, the ratio of consumption of the top 1% relative to the median worker is relatively high and it grows relatively rapidly over the life-cycle. This shift of resources away from the median and towards the highest lifetime consumption workers reduces welfare in our model relative to the AIRM. Counteracting this effect, consumption inequality at the bottom of the distribution is somewhat lower in our age-varying risk model. Measuring welfare in terms of the consumption an unborn household is willing to pay to insure against idiosyncratic earnings heterogeneity, we find that the former effect dominates, that is, the welfare costs of incomplete insurance markets are higher in the age-varying risk model.

Age-varying non-normally distributed risk also helps to explain the dynamics of cross-sectional consumption inequality over the life-cycle. In specific, large negative tail shocks late in life increase the desired stock of workers’ precautionary savings. We show that more precautionary savings and a shift towards more persistent and positive shocks increase the speed at which consumption dispersion increases late in life. As a result, the cross-sectional variance of log consumption grows close to linear in age, which is consistent with the German data analyzed by Fuchs-Schündeln et al. (2010).

Our findings contribute to the recent macroeconomic literature that studies the implications of non-normally distributed shocks for individuals’ savings and consumption. Civale et al. (2017) show that wealth inequality decreases when earnings shocks become more negatively skewed. Castañeda et al. (2003) calibrate the earnings process such that it matches the observed right tail of the wealth distribution which implies a “superstar” earnings state. The large and persistent positive shocks we find early in the life-cycle have qualitatively the same effect. De Nardi et al. (2019) use a two-step approach to study higher-order earnings risk. First, they estimate the model proposed by Arellano et al. (2017) and, thereafter, estimate Markov processes on simulated data resulting from step one. Importantly, this approach allows for non-linear log earnings dynamics that imply shocks being less persistent; therefore, less costly in terms of welfare. Our finding that a shift of resources towards the
right tail of the earnings distribution increases the welfare costs relative to an age-invariant risk model is complementary to theirs.

The rest of the paper is organized as follows. Section 2 describes the German data set. Section 3 presents the moments of residual earnings growth over the life-cycle. Section 4 describes the econometric model. Finally, Section 5 introduces our earnings process into a life-cycle savings model.

2. Data and Sample Construction

2.1. Data Description

Our data source is the Sample of Integrated Labour Market Biographies (SIAB) for the years 1975-2010. The data originates from the German notification procedure for social security. This requires employers to report their employees' working spells, earnings, and some socioeconomic information. The data covers the population of German employment except for civil servants, the self-employed, and regular students (about 20% of the employment-population). From this population, the German employment agency draws a 2% random sample of individuals' careers. In total, the data has information on 1,594,466 individuals and 41,390,318 unique person-year records. Thus, SIAB provides a large number of career-long earnings profiles with little measurement error.

We focus on the earnings risk of workers with a high attachment to the labor force and abstract from any employment decisions resulting from earnings shocks. We drop workers in an apprenticeship, partial retirement, marginal part-time workers (geringfügig Beschäftigte), and part-time workers not eligible for unemployment benefits. Moreover, we only consider German male workers to avoid female decisions over maternity leave. We define a worker as employed within a year when he is contracted for at least 90 days of that year. Hence, our analysis abstracts from earnings shocks arising from long-term unemployment. Following the literature that focuses on workers with a high attachment to the labor market, we keep for each individual the longest spell of earnings with at least 7 years of observations (see Meghir and Pistaferri (2004), Guvenen (2009) and Hryshko (2012)).

To avoid misinterpreting predictable earnings changes as shocks, the age range under consideration is of some importance. For the time period of our sample, a high school degree takes up to 13 years of schooling and male workers are obliged to perform 1 year of military service. Most workers enter professional training (2-3 years) thereafter. Hence, we expect workers to have made a full transition to the labor market by the age of 24. The intended retirement age in Germany used to be 65. Yet, Arnds and Bonin (2002) show that early retirement schemes lead to an average retirement age around the age of 60. Moreover, generous unemployment benefits for high tenured workers often lead to an effective retirement age of 55. To avoid these endogenous decisions, we restrict the panel to workers aged 24 to 55. Finally, we discard workers in East-Germany as those observations are only available after 1991. Our final sample contains information for 251,352 individuals with a total of 3,566,212 person-year observations.

For each calendar year, we aggregate an individual’s earnings across all job spells. We deflate earnings using the German consumer price index of 2010. Changes in real earnings may arise from inflation, a change in working hours, a change in employer, an unemployment spell, bonuses, promotions, etc. Workers entering the sample for the first time are statistically expected to enter in the middle of the year. Daly et al. (2016) show that this may lead to a bias in the estimates of permanent shocks. To avoid this bias, we assume that earnings in the months preceding the first employment spell are the same as the observed months in that year. Similarly, we assume that earnings in the months following the last employment spell are the same as the observed months in that year. Following Dustmann
et al. (2009), we drop real daily-earnings that are below 5 euros. Daily-earnings are top-coded by the limit liable to social security. On average, this affects around 6% of observations per year. We follow Daly et al. (2016) and impute daily earnings from an extrapolated Pareto density fitted to the non-top-coded upper-end of the observed distribution for each year. Alternatively, we could drop workers affected by top-coding. The moments of residual earnings growth are almost identical for the two approaches. We opt for the former because it allows us to infer the entire cross-sectional earnings distribution of the German employment-population.\footnote{By doing so, we assume earnings growth behaves similarly for the top decile of the German earnings distribution relative to the rest of the distribution.}

Our interest is in annual earnings changes that are idiosyncratic to the individual. To this end, we remove predictable changes from earnings growth by running cross-sectional regressions for each workers’ age. The regressions control for an education dummy, year dummies, region of residence, and 14 major industries. Next, we assign each individual to a birth cohort defined as being born in a seven-year interval starting in 1923. Figure A2 in the Appendix shows, using as an example the variance of residual earnings over the life-cycle, that the data features both a calendar time and a cohort effect. The latter may partially arise from the data not reporting one time payments before 1984. Following Blundell et al. (2015), we average all data moments across cohorts to eliminate these types of time effects, assigning equal weight to all cohorts. Therefore, our results can be interpreted as the risk a typical cohort is facing. To compute the cross-sectional earnings inequality over the life-cycle, we follow Deaton and Paxson (1994) and regress the cross-sectional variance of log earnings on a full set of age and cohort dummies. We compute the cross-sectional variance at age 24 as the mean of the cohorts’ intercepts.\footnote{Lowering the work requirement to 65 days increases the variance of residual earnings growth from 0.089 to 0.098.}

Figure A3 in the Appendix compares the resulting life-cycle moments of the variance, skewness, and kurtosis of earnings growth to those reported in Guvenen et al. (2016) for the US. The life-cycle behavior of these moments is remarkably similar across the two countries, yet, there are some differences in their levels. The age-averaged variance of earnings growth is two to three times larger in the US. For one, Guvenen et al. (2016) impose a $1500 lower income limit to enter into their sample which is less stringent than the limit implied by our restrictions on minimum wages and working days. Moreover, the US data includes income from operating a business that is more volatile than employees’ earnings. Yet, there are also some institutional differences between the countries worth highlighting. For many German sectors, wage floors are centrally bargained implying more nominal wage rigidity. Moreover, Germany has strong employment protection for high tenured workers that leads to a lower probability of becoming unemployed but also to a lower probability of finding a new job. Bachmann et al. (2019) show that both the German accession and separation rate of workers within establishments are only 60% of the US level, yet such switches are a major source of earnings volatility. This latter fact also contributes to skewness being less negative on average in Germany. We find that skewness becomes more negative as we loosen the requirement for the number of days worked to enter into the sample, i.e., negative skewness is strongly driven by workers reducing their amount of working days from one year to the next. In Germany, there are fewer of such non-employment events.

3. Moments of Residual Earnings Growth

This section highlights the salient features of residual earnings dynamics over the life-cycle. Figure 1a displays the cross-sectional variance of residual log earnings across ages, \( \text{Var}(y_{i,h}) \), where \( i \) denotes the individual and \( h \) denotes age. The variance is falling for the first three years and reaches a low of 0.09. Inequality accelerates up to age 40 when its growth slows down somewhat. In total, between the ages of 27 and 55, residual earnings inequality more than doubles. Guvenen et al. (2016) show...
that cross-sectional inequality also doubles over the life-cycle in the US. However, the cross-sectional variance of earnings at labor market entry is substantially higher in the US (0.47 at age 27).

