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Insights Gained from Conversations with Labor Market Decision Makers

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Insights Gained from Conversations with Labor Market Decision Makers

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In the early 1990s, I carried out an interview study of the labor market in the Northeast of the United States with the intention of learning why labor markets do not respond to surplus by rapid price declines, as do markets for products such as lettuce or fish. I did not know which of the many theories of downward wage rigidity to believe or whether I believed any of them and hoped by directly observing the labor market to come upon the explanation. In the course of my study, I gathered qualitative information about firms, job search, and labor markets that may be of use in understanding wage and labor cost dynamics. My conclusions and supporting evidence are presented in Bewley (1999). Here I describe briefly the study and those findings that are relevant to wage and salary dynamics.

I interviewed company managers and owners, labor leaders, labor market intermediaries, such as professional recruiters and managers of temporary help agencies, and people who dealt regularly with the unemployed, such as counselors in unemployment agencies and outplacement companies. In choosing people to interview, I sought to hear about widely varied experiences in the world of labor. I interviewed in companies of many sizes and in many lines of business. I talked to counselors in unemployment agencies in economically depressed regions and in prosperous ones. I spoke with labor leaders in a variety of industries. I also sought key informants, people who had a reputation for being knowledgeable, articulate, and intelligent. I obtained the names of people to interview largely through referrals from people I knew or interviewed. Such referrals proved useful in gaining cooperation. It seemed pointless to select informants randomly, since I sought especially interesting informants and did not intend to test hypotheses statistically. Rather I was looking for hypotheses. I had no fixed list of questions, but explained my project and then let informants talk. I posed questions only when necessary to guide the conversation in interesting directions. I did as many interviews as I could to broaden my experience and assure myself that the patterns I saw were probably real. I ended up doing 336. The method can be replicated, despite its flexibility, and makes it easy to learn new and unexpected things, to exploit unanticipated directions of investigation, and to obtain a broad vision of what goes on in the labor market. The method also has clear disadvantages. One is the absence of meaningful statistical data on the incidence of various behaviors. Another is the possibility that informants might give misleading information. A check on the latter problem is to see if what people say they think and do makes sense

given what is known of their circumstances and interests. My conclusions should all be thought of as tentative. Better confirmation could be obtained by a series of studies of a narrower scope that could use statistical methods.

In evaluating my findings, one should keep in mind that a much smaller fraction of the labor force is unionized in the United States than in Europe. In the period in which I was interviewing, only about 11% of the labor force in the United States belonged to unions. In the region I studied, these were concentrated in large old manufacturing companies and in public service jobs. There was also some union presence in construction and supermarkets.

The central feature of the explanation of downward wage rigidity is employee morale. By good morale, employers can mean simply a good mood, but usually they mean internalization of the objectives of the firm and a willingness to make sacrifices for it. Like many human relationships, that between a firm and its employees is based on reciprocation, and good morale is in part a belief that the firm gives an appropriate return to employees for their efforts. Employers care about morale because it affects productivity, labor turnover, and the ability to hire good quality employees. A good mood helps productivity because it facilitates cooperation among workers and makes them more agreeable when dealing with customers. Sometimes work is so unpleasant that employers cannot expect moods to be good, but the zest for work that goes with good morale can make the unpleasantness easier to bear and less distracting. When employers speak of the impact of morale on productivity, they do not have in mind the speed with which routine jobs are performed, but doing the extra thing, coming up with useful suggestions, working well without supervision, and helping coworkers with their tasks. Good morale reduces turnover, because disgruntled workers are likely to quit. Employers wish to limit quitting because hiring and training costs are high. Good morale makes recruitment easier, because a large proportion of hiring is done through contacts with employees, who consequently are usually a company's most effective recruiters. For all these reasons, management is preoccupied with morale.

The opposition to pay reduction comes in the first instance from the owners and top management of a firm. In understanding the reasons for this resistance, it is important to distinguish existing employees from new hires or those who have not yet been hired. Employers are reluctant to cut the pay

of existing employees because of the anticipated damage to employee morale. In explaining why pay cuts would hurt morale, employers and labor leaders normally distinguish between what I call an insult effect and a standard of living effect. The insult effect arises because employees interpret a pay cut as an affront or slap in the face. They are used to receiving regular raises, and the replacement of a raise with a cut is almost automatically interpreted as a lack of appreciation of employee efforts. It ruptures the reciprocation that is central to the employees' partnership with their employer. This is so even if everyone's pay is cut. Workers might initially be less insulted by a general pay cut than one applying to one or a few individuals, but when the entire work force receives such a setback, they feed each other's resentment by complaining to each other. The standard of living effect is the discontent generated by the hardship brought on by income reduction, adversity that workers naturally blame on their employer.

