Labor Market Behavior

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In this paper, I separate the economic from the psychological aspects of labor market behavior and argue that the psychological ones deserve careful study. By the economic aspects, I mean rational responses to aspects of the environment normally thought of as economic, such as opportunities for financial gain. By the psychological aspects, I mean all other facets of behavior at work and in the search for and choice of jobs. My qualifications for addressing this topic are a study of the labor market through extensive interviews with businesspeople, labor leaders, labor market intermediaries, and counselors of unemployed job seekers, work reported on in Bewley (1999). I have had no training in psychology.

The definition just given of economic aspects includes the word “rational.” Rationality, as used in economics, is an extension of Freud’s pleasure principle, which, roughly speaking, is the assertion that people act so as to fulfill their desires. If people make no logical errors when doing so and use all available information, they are said to be rational. Rationality can be treated either as a testable scientific hypothesis or as a principle for organizing thought about behavior. If rationality is treated as an organizing principle, there is no need for it to be testable; it is necessary only that it prove useful. If rationality is to be testable, then some other principles must restrict people’s assumed objectives. If we infer the objectives solely from observed behavior, then rationality is consistent with any behavior and so cannot be tested. No matter how crazy or self-destructive someone’s behavior may be, we can always say they do what they do because they want to, an assertion that yields no understanding. A possible but probably false restriction on desires is that they do not change over time.

My view is that rationality makes sense in contexts involving clear choices and basic appetites that we all feel, but becomes less reliable as a guide in contexts where motives and consequences are complex and ambiguous. In order to grasp what I mean, imagine that we test an individual’s preferences among various quantities of peas, rice, and hamburger by having the person live in a laboratory for a while and eat only these items in quantities purchased at varying prices and with varying quantities of money provided each day. If the subject’s tastes remained stable, we could test rationality as it applied to his or her choices. For instance, if the choices revealed that consumption bundle A was preferred to bundle B, then rationality would imply that B was never chosen when A was affordable. We could use the rationality hypothesis to estimate a preference ordering that would predict future choices. This approach would fail, however, to predict behavior outside the experimental context. For instance, the estimated preference ordering would not predict that the subject would become exasperated, return whatever money had been saved, and walk out. If this happened, we could say that he or she was rationally expressing new desires, but this assertion would not disguise the inadequacy of our original theory of the person's behavior.

All of labor market behavior could be made rational *ex post* in a similar empty way. For this reason, I define rationality narrowly by requiring that the desires that rational people seek to fulfill be crudely selfish. For instance, I treat generosity as irrational or psychological, though it would be legitimate to suppose that people derive pleasure from helping others.

The description of labor market behavior that follows is based on interviews with labor market participants and on a survey of empirical literature related to labor market behavior. I have reported on the interviews in Bewley (1999) and on the literature in that work and in (Bewley, forthcoming). I focus on employee behavior. That of managers, in their management role, appears rational, given employees' reactions, though by heir own admission they behave as employees like everyone else.

The Primary and Secondary Sectors. In order to understand the labor market, it is important to realize that it is made up of two worlds, which, following Doeringer and Piore (1971), I call the primary and secondary sectors. The primary sector consists of jobs that are typically full-time and long-term and can be viewed as careers. Examples include most direct labor in manufacturing, office work, and management and technical work. Such jobs typically require enough on-the-job training to make labor turnover costly to the employer. Secondary sector jobs are part-time and short-term and require little on-the-job training. Examples of secondary sector employees include many assembly workers in manufacturing, waiters and waitresses, most retail clerical workers, taxi drivers, janitors, night watchmen, many bank tellers, and any kind of temporary worker. Sales clerks in exclusive stores belong to the primary sector, if they should know regular customers by name, whereas floor crews in fast food restaurants and supermarkets definitely belong to the secondary sector. Engineers and managers belong to the secondary sector, if they hold temporary engineering or management jobs, and belong to the primary sector if they hold permanent positions, though they may be well paid in both. Secondary sector workers are often people who are not fully dependent on their jobs or are in transition between distinct stages of life, such as students working part-time or in the summer, housewives, people who have retired or been laid off from primary sector jobs, or people who have other career interests that do not pay well, such as writing. A single company may have both primary and secondary jobs at one work site. For instance, the managerial positions at a fast food restaurant belong to the primary sector, whereas the floor crew belongs to the secondary sector. An important difference between primary and secondary sector workers is that those in the secondary sector know their co-workers less well and take their jobs less seriously as careers than do people in the primary sector. Although no statistics are available for the United States on the relative sizes of the two sectors, it is clear that the secondary sector is enormous there, though smaller than the primary sector.

Internal Pay Structure. Another important distinction is that between internal and external pay structure. An internal structure determines pay or pay differentials within a work place or company. The external structure is the relation between pay at different work sites or companies. Internal structures vary widely and are usually quite elaborate for primary sector jobs. The factors that the systems take into account are the type of job, the skill and amount of responsibility it entails, the employee's skills, training, and experience, and his or her length of service at the company. Some of these variables are qualitative, so that supervisors' judgment plays a role in pay determination. Internal structures for secondary sector positions are often simple and may not determine pay levels at all, but only prescribe a schedule of raises. The pay of a particular worker is then the sum of pay when first hired and all the raises received since hiring.

The internal structure applies to workers who are in close contact with each other. As a result, it may apply to low-level workers at only one site, whereas for upper management, it may apply to an entire national corporation.