We now turn to the dynamics in residual earnings that create this life-cycle pattern in inequality. A common way to identify earnings shocks is to study the covariance structure of residual earnings growth (we use interchangeably the terms growth/innovations/changes), $g_{i,h}$. Figure 1b plots its cross-sectional variance over the life-cycle. The variance declines by almost 43% between the age of 24 and age 55 with most of the decline, close to 80%, occurring before the age of 30.

To better understand the changes in the distribution of residual earnings growth that lead to the decreasing variance, we study separately positive, $g_{i,h}^+$, and negative, $g_{i,h}^-$, residual earnings growth. Figure 2a displays the conditional variances of these innovations, $\text{Var}(g_{i,h}|g_{i,h} \leq 0)$. The figure shows that the decline in the variance of residual earnings growth up to age 30 results from positive changes becoming less dispersed. In contrast, the variance of negative residual earnings growth slightly increases during these years. Afterward, the variance of positive growth continues to decline and the variance of negative growth continues to increase. The latter is more than 60% larger at age 55 than at age 25.

Figure 2b shows that the average sizes of conditional residual earnings growths closely track their variances. Positive residual earnings growth is large on average early in life, and it becomes smaller throughout the life-cycle. Mean negative residual earnings growth is almost constant until the age of 50 and becomes larger in absolute size thereafter. Figure 2c plots the probability to observe a positive innovation at each age, $\text{Prob}(g_{i,h} > 0)$. Its behavior over the life-cycle reconciles the different means of conditional growths with the mean-zero unconditional growth. Early in life, close to 70% of innovations are negative, but the probability of a positive change is increasing throughout the working life and reaches 62% at the age of 55. Average positive growth becoming more likely with age implies that the distribution of earnings growth becomes more negatively skewed as workers age. Figure 2d shows that the distribution is initially positively skewed, and skewness turns negative around the
Notes: Panel (a) displays the variance of residual earnings growth across ages conditional on residual earnings growth being positive (negative). Panel (b) displays the corresponding means of residual earnings growth. Panel (c) depicts the fraction of residual earnings growth that is positive at each age. Panel (d) displays Kelly’s skewness measure of residual earnings growth across ages. The dashed lines display block-bootstrapped 95% confidence intervals.

Figure 2: Variances and Means of Conditional Residual Earnings Growth

Guvenen et al. (2016) highlight that US earnings growth features fat tail behavior. We find a similar magnitude of kurtosis in the German data. What is more, Figure 3a shows that kurtosis increases in a concave fashion throughout the life-cycle. At its peak, it is 5 times larger than what is suggested by a normal distribution. The large kurtosis implies that a substantial fraction of workers experiences very small residual earnings changes. To put this into perspective, Figure 3b displays the fraction of

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8To avoid outliers affecting the skewness, we use Kelly’s measure of skewness.  
9To avoid outliers affecting the kurtosis, we use Crow-Siddiqui’s measure of kurtosis (Crow and Siddiqui 1967).
residual earnings growth by age that is above 5 percent (in absolute value). In the cross-section, 48 percent of workers experience a residual log earnings change of less than 5 percent. Figure 3b also displays the fraction of workers with an earnings change of more than five percent that is implied by a normal distribution with the same variance as the data. In that case, only 13 percent of workers would experience such a small change. What is more, in the data, the share of workers experiencing small residual earnings changes has a strong age dimension. At age 40, 50 percent of workers experience residual earnings changes of magnitude smaller than 5 percent. In contrast, between the ages of 25 and 30, only 21 percent of innovations are smaller than 5 percent, a change of almost 30 percentage points. Under the assumption of normally distributed earnings growth, the change in the fraction would only be 3.9 percentage points.

So far, we have not addressed the persistence of earnings changes. The literature commonly differentiates between persistent (e.g., promotions, large health shocks) and transitory (e.g., bonuses, temporary sickness) changes. To understand the persistence of earnings changes, we study the first and second conditional autocovariances. A negative first autocovariance of residual earnings growth implies that part of the contemporaneous growth is offset the following year, i.e., it provides information regarding the amount of mean reversion. The second autocovariance identifies whether this mean reversion lasts longer than one year. Figures 4a and 4b display the conditional first and second autocovariances of residual earnings growth, respectively. The first autocovariance of positive growth is small relative to the first autocovariance of negative growth. Neither shows a pronounced life-cycle pattern. The second autocovariance is negative for both types of earnings changes, but it is small in size after the age of 30 in either case. Figure 4c displays the age-averaged (unconditional) autocovariance at longer leads. All autocovariances after lead two oscillate around zero suggesting that the mean reversion of earnings changes takes place during the first two years.

3.1. Sources of Earnings Innovations

Taken together, the data suggest that positive (negative) residual earnings fluctuations are particularly large before the age of 30 (after the age of 50). We end this section by briefly showing that two observable labor market events, job-to-job transitions and non-employment spells are quantitatively
important to understand these large labor earnings changes. Appendix A.1 displays in more detail the earnings changes accompanying these labor market events.

First, we consider workers younger than age 30. We define a large positive innovation as a positive change in residual log earnings of at least 0.2 (or approximately 22%). Consistent with the job-ladder effects documented by Topel and Ward (1992), we find that in 32% of cases where we observe a large positive earnings change early in life, the individual changes his establishment. Topel and Ward (1992) also show that young workers’ careers are characterized by repeated non-employment spells between jobs. In this vein, we ask how many of the large positive innovations in the data coincide with workers increasing the number of working days during a year. We define a “substantial” increase in working days as an increase in contracted days by more than 30 days from one year to the next. Around 29% of large positive earnings innovations early in life are associated with such an increase in working days.

Turning to workers older than age 50, we define a large negative innovation as a negative change in residual log earnings of at least -0.2 (or approximately -19%). Jacobson et al. (1993) show that reemployment earnings are substantially lower after losing a highly tenured job. To understand the importance of this effect for elderly workers in Germany, we calculate the share of large negative earnings changes associated with the worker changing his establishment. We find that the worker changes establishments in only 7% of cases where we observe a large negative innovation. Put differently, losing a high paying job and reentering with a lower-paying job is not a common phenomenon for elderly German workers. Instead, large negative residual earnings changes are predominantly associated with a reduction in working days. Workers reduce their amount of working days by at least 30 per year in 57% of the cases where we observe a large negative earnings change.

4. A Time Series Model of Earnings Dynamics

4.1. Model

We model residual log earnings as the sum of permanent initial inequality and a stochastic component:

$$y_{i,h} = \alpha_i + u_{i,h},$$

(1)
where $\alpha_i \sim N(0, \sigma^2_{\alpha})$. $\alpha_i$ is the only source of deterministic unobserved inequality between workers in our model. Appendix A.3 shows that our results are mostly invariant when including deterministic heterogeneity in individual earnings growth.

We want our model to capture the rich dynamics of positive and negative residual earnings growth over the life-cycle. We achieve this by modeling shocks to the stochastic component of residual earnings as an age-varying mixture of several specified parametric distributions. To be specific, we let $u_{i,h}$ consist of a mean zero component and, following our analysis above, a positive and a negative component that all have age-varying properties:

$$u_{i,h} = W^+_{i,h} + W^-_{i,h} + \iota^0_{i,h},$$

(2)

where $\iota^0_{i,h} \sim N(0, \sigma^2_{\iota^0})$ is a transitory shock to earnings that realizes for each individual at every age. The positive component, $W^+_{i,h}$, and the negative component, $W^-_{i,h}$, contain both a persistent and a transitory part:

$$W^+_{i,h} = w^+_{i,h} + \tau^+_{i,h} \quad \quad \quad W^-_{i,h} = w^-_{i,h} + \tau^-_{i,h}$$

(3)

$$w^j_{i,h} = \rho^j w^0_{i,h-1} + \xi^j_{i,h} \quad \text{for } j = -, + \quad \quad \quad \tau^j = \iota^j_{i,h} + \theta^j \iota^0_{i,h-1} \quad \text{for } j = -, +$$

(4)

Thus, innovations to the positive and the negative components are a combination of a persistent, $\xi^j_{i,h}$, and a transitory, $\iota^j_{i,h}$ shock. These shocks have by assumption the same sign which deviates from the independence assumption common in the literature. This structure captures a wide range of economic phenomena. For example, consider the case of workers losing their job shown in Appendix A.1. Average residual earnings are lowest, probably resulting from a reduction in the number of days worked, in the year of displacement, recuperate somewhat afterward, but they stay persistently lower than before the displacement. The model will identify this as an innovation to the negative component of log earnings. The initial reduction in working days will be identified as the transitory shock. The longer-lasting earnings loss will be identified as the persistent shock. The appendix also shows that job-to-job transitions display a similar pattern. Earnings are highest in the year of a job-to-job transition, possibly due to signing bonuses, but reverse on average towards their old level thereafter. Such a move up the job ladder will be identified as a shock to the positive component. The initial overshooting of earnings will be identified as the transitory shock and the longer-lasting earnings increase will be identified as the persistent shock. Note that the model does, nevertheless, not impose a perfect correlation between persistent and transitory shocks because the mean zero shocks, $\iota^0_{i,h}$, realize additionally at each age.