I should be clear about what I mean by a pay cut. By this, I mean a reduction in nominal pay for an employee in the same job, working under the same conditions and for the same employer as before the reduction. The reduction is in salary for a salaried worker, in the hourly rate for someone paid by the hour, and in piece rates for workers receiving them.

Central to an understanding of the labor market are the pay structures internal to firms. These determine the differentials among the pay of the various employees. In large companies, the structure is normally described in a formal document. In small companies, it is usually an informal understanding preserved by custom. Internal structures place employees in categories that are based on one or more factors, such as job description, responsibility, work experience, time on the job, time with the company, or employee qualifications or skills. The categories may be given grades, which convey employee rank and prestige. A common practice is to associate with each category a pay range or sometimes a series of pay steps. The pay of each employee is supposed to be within the range or at one of the steps. The ranges can be quite wide, and the place within the range is determined by the same factors that determine the employee's category or grade as well as, sometimes, the employee's performance. There are structures that do not fit this description. For instance, piece rates depend on the task performed and make pay proportional to output. There are floating progressions, according to which the structure specifies a schedule of raises given at regular time intervals to employees whose performance meets

some minimum standard. Such a structure does not specify the level of pay, which is determined by pay on hiring plus intervening raises. Floating progressions are used when the pay of new hires is market determined and can move up and down as conditions change. Such systems are often used for the floor crews of supermarkets. For low level jobs, structures tend to apply to one work place or establishment or to a local geographic area within a company. The higher the job level, the wider the scope of the structure, and in large corporations top management has one structure that applies nationally or even internationally.

The main reason for having internal structure is to achieve a sense of internal equity or fairness. Employers usually do not reveal information about the pay of individuals and discourage exchange of pay information among employees. Nevertheless employees share pay information often enough that any perceived inequities can cause an uproar and be demoralizing. Equity does not mean that all employees receive nearly equal pay. The increase in pay with rank can be quite steep, both to provide incentives and because employees themselves find it just that skill, talent, responsibility, and performance be acknowledged and rewarded. Managers recognize that the definition of fairness is ambiguous, so that standards of equity depend to some extent on company tradition. The potential tensions over pay comparisons are so powerful that internal pay structures are usually rigidly respected and considered to be vital to the health of an organization.

There are other reasons for internal pay structure. An important one is to create status that is itself an incentive to work hard. Another is to make clear the avenues of promotion, so that employees understand this class of performance incentives. Still another function of internal structure is to control the abuse of management authority by having clear rules specify pay.

In understanding the impact of internal structure, it is helpful to distinguish the primary and secondary sectors of the labor market. Primary sector employment is long-term and full-time, and that of the secondary sector is just the opposite. Jobs are more likely to be considered a career in the primary than the secondary sector. Primary sector workers include most managers and professional people, non-retail salespeople, factory, clerical, technical, and construction workers, and truck drivers. Secondary sector workers include temporary or contract help of all kinds, night watchmen, security guards, and

janitors, taxi drivers, waiters and waitresses but usually not restaurant cooks, and most of the salespeople, clerks, cashiers, and stockers who work in retail trade. The sector categories apply to employees, not firms; all companies that employee secondary sector help also have primary sector workers, such as the managers. Most workers in the secondary sector are paid less than people in the primary sector, but there are exceptions. For instance, some high-priced engineers and managers work on a temporary basis. A consequence of part-time employment and short job tenure is that workers in the secondary sector have less contact with colleagues in the same work place than do employees in the primary sector. For this reason, workers in the secondary sector are less likely than those in the primary sector to share pay information with coworkers or to care about pay comparisons. As a result, internal pay structures tend to be looser in the secondary than in the primary sector.

I begin the discussion of pay determination with the wages and salaries of new hires. In the primary sector, the pay of new hires is closely tied to the internal structure. The recruiter tries to understand how the new hire fits into the structure, given her or his training, experience, skills, and new job. Though there may be some room for discretion and negotiation, the structure dominates the decision. In the 1980s, there was a vogue for what were called two-tier wage and salary systems, according to which a firm could react to financial distress or a weak labor market by having all new hires brought in after a certain date be paid according to a lower internal structure than those hired earlier. Such systems led to so much resentment and tension among workers in the primary sector that they were unpopular there by the time I interviewed in the early 1990s. Although new employees might at first be glad to have their job, they become disgruntled when they discover that they are paid according to a lower progression than coworkers hired earlier. I was also told that paying new employees according to a higher schedule than existing employees can cause even more trouble than paying them at a lower level, because such higher pay arouses the jealousy and resentment of all existing employees.