A major purpose of internal structure is to avoid disputes and jealousy over pay. The scheme is chosen so that most employees will deem it to be fair and equitable. Since there are no universally accepted norms of justice, the system is inevitably somewhat arbitrary and its legitimacy may depend largely on company tradition. The hold of tradition can be strong enough to make it extremely difficult to change the relative pay of various categories of employees.

Another purpose of the structure is to create work incentives. The relation between pay on the one hand and position, training, longevity, etc. on the other makes clear the rewards for promotion, loyalty, and the acquisition of new skills.

A third purpose is to control management. A person's immediate supervisor usually determines their pay, and companies seek to discourage favoritism by defining rules that govern pay decisions. Favoritism can be extremely harmful, because it antagonizes employees and creates incentives to cultivate good relations with superiors rather than to work well.

The equity incorporated in an internal structure has both vertical and horizontal components. The pay differentials between successive levels of employees should be large enough to recognize achievements and authority, and the differentials among people at nearly the same level should be small enough to avoid hurting anyone's feelings.

A natural question is how people could know enough about each other's pay to make internal equity an issue. Although companies try to discourage employees from sharing pay information, enough people in the primary sector complain about injustices so as to make internal equity a major management issue. Less information is shared among secondary sector workers, because high turnover and changing part-time schedules keep them from getting to know each other. Also, such workers care less about inequities, because they take their jobs less seriously. These reasons explain why internal equity is less of an issue in the secondary than in the primary sector.

There is a tension between internal structure and the external labor market. Internal structures are designed in part to reflect market pay rates for various skills and jobs. Market relative pay rates can, however, change faster than internal structures can follow. There is enough looseness in internal structures to allow some adjustment, but internal structures are fairly tight and major increases in the market price of particular skills can require that the structure be changed. Such modifications can cause major discontent.

External Pay Structure. In contrast to the internal structure, the external one is almost entirely determined by market forces. Since it is difficult to change the relative pay of various categories of primary sector employees, firms adjust pay to overall labor market conditions by shifting the entire pay structure while leaving internal relative pay differentials nearly unchanged. The shift is usually upward and often quite small. It is made after taking account of the ease of hiring, the level of quits, wage and salary surveys, and projected rates of inflation. The key consideration is optimization of the firm's overall level of labor turnover and ease of hiring. Too much turnover is expensive because of hiring and training costs. Some turnover is desirable, however, because new employees bring new ideas and fresh enthusiasm. Also, employees who stay too long can get sick of their jobs or become too expensive because of regular raises. In hiring, firms try to optimize the trade-off between pay and the expense of using recruiters and advertising to attract new employees. The desired quality of employees also plays a role in determining the overall pay level, because higher pay makes it easier to hire good quality people.

The overall level of a structure can be forced upward by the need to protect workers' standard of living against inflation, which is a concern because of the negative impact of declining living standards on morale. Apart from this consideration, morale plays little role in determining the overall pay level of a firm. Keynes (1936) suggested that the relation of a firm's pay level to that at other nearby firms affects morale. However, this effect is weak, because employees usually know little about pay levels at other firms and so are not likely to be outraged if they are paid less than workers in similar jobs at nearby companies. Firms do not make wage and salary surveys available to employees, and differences in jobs and internal structures at different firms often make pay comparisons difficult, in any case. Those best informed about market pay levels are likely to be workers who were recently hired after a long period of job search or members of labor unions that conduct and publicize wage and salary surveys. Employees are often loyal to their employers and do not look for new jobs or pay much attention to market pay levels as long as their jobs feel secure. Many firms discourage employees from searching for new jobs by refusing to match outside offers or even by firing workers caught looking for new jobs. Matching outside offers encourages others to seek them and can create internal inequities. Outside offers are tolerated only for specialists, such as research scientists, whose skills are crucial and highly marketable. High pay for such employees is not likely to cause jealousy, because co-workers recognize them as unusual.

Hiring Pay. The contrast between the primary and secondary sectors is especially pronounced in the determination of hiring pay. In the secondary sector, labor market conditions govern the pay of new hires, which moves freely up and down. The market for temporary labor is nearly an auction market for labor, with the pay rate on contracts determined by bargaining among the client company, the temporary labor agency, and sometimes the worker as well. Retail and other employers of secondary sector labor experience little difficulty in reducing the wages paid to new hires while continuing to provide increases to workers hired earlier. The resulting internal pay disparities are not felt for reasons mentioned earlier; workers in the secondary sector do not know each other well enough to share much pay information and often care little about pay differentials. Internal equity imposes, however, some limits on hiring pay. Firms try to pay similar new hires nearly the same amount if they are hired at about the same time, and large increases in the pay of new hires normally call for corresponding increases in the pay of existing employees, who find it extremely offensive to discover that they are paid less than newly hired people with similar jobs and skills.

In the primary sector, the pay of a new hire is determined largely by the internal structure. This structure has enough flexibility to permit limited adjustment to labor market conditions, but the main influences on hiring pay are a new worker's skills and their place in the organization. When there is ambiguity, the manager setting the pay may err on the generous side in order to create goodwill. It is recognized that such gratitude is short-lived, however, for workers get used to their pay and grow to believe they deserve it. This habituation effect is an important psychological influence. The need to respect internal equity prevents most companies from reducing the pay at which new primary sector employees are hired while maintaining the pay of existing employees. The two-tier or multiple tier pay systems that result, while almost automatic in the secondary sector, are not often used in the primary sector, because they have been found to be disruptive. Although new hires might at first be glad to have new jobs, they would become disgruntled when they learned that they were paid on a lower scale than workers hired earlier.