We let the probability to receive innovations to the positive and negative components vary with age. Mutually exclusive, and at each age, an individual draws with probability $p^+_{h}$ an innovation to his negative component, (both $\xi^-_{i,h}, \iota^-_{i,h}$), and with probability $p^-_{h}$ an innovation to his positive component, (both $\xi^+_{i,h}, \iota^+_{i,h}$). With probability $1 - p^+_h - p^-_h$ he draws neither. We specify second order polynomials in age for these probabilities:

$$p^j_{h} = \delta^j_I + \delta^j_{II} h + \delta^j_{III} h^2 \quad \text{for } j = -, + \quad \text{and } h = 0 \text{ at age } 24.$$
Different from most of the literature on earnings dynamics, we explicitly specify the shock distributions. The persistent and the transitory shocks to the positive and negative components follow age-varying log-normal distributions:

\[\xi_{i,h}^+ \sim \exp(N(\mu^+_h, \sigma^2_{\xi^+,h})), \quad \xi_{i,h}^- \sim -\exp(N(\mu^-_h, \sigma^2_{\xi^-,h}))\] (6)

\[\iota_{i,h}^+ \sim \exp(N(\mu^+_h, \sigma^2_{\iota^+,h})), \quad \iota_{i,h}^- \sim -\exp(N(\mu^-_h, \sigma^2_{\iota^-,h}))\] (7)

The log-normal specification allows the model to match the fat tails of the residual earnings growth distribution. To provide intuition for this, Figure A4 plots the density function of earnings growth. We do not impose it, but it is natural to think of the mean zero component as mostly representing small changes in real earnings that are close to zero (inflation, small changes in hours, etc...), thus, capturing in part the many earnings changes close to zero. In contrast, the positive and negative components mostly allow the model to match the fat tails of the distribution.

To accommodate for the age-variation in the variances of positive and negative residual earnings growth, the dispersion parameters in equations (6) and (7) vary with age in a linear fashion:

\[\sigma_{k,h} = \gamma_{a,k} h + \gamma_{b,k} h^2 \text{ for } j = -, + \text{ and } k = \xi, \iota; \quad h = 0 \text{ at age } 24.\] (8)

Also, to allow for age-varying conditional means, the location parameters of these shocks are age-varying:

\[\mu_j^h = \lambda^1_a + \lambda^2_b h \text{ for } j = -, + ; h = 0 \text{ at age } 24.\] (9)

Different from Karahan and Ozkan (2013) and Blundell et al. (2015), we do not allow the variances of shocks to change arbitrarily with age but, to keep the number of parameters manageable, restrict the age variations to be linear. In our framework, age variations in the unconditional distributions of transitory and persistent shocks arise from the age-variations in the parametric shock distributions (equations (8) and (9)) together with the age-varying sampling probabilities of the three components of log earnings (equation (5)). Figure A5 in the Appendix shows that, as a result, the model generates non-linear moments, among them the variance of residual earnings growth, that are very similar to the data.

As workers accumulate different shocks over their life-cycles, the process implies that the variance of log residual earnings is increasing over the life-cycle. However, Figure 1a shows that residual earnings inequality is decreasing during the initial years. We interpret this initial decline as resulting from heterogeneity in the initial transitory components:

\[\iota_{i,0}^j \sim \exp(N(\mu_0^j, \sigma_0^j))\], for \( j = -, + \). (10)

4.2. Identification

We estimate the model by the method of simulated moments (MSM) and use the block bootstrapping procedure suggested by Horowitz (2003) to obtain standard errors that we report in Table A4. We target three main sets of empirical moments over the life-cycle: (i) moments of unconditional residual
earnings growth: the mean, skewness, kurtosis, fraction of shocks above 5%, and the autocovariance function; (ii) moments of conditional positive and negative residual earnings growth: the means, variances, share of positive changes, and the first and second autocovariances; and (iii) the variance of residual log earnings. In our main specification, we estimate 28 parameters using 461 moments. Sections A.2 and A.4 in the Appendix describe further details about the estimation procedure and the set of moments.

The matrix of first derivatives (evaluated at the minimum) of the moment conditions with respect to the parameter vector has full rank suggesting that our selected data moments do identify the model. The Online Appendix A provides a visualization of this test. It displays the partial impact of each parameter on each moment evaluated at the minimum. Most parameters affect all moments simultaneously. To gain some intuition for the identification, we briefly discuss here which moments are the most affected by the different parameters.

As shown, e.g., by Hryshko (2012) the variance and first two autocovariances of earnings growth identify the variance of persistent and transitory shocks and the persistence parameter of transitory shocks in a model with one persistent and one transitory mean-zero shock. Moreover, the distant lags of the autocovariance function of earnings growth identify the autocorrelation parameter of persistent shocks. The intuition extends straightforwardly to our model with conditional shocks. The conditional variances and autocovariances, together with the unconditional autocovariance, identify the parameters $\rho^+, \rho^-, \theta^+, \theta^-, \gamma_{a,k}$, for $j = -, +$ and $k = \iota, \xi$. Additionally, the conditional means of these changes contain information about the location parameters $\lambda^a_j, \lambda^b_j$, for $j = -, +$.

Storesletten et al. (2004) show that the cross-sectional dispersion of residual log earnings across ages contains information on the model parameters in a model with one persistent and one transitory mean-zero shock. Again, the intuition carries over to our model and provides additional identification. The cross-sectional variance of residual log earnings early in life identifies initial heterogeneity. The initial changes in cross-sectional inequality identify how much of this initial inequality is permanent, $\sigma_\alpha$, or transitory, $\lambda_0^j$ and $\sigma_0^j$, for $j = -, +$. The increase in inequality over the life-cycle contains information on the size of positive and negative persistent shocks, and the shape of the increase contains information on their persistence parameters.

Finally, the fraction of positive shocks over the life-cycle, skewness, the share of shocks above 5%, and kurtosis identify the variance of the mean zero component and the sampling probabilities, $\delta^I, \delta^I_{II}, \delta^II_{II}$, for $j = -, +$. To see the latter point, consider an increase in the sampling probability of positive shocks. This implies a higher fraction of those and a more negatively skewed distribution of earnings growth. To understand the relationship with kurtosis, we show in the next section that the mean zero transitory shocks, $\iota''$, have little variance. Hence, these shocks allow the model to create a large share of shocks centered around zero, thereby, given a fixed variance, a large kurtosis in earnings growth.

Put differently, lower probabilities to draw any persistent shock imply more kurtosis.

