FAIRNESS, RECIPROCITY, AND WAGE RIGIDITY

Truman Bewley

CONTEXT

- Significant wage rigidities exist – both in real and nominal terms.
- Why don’t we see pay cuts?
  - Firms can cut pay instead of laying off workers.
  - Unemployed workers can try to take jobs away from employed people by offering to replace them at lower pay.
  - Firm can replace employees during recessions with cheaper unemployed workers.

QUESTION: WHY ARE WAGES RIGID?

- **Morale theory**: Solow (1979), Akerlof (1982), Akerlof and Yellen (1988, 1990)
  - More effort from workers when wage greater than market clearing level
  - Employers avoid cutting pay because doing so would hurt morale
- **No shirking theory**: Shapiro and Stiglitz (1984)
  - Managers set wages to optimize tradeoffs between productivity and wage costs
- **Adverse selection theory**: Andrew Weiss (1980, 1990)
  - Quits vs. Hires models
  - Layoffs vs. Pay cuts

ANSWER: EVIDENCE FROM SURVEYS

- **Morale theory**: Workers are used to regular wage increases and so they interpret pay cuts as an affront and unfair
  - Sense of fairness → good morale. Pay cuts damage morale.
- **No shirking theory**: Fire workers if productivity falls below a cutoff
  - Being fired is costly, so workers exert more effort the higher the wage
- **Adverse selection theory**: Managers prefer layoffs to pay cuts
  - Quits: Best workers become disgruntled and leave if pay is cut (layoffs allow managers to select who leaves)
  - Hires: Managers believe that willingness to accept a high pay signals high unobservable worker quality

ANSWER: EVIDENCE FROM EXPERIMENTS

- Repeated game where individuals are assigned to role of worker or employer
  - First stage: Wage offer from employer
  - Second stage: Effort level chosen by employee (if offer accepted)
- Average wage is consistently higher than reservation wage and worker effort increases with wage offered
  - Prevalence of reciprocity → good for morale!
  - **Quid pro quo**, even when none is required

POSITIONING

- Reviews survey evidence to explain puzzles
  - **Layoffs vs. Pay cuts**: Damage to morale from layoff is temporary, whereas long-term for pay cuts
  - **Replacements**: Explicit undercutting impossible due to lack of knowledge about exact pay; replacement may lack skills of existing ones and it demoralizes the workforce
- Resistance to wage cuts comes from management, not employees.
  - Pay cuts damage morale and affect notions of fairness
  - Morale depends on internalization with firm objectives, reciprocation, and good mood.

CONCLUSION

- Survey evidence points to damaging morale seems to the primary reason employers avoid pay cuts.
  - No evidence for no-shirking theory
  - Some evidence of adverse selection in quits (but not in hires)
- Wage effects are asymmetric!
- Internal pay structures → Fairness
  - Lot more pay transparency today (e.g. LinkedIn, Glassdoor)
  - Is this why we see downward nominal wage rigidity for new hires? (Hazell and Taska, 2025)