Because of the habituation effect, employers find that the long-run level of pay is not an effective instrument for stimulating productivity. Employers use, when they can, financial incentives linked to performance and they claim these stimulate effort powerfully. Their views on the effects of pay levels and incentives are supported by a large body of research in management science that is reviewed in Vroom (1964, p. 252) and Lawler (1971, p. 133). Managers' opinions about the impact of pay levels on work effort seem to contradict a large number of laboratory experiments with mock employment relationships that indicate the importance of reciprocity (Fehr, Kirchsteiger, and Riedl (1993, 1998); Kirchler, Fehr, and Evans (1996); Fehr, Kirchler, Weichbold, and Gächter (1998); and Gächter and Falk (2002)). In these experiments, workers voluntarily offer effort in the form of a monetary sacrifice and on average the amount they offer increases with their wage. Furthermore, employers seem to expect this response, for they offer wages considerably above the minimum needed to hire workers. The discrepancy between the experiments and reality is explained, I believe, by the fact that the experiments are too short-lived to capture the habituation effect. The reciprocity they demonstrate is reflected in the tendency of actual employers sometimes to encourage good attitudes in new employees by offering a little more than is needed to hire them.

<u>Pay Increases</u>. In order to understand raises, it is important to realize that they contain two components. One is made up of all the increases that occur because workers rise through the internal pay structure as they gain experience, skills, and longevity and are promoted. The other component is the change in the structure's level. The component that has to do with rising through the structure may cost the firm nothing because of what are called turnover savings. Workers who quit are usually paid more than new hires, so that normal turnover decreases average labor costs. If a firm was in a stationary equilibrium, workers would be hired, ascend the internal structure, and leave with no change in the firm's total labor costs. Because most workers advance within the structure, it is possible gradually to decrease the level of the structure while cutting almost no one's pay and keeping the pay of new hires roughly in line with that of existing employees. One of the problems caused by a recession is that it discourages quitting and so reduces turnover savings. The impact of this reduction can be especially severe in the secondary sector, where firms count on labor turnover to keep their costs down.

Raises are paid above all to create incentives; workers work well, in part because they know that if they do so they will advance and be rewarded. Most raises are a form of performance-based incentive. The incentive is especially marked if increases are granted on the basis of merit, but it exists even when raises are granted automatically on condition of satisfactory performance.

Another related reason for paying increases is to maintain good morale. Workers expect raises and are indignant if they know they have been loyal, done well, or improved and their achievements are not recognized with a pay increase. Workers expect raises even if they have not acquired new skills or increased their performance. Their reaction is another instance of the habituation effect.

The control of turnover is still another reason for increasing pay regularly. As employees acquire experience and skills, they become more valuable and are likely to be bid away by other employers if their pay is not increased accordingly. Firms avoid letting pay fall behind labor market levels for the same reason.

Cost of living inflation can be a powerful reason for paying increases. Workers do not expect pay increases to equal the rate of inflation plus what they would obtain if there were no inflation. They do, however, notice a decline in living standards. Workers have fairly accurate information about the rate of inflation, both from the news and personal experience. Declines in the purchasing power of pay are demoralizing, especially if they continue for a long time. The negative reaction to such decreases appears to be an instance of what experimental economists call loss aversion; the loss felt from giving things up exceeds the gain felt from acquiring them. Inflation has little impact on raises if the rate of inflation in the cost of living is less than the size of the increases that would be granted to most employees in the absence of inflation.

Another factor influencing the overall level of raises is how well a firm is doing financially. Firms provide a group incentive to all employees by sharing with them increases in profits and holding back somewhat in periods of financial distress.

In determining the overall level of raises, firms focus primarily on projections of future labor market pay rates and on the rate of increase in the cost of living. The interest in wage inflation stems from the desire to remain competitive. The choices of average raises and of hiring pay determine the level of the pay structure.

Pay Reduction. In thinking about pay reduction, it is important to distinguish existing employees from the newly hired. As has been mentioned, it is difficult in the primary sector to reduce the pay at which new employees are hired without changing that of existing employees, whereas such reductions are routine in the secondary sector. I here discuss reduction in the pay of existing employees. The reductions I consider are nominal ones for individuals with unchanged jobs and working conditions. I do not include nominal reductions that occur because of changes in responsibilities, shift, or hours or because of loss of overtime supplements.

The main resistance to pay cuts comes from employers, not their workers. Employers believe that under normal circumstances pay cuts would reduce profits, and the main reason given for this belief is damage to morale. Morale is hurt because of what may be termed a standard of living effect and an insult effect. Employees are likely to blame the employer for the decline in living standards caused by a pay cut. Such reductions usually hit hard, because they come at a time when worker incomes have already been depressed by reduced hours, loss of overtime pay, reduced bonuses or profit sharing income, or lower commission earnings. The insult effect arises because people expect regular raises and so instinctively interpret pay reduction as an expression of employer dissatisfaction, even when the pay of all employees is cut. Although cutting everyone's pay makes the insult less personal, the fact that everyone is hurt means that all employees complain to each other and so mutually excite each other's indignation. For these reasons, a pay cut is likely to be interpreted as a high-handed affront or a slap in the face. The impact on morale can be long-term. Many managers claim that employees "never forget" a pay cut that is viewed as unjust, even if pay is restored to its former level after six months or a year.

