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When are wages cut? The roles of incomplete contracts and employee involvement

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Non-Technical Summary

- Firms tend to avoid cutting nominal wages.
- Survey responses from compensation managers suggest that this is because of concerns about damaging employee morale and productivity.
- This provides an explanation for downward nominal wage rigidity, a well-established empirical fact and a central theme in macroeconomics, affecting a wide range of issues from optimal exchange rate regimes to macroeconomic stabilisation.
- Despite a large body of empirical literature measuring the extent of nominal wage rigidity, much less is known about whether those managers' concerns systematically translate into actual restraint about wage cuts. This paper attempts to deepen the understanding of this issue.
- To do so, we develop a model in which employees can choose their work effort after observing the wages set by the firm. A nominal wage cut leads to a drop in effort and productivity, since employees retaliate against what they perceive as unfair treatment. This negative response is somewhat mitigated when employees feel involved in workplace decision-making, because involvement boosts employee morale.
- We test the predictions of our model using a longitudinal matched employee-employer dataset of wages that is linked to a manager survey from Great Britain. Confirming our predictions, year-to-year nominal wage cuts are only half as likely when managers believe that their employees have some discretion over how they perform their jobs, but this likelihood recovers by up to 10 percent when employees are also involved in the decision-making process at their workplace.

You can read the full paper here.