4.3. Description of the Empirical Results

Table 1 reports selected parameter estimates for the process described by Equations (1) to (10). Table A3 in the Appendix reports the remaining parameters. Column (1) is the full specification of the econometric model. We estimate the autocorrelation coefficients of positive and negative persistent shocks to be close to a unit-root process. The age-averaged means of positive and negative persistent shocks are similar, but their life-cycle behaviors differ (cf. Figure 5a). Positive shocks decrease in

---

To estimate earnings shocks from residual earnings growth, we require that the information set of the econometrician is the same as that of the worker. Quite likely, it is impossible for the worker to predict wage changes conditional on all the observables that we use in our regressions; therefore, we may underestimate earnings risk. However, our moments are almost unchanged when excluding some of the observables. At the same time, a worker may have more information than the econometrician about the path of his earnings, thus, leading to an overstatement of risk.
Table 1: Parameter Estimates of the Labor Income Process

<table>
<thead>
<tr>
<th>Model:</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
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<tr>
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<td>No</td>
<td>Macro</td>
<td>Micro</td>
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<tr>
<td>Model</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\rho^-$</td>
<td>0.9788</td>
<td>0.1357</td>
<td>0.4179</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\rho^+$</td>
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<td>0.2411</td>
<td>0.9685</td>
<td>0.9902</td>
</tr>
<tr>
<td>$\theta^-$</td>
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<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\theta^+$</td>
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<td>0.9995</td>
<td>-</td>
<td></td>
<td></td>
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<tr>
<td>$\sigma_\alpha$</td>
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<td>0.3486</td>
<td>0.3249</td>
<td>0.0302</td>
<td>-</td>
</tr>
<tr>
<td>$\sigma_\iota$</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.2364</td>
<td>0.1744</td>
</tr>
<tr>
<td>$\sigma_\xi$</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.1074</td>
<td>0.1674</td>
</tr>
<tr>
<td>Obj. Function</td>
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<td>196.05</td>
<td>138.79</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes: The table displays selected parameter estimates of the earnings process described by Equations (1)-(10). The remaining parameter estimates are displayed in Table A3. Table A4 displays standard errors. The process is estimated by the method of simulated moments. We use the sample from SIAB described in Section 2. Column (1) is the full model. Columns (2)-(3) shut down age-dependence and transitory shocks, respectively. The last two columns display parameter estimates of the model in equation (11).

size throughout the life-cycle, but negative persistent shocks are smallest early in life and become larger on average with age. Figure 5b shows that the variances of these two shocks differ in their size and their behavior over the life-cycle. Positive persistent shocks are heavily dispersed early in life. Their variance decreases from 0.08 at age 24 to 0.02 at age 55. In contrast, the variance of negative persistent shocks is close to zero early in life and reaches 0.035 at age 55. Figure 5e shows that early in life, about 43% of workers receive a negative persistent shock and this probability is decreasing to 13% late in life. In contrast, the probability to receive a persistent positive shock is increasing throughout life. The joint probability to receive any persistent shock during a year is U-shaped over the life-cycle and is particularly low around the age of 40 when 67% of workers receive no such shock. That is, they only receive a transitory mean-zero shock. The variance of these latter shocks is close to zero for most of the life-cycle. But differently, during ages when individuals are unlikely to receive shocks to their positive or negative component, they face little earnings risk.

Unlike transitory mean-zero shocks, transitory shocks to the positive and negative components do present major earnings risks. Figures 5c and 5d show that particularly negative transitory shocks are large on average and highly dispersed throughout the life-cycle. In fact, Figure 5c shows that most large negative shocks, defined as a log earnings decrease of at least 0.2, are transitory. Early in life, almost all large negative shocks are transitory. The share declines with age and reaches close to 50% at age 55. Likewise, most large positive shocks are transitory, yet, the share of large positive shocks explained by transitory shocks is somewhat smaller than in the case of large negative shocks. In contrast to large negative shocks, the share of large positive shocks explained by transitory shocks is increasing with age. It increases from 50% at age 24 to over 60% at age 55.

Figure A5 in the Appendix compares the targeted moments in the model to the data. Moreover, Table A2 shows the loss function with respect to the different data moments. Overall, the model fits the data moments closely. The main conceptual issue is that the model cannot rationalize (by
Notes: The figures display age specific estimates from the earnings process described by Equations (1)-(10). Panel (a) displays the means of persistent shocks. Panel (b) shows the variances of persistent shocks. Panel (c) displays the means of transitory shocks. Panel (d) displays the variances of transitory shocks. Panel (e) shows the probabilities of drawing a shock to the positive and negative components. Panel (f) displays the fraction of shocks above 0.2 that are transitory.

Figure 5: Model Predictions
construction) a cross-sectional inequality that is decreasing for several years at the beginning of the life-cycle.

4.4. Discussion of the Empirical Results

Age-varying distributions turn out to be key in fitting the moments of residual earnings growth over the life-cycle. In Column (2), we restrict the means and variances of all shocks to constants across ages. In this case, changes in the sampling probabilities of the age-invariant distributions drive all the life-cycle dynamics. Relative to our full model, the loss function more than doubles. Figure IX in the Online Appendix shows that the model generates little age variation in the moments of residual earnings growth. In particular, the model fails to match the decrease in the variance of positive shocks, the age variation in the share of positive shocks, and the resulting decrease in skewness over the life-cycle.15

Column (3) highlights the importance of distinguishing between persistent and transitory shocks. Omitting transitory shocks provides a substantial worse model fit and raises the objective function. The intuition is the following: when neglecting transitory shocks, the moment estimator implies $\rho \ll 1$ to match the negative autocovariances of earnings growth at lag one and two. Column (3) shows that particularly the estimated autocorrelation of persistent positive shocks decreases. Similarly, Guvenen et al. (2016), who also estimate a model with mixture probabilities, find that positive persistent shocks are only mildly persistent. They allow, similar to us, for a purely transitory shock, but, different from us, they model the other two components as pure AR(1) processes. We find that by modeling the positive and negative components to be a combination of both transitory and persistent shocks, our model identifies persistent shocks that are close to permanent and, at the same time, identifies most large shocks as being purely transitory.

We find age variations in the variances of shocks that are similar to those in Karahan and Ozkan (2013) using PSID data. Our specification allows for a deeper understanding of these life-cycle variations. In particular, the decreasing dispersion in persistent shocks early in life is entirely driven by a decreasing dispersion of positive shocks. Similarly, the increasing dispersion of persistent shocks late in life is entirely driven by an increasing variance of negative shocks. Finally, the increasing variance in transitory shocks is mostly driven by an increasing variance of negative transitory shocks. Our results regarding the persistence of a typical shock early in a worker’s life-cycle are somewhat different from theirs, though. They find that a typical shock is less persistent when young than at prime age. Instead, we find that the share of persistent shocks is declining until prime-age (see Figure 5c).

Finally, we compare the results to the earlier literature that models a single age-invariant mean zero AR(1) shock process. To capture the decline in the variance of log earnings at young ages, we extend this framework and allow for an age varying variance of transitory shocks at age 24:

$$\hat{y}_{t,h} = \alpha_i + \tilde{Z}_{t,h} + \tilde{\epsilon}_{t,h}, \quad \mathbb{E}(\tilde{\epsilon}_{t,h}) = 0, \quad \text{Var}(\tilde{\epsilon}_{t,h}) = \sigma^2_{\tilde{\epsilon}} \tag{11}$$

$$\tilde{Z}_{t,h} = \rho \tilde{Z}_{t,h-1} + \tilde{\xi}_{t,h}, \quad \mathbb{E}(\tilde{\xi}_i) = 0, \quad \text{Var}(\tilde{\xi}_i) = \sigma^2_{\tilde{\xi}} \tag{12}$$

$$\hat{y}_{t,0} = \alpha_i + \tilde{\epsilon}_{t,0} + \tilde{\xi}_{t,0}, \quad \mathbb{E}(\tilde{\epsilon}_{t,0}) = 0, \quad \text{Var}(\tilde{\epsilon}_{t,0}) = \sigma^2_{\tilde{\epsilon}_0} \tag{13}$$

In this model, either the autocovariance function of residual earnings growth or the covariance function of log residual earnings over the life-cycle identify the model moments. Heathcote et al. (2010) show that what they refer to as Micro estimation (targeting the autocovariance function of earnings

15The poor life-cycle behavior of the model also implies counter-intuitive parameter estimates, e.g., persistent shocks are estimated to be almost transitory.

16Figure X in the Online Appendix displays all the model moments over the life-cycle.
growth) leads to substantially larger persistent shocks than a *Macro* estimation (targeting covariances of cross-sectional inequality). As a consequence, simulations of the *Micro* estimates lead to a too large increase in cross-sectional inequality over the life-cycle and simulations of the *Macro* estimates imply a too negative first autocovariance of earnings growth, i.e., too much of the average shock is off-set the following year. Columns (4) and (5) present the parameter estimates resulting from GMM estimators of the two identification strategies. As expected, the standard deviation of persistent shocks is about twice as large in the *Micro* approach.