Employers care about morale because of its impact on recruiting, turnover, and productivity. Recruiting is affected because most firms treat own employees as their best recruiters and prefer to hire the candidates they suggest. There are many reasons for this preference. Firms can usually learn more about a potential recruit from an employee than they can from an interview. Managers know that people like to work with friends and relatives. In addition, employees inform the people they bring in about the company, help them adjust to it, and encourage them to perform well, so that new hires referred by employees are less likely to quit and more likely to do well than other new hires.

Poor morale increases turnover, because disgruntled workers leave if they can. Although there is likely to be little quitting during a recession, employers worry that dissatisfied workers will leave as soon as the economy starts to recover and jobs become easier to find.

The impact of morale on productivity is subtle. Morale has little effect on productivity in the sense of the speed with which routine jobs are performed, though workers with poor morale are likely to require more supervision than those with good morale. Productivity in routine activities is determined largely by habit, working conditions, equipment, procedures, training, and financial incentives. The productivity that managers have in mind has to do with what organizational psychologists term extra-role performance and organizational citizenship (Organ, 1988). These include acts that are not explicitly part of the job, such as making useful suggestions, helping each other, enforcing rules, creating a good work atmosphere, and working well in the absence of supervision. Examples are reminding the boss of an appointment, helping a colleague lift a heavy box, or suggesting a way to simplify an internal form. These kinds of performance may not seem significant, but organizational psychologists have found that they are important to work group performance (George and Bettenhausen, 1990; Podsakoff and MacKenzie, 1994 and 1997; Walz and Niehoff, 1996; and Podsakoff, Ahearne, and MacKenzie, 1997).

Even if pay is cut, earnings are likely to fluctuate as a result of changes in bonuses, hours, piecework, shift, commission earnings, and even job assignments. These fluctuations cause few management problems, if the changes are so frequent that workers learn to prepare for them. However, major pay decreases associated with company distress or economic downturns do depress morale and are one of the reasons managers are aware of the impact of morale on company performance. When I did my study in the early 1990s, there was a great deal of discussion by managers of the negative impact on employee behavior of decreases in bonuses and profit shares. Although such automatic pay reduction schemes avoided the insult effect, they gave rise to discontent. Worry about such unhappiness discouraged managers from minimizing layoffs by reducing the hours of hourly workers. Many employers asserted that in the future they would try to give bonuses irregularly or by surprise, so that employees would not count on them.

It is possible to reduce pay with little effect on morale if employees understand that the cuts are necessary to save a large number of jobs or to prevent a company from closing, and most managers of non-union firms claim they can convince the work force of the need for pay reduction, if the need is real. It may not be easy to do so, because employees, like almost everyone else, resist accepting bad news. Employees are, however, usually well informed about their company's condition, because they are the ones who take and fill orders. If employees are represented by a trade union, the attitude of the union leadership can be crucial. Unions may be recalcitrant because of a history of bad relations with management or because they wish to demonstrate to an industry that they are strong enough to put a company out of business. Unions that wish to protect membership size, however, may even encourage pay cuts. Labor unions normally go to great lengths to keep themselves informed about the financial condition of the companies they deal with, so that the need for pay reduction is often not an issue. Actual pay cuts normally occur only when they do save lots of jobs or are clearly needed to keep a company in business. For this reason, actual pay cuts hurt morale much less than might be imagined from what managers say when they explain the reasons for not cutting pay. Many of the same managers explain, however, that if a pay cut is needed, it can and should be done.

Pay cuts are uncommon because companies cannot often argue that reducing pay would save jobs or the company. Dunlop (1944, pp. 130-48 and 1988, p. 66) has argued that during the Great Depression, price cuts became common only when falling product prices forced companies either to cut pay or go under.

Pay Cuts Versus Layoffs. A natural question is why firms typically lay off workers rather than cut their pay, since layoffs must hurt morale too. Typical answers given by managers are "layoffs get the misery out the door" and "why make ten people mad rather than just one?" Those who suffer most from layoffs are those who leave, and they are not there to disrupt the work place. These answers are not fully accurate. In periods of layoffs, workers worry about whether they too will be laid off, how they will fare if they are, and about friends who have been let go. Managers try to diminish these problems by paying generous severance benefits to those dismissed, and the main reason given for paying these benefits is to protect the morale of the retained workers. Other problems caused by layoffs are that they lead to job reassignments, so that workers may have to get used to new tasks, colleagues, and supervisors. Still another problem is that when salaried people are laid off, their work is typically distributed to others, so that the remaining salaried workers have to work harder and for longer hours. If these people are exempt from the overtime law, as many are, they receive no additional compensation for working the extra time.

Another important reason for preferring layoffs is that most firms' elasticity of demand for labor is quite low, because direct labor costs are a small fraction of marginal costs and the elasticity of demand of the products sold is far from infinite. Although an economist might assume that firms could avoid layoffs by reducing wages and product prices and so increasing sales, wages influence prices only through their effect on marginal costs, and for most companies the bulk of marginal costs are purchases from other firms, not labor costs. Furthermore, the impact of price reduction on sales is usually thought to be not large and slow to occur. A typical assertion is that competitors would reduce their prices too and customers would react only gradually to reductions in industry prices. There are firms, however, that have a high elasticity of product demand, and in my study I found that most pay cuts occurred either in such companies or in companies that would shut down if not saved by a pay cut. For instance, pay cuts were common among construction companies, which have a highly elastic product demand because they bid for work.