In the secondary sector, the pay of new hires tends to be market determined and to fall readily in a slack labor market, though the pay of existing employees is just as rigid downward as the pay of primary sector workers and for the same reasons. The lack of internal contact in the secondary sector and the lack of interest in pay comparisons means that two- or even multiple-tier systems have less

negative impact than they do in the primary sector. Supermarkets routinely have many-tiered pay systems that arise automatically when the pay of new hires declines in response to labor market conditions. For this reason, many food retailers use floating progressions to organize pay internally. Union contracts for supermarkets may not specify the pay of new hires, but only a schedule of raises. One supermarket company where I interviewed had tried multiple-tiered systems in its distribution centers and found that they caused turmoil there, even though they caused no trouble in the stores. The reason was that warehouse employees worked full-time and treated their jobs as careers - they belonged to the primary sector. Even in the secondary sector, many employers have to be careful when increasing the pay of new hires not to allow it to exceed the current pay of existing employees in similar jobs and of similar qualifications. Such disparity between the pay of new and existing employees can so antagonize existing employees that it is considered good practice to raise their pay in step with the pay of new hires. This observation does not apply to temporary labor. The market for temporary labor is nearly an auction market for labor. I never heard that morale was a consideration in setting pay for such labor, except when temporary help is hired from several sources into one work place. Temporary labor companies try to avoid trouble by arranging that workers from different agencies doing similar work at the same place receive similar pay.

A possible explanation of downward rigidity of the pay of new hires is that job seekers refuse pay below a certain level. With this possibility in mind, I asked employers whether they thought they could hire enough good quality workers at pay rates lower than those currently offered. This question was especially relevant, because I interviewed during a period of fairly high unemployment. Most recruiters filling positions in the primary sector believed their efforts would not be harmed by reducing the pay of new hires. Many of them were overwhelmed by applications from unemployed job seekers. It was the internal structure that sustained the pay of new hires at its current level. There were some exceptions among employers hiring specialties that were in short supply, such as physical therapists and certain types of engineers working on defense projects. The responses were nearly the opposite in the secondary sector, for there starting pay was generally kept as low as labor market conditions permitted.

Once employees are hired, the evolution of their pay is determined by pay increases, (or cuts, though these are rare). Pay raises normally occur at regular intervals, usually annually or semiannually. They are administered either as general or as merit increases. General increases are usually by a uniform percentage. Merit increases were by far the most common at the time and in the region where I interviewed. They applied to all management or supervisory personnel. General increases were most common for unionized employees or for employees who were vulnerable to unionization, because it was thought that merit increases give management too much power and breed suspicion. Even general increases might not be given to employees whose performance had clearly been below standard. Increases in piece rates were always general.

Merit increases are based on an evaluation of an employee's performance. They normally are not allowed to bring an employee's pay above the top end of the range applying to her or his job grade. Employees at this upper bound are said to have "maxed out" and cannot receive more pay until they have been promoted or the ranges have been increased.

It is important to distinguish between raises due to an increase in the level of the internal pay structure and raises associated with advancement within the structure. Increases in the structure are associated with increases in the pay ranges or steps applying to each job or grade. Increases within the structure bring pay higher within the ranges or steps associated with the employee's grade.

Raises have many important functions besides simply keeping average pay rates at market levels. The main reason for paying raises is to provide incentives for hard work and loyalty to the employer. Raises are considered to be rewards for good work. They also serve to discourage quitting both by generating loyalty and by keeping the pay of individuals in line with their market worth as they gain skill and experience. Raises are important for morale, because people expect them and are offended if they don't receive them. Raises are also used to protect employees' living standards by assuring that pay rates grow at least as fast as the cost of living. It is believed that declines in the purchasing power of pay are demoralizing, especially if they occur over long periods of time. During the period in which I was interviewing, the increase in the cost of living was not an important consideration at many firms, because the increases given for other reasons more than made up for it.