In the estimation of our full model, we target the autocovariance function of residual earnings growth and the cross-sectional variance of residual log earnings over the life-cycle. Figure A5 in the Appendix shows that our full model jointly matches these moments. The reason for the relatively modest increase in earnings inequality over the life-cycle (compared to the *Micro* model) is not that persistent shocks have little dispersion. Conditional on receiving such a shock, the age-averaged variance is similar to the *Micro* estimation (0.0280). Instead, the fact that in a given year a substantial fraction of workers receives no persistent shock is key.

5. Life-Cycle Consumption and Savings Model

We now turn to the implications of our earnings process for consumption and wealth inequality and the degree to which workers can insure against idiosyncratic earnings shocks. To this end, we introduce the estimated earnings uncertainty into a structural model with incomplete insurance markets.

For simplicity, we consider a partial equilibrium model with exogenous earnings and interest rates. Individuals work for $H_W$ years in the labor market and die with certainty at age $H > H_W$. They have CRRA preferences over consumption with a risk aversion parameter $\gamma$, and they discount the future with factor $\beta$. There exists a one-period risk free asset $a$ that pays certain returns $1 + r$. Individuals face a zero borrowing constrained $a_{h+1} \geq 0$ and make consumption decisions to maximize expected lifetime utility:

$$
\max \{ E_0 \sum_{h=1}^{H} \beta^{h-1} c_{1,h}^{1-\gamma} \} \\
\left\{ \begin{array}{ll}
c_{h=1 \ldots H, a_{h=1 \ldots H}} \\
a_{h+1} = (1 + r) a_h + Y_h^i - c_h \\
a_{h+1} \geq 0, \quad c_h \geq 0
\end{array} \right.
$$

where $Y_h^i$ are post tax earnings of individual $i$ at age $h$. During working life, log gross earnings follow the sum of a common deterministic and an individual specific stochastic component:

$$
E_h^i = \exp(d_h + v_{i,h}) \quad \text{if } h \leq H_W.
$$

The government reduces earnings inequality by applying a progressive income tax schedule. We apply the statutory income and social security tax schedule from Germany to map gross earnings into after tax income:

$$
Y_h^i = G(E_h^i) \quad \text{if } h \leq H_W.
$$

During retirement, workers face no further uncertainty and receive social security benefits. To avoid keeping track of individuals’ average earnings, we assume social security benefits depend only on the

---

1Daly et al. (2016) show that eliminating beginning and end of earnings spell observations helps to reconcile the two approaches within this framework.

2For the *Macro* estimation, we use the variance and first ten covariances of log residual earnings. We have also estimated a just identified model with only the first two covariances, and the results remain quantitatively very similar.
5.1. Calibration

We calibrate the coefficient of relative risk aversion and the interest rate outside of our data. The former, $\gamma$, is set to 1.5, consistent with Attanasio and Weber (1995). Following Siegel (2002), we fix the value of $r$ to imply a yearly interest rate of 4%. To ensure that households have on average an adequate level of self-insurance, we match median wealth to earnings ratios using data for Germany from the Eurosystem Household Finance and Consumption Survey (see Eurosystem Household Finance and Consumption Network (2013)). To make the data comparable to the SIAB, we restrict the sample to males aged 24-55, who are employees and have positive earnings. We calibrate $\beta$ to match a median wealth-to-earnings ratio of 4.3 at age 55 leading to a value of 0.9725. As in the data, we assign individuals’ initial assets equal to 71% of initial earnings.

Workers work until the age of 55 and, after that, spend twenty years in retirement. We match average earnings during working life, $d_h$, by estimating cohort averaged age profiles as in Deaton and Paxson (1994). In what we call the age-varying risk model (AVRM), the stochastic log earnings component, $v_{i,h}$, follows the process estimated in Column (1) of Table 1. For simplicity, we impose $\theta^+ = \theta^- = 0$. We compare the implications of this model to those from the Macro approach. To ensure that income inequality is the same in the two models, we estimate the latter model on the variance and the first ten covariances of log earnings implied by the AVRM, instead of the data. Figure 6b shows that the resulting variance of log earnings over the life-cycle closely tracks the AVRM. We refer to this model as the age-invariant risk model (AIRM). As it is common in the literature, we assume shocks follow normal distributions in the AIRM. We assure that mean earnings are the same in both models at each age by adjusting the path of deterministic earnings over the life-cycle accordingly in the AIRM. Finally, we recalibrate $\beta$ to match the median wealth-to-earnings ratio of 4.3 at age 55 which leads to a somewhat larger value (0.9785) than in the AVRM.

5.2. Wealth Inequality

De Nardi et al. (2019) show that existing life-cycle models fail to rationalize sufficient cross-sectional wealth inequality given the observed earnings inequality in the US data. Particularly, the models imply too little wealth holdings by the very top of the wealth distribution. Wealth is also top-concentrated in our German sample of workers: the top 1% own 18.5% of net wealth, and the bottom 50% only own 6.8% of net wealth. The AVRM implies wealth shares of 8.8% and 13.6%, respectively. Therefore, wealth inequality is still much lower than in the data, but it is higher than in the AIRM which implies wealth shares of 5.5% and 15.6%, respectively. Figure 6a shows the share of wealth held by the top 10% over the entire life-cycle. After age 35, the share is around 0.37 in the AVRM, compared to 0.22 in the AIRM. The figure also highlights that the model, in part, falls short of the data because the calibration restricts wealth inequality to equal earnings inequality at age 24.

The models feature wealth heterogeneity for two reasons. The first is heterogeneity in lifetime earnings. Retirement benefits are lower than average earnings; hence, workers accumulate wealth to smooth consumption. Put differently, heterogeneity in lifetime earnings translate into heterogeneity in retirement savings. This channel is particularly potent to explain large top wealth inequality when large earnings differences at the top of the distribution arise early in the working life and are persistent.

---

11 Bundesministerium (2015) shows that the retirement replacement rate has decreased over the last decades and is projected to continue to do so. We assume households expect the replacement rate from 2010.

12 The survey imposes that earnings are larger than 1100 Euro per year to be considered employed, which is somewhat more than our restriction in STAB.

13 Cagetti and Nardi (2006) show that a model with entrepreneurial choice is one possibility to match the right tail of the wealth distribution of workers because former entrepreneurs have high wealth holdings.

17
Notes: Panel (a) displays the share of wealth held by the top 10%. AVG: Age-varying risk model. AIR: Age-invariant risk model. Data: Eurosystem Household Finance and Consumption Survey. Panel (b) displays the variance of log earnings in the models. Panels (c) to (e) compare selected percentiles of earnings in the models and the data from the SIAB.

Figure 6: Wealth and Earnings Inequality over the Life-Cycle

hence, they translate into large differences in lifetime earnings. Figure 6c shows that top earnings (99th percentile) are much higher in the AVG than in the AIR, and they match almost perfectly.
the data. At the beginning of the life-cycle, top earnings are almost identical in the two models and the data, but they grow much more rapidly in the AVRM than in the AIRM afterward. This rapid growth in top earnings results from the rare but persistent and fat-tailed positive shocks early in life. Figure 6d shows that median earnings are almost identical in the two models; thus, the top 1% have much higher earnings relative to the median worker in the AVRM. Finally, Figure 6e shows that bottom earnings (the 10th percentile of earnings) are higher and, thus, closer to median earnings in the AVRM (and in the data) than in the AIRM, therefore, rationalizing that the two models feature the same variance in log earnings over the life-cycle.

The second mechanism that generates wealth inequality is precautionary savings. Castañeda et al. (2003) show that this mechanism contributes strongly to top wealth inequality when there exists a “superstar” earnings state that occurs infrequently and is mildly persistent. When the state is only mildly persistent, workers have incentives to save most of the temporary earnings increase because their earnings are expected to soon be lower. Though rare and large positive shocks early in life have some flavor of this type of shock, these shocks are highly persistent in the AVRM. Given their persistent nature, households increase consumption and the effect on precautionary savings is small. Large and persistent negative shocks late in life do increase the need for precautionary savings. Yet, as Civale et al. (2017) show, negative skewness in the shock distribution increase precautionary savings most at the left tail of the wealth distribution; thus, they decrease wealth inequality. Consistent with this, the 10th percentile of the wealth distribution is higher in the AVRM than in the AIRM, particularly after the age of 45.22 Measuring overall wealth inequality by the Gini-coefficient of wealth, we find that the increase in top wealth inequality outweighs the decrease in bottom inequality. That is, the Gini-coefficient of wealth is 0.54 in the AVRM and 0.49 in the AIRM (0.64 in the data).