An important advantage of layoffs over pay cuts is that layoffs save much more money. Financial distress is a common reason for layoffs. Employees let go to save money are usually well-paid overhead workers, such as managers and technical personnel. Companies can continue to function for a few years without many of these people, because they work on projects, such as developing new products or markets, that increase profits only in the distant future. Such layoffs are commonly termed, "eating the seed corn." Other layoffs of overhead personnel are made without any reduction in the total workload, for the work of those let go is reassigned to others, who must work harder and may receive no additional pay. Layoffs of overhead personnel can save enormous amounts of money, because they eliminate both the fixed and variable parts of pay as well as other fixed costs of employment. The fixed part of pay consists primarily of benefits. Other fixed employment costs include office space and equipment. For instance, empty office space can be abandoned, rented to other companies or sold. In addition, dismissing some people makes it possible to let go other support personnel, such as secretaries and human resource workers. Pay cuts, in contrast, save only some of the variable part of pay, which can seldom be reduced by more than 20%. Although benefits are sometimes reduced from the employees' point of view, these cuts often merely reflect increases in the cost of medical insurance.

Still another advantage of layoffs is that their negative effects on the morale of the retained workers normally subside quickly, whereas pay cuts continue to hurt morale until they are rescinded. Layoffs have long-term bad effects only if they are repeated often. It is considered good management practice to exaggerate the size of layoffs so that they will not soon be repeated, and then to give generous raises to the remaining employees to motivate them to make extra efforts to help the company recover.

Overqualification. Labor recruiters label as overqualified job applicants that previously held a job with considerably more pay or that involved much more responsibility and was more interesting. "Considerably more pay" means, roughly, at least 20% more. Overqualified applicants are rare when labor markets are tight, but they are common in slack markets, because job hunters despair of finding jobs as good as the ones they held previously. Recruiters usually reject overqualified applicants for positions in the primary sector. The concern is that the overqualified would be unhappy in their new jobs, create a bad atmosphere within the company, and quit as soon as they found a better job. Loss aversion seems to be the main explanation of why overqualified workers are discontent in their new jobs. Recruiters' primary concern is about labor turnover. In the secondary sector, where turnover is less costly, employers are less put off by the overqualified and may even seek them. Taxi companies value them highly, for instance, because they do well and relieve a chronic shortage of drivers.

Morale and Work Motivation. Employers attach great importance to employee morale and refer to it often when justifying company policies. The term means many things, including attitudes toward work, colleagues, and the company. Good morale means a sense of common purpose, trust in the organization and in fellow workers, ease of communication among the various levels of an organization, willingness to tolerate disagreeable tasks, and zest for the job. Morale does not necessarily mean happiness. Happiness is important for employees who deal with customers, but is not always what managers look for. What they seek is productive attitudes, and these may involve bad moods, if the work calls for aggressiveness and concentrated effort.

Good morale has two main components, productive moods and identification with the organization and its goals. Workers who have internalized company objectives work well without supervision and will spontaneously find an efficient way to perform a task. Appropriate moods also contribute to employee effectiveness.

One of the main sources of good morale is a sense of fair treatment, and it is not clear why this is so. Perhaps fairness makes people confident that their efforts will be rewarded. This idea is contradicted, however, by the willingness of people with good morale to work well, even when supervisors do not observe them. Perhaps people value fairness itself and are proud to belong to a fair organization. Many managers say that people long for a reasonable, orderly, and fair world and are attracted to an organization that appears to offer that.

Organizational pride is another important factor creating good morale. According to managers, most employees enjoy being part of something larger than themselves. One way to promote good morale is to explain to workers the importance of their contribution to the organization and to the outside world. Organizational pride may in part be an extension of personal ego satisfaction. It may also have to do with people's enjoyment of social contacts, for another common way to promote good morale is to have company social gatherings. Friendly behavior by supervisors also helps morale, as long as it does not lead to favoritism or lax discipline.

The organizational psychologists Tyler (1999) and Tyler and Blader (2000, 2001) have studied identification of workers with their employing organizations. They find that identification is positively linked to work performance and, in particular, to extra-role performance, which was mentioned earlier in connection with the impact of pay cuts on performance. They also find that pride in an organization and its fairness help persuade members to identify with it.

There is a tension between the goal of having company life be absorbing and fulfilling and having a stable atmosphere at work. Managers know that employees are likely to have personal difficulties and want the work place to be sufficiently engrossing that they are able to "leave their problems at the door." On the other hand, people who become attached to their organization feel vulnerable. Employers assert that good morale is fragile and quickly falls apart from time to time, usually as the result of some manager's unjust behavior.

I never heard anyone articulate the idea that it is destabilizing to focus too closely on the relationship between employee and company, but this bit of wisdom seems to be felt, for another common way to promote good morale is to encourage charitable giving and community service. The unspoken goal may to spur people to think of things other than selfish concerns. In this frame of mind, people may be better able to engage in a free and trusting exchange with co-workers and with their employer.