Because raises are used to create work incentives, they can eventually bring pay above a worker's marginal product. For this reason, companies count on a certain amount of labor turnover to remove high priced employees. One of the negative impacts of economic recession on companies is that by discouraging quitting it increases the proportion of employees with high job tenure and hence high pay. I heard the most complaints about this effect from managers of retail companies with floating progressions that gave workers nearly automatic increases at regular intervals. In the secondary sector, it was not unusual for employers to reduce the hours of high-priced, part-time workers to induce them to quit. Companies seek to manage turnover, not to minimize it.

I mention in passing that the pay of individuals can differ markedly from the value of their marginal product. This value plays no direct role in the determination of wages and salaries, though it does play a role in the determination of the number employed in each of the various job categories. The average value of marginal product for workers in each category is kept roughly equal to the average total compensation for the category by decisions about hiring, layoffs, and internal reassignments of labor. Layoff decisions often involve comparison of labor costs for both individuals and groups with estimates of the value of their marginal product.

In deciding on the average level of raises, companies use labor market surveys and also forecast future market wage and salary levels. They base their forecasts on the recent history of indices of market wages and salaries and of the cost of living and on information gathered about the pay increases planned by their competitors in the labor market. The wage and salary surveys contain questions about these plans.

Although raises are in part a response to market forces, these influences are seldom permitted to affect pay increases directly through the process of meeting outside offers. Employers normally do not match outside offers, because they do not want to encourage employees to solicit them and matching would upset and call into question the internal pay structure. At many job levels, it is advisable for employees to keep secret any outside offers, because the employer is likely to take revenge on an employee who receives one by looking for a replacement and dismissing the worker as soon as one is found. A few employers told me stories of having summarily fired employees for considering or seeking

such offers. One owner of a construction company fired an estimator simply for coming to work in a nice suit, thereby revealing that he was going to a job interview during his lunch break. Employers act in this way, because they interpret the consideration of outside offers as a sign of disloyalty. Employers react especially badly to outside offers made to employees in sensitive positions, such as the estimator, who knew company secrets, or salespeople, who can take their network of customer contacts with them when they leave. Employers are likely to impound immediately all the records of a salesperson they suspect of infidelity and to walk them to the door when they are fired. Employers are less likely to take revenge for outside offers made to employees at low levels in the company hierarchy, though they frown on the offers. There is almost no resistance to outside offers to employees with rare skills and knowledge that are important to a company and difficult to replace. Examples of such people are scientists at pharmaceutical and chemical companies and even some computer programmers. Not only do such people have their company over a barrel, so to speak, but their market value and value to the company are understood to be ambiguous, so that dramatic changes in their pay are not likely to cause resentment or to strain the internal pay structure. Such specialists are similar to American academics in that they can seek outside offers with impunity and expect to have them matched.

Although employers usually protect their pay structure by refusing to respond to outside offers, they are willing to adjust internal pay differentials in response to market pressures. Upward adjustments are typically made when a particular skill is in short supply. These changes require a great deal of explanation in order to head off resentment by employees not benefiting from them. Nevertheless, such upward adjustments can be large and rapid. I never heard of downward adjustments applied to particular types of labor in excess supply.

Besides internal structures, there are external structures that are relations among the pay of workers at different firms or even among widely separated work sites within the same company. This structure is far less rigid and clearly defined than internal structure, because it is determined by market forces and these are much weaker than the forces of envy and morale that make internal structures necessary. Market forces manifest themselves through the difficulty of hiring and retaining employees. Although this difficulty does respond to pay levels, the response is not so sensitive as to determine

narrowly the appropriate level of pay. This level depends in part on management opinion and policy and on perceptions of such imponderables as the trade-offs between pay, on the one hand, and the cost of hiring and the quality of the work force, on the other hand. Morale is fairly insensitive to the overall level of a company's pay structure, though morale can be badly damaged by reducing pay. Sometimes firms make mistakes and pay certain classes of labor much less than market rates. I heard accounts of a few errors of this kind, and the consequence was high labor turnover, not poor morale. The main explanation of why morale is insensitive to pay levels is that workers do not have a clear idea of what alternative employers pay people like themselves. Because internal pay structures are complicated and somewhat unique to each firm, it is often difficulty to compare the pay in different companies, and unless workers belong to a strong labor union or professional society, they do not have access to systematic wage and salary surveys that organize information about pay. Firms are careful not to share wage and salary surveys with their own employees. Workers can learn about pay levels at other companies from friends and neighbors, but such information is truly revealing only in tight local communities and for local labor markets, such as those for retail trade or local construction contractors. One might imagine that generous pay raises improve morale, but this is usually not so. Although morale can be hurt if raises are viewed as too small, the experience of employers is that the generosity of large raises is soon forgotten and workers quickly grow to believe they are entitled to them. The weakness of external pay structure permits a remarkable variation in pay levels for similar jobs in nearby firms producing similar products. Differences of 20 to 30 percent are not uncommon. The insensitivity of morale to pay levels contradicts the efficiency wage theory that makes morale and hence productivity depend on them.