5.3. Consumption Inequality and Insurance
Figures 7b to 7d compare the consumption distributions in the AVRM and the AIRM. Bottom inequality (50/10 consumption ratio) grows by a similar amount in the two models over the life-cycle. However, it is somewhat higher in the AIRM throughout the life-cycle. To understand higher bottom inequality, the timing and composition of shocks play a key role. Regarding the timing, note that at the beginning of life, when self-insurance is at its lowest, the AVRM features relatively few large negative shocks and, thus, relatively few catastrophic events that lead to a large downward consumption adjustment. Regarding the composition, remember that relatively many large negative shocks are transitory and, thus, relatively easy to insure in the AVRM and this is particularly the case at the beginning of the life-cycle. In contrast, in the AIRM, the fraction of large shocks that are negative is age-invariant, and the fraction of large shocks that are transitory is the same for positive and negative shocks.22 Upper consumption inequality (90/50 ratio) grows somewhat faster in the AVRM, but the overall level is similar in the two models. The main difference between the two models is, again, top inequality (99/50 ratio). Mirroring top earnings and wealth inequality, top consumption inequality grows much more rapidly with age in the AVRM, and it is substantially higher on average than in the AIRM. That is, large and persistent positive shocks early in life allow a few lucky workers to enjoy particularly high consumption levels. Those in the top 1% consume 2.6 times more than the median at age 55 in the AVRM, but only 1.9 times more in the AIRM.

These consumption dynamics have qualitative ambiguous effects on the welfare costs of incomplete insurance markets. On the one hand, fewer catastrophic consumption events, i.e., less consumption

22Consistent with precautionary savings being relatively unimportant for top wealth inequality, we find that fixing earnings uncertainty beyond age 40 to the process workers face at age 40 leaves top wealth inequality almost unchanged.
23We opt for a model with age-invariant shocks as the comparison to the AVRM because it is the most widely used framework. Alternatively, one could estimate age-varying variances for transitory and persistent shocks and assume that these shocks are normally distributed. This extension would allow the fraction of large shocks and the fraction of large shocks that are transitory to vary, but, by assumption, these fractions would be the same for positive and negative shocks.
Notes: Panel (a) displays the variance of log consumption by age. Panels (c)-(d) display selected percentile ratios of consumption by age. AVRM: Age-varying risk model. AIRM: Age-invariant risk model.

Figure 7: Consumption Inequality over the Life-Cycle

Inequality at the bottom of the distribution, imply lower welfare costs from incomplete markets in the AVRM. On the other hand, more resources allocated to the top 1% imply that the typical household has lower average consumption and, thus, implies higher welfare costs arising from incomplete markets.

Figure 8 displays these two effects graphically. It displays the densities of lifetime consumption equivalences an individual worker is willing to pay to receive the consumption stream from the social planner solution instead of his realized stream. The figure shows that poor individual outcomes, values greater than zero, are more likely in the AIRM. Put differently, even on a lifetime utility basis, the left tail of the consumption distribution is more dispersed in the AIRM leading to lower welfare.

At the same time, the AVRM has a higher probability of lifetime utility outcomes that are much better than the social planner solution (large negative values in the graph). An outcome that is better than 130% of the social planner solution occurs with 2.5% in the AIRM and 3.6% in the AVRM. Again, this is a different way of saying that the fatter right tail in the consumption distribution translates

\[\text{Notes: Panel (a) displays the variance of log consumption by age. Panels (c)-(d) display selected percentile ratios of consumption by age. AVRM: Age-varying risk model. AIRM: Age-invariant risk model.}\]

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24\footnote{We define the social planner solution as the discounted utility resulting from optimal choices when earnings are pooled across all agents at each age, but they are not pooled across ages. That is, the social planner cannot use future labor income to finance today’s consumption.}
Notes: The figure displays the densities of lifetime consumption equivalences that a worker is willing to pay to receive the consumption stream from the social planer solution instead of his realized stream. Values greater than zero imply the worker is worse off than in the social planner solution. AVRM: Age-varying risk model. AIRM: Age-invariant risk model.

Figure 8: Consumption Equivalences

to a fatter left tail in the distribution of lifetime consumption equivalences in the AVRM. Given that the two models have the same amount of total labor income, the resources used to finance these tail events must come from workers in the center of the distribution. Indeed, the center of the distribution of willingness to pay is shifted to the right and is thinner in the AVRM relative to the AIRM. This also manifests in a kurtosis of the distribution that is larger in the former. Shifting resources from median lifetime consumption outcomes towards high lifetime consumption reduces welfare. We find that this effect dominates the effect of less catastrophic outcomes, i.e., welfare is lower in the AVRM.

An unborn worker is willing to pay 4.4% of lifetime consumption to avoid the idiosyncratic earnings risk in the AVRM and 3.7% in the AIRM. Finally, we inspect in more detail the differences between the two models concerning the dynamics of cross-sectional consumption inequality over the life-cycle. Guvenen (2007) shows that the shape of this moment is informative about the age-varying insurance that households have against earnings risk. More specifically, he shows that standard earnings risk models generate a concave profile of consumption inequality over the life-cycle because earnings shocks become effectively more transitory as workers approach retirement. He shows that learning about deterministic differences in individual earnings growth profiles can reconcile the model with the more linear increase in US data. Fuchs-Schündeln et al. (2010) find that the German data also displays close to a linear increase in the variance of log consumption over the life-cycle.

Figure 7a shows that consumption inequality over the life-cycle also shows a concave shape in the AIRM calibrated to German data. The model implies a total increase in the variance of log consumption of 0.05 from age 25 to age 55 which is consistent with the consumption data analyzed by Fuchs-Schündeln et al. (2010). The total increase in consumption inequality over the life-cycle is similar in the AVRM, however, the shape of the increase is somewhat different. In particular, after an initial fall, the increase is steeper than in the AIRM and shows less flattering at old age.

To understand how age-varying risk affects cross-sectional consumption inequality over the life-cycle, we compute at each age the average consumption responses to different shocks using a linear regres-

25De Nardi et al. (2019) come to a different conclusion regarding the shape of this moment in US data. Their results imply a concave shape.

26Similar to wealth data, consumption data is only available at the household level in Germany.
Notes: Panel (a) displays the fraction of persistent shocks that do not translate into consumption changes. Panel (b) displays the same for transitory shocks. AVRM: Age-varying risk model. AIRM: Age-invariant risk model.

Figure 9: Insurance against Shocks

\[
\Delta \log(c_{i,h}) = \varphi_{0,h} + \varphi_{\xi^+,h}(\xi_{i,h} | \xi_{i,h} > 0) + \varphi_{\xi^-,h}(\xi_{i,h} | \xi_{i,h} < 0) + \varphi_{\iota^+,h}(\iota_{i,h} | \iota_{i,h} > 0) + \varphi_{\iota^-,h}(\iota_{i,h} | \iota_{i,h} < 0) + \varsigma_{i,h}. \]

Thus, \(1 - \varphi_{\xi^+,h}\) measures how much of a persistent positive shock does not translate into consumption, i.e., how much of a shock is insured. We calculate these insurance coefficients for the four types of shocks. In case of uncorrelated shocks, as in the AIRM, and without conditioning on the sign of the shocks, these insurance coefficients are equal to those calculated by Kaplan and Violante (2010).

Figure 9 shows that consumption responds more strongly to positive than to negative shocks, particularly late in life. The asymmetry is larger in the AVRM because precautionary savings are higher late in life. Hence, when a positive shock occurs, a worker requires fewer precautionary savings for the rest of the working life; hence, he can consume these. The figure also shows that consumption responds more to persistent than to transitory shocks in both models. Remember that the probability to receive a positive shock and the probability to receive a persistent shock are increasing late in life in the AVRM. As a consequence, consumption responses become relatively large in this model leading to a relatively rapidly growing consumption inequality.

In the AVRM, transitory shocks include those from the mean zero component of earnings, that tend to be small and those draws from the positive and negative components that tend to be large. Because the former have almost no dispersion and, thus, almost no quantitative effect on consumption, we only focus on the latter.