<u>Incentives and Discipline</u>. As was mentioned earlier, positive financial incentives stimulate effort strongly. The main problem with them is that it is hard to control their effects. Apart from piecework in manufacturing and commissioned sales work, there are few tasks that can be described so precisely that performance may be tied to pay without distorting behavior. People on incentives usually work to maximize the indicators that their pay depends on, rather than for the good of the company. For instance, most stockbrokers earn a commission that depends on the number and size of transactions they make, with the result that they encourage

clients to buy and sell too often and waste money on fees. However, some investment banks that deal with the very wealthy pay their brokers salaries, because they do not wish to alienate the handful of extremely wealthy people in the world by having brokers give them bad advice. This example is extreme, but the phenomenon is so common that true performance pay is nearly restricted to piecework and commissions on sales. It is common for pay to be loosely linked to performance, as by annual or semiannual merit pay increases or bonuses, but the incentive impact of such links is much weaker than that of piecework or sales commissions.

William Notz (1975), Edward Deci and Richard Ryan (1985), and Bruno Frey (1997) have proposed that financial incentives can have a negative effect on effort by displacing intrinsic rewards, which are enjoyment of a task and belief in it. Although this suggestion may be valid, I found no evidence for it in my discussions with managers and labor leaders. The emphasis was rather on the idea that the impact of financial incentives on effort was so powerful that they should not be used unless they could be directed at a specific goal.

A form of negative incentive is the basis of the no shirking theory of wage determination devised by Eaton and White (1983) and Shapiro and Stiglitz (1984). According to this theory, employers fire employees who do not meet preset performance standards. In order to make the threat of firing more effective, firms pay more than they need to in order to hire or retain their workers. In setting pay, managers take into account a trade-off between pay and productivity; productivity increases with pay, because higher pay makes workers value their jobs more and so work harder to keep them.

Most managers (and labor leaders as well) react negatively to this theory. They see no trade-off between long-run pay levels and the productivity of existing employees. The only mechanism linking pay levels to productivity is that higher pay enables companies to hire and retain better workers. Pay reduction can hurt productivity, but then it is the change in pay that affects productivity, not its level. Pay raises, on the other hand, do not increase productivity, even initially, and workers soon get used to them and grow to believe they have a right to their new pay rate. The absence of raises can hurt productivity, because it withdraws an incentive and workers expect raises as a reward for effort and so resent their being withheld.

Another objection managers have to the no shirking theory is the idea that greater productivity can be achieved through threats. Threats are viewed as counter productive, because they are interpreted as expressing hostility and so antagonize employees, hurt their morale, reduce their initiative, and invite revenge. Managers deny using firing to stimulate productivity and say that threatening workers with severe disciplinary action demeans them and "boxes them in." Managers claim that employees want to feel that they have some control over their lives and lose interest in their jobs if they feel trapped by excessive supervision.

Firing has two functions, to protect the firm and work force against malefactors and to enforce internal equity by removing people who do not do their share of the work. Workers who do their jobs well can be infuriated, if they see others malinger and yet get paid at normal rates. For this reason, discipline itself sustains good morale, and a lax atmosphere can ruin faith in a company. Supervision is so difficult in most jobs, however, that discipline alone cannot be counted on to sustain a high level of effort.

Negative incentives are effective when they are not viewed as initiated by management. For instance, work effort increases in periods of high unemployment and frequent layoffs, if the layoffs are made on the basis of performance, for workers want to look good in order not to be selected for dismissal. This negative incentive works, because the circumstances generating it are not the result of management manipulation but of economic conditions.

In order to encourage work effort, managers try to entice and encourage subordinates and also to give constructive criticism. Good management practice calls for showing appreciation for good work and offering realistic criticism of employees who are not performing well, so that they are aware of their failings and know what to do to improve. It requires skill, of course, to offer such criticism without giving offense.

In the opinion of managers, another problem with the no shirking theory is that it reflects a false understanding of the nature of work. The theory implies that supervisors give orders, check up on subordinates, and determine whether they are meeting performances standards. The reality is that few orders are given, that close supervision is difficult and expensive, and that most employees make many decisions in their work. The objective is to have workers do well on their own with little or no supervision.

The no shirking theory may apply at the bottom end of the labor market to jobs that require little skill or training and where supervision is easy. Such work usually belongs to the secondary sector, and I believe coercive methods are often used to get it done. Unfortunately, I did not gather sufficient evidence to be convinced of these conclusions, but I did notice that managers working in such environments belittled morale and said they regularly fired workers "to keep the level of terror sufficiently high."

There has been extensive experimental work on games that imitate the no shirking model and also on games with punishment (Fehr, Kirchsteiger, and Riedl, 1996; Fehr, Gächter, and Kirchsteiger, 1997; Fehr and Gächter, 1998; Fehr, Klein, and Schmidt, 2001; Brown, Falk, and Fehr, 2002; Fehr and Gächter, 2002; and Fehr and Rockenbach, 2003). This research supports the conclusion that a significant fraction of experimental subjects are rational in the selfish sense and another fraction reciprocate. Negative incentives or threats of punishment elicit more effort from selfish people than is obtained through reciprocation alone, but threats do cause offense and discourage positive reciprocation. The total impact of negative incentives on productive effort depends on the balance between the two effects. The offense given by threats in the experiments is not nearly as strong as managers indicate it is in business, probably because the punishments in the experiments are not as extreme as is actual firing.