Although pay levels have little effect on morale, they do have an impact on productivity through their effect on the quality of the work force. The trade-off between pay and productivity through this mechanism is a major determinant of pay, but has little to do with downward wage rigidity.

In the primary sector, firms adjust the overall level of the internal structure by making coordinated changes in the pay of new hires, the ranges or steps associated with each labor grade, and the pay of existing employees. When choosing the level, upper management considers recent experience with hiring and quits plus the same information used in choosing the average level of raises, namely, wage

and salary surveys, and information about other firms' planned pay increases. The use of surveys of planned pay increases may build inflationary momentum into the system determining wages and salaries. The adjustments in internal structure levels are almost always upward, as pay cuts are very unusual. Employers, of course, resist upward adjustment, especially because it is difficult to reverse. Nevertheless, upward adjustments can be rapid if they are believed to be necessary to recruit and retain labor. Pay structures sometimes move downward slowly. Declines can be arranged without reducing anyone's pay, because the pay of individual employees grows or at least stays flat despite the downward shift in structure; most receive raises.

In the secondary sector, adjustments in the level of the internal structure occur primarily as a result of changes in the pay of new hires, which may move downward substantially as well as upward. Before I began my study, the pay of new hires for floor crews in fast food restaurants in my area had fallen from about $6.50 an hour to the minimum wage of $4.27. Since the pay of individuals is their wage at the time of hiring plus raises received since then, changes in the pay of new hires eventually shift the level of the entire pay structure. This shift occurs fairly rapidly in the secondary sector because turnover is high there.

Pay in the primary sector is also the wage or salary at the time of hiring plus subsequent raises, but in the primary sector the pay of new hires usually declines only by a small amount unless there is a general pay cut. These small declines are arranged by taking advantage of ambiguities in the internal structure and are not acknowledged officially.

A common reaction to economic recession, even in the primary sector, is to allow the level of the internal structure to drift downward in real terms by not increasing it in step with the cost of living. Such declines, of course, can occur without the real value of anyone's pay falling, because employees continue to receive regular increases. Such declines in the real level of the structure have no negative impact on morale, because few employees suffer a decline in the purchasing power of their pay and the internal structure continues to serve its purpose of maintaining appropriate differentials between the pay of the various employees. I never heard that there is an association between levels in the job hierarchy and real, as opposed to nominal, levels of pay, though I suppose a strong union could create such a link.

In order to understand the process of wage inflation, it is important to realize that the rate of inflation of average wage costs can be less than the average rate of increase of the wage paid to an existing worker. This is so because of what are termed turnover savings. Employees who leave a firm as a result of quits, retirement, or layoff usually earn more than new hires, and the difference creates the savings. These are a natural consequence of the fact that an employee's pay increases as she or he rises though the internal structure. In order to see this point clearly, consider a simple example in which there are two levels in the internal structure, the same number are hired each period, employees all advance to the next pay level in the next period after they are hired, and they all leave at the end of the second period. Suppose that advancement to level two brings a 20 percent pay increase. The following table shows that though average raises remain positive, average wage costs behave as a hire's pay does, remaining constant or falling.

Period	A New Hire's Pay	An Old Worker's Pay	Average Pay Increases	Average Wage Cost	Change in Average Wage Cost
1	1.0	1.2	–	1.1	–
2	1.0	1.2	0.2	1.1	0
3	1.0	1.2	0.2	1.1	0
4	0.9	1.2	0.2	1.05	–0.05
5	0.9	1.08	0.18	0.99	–0.06
6	0.9	1.08	0.18	0.99	0

The Impact of Turnover Savings

A question of interest to macroeconomists is whether downward wage rigidity is real or nominal. The answer is that it is both; management does not like to see either the real or nominal value of pay decline. This distaste for declines stems, of course, from the projected reaction of the work force. Recall that the impact on morale of pay cuts is due to an insult effect and a standard of living effect. The insult effect is linked to the shock of a sudden reduction in nominal pay, and the standard of living effect results from the decline in the purchasing power of pay. The standard of living effect is felt only slowly as workers realize they must give things up because of the reduced value of earnings. For this reason,

there is some tolerance of a slow decline in living standards, provided it does not last a long time. Pay freezes lasting two or more years can have a terrible effect on morale, after inflation makes them painful. In a time of price deflation, nominal wages could be reduced without decreasing living standards, but it would probably be hard to do so because of the insult effect. This is only a guess, however, because my interviews occurred during a period of slow inflation and none of my informants had experienced a period of significant deflation.

