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St. Louis Fed's *Review*:

Cutting Workers' Pay Isn't Worth the Savings, Says Economist

ST. LOUIS, Mo. -- Managers resist cutting workers' pay during a recession, even if a company is in danger of closing, because they believe that any savings would more than be offset by lower productivity due to poor morale, said a Yale University economist.

Truman Bewley, a professor of economics at Yale, interviewed more than 330 business people, labor leaders, labor lawyers, management consultants, and counselors of unemployed workers in 1992 and 1993. His research appears in the latest issue of ***Review***, a bimonthly journal of economic and business issues produced by the Federal Reserve Bank of St. Louis.

Bewley presented his findings at the St. Louis Fed's 23rd Annual Economic Policy Conference in October of 1998. The theme of the conference was "Labor Markets and Macroeconomics."

"The companies I researched represented a broad spectrum of industries and a full range of sizes and financial conditions," said Bewley. "Some were growing rapidly, while others were shrinking or going bankrupt. Most were well established and others had been founded only recently. Some were unionized but many had no union presence. Some were public corporations and others were more closely held or family-owned. I made a point, however, to find businesses that had cut or frozen pay during the recession."

Bewley found that employees' morale is hurt by pay cuts because of what he calls the "insult" effect and the effect on standards of living. "The latter occurs because lower living standards distract and aggravate workers, and cause them to blame the company for the difficult adaptation to lower incomes," said Bewley. "The insult effect occurs because workers associate pay with self-worth and recognition of their value to the company."

He also found, however, that both business and labor leaders were confident that they could convince employees — albeit with some effort — that pay cuts were justified if the alternatives were worse, such as layoffs.

Bewley's exploration of the link between pay and productivity also revealed some insights about morale and its effect on workers, specifically that "morale is fragile and can be destroyed quickly by matters more minor than pay cuts." He noted that good morale normally takes a long time to establish and is fostered by:frank, but good, relations between subordinates and superiors;prospects for economic security and progress within the company;recognition and reward of contributions to the company;good explanations of the social contribution of the company's products; andsatisfying explanations of a worker's role in the production process.

"Collective activities within the company such as charity drives and company picnics also improve morale," said Bewley, "as does almost anything that encourages workers to think of people other than themselves."

He noted that another benefit to companies produced by good morale is the sharing of information among workers and their supervisors. Coercion, on the other hand, produces only short-term results. "Though force may succeed in making people work with great intensity," he said, "people working under such pressure may only make a show of

cooperation and may not use their heads to help the company. Managers said that compulsion is inefficient when workers know best what they ought to do."

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