In either model, average consumption responses are weaker than those found by Kaplan and Violante (2010) for a US calibration. For one, the differences arise from their model featuring permanent shocks (shocks are highly persistent in our case). Moreover, taxes are more progressive in Germany leading to smaller net earnings changes and, thus, consumption changes, given a gross earnings change. Relative to their findings, consumption responds particularly weak at the beginning of life. Different from them, workers start with positive assets in our model which weakens consumption responses, particularly of persistent negative earnings shocks. Moreover, net income growth is smaller in Germany over the life-cycle which weakens initial consumption responses to positive shocks.

We find that when decreasing the variance of shocks after age 45 by 30% and recalibrating the location parameters of the distributions to ensure that the conditional means of the shocks are unchanged results in a flattering in the growth rate of consumption inequality late in life.
6. Conclusion

This paper estimates explicit age-varying distributions of positive and negative (transitory and persistent) earnings shocks in Germany. Early in the working life, workers experience rare but large positive shocks, both transitory and persistent. As workers move into prime-age, earnings risk decreases, both because earnings fluctuate less and fluctuations are more transitory on average. For elderly workers, rare but large (persistent and transitory) negative earnings shocks become a major source of risk. Our parametric earnings process is simple enough to introduce it into a model of consumption decisions with incomplete financial markets. The age-varying risk structure helps us to reconcile two stylized facts from the data. First, relative to a model with an age-invariant $AR(1)$ process and Gaussian shocks, wealth is more concentrated at the top of the wealth distribution. Large persistent positive shocks early in life imply high lifetime incomes for a small group of workers. These workers have incentives to accumulate large savings for life-cycle purposes. As a result, the share of wealth held by the top one percent increases by a factor of 1.6. Second, cross-section consumption inequality grows relatively more rapidly close to retirement in our model. This results from positive and persistent shocks becoming relatively more likely at the end of working life and consumption responding relatively strongly to these types of shocks. As individual consumption responses become stronger, the variance of consumption inequality increases.

Our analysis restricts itself to male workers with a high attachment to the labor force, mainly, because our data do not allow us to identify workers’ participation decisions upon shocks as in [Low et al. (2010)]. Studying age-varying, non-normally distributed earnings risk while allowing at the same time for employment decisions resulting from shocks promises further insights into the welfare costs of incomplete insurance markets. Similarly, little is known about the effects that this richer risk structure has on joint household decisions of labor supply, consumption, and fertility.

Age-varying risk also raises several questions regarding social insurance. On average, earnings risk is negatively skewed, implying that insurance against catastrophic events is highly valuable to society. Yet, early in life, when self-insurance is lowest, earnings risk is positively skewed, thus, decreasing the need for insurance. What is more, most large shocks early in life are transitory. The optimal size and design of the welfare state is, therefore, an even more complex question than that of age-independent Gaussian shocks. Finally, the risk structure also has implications on the level of attainable private (and public) insurance. [Krueger and Perri (2006)] analyze privately efficient risk-sharing contracts. We show that prime-aged workers face little risk; thus, they have little incentives to enter into any private risk-sharing contract or support large public risk-sharing contracts.

[30] Golosov et al. (2016) is a recent example that studies optimal redistribution with non-normally distributed earnings shocks.
References


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A. Appendix

A.1. Residual Earnings Dynamics After Observable Events

The figure displays mean residual log earnings around observable labor market events. We normalize mean residual log earnings to zero in the year before the event. Panel (a) shows the case of workers becoming unemployed, and panel (b) shows the case of a job-to-job transition that resulted in an earnings gain in year one. The dashed lines display bootstrapped 95% confidence intervals.

Figure A1: Residual Log Earnings after Unemployment and Job-to-Job Transition

Figures A1a and A1b display residual log earnings around observable labor market events. In constructing these figures, we first obtain residual log earnings by regressing for each age the log earnings on workers’ observable characteristics. Next, we define an unemployment event as a worker working less than 300 natural days in a given year while in the previous year he has worked more than 300 natural days. Moreover, we define a job-to-job transition as a worker working more than 300 natural days in two consecutive years while he changes his establishment. Tjaden and Wellschmied (2014) show that about one third of job-to-job transitions result in a downward move in the job ladder. To avoid this complication, we condition on job-to-job transitions that lead to an earnings gain in the initial year. We normalize a worker’s residual log earnings to zero in the year before the labor market event occurs and trace average residual log earnings for the consecutive five years.

Figure A1a shows that residual log earnings fall by about 0.57 log points in the year of an unemployment spell. However, they partially recover during the consecutive years leaving a worker with 8% lower earnings on average after 5 years. This pattern is qualitatively consistent with the US data analyzed by Jacobson et al. (1993). The reduction in workdays during the first year of unemployment contributes to the initially large decline in earnings. As workers find work and reclimb the job-ladder, their earnings return towards their pre-unemployment level. Figure A1b shows that job-to-job transitions show a similar pattern. On average, residual log earnings rise by 0.14 log points in the year of the transition but fall during subsequent years resulting in an average increase in log earnings of 0.06 after 5 years. A possible explanation for the initial overshooting of residual earnings are signing bonuses paid upon hiring.

A.2. Constructing the Moments

We model log earnings as the sum of deterministic and stochastic components that may depend on cohort and time effects. Let $Y_{i,h,t}^c$ be the log earnings of individual $i$, at age $h$, belonging to the birth cohort $c$, in year $t$:

$$
Y_{i,h,t}^c = f(X_{i,h,t}) + y_{i,h,t}^c.
$$

(A.17)
where $f(X_{i,t,h})$ is a function representing observable differences among workers ($X_{i,h,t}$) such as education, region, age and industrial sector, and year effects. $y_{i,h,t}^c$ represents the unobserved component of earnings. Rewriting the above process in first differences yields

$$\Delta Y_{i,h,t}^c = \Delta f(X_{i,t,h}) + \Delta y_{i,h,t}^c. \quad (A.18)$$

First, we remove predictable changes in log earnings, such as education, by running for each age cross-sectional regressions. The regressions control for a dummy of workers’ education, year, region of residence, and 14 major industries. Denote the corresponding residual by $g_{i,h,t}^c$:

$$g_{i,h,t}^c \equiv \Delta y_{i,h,t}^c \quad (A.19)$$

So far, our specification allows the moments of residual earnings growth to be calendar year and birth cohort specific. As an illustration of such effects, Figure A2 shows the variance of residual earnings growth for each of our 9 cohorts. There are two salient features. First, there is a calendar year effect with large variances for all cohorts about 5 years after the German reunification. For example, for the 5th birth cohort, born between 1951-1957 (green line) the German reunification occurs at ages 34-40, and the time effect increases the variances after age 45. Second, there is also a visible cohort effect, with later cohorts facing substantial higher variances than earlier cohorts. We follow Blundell et al. (2015) and eliminate these effects by averaging all moments (variance, skewness, kurtosis, etc.) across cohorts, assigning equal weight to each. Therefore, our results can be interpreted as the risk a typical cohort faces.

To compute the cross-sectional earnings inequality over the life-cycle, $\text{Var}(y_{i,h})$, we follow Deaton and Paxson (1994) and regress the cross-sectional variance of log earnings on a full set of age and cohort dummies. We compute the intercept (age 24) as the mean effect across cohorts.
A.3. US Comparison

Panels (a), (b), and (c) display, respectively, the variance, skewness and kurtosis of residual earnings growth by age for the US and Germany. Section 2 describes the German data. For the US, we compute for each age groups (25-29,...,50-54) the average over the percentiles reported in Guvenen et al. (2016).

Figure A3: US and German Higher Order Moments

Figure A3 compares the variance, skewness and kurtosis of residual earnings growth. The German data refers to labor earnings from the SIAB sample described in Section 2. For the US, we compute for each age groups (25-29,...,50-54) the average over the percentiles reported in Guvenen et al. (2016). Different from the SIAB data, the latter includes self-employment income.