It is important to realize that pay can be cut without seriously damaging morale provided management can argue convincingly that the cut will save lots of jobs. A cut would do so if it would prevent a company or work establishment from closing or if it would prevent lots of layoffs. Most employers were confident that they could convince employees that pay cuts were needed for these reasons, provided it was true that they were needed. Most employers believed that workers would be mature enough to tolerate the cuts if they or their coworkers would benefit from them. Of course, no one likes to hear bad news and employees are as likely to resist and deny it as anyone else. For this reason, management normally holds meetings with employees when announcing a pay cut and offers detailed explanations of why it is required. Pay cuts are unusual precisely because they normally would not save many jobs. Pay cuts in firms where I interviewed did save jobs, because they enabled the companies to avoid closing or they were in businesses, such as construction, that had highly price elastic product demand. Actual pay cuts caused little harm to morale, because firms reduced pay only when management was fairly sure that the damage would be minimal. Nevertheless, quite a few managers I talked to told stories of past pay cuts that they had experienced or heard about and that went awry because they were made under the wrong circumstances.

One reason that pay cuts would save few jobs is that the elasticity of demand for labor at individual firms is normally small. This is so because labor costs are typically a small fraction of marginal costs and because the price elasticity of product demand is not large. Although about 70 percent of costs are paid to labor at a national level, at the level of an individual firm most costs are for inputs purchased from other firms. In many firms, labor costs are as low as 5 to 10 percent of revenue and are probably an even smaller percentage of marginal cost, since typically a significant fraction of labor costs are fixed,

because they are paid to overhead personnel. Price elasticities of product demand are not large because few firms sell in markets where a small decrease in price would bring a big increase in demand.

The low wage elasticity of the demand for labor explains why pay reduction prevents few layoffs of production workers, whose jobs are threatened by reduced product demand or by technical progress. Many layoffs, however, are made simply to save money so as to meet a company financial crisis, and layoffs are a much more effective way to save money than are pay cuts. Because of the high fixed costs of employment, layoffs of relatively few employees typically save as much money as would a general pay cut of feasible size. Managers believe that pay cannot be reduced by more than 15 or 20 percent without having a devastating impact on morale. Pay cuts apply only to the variable part of pay and usually not to benefits and certainly not to all the other fixed costs associated with employment.

When pay cuts do occur, they are usually across the board or apply only to the higher levels of employees. The reductions are made in this way in order to preserve the pay differentials required by the internal structure and to create a sense of fairness. The cuts never apply just to those employees whose jobs are threatened by a decrease in demand for what they produce.

The explanation of why pay cuts do not necessarily hurt morale is related to the explanation of why management usually prefers layoffs to pay cuts. A primary consideration is that a pay cut would save few jobs and so is not really an alternative to layoffs. Production workers would have too little to do if, after a decline in the need for them, their pay was cut and there were no layoffs. Employers worry that such a lax situation would lead to bad work habits and could damage the company culture. They prefer that employees have too much to do, not too little. Another important consideration is that layoffs "get the misery out the door." Those who suffer from layoffs leave the work place and so do not depress its atmosphere. Employers assert that there is no reason to antagonize everyone with a pay cut when they could make just a few unhappy through layoffs, and those few would be out of the work place and happy to return if recalled. Employers recognize that layoffs cause hardship and can even be dangerous to those let go, but believe they can do little about the suffering, except to offer some severance benefits. Because the fear of future layoffs depresses the spirits of employees, employers try to have layoffs only infrequently. It is considered good practice to save them up, let many people go at once, and then argue

that there will be no more dismissals for some time. Employees worry about the welfare of their coworkers who had to leave, and a major reason for paying severance benefits is to assuage the feelings of the employees who remain after layoffs. Employers argue that the future of their companies depends on their core employees and that to survive hard times it is essential to retain them and their enthusiasm and loyalty. Employees not in the core who are not needed should be dismissed quickly and those retained should be given pay increases to encourage them to help pull the company out of trouble. Layoffs are often made in order to pay for such raises. Still another consideration is that pay cuts can damage productivity because they hurt morale and the best employees are typically those who leave first after pay cuts, since they are the ones who can find other jobs most easily. Layoffs, on the other hand, usually improve productivity after the initial reorganization made to reassign tasks among a smaller labor force. The increase in productivity occurs because employers try to lay off their least productive employees first and because people try to look good to avoid being let go in the next round of layoffs. Within job categories, workers are selected for layoff on the basis of seniority or performance. These criteria have to be used consistently to avoid suits for improper dismissal. Whatever the system used, employers are usually able to arrange the layoffs so that the least productive go first. Only in some settings do layoffs hurt productivity. A unionized work force may try to protect jobs by slowing work down so as to make it last. Too frequent layoffs can so discourage employees as to make them apathetic.

