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Why wages do not fall in recessions

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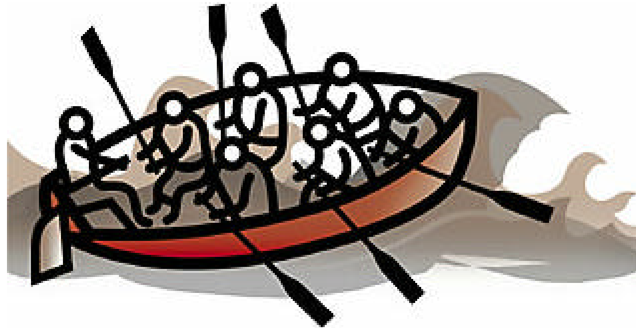

An intrepid economist ventures into the real world to investigate—and finds conventional explanations wanting

ECONOMISTS dislike talking to people. They prefer a more "scientific" approach to research, such as number-crunching or abstract theorising. But that can be a weakness, as a new book by Truman Bewley, an economist at Yale University, makes clear. In "Why Wages Don't Fall During A Recession", published by Harvard University Press, he tackles one of the oldest, and most controversial, puzzles in economics: why nominal wages rarely fall (and real wages do not fall enough) when unemployment is high. But he does so in a novel way, through interviews with over 300 businessmen, union leaders, job recruiters and unemployment counsellors in the north-eastern United States during the early 1990s recession.

Explanations for why wages are sticky abound, but they are often unconvincing. Neoclassical economists, who have a starry-eyed faith in the efficiency of markets, think wage rigidity is an illusion. In their view, workers quit their jobs when pay starts to fall in a downturn. This stops wages falling much and makes them appear inflexible. But their theory implies that unemployment in a recession is voluntary—a view at which reasonable people might rightly scoff.

Keynesians, who accept that markets are often imperfect, think wages are sticky, but cannot agree why. Some blame unions or established employees ("insiders") for blocking pay cuts. Keynes himself thought that workers were so concerned about their wages relative to those at other firms that no company dared to cut pay. Others argue that firms pay high "efficiency wages" in order to make the threat of job loss more costly for workers and so spur them to work harder. (Wages might still fall in a recession, though, since workers are more afraid of not finding another job when unemployment rises.) Still others claim that firms implicitly insure workers against a fall in income in exchange for lower long-term average wages. And so on.

One or more of these theories may be true. Or perhaps none is. Economists do not really know, because the labour-market data with which they test their theories is inadequate. So Mr Bewley tried asking people who should be in the know. He is aware of the pitfalls: interviewees may be unrepresentative, lie or obfuscate. They may not understand their own motives. Still, since economists are ultimately trying to describe human behaviour, meeting real people ought sometimes to help.

Mr Bewley finds scant evidence to support the various wage-stickiness theories. His interviewees say unions are not to blame for wage rigidity: few American firms are unionised, and in those where unions are important "the first line of resistance to pay reduction was almost always management." Nor are "insiders" blocking pay cuts: few non-union workers bargain over wages with their employers, and no employer remarked on a sharp division

of opinion over layoffs among workers, who more typically thought that pay cuts would not save jobs.

Keynes's theory gets short shrift too. Mr Bewley finds that, although pay rates across non-union companies are connected by supply and demand, firms still have plenty of latitude in setting pay because workers have scant knowledge of pay rates elsewhere. Nor is much credence given to the efficiency-wage model. "People do work harder during a recession because they are concerned about their jobs ...however, the logic does not imply that companies pay well for reasons of discipline. They do so in order to attract and retain employees," says a typical personnel officer in a middling manufacturer. The implicit insurance model fares little better. Employers do not think such a bargain exists and believe that it would be unenforceable in any case, since long-term pay is determined by competitive conditions.

All in a day's work

Why, then, are wages sticky? Mr Bewley concludes that employers resist pay cuts largely because the savings from lower wages are usually outweighed by the cost of denting workers' morale: pay cuts hit workers' standard of living and lower their self-esteem. Falling morale raises staff turnover and reduces productivity. Cheerier workers are more productive workers, not only because they work better, but also because they identify more closely with the company's interests. This last point is crucial. Mr Bewley argues that monitoring workers' performance is usually so tricky that firms rarely rely on coercion and financial carrots alone as motivators. In particular, high morale fosters teamwork and information-sharing, which are otherwise difficult to encourage.

Firms typically prefer layoffs to pay cuts because they harm morale less, says Mr Bewley. Pay cuts hurt everybody and can cause festering resentment; layoffs hit morale only for a while, since the aggrieved have, after all, left. And whereas a generalised pay cut might make the best workers leave, and a selective one damage morale because it is seen as unfair, firms can often lay off their least competent staff.

Mr Bewley's theory has some interesting implications. Pay cuts are more likely at firms whose demand for labour is price-sensitive, such as those in highly competitive industries. Since many markets are becoming more competitive, wages may also be getting more flexible—and unemployment may rise less in recessions. Wages are also likely to be less rigid in short-term jobs, where workers do not become attached to their firm. On the other hand, since more workers now do jobs that are hard to monitor, or in which they need to co-operate, share information, be creative or be nice to customers, wages may become stickier.

Mr Bewley's book is not the last word on sticky wages. Some of his findings are probably specific to the north-eastern United States in the early 1990s. But his theory has a ring of truth to it. And if his example spurs other economists to venture out of their ivory towers, so much the better.

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