Why People Work. When speaking of work motivation, it is natural to address the question of why people take jobs at all. An obvious answer is that they need the income they earn. People also enjoy the social contacts at work and the sense of accomplishment that comes from doing a job well, though some low-level jobs are so unpleasant that people would give them up but for the income. Managers say that most employees want to please their bosses and do well. Managers, labor leaders, and counselors of the unemployed all agree that layoff is a devastating blow, especially during a recession when new jobs are hard to find. Juster (1985) found in a survey that ordinary people prefer work to the activities associated with leisure. The idea prevalent in economics that labor entails disutility can apply only at the margin when a great deal of time and effort is demanded. Evidence for such marginal discomfort did appear in my interviews. Although most hourly wage earners and piece rate workers are eager for overtime, excessive overtime work for long periods is exhausting and disrupts lives. Because I interviewed during a recession, many overtime exempt overhead employees had been laid off and their work distributed among those who remained, increasing workloads so much that many had to work intensely for 60 or more hours a week. Such stressful conditions led to discontent that employees could not escape by quitting, because few other jobs were available.

Job Search and Unemployment. According to a well-known theory of Lucas and Rapping (1969), unemployment increases during recessions because of the reactions of employed workers to decreases in actual relative to expected pay. There are two versions of the theory. According to one, workers quit into unemployment in order to enjoy leisure while leisure is relatively less costly in terms of income forgone. The unemployed take jobs again when wages return to levels that make working worthwhile. According to the other theory, employees quit into unemployment, because they believe that wages are low only at their own place of employment and hope to find better paying work elsewhere. They take jobs again when they learn through job search that wages are low everywhere. Underlying the theory is the assumption that anyone at any time can find a new job quickly, provided they are willing to accept a low enough wage or salary. The theory has been criticized on the grounds that most of the increase in unemployment during recessions results from layoffs, not quits; quits decline and layoffs rise dramatically during economic downturns. In answer to this criticism, McLaughlin (1990, 1991) proposed that layoffs are equivalent to quits, because employers propose continued work at reduced pay as an alternative to layoff. Since workers are laid off only when they refuse such offers, they in effect quit.

These theories do not reflect accurately how the labor works during recessions, though there is some truth to the idea that the stubbornness of job searchers prolongs unemployment. I asked a great many employers whether they offered continued employment at reduced pay as an alternative to layoff and the answer was systematically no. Although workers might accept such offers, doing so would create resentment and internal inequities, and the offers themselves would undermine the legal basis for layoffs. What is more important, when firms lay off employees, they usually do not need them at any price; the elasticity of demand for labor is too low for a change in pay rates of marginal workers to have a significant effect on the demand for labor. Wages and salaries seldom fall, though raises may decline in magnitude or be eliminated. My informants made it clear that during a recession few workers quit into unemployment. The idea that the unemployed choose leisure over work is incongruous in the context of a recession. All informants agreed that layoff and unemployment were a tremendous hardship. Studies of the spending habits of the unemployed have shown that their living standards decline and spending on leisure activities declines even more (Burgess and Kingston, 1981; Dynarski and Sheffrin, 1987; and Heady and Smyth, 1989; Cochrane, 1991; and Gruber, 1997). Counselors of the unemployed and labor market intermediaries explained to me that layoff is such a shock to most people that they go through a period of denial in which they tell themselves they can easily find a new job as good as the one they lost. They usually become more realistic after disappointments in job hunting and especially as they begin to run out of money. This transition takes a few weeks and may take longer for people who held well-paid jobs protected by a strong union or by high rank within a company. After making this transition, people become more flexible about pay and type of work. The danger is that they then become too flexible and are turned down as overqualified. Such rejections outrage and discourage job hunters, and counselors take pains to explain to them that they have to look for the type of work and range of pay for which they are precisely qualified. The alternative exists of taking a temporary job or some other probably poorly paid, short-term job in the secondary sector, where overqualification is seldom an issue. Counselors advise against taking such stopgap positions except to meet urgent financial needs, because work distracts from job hunting. Job search is a major long-term project in the conditions of a recession. The problem faced by those looking for work is that there are not enough jobs to go around. During a recession, the shortage is so great that it is not at all true that anyone can find some job quickly. There is competition even for low-paying positions in the secondary sector. Statistically, the unemployed respond to bad labor market conditions by becoming more flexible, for econometric studies show that the proportion of job offers that unemployed people accept increases with the unemployment rate (Blau and Robins, 1990, table 4 and Jones, 1989, table 8).

Interpretation. The various psychological phenomena that have been mentioned fall into three categories, those that have to do with adjustment to change, those that have to do with dealing with groups, and those that have to do with the internal mental economy of the individual, that is, the governance of emotions and action. The phenomena that have to do with adjustment to change are denial, loss aversion, and habituation. Those that have to do with interaction with groups are empathy, reciprocation, fairness, and identification with an organization. The phenomena having to do with a person's mental economy are the impact of mood on performance and the fact that reason can surmount many emotional reactions.

People have difficulty adjusting to adverse change. What is termed denial is the refusal to recognize and understand that change has occurred. Experimental economists have applied the term loss aversion to the marked tendency of subjects to want more in compensation for giving something up than they were willing to pay to acquire it. Managers notice similar behavior among employees who react more angrily to a negative change than they rejoice at the reverse change in the positive direction. Psychologists apply the term habituation to the tendency of people to get so used to an agreeable stimulus that they require an increase in the stimulus to derive the same pleasure from it. The same term may be applied to employees' tendency to come to believe, as time passes, that they have a right to their level of pay and to feel less gratitude for it. Habituation in this second sense is closely related to the form of loss aversion that managers observe. Because workers believe they have a right to their level of pay, they object strongly when it declines. Loss aversion appears in the reactions to real or nominal pay reduction and in the discontent of overqualified workers. Habituation explains why pay levels have little effect on work effort, though performance based incentives have a big impact on it. Denial explains some of the difficulties managers have convincing workers of the need for pay cuts and explains the delay between layoff and serious job search. In both cases, workers usually end up reacting appropriately.