An obvious question is why firms do not avoid layoffs more often by means of worksharing, which is an arrangement by which employees work fewer hours or have rotating furloughs i.e., short periods of layoff. When asked about this, employers explain, when speaking of hourly workers, that worksharing has some of the same bad effects as pay cuts; reduced earnings impinge on living standards and for this reason are greatly resented if they last too long. Rotating furloughs have the advantage over hours reduction that workers can collect unemployment benefits when on furlough. In the United States, the collection of such benefits has the disadvantage that it increases the unemployment tax paid by the employer. Worksharing through hours reduction is expensive for another reason. Because of the fixed costs of employment, unit labor costs are normally lowest when employees work more than 40 hours a week, despite the overtime premium. Since the fixed labor costs, such as those of benefits, do not

decline with hours worked, employing people part-time who are normally full-time can increase hourly labor costs substantially. Worksharing is typically used only for workers, such as expert machinists, who have skills that would be difficult to replace if they were laid off and then found work elsewhere and did not return when recalled.

Worksharing makes little sense in the context of salaried overhead employees who are overtime exempt. ("Overtime exempt" is a term that applies to the American labor force and describes employees who are exempt from the federal statutes that require that workers be paid time and a half for hours worked per week above 40.) It is standard practice for employers to save money during economic downturns by laying off a fraction of such employees and giving their work to those who remain. The total overhead workload typically does not decrease during a downturn and may even increase because of all the adjustments the company must make in its product markets. Whatever the case, the remaining employees must work more hours per week after the layoffs. They are not paid more for the additional time, because they are salaried and overtime exempt. They normally tolerate such treatment, because it is hard to find alternative employment during a recession and it is expected that overtime exempt employees make extra efforts to help their company through a crisis. When the total overhead workload does decrease during a downturn, it is often because the company abandons projects, such as new product development, that are investments meant to increase future income. Thus, worksharing is inappropriate in the context of overhead people, because slowdowns do not necessarily entail a reduction in the total amount of work to be done and avoidance of layoffs would burden a firm with unnecessary costs at a time when it should be reducing them.

A natural question for an economist is why during periods of high unemployment a firm does not make a deal with unemployed workers to hire them for less than what it pays its current employees. One possibility would be to replace some or all employees with cheaper unemployed ones. (I have never heard of a company doing this, except to break a strike or union.) The main answer as to why firms do not take advantage of unemployment in this way is that they do not want to lose the skills, knowledge, and training of their work force. Other important reasons are that such a move would deal a terrible blow

to company morale. Even if all employees were replaced, it would give an example of treacherous behavior that workers might well imitate. Partial replacements would violate the internal pay structure.

Another way to use unemployed workers would be not as replacements but to fill open positions at pay rates lower than those of existing employees. I have already mentioned that employers do precisely this in the secondary sector and that employers in the primary sector feel constrained not to do so by the internal pay structure and the need for internal equity.

Solow (1990, p. 37) asked why unemployed workers do not try to take jobs away from the employed by offering to do their work for less than they are paid. One answer to this query is that in hard times workers do sometimes offer to work for very little and that employers normally do not accept these offers, except perhaps to pay them less during a probationary period. The offers are refused because of concern about internal equity. This is so even in the secondary sector, where employers feel obliged to pay equitably all equally qualified new hires, for the new workers find it easier to compare their pay with that of other current hires than with that of people hired earlier. The reason employers reject low offers is not that they think badly of job applicants for making them. They may even admire their eagerness to work.

Another answer to Solow's question is that it is difficult, from a practical point of view, for job searchers to offer to work for less than existing employees, because job applicants seldom apply for particular jobs and if they do they almost certainly do not know what existing job holders are paid. They obtain precise information only about their own pay and that when they receive a job offer. Before then, they have only vague impressions of pay levels at a firm.