A.4. Moments Selection and Estimation

We simulate life-cycle employment histories for 20,000 workers who enter the labor market at the age of 24 and work until the age of 55. The resulting simulated minimum distance estimator is given by:

$$\hat{\theta} = \arg\min_{\theta} F(\theta)'I_F(\theta)$$

$$F(\theta)_n = \frac{f_n(\theta) - m_n}{\omega_n},$$

where $f_n(\theta)$ is the $n^{th}$ model moment, and $m_n$ is the corresponding $n^{th}$ data moment. Similar to Guvenen et al. (2016), we employ moment specific adjustment factors, $\omega_n$. We use these adjustment factors to jointly deal with two issues presented by the data. First, the moments are measured on different scales. For example, kurtosis is in absolute value about 500 times larger than the first autocovariance. If we had minimized the sum of absolute squared deviations ($\omega_n = 1$), the optimization would not have put any emphasis on moments with low absolute sizes. At the same time, we have several moments which are close to zero, such as the autocovariance function, but fluctuate substantially in relative terms from one age to the next. Hence, if we had minimized the sum of relative squared deviations ($\omega_n = \text{abs}(m_n)$), the optimization would have concentrated almost exclusively on these large relative deviations close to zero that are likely the result of a small sample.

Using moment specific adjustment factors allows us to use absolute deviations but reduce the emphasis on moments with large absolute numbers. Unfortunately, it gives us a degree of discretion. We choose the adjustment factors in an iterative fashion such that the implied loss function displayed in Table A2 is consistent with the model fit we observe in Figure A5. We opt to give the variance of log earnings over the life-cycle and the mean earnings growth by age (which is zero by construction in the data) somewhat larger weights as we want to ensure a good fit with these moments. We keep the adjustment factors fixed when estimating restricted versions of the model.

Most sets of moments contain 31 year moments. This is the case for the skewness, kurtosis, fraction of positive shocks, fraction of shocks above 5%, unconditional mean, unconditional autocovariance,
conditional mean and conditional variance. This amounts to $31 \times 10 = 310$ moments. The conditional first autocovariance are observed for 30 years. These amount to $30 \times 2 = 60$ moments. The conditional second autocovariance are observed for 29 years, amounting to $29 \times 2 = 58$ moments. The variance of log earnings amount to 32 moments. Lastly, the initial mean of log residual earnings at age 24 amounts to 1 moment. The total number of moments that we target is then $N = 310 + 60 + 58 + 32 + 1 = 461$.

Given our large parameter set, the issue of finding a global minimum arises. We first obtain reasonable starting values by experimenting with different combinations of parameters. We tested different global minimum algorithms and a pattern search algorithm performed best in finding a minimum. Provided the optimal parameters, we compare the minimum to (possibly) other minima where we start the algorithm from different starting points. We find that the pattern search algorithm, in general, is able to converge to the same minimum from different starting points.

We obtain standard errors by 100 block bootstraps. Using a global search algorithm in each iteration is infeasible numerically. Therefore, we use a local optimizer, a sequential quadratic programming algorithm. Implicitly, we assume that a change in the data sample does not lead to a too large change in our estimates, therefore, possibly downward biasing the standard errors.

### A.5. Growth Rate Heterogeneity

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**Obj. Function 81.95**

Notes: The table displays selected parameter estimates of the earnings process described by Equation (A.22). The process is estimated by the method of simulated moments. We use the sample from SIAB described in Section 2.

Our baseline specification omits heterogeneity in individual earnings growth rates. Guvenen (2009) (and the citations within) show that this type of heterogeneity is potentially an important source of individual earnings dynamics. In particular, this line of literature finds that the increase in the cross-sectional inequality of earnings over the life-cycle is driven partly by this type of heterogeneity. Moreover, this literature finds that shocks to earnings, instead of featuring a close to permanent component as in our baseline results, are only mildly persistent. To show the robustness of our results, we estimate the following augmented version of the model:

$$y_{i,h} = \underbrace{\alpha_i + \kappa_i h}_{\text{initial heterogeneity}} + \underbrace{u_{i,h}}_{\text{stochastic component}},$$

(A.22)

where $\alpha_i \sim N(0, \sigma_\alpha^2)$, $\kappa_i \sim N(0, \sigma_\kappa^2)$, and $\text{COV}(\alpha_i, \kappa_i) = 0$. Our moments identify $\sigma_\kappa^2$ in two distinct ways. First, Guvenen (2009) shows that heterogeneous growth rates imply that the cross-sectional variance of residual earnings growth increases in a convex fashion over the life-cycle. Second, Hryshko (2012) shows that the the autocovariance function of residual earnings growth converges at distant lags towards $\sigma_\kappa^2$.

Table A1 shows the results from estimating this model. The resulting change in the objective function is small, and we find little unobserved heterogeneity in individual earnings growth rates. Within two
standard errors, the variance is smaller than 0.000013 which is by an order of magnitude smaller than the values found by the literature that estimates this parameter jointly with modestly persistent earnings shocks. These results are consistent with those in [Blundell et al. (2015)] who, similar to us, identify the parameter from the autocovariance function of earnings growth with sufficient long lags. The tight estimate of the parameter may be surprising at first, given the large noise in this moment even in administrative data (see Figure 4c). [Hryshko (2012)] uses simulation exercises to show that a minimum distant estimator closely identifies \( \sigma^2_\kappa \) when it takes all, though noisy, autocovariances into account.

In a simpler model, [Hryshko (2012)] also shows that omitting transitory shocks downward biases the estimate for persistent shocks and upward biases \( \sigma^2_\kappa \). Following this idea, we reestimate the model without transitory shocks.\(^{31}\) We find much lower AR(1) estimates and a larger estimate of profile heterogeneity, \( \sigma_\kappa = 0.0112 \). The intuition is simple. When neglecting transitory shocks, the moments estimator implies \( \rho << 1 \) to match the negative autocovariance function at lag one. Yet, \( \rho << 1 \) alone implies that the autocovariance function is negative at intermediate lags. To obtain an autocovariance function which is closer to zero at those lags, \( \sigma_\kappa >> 0 \) is required.

A.6. Estimation Results

![Figure A4a](image-url)  ![Figure A4b](image-url)

(a) Data  (b) Model

Figure A4a displays the kernel distribution of residual earnings growth at the age of 36 in our data described in Section 2. Figure A4b displays the densities of shocks from the model described in Section 4.1 at age 36. We weigh the individual densities with the probability that each shock occurs.

Figure A4: Density of Residual Earnings Growth

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\(^{31}\)The results are available upon request from the authors.
Figure A5: Model Fit - Column (1), Table 1
Table A2: Objective Function Decomposition

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Notes: The table displays a decomposition of the loss function. The process is estimated by the method of simulated moments. We use the SIAB sample selection described in Section 2. Column (1) estimates our Baseline specification outlined in 4.1. Columns (2)-(3) shut down age-dependence and transitory shocks, respectively. Column (4) includes heterogeneity in deterministic individual earnings growth.
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**Objective Function** 82.70 196.05 138.79 81.95

Notes: The table displays additional estimates to Table 1. The last column refers to Table A1.
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<td>0.0007***</td>
</tr>
<tr>
<td>$\gamma_{b,c}^-$</td>
<td>0.0013***</td>
<td>$\gamma_{b,\xi}$</td>
<td>0.016</td>
</tr>
<tr>
<td>$\lambda_a^+$</td>
<td>0.0063***</td>
<td>$\gamma_{a,\xi}^+$</td>
<td>0.0002***</td>
</tr>
<tr>
<td>$\lambda_b^+$</td>
<td>0.0010***</td>
<td>$\gamma_{b,\xi}^+$</td>
<td>0.0006***</td>
</tr>
<tr>
<td>$\gamma_{b,\alpha}^+$</td>
<td>0.0000***</td>
<td>$\lambda_a^-$</td>
<td>0.0058***</td>
</tr>
<tr>
<td>$\gamma_{b,\alpha}^-$</td>
<td>0.0000***</td>
<td>$\lambda_b^-$</td>
<td>0.0020***</td>
</tr>
<tr>
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<td>$\lambda_{0,\alpha}^-$</td>
<td>0.0001***</td>
</tr>
<tr>
<td>$\theta^+$</td>
<td>0.0000***</td>
<td>$\theta^-$</td>
<td>0.0000***</td>
</tr>
<tr>
<td>$\sigma_\kappa$</td>
<td>0.0005***</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: The table displays standard errors for the estimates of our full model, displayed in Column (1) of Tables A1. Standard errors are obtained by 100 block bootstraps. Estimates with superscripts \{*, **, ***\} imply the parameter is different from zero at the 10, 5, and 1 percent significance level, respectively.