It is not obvious that there is a clearly rational way to deal with groups, and people's behavior towards them seems to be guided by almost instinctive reactions. One is empathy, a key indicator of mental health. Another is reciprocation in both the positive and negative senses. People expect and give good for good and bad for bad. Reciprocation may be part of a general valuing of fairness. Not only are people jealous if someone else receives advantages that they deserve, but they are offended by inequities in the treatment of people other than themselves. There are, of course, no absolute standards of justice, but particular standards become accepted within each organization and people can be outraged if these are flouted. Perhaps people intuitively desire the security created by rules of behavior. A drive for security may also explain why people easily identify with groups, though other explanations come to mind. For instance, people's self-image may be enhanced by identification with a desirable group. Identification may be an emotional mechanism people use to bring themselves to reciprocate the benefits gained from association with a group. In any case, people seem most willing to identify with those organizations they view as acting fairly. All these attitudes toward other people are central to labor market behavior. Empathy appears in the concern workers show for colleagues who have been laid off. It may also be a component of the general desire for fair treatment of all members of a group. Reciprocation underlies the insult effect of pay cuts, the harmful effects on morale of threats of reprisals for poor performance, and the positive effect of fair treatment on morale and productivity. The desire for fairness explains the great importance of internal equity and of the internal pay structure. Identification with the organization is the core of good morale; managers hope that employees so internalize the firm's objectives that they will act in its interests even if there is no chance that a superior will observe their deeds.

The function of mood may be to mobilize a person's physical and mental resources to perform a task deemed worthwhile. Whatever the mental role of mood may be, it is an important component of morale and is especially important to managers because it is contagious. A phrase they commonly use in explaining why they don't like having any disgruntled employees is that "one bad apple spoils the barrel."

The ability of reason to displace all other reactions is another aspect of the mind that seems to have to do with how people mobilize themselves for action. Managers count on exploiting the force of reason. If workers believe that a pay cut is necessary to save their jobs, they accept it and even work extra hard to save their company. Workers respond vigorously to financial incentives that are tied to performance, even when morale is poor.

The influence of reason is the only psychological tendency mentioned that is easy to reconcile with the pleasure principle and rationality in the narrow sense. Although normal, the other influences are irrational from an economist's point of view. It is perhaps worthwhile to consider in what way some of them are irrational. Denial is perhaps consistent with the pleasure principle in that it avoids the unpleasantness of facing bad news, but is irrational if self-delusion blocks doing something to correct a bad situation. Loss aversion is rational if people feel a pain from giving something up in addition to the loss of the utility of that thing. In labor market contexts, however, loss aversion has more to do with attitudes and imagined entitlements than changes in utility levels. Reciprocity is rational if people give in order to get, but not if people give because they got, and it is the latter type of reciprocity that concerns us here. Vengeance is a form of reciprocation, and real people irrationally hurt themselves in achieving it, a possibility that is a concern for managers contemplating pay cuts or disciplinary action. Identification with an organization is rational in the trivial sense once people make the group's objectives their own, but is the very opposite of selfish rationality; to internalize someone else's goals is the essence of generosity. Behavior stemming from moods is also rational in the trivial sense, if we think of mood as modifying a person's desires, but such instability of wants is hardly rational in the ordinary sense of the word.

The nature of most work is such that businesses probably could not function with purely rational employees. Firms must count on most workers to make decisions on their own. This autonomy means that performance based incentives or close monitoring and discipline can be relied on to motivate only special categories of workers. The main motivators for other workers have more to do with generosity than self-interest and so have little to do with rationality in the narrow sense.

It would be useful to have a good psychological theory that explained the psychological motivators, if only to make better use of them. Perhaps such a theory exists, but I have found none in my perusal of psychology texts. One possible basis for such a theory would be to attribute human behavioral characteristics to our evolutionary history. This approach, I believe, would suffer from the same disadvantages as the theory that desires explain all behavior; the theorist has too much freedom and the approach implies a teleological point of view that may be misplaced. We know so little about the circumstances and, above all, behavior of our ancestors hundreds of thousands or millions of years ago when the mind took shape, that only our imagination limits the number of evolutionary stories we could invent to explain current behavior. The approach imposes little structure, points to no large untapped sources of data to test theories, and suggests that our emotional reactions once served some purpose. For instance an evolutionary approach leads naturally to the idea that we are able to cooperate because cooperation once increased the chances of survival of small groups of people. It may also be that the ability to cooperate is an inevitable by-product of having an intellect. We probably cannot know which of these proposals is more accurate. Perhaps the mind is similar to the chemistry of our bodies, which works through complicated interacting pathways guided by a multitude of inhibitors and stimulants, a system that is, I believe, not optimal in any sense and could not be predicted from any general principle, such as optimality. It may be that many conflicting tendencies are present in the human mind and that all we can do is understand its mechanisms in detail without the help of general laws.

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