Because the market behavior of the unemployed is critical to many explanations of downward wage rigidity in the literature, I devoted a good deal of time to learning as much as I could about the behavior of unemployed job seekers. This effort was particularly appropriate, because I was interviewing during a period of fairly high unemployment. I was particularly interested in the question of whether job hunters could count on finding a job quickly if they were sufficiently flexible about working conditions and pay. The answer was definitely not, though some flexibility certainly improved the chances of finding work. Except for a few special skills, there was a shortage of jobs, even at low levels. Furthermore, job

hunters risked being rejected as overqualified, if they looked at too low a level relative to their qualifications and their previous employment. Job seekers were very likely to be labeled as overqualified if the job they sought paid 80% or less than their previous job. Primary sector employers were especially likely to shun the overqualified because of worry that they would quit as soon as they found a better position. There was less concern about overqualification in the secondary sector, because labor turnover is high there in any case. Overqualification was not an issue at all for taxi drivers or for temporary labor. There was concern, however, about overqualification among secondary sector employers of workers who deal with customers, for it was believed that workers used to better jobs would be so disgruntled that they would be impatient and unpleasant. Because of the overqualification problem, the wisest job hunting strategy was said to be first to look hard for the type of work for which one was precisely qualified and with pay that was probably close to that earned before layoff. If no such job were found, it was best next to look for positions similar to those for which one was exactly qualified.

For a few weeks after layoff, many unemployed people suffered from shock and retreated into denial of their circumstances. During this period, they were likely to be quite inflexible about the kind of job and the pay they were seeking and they were not likely to be energetic about job search. After recovering, most unemployed job hunters were fairly energetic and flexible and many were too flexible and ran into the overqualification problem, which came as a frustrating surprise. Job search counselors spent a good deal of time explaining how to avoid this obstacle. Some even recommended removing qualifications from resumes and reducing the pay claimed there on previous jobs - a dangerous practice since any lie during the hiring process can later be grounds for firing. I heard many complaints from employers who suspected that job applicants were hiding qualifications and deflating past pay. Some job seekers were unrealistically stubborn and insisted on receiving the same sort of job and the same pay as they had before layoff. Such obstinacy was especially common among unemployed workers who had been laid off from jobs where they had been protected by a strong union.

I also inquired about employers' reactions to the unemployed. There was little prejudice against unemployed job applicants, though employers wanted to know how applicants had become unemployed and what they had done since. If they had been laid off, recruiters wanted to know why. They were

concerned that those laid off had been selected as the least productive and that those who had not looked actively for work were depressive or lacked initiative. On the other hand, it was understood that there had been massive layoffs and that jobs were in such short supply that it often took months for many to find work. Hence, employers believed that many very good people could be found among those who had been laid off and even those who had remained unemployed for a long time. Many employers were furious about the flood of overqualified job applicants, who "just want to get their foot in the door" and then would be disruptive, demand promotion, or soon quit. I heard few complaints about the inflexibility and apathy of job applicants, except from employers offering positions at the bottom end of the job spectrum, such as work in laundries and candy factories, where work was in competition with the welfare system.

The job hunting experience of the unemployed was that for a great many job search took a very long time, simply because jobs were scarce. The best way to find work was through friends and acquaintances - the term used by job search counselors was "networking." Employers prefer to hire through personal contacts, because these enable recruiters to learn things about applicants that they could not know easily otherwise. I was told by people who worked regularly with job searchers that many unemployed put a great deal of effort into job hunting and that some eventually became desperate. Such people were the ones most likely to look too low and be rejected as overqualified. Others who could afford to do so just gave up.

As I hope you have realized, wage and salary dynamics result from a complicated interaction of labor market pressures, the need to maintain good morale, and pay structures internal to firms. People use as reference points their own past pay and, if they are part of a close-knit company work force, the pay of coworkers. They easily take offense if they perceive that their pay as inadequate relative to these references. Employer efforts to avoid such resentment explain nominal downward wage rigidity. The real value of pay is downwardly rigid, because employers wish to avoid the discouragement caused by declines in living standards. Close contact among employees within a firm calls for elaborate pay gradations that create incentives and a sense of justice, and the movement of workers upward through the resulting internal structure gives rise to a confusing disjunction between the rate of change of average

company labor costs and the average rate of change of employees' pay. Personnel management gives rise to many difficult problems, especially during downturns, for which there are probably no good solutions. The actual practices are pragmatic measures that are part of business culture and are rediscovered independently by businesspeople as they react to experience.

References

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