Comments on "Labor Market Behavior" by Truman Bewley

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Truman Bewley's paper summarizes insights about labor market behavior he has gleaned from talking at length with managers, union leaders and job counselors. The hundreds of interviews on which the paper rests are described in much greater detail in his fascinating book <u>Why Wages Don't Fall During Recessions</u> (Bewley 1999). I had not read the book prior to being asked to discuss this paper, but ended up feeling that I needed to do so if I hoped to comment knowledgeably about the work be describes. My remarks relate as much to the book as to the paper.

Although he himself was not trained as an institutional labor economist, Bewley's research fits into a rich tradition of observational studies of labor market behavior conducted by industrial relations scholars during the post-WWII decades. I can recall reading <u>The Impact of Collective Bargaining on Management</u>, a seminal work authored by Sumner H. Slichter, James J. Healy and E. Robert Livernash and published in 1960, as a graduate student in the late 1970s. It is not an exaggeration to say I learned as much about how the labor market works from this book as from anything else I have read before or since. Important work in a similar style also includes <u>The Dynamics of a Labor Market</u>, by Charles Myers and George P. Shultz, published in 1951. And the perspective offered in <u>Internal Labor Markets</u>, an influential book written by Peter Doeringer and

Michael Piore and published in 1971, clearly draws its inspiration from the reports of labor market participants.

By the late 1970s and 1980s, unfortunately, such studies largely had fallen out of favor. The new labor economics emphasized mathematically elegant optimization models designed to explain the “stylized facts” of the labor market and econometric analyses designed to “test” these models. The older, more qualitative approach to studying the labor market by talking with labor market participants and observing their behavior came to be viewed as less rigorous and less worthy than the newer, more mathematical approaches. I think we have lost something as a result.

I am not sure that I would have expected the research we are discussing today to have been produced by Truman Bewley, the author of “The Aysmptotic Solution of a Recursion Equation Ocurring in Stochastic Games” (Bewley and Kohlberg 1976) and “A Very Weak Theorem on the Existence of Equilibria in Atomless Economies with Infinitely Many Commodities” (Bewley 1991). But just as it may have been true that only Nixon could have gone to China, it may be that only Truman Bewley will be able to persuade certain segments of the economics profession that this sort of research has value!

The paper makes a persuasive case for viewing people as social creatures who care about a great many features of their work lives in addition to the material rewards they receive. This is a very different perspective than is offered by much of modern labor economics. One thing that I am struck by in much of the modern theory about pay structures is the underlying assumption that people care only about themselves and the rewards they will receive. There may be groups for which this is correct – perhaps car salesmen or members of the faculty of certain Departments of Economics. But my own experience as a senior manager in a large organization leads me to believe that a more realistic perspective must acknowledge the great enjoyment people often derive from functioning as part of a team and the considerable pride they frequently take in the work of their organizations as distinct from their own monetary rewards.

A second thing that especially strikes me about much of modern labor economics is the extent to which employee productivity is conceived as resulting from managers' control over their employees, rather than resulting from employees having internalized an organization's goals sufficiently that they will strive to do the best job they can independent of any rewards or punishments that may be directly linked to their performance. Any organization whose employees "work to rule" – do nothing more than what the letter of their job description says they are to do – is most unlikely to function effectively. As Bewley observes (p. 11), what organizational psychologists term extra-role performance and organizational citizenship are critical to organizational success.

Though the perspective Bewley articulates has broader implications, much of the present paper relates to understanding firms' adjustment to changes in their economic circumstances and specifically the demand for their product. When product demand falls, firms might respond in any of a number of ways. Restricting attention to their labor market responses, they might cut wages, cut hours to spread the reduced amount of work available across the current workforce, or lay off employees.

Bewley tells a story about why firms do not cut wages; some of the arguments advanced apply as well to explaining why they do not institute worksharing, i.e., cut weekly hours. Many of the employers Bewley talked with said they were reluctant to cut wages because they feared workers would view the lower wage as "unfair" and thus become disgruntled. Given that labor often does not represent a large share of an individual employer's total costs, even large cuts in wages at an individual firm often would not have a large effect on the demand for that firm's products and thus would not save many jobs. Managers also expressed concern that, with reduced wages, the best workers would choose to leave, leaving the employer with a lower quality workforce. And cutting wages selectively was not generally viewed as an acceptable option.

This is an appealing story. It also raises some further questions that it might be interesting to explore. One set of intriguing questions relates to the determination of workers' perceptions of what is "fair". What is it, for example, that makes cutting expected bonuses acceptable and cutting base pay unacceptable? Or to take another example, are pay cuts in fact more acceptable in response to a given decline in demand at firms where labor costs are a larger share of total production costs or where the elasticity of demand for output is greater, as would be suggested by the argument that pay cuts can more easily be justified where they would in fact save jobs? The paper provides some anecdotal evidence that they are – pay cuts appear to be much more common in construction than in other industries – but a more systematic investigation could be interesting.

It is also worth noting, I think, that patterns of adjustment to changes in demand vary across countries, further suggesting the importance of context in shaping notions of what is “fair”. Very broadly, in the United States, adjustment to fluctuations in demand occurs primarily through changes in employment, with pay and hours of work little affected. In Europe, in contrast, there is greater use of worksharing and hours adjustments, with employment adjusting only with some lag and to a larger extent through attrition (Abraham and Houseman 1994). And in Japan, both hours and compensation appear to be relatively more flexible than in the United States and to absorb rather more of the burden of adjustment (Hashimoto 1993, Hashimoto and Raisian 1987). One can speculate about why this should be – the greater strength of industry-wide collective bargaining coupled with substantial severance payments in the event of layoffs in the European context and the greater coordination of pay setting in Japan come to mind as relevant features of those labor markets – but I am not sure this is the whole story. Among other things, it would be interesting to talk with managers and labor leaders in Europe and Japan about why they choose the paths to adjustment they do, with an eye towards understanding whether different notions of “fairness” are at work.

Having expressed my enthusiasm for talking with labor market participants as an important part of any effort to understand labor market behavior, I would be remiss if I did not also say a few words about the limitations of this approach. While it is reasonable to take managers’ reports seriously, one also should be appropriately cautious in accepting at face value what they tell you about the consequences of different potential courses of action or even about their own behavior. For example, the managers that Bewley talked with may or may not be right about how their workers would have reacted to pay cuts, since most of them, relying on the conventional wisdom that pay cuts are a very bad thing, have no experience with them. To take another example, most of the managers he interviewed told Bewley that when layoffs occur, the selection of workers to be laid off is based primarily on performance (Bewley 1999, pp. 235-238). I am concerned, however, that this may reflect what they think they ought to say rather than what in fact occurs. Some years ago James Medoff and I explored this general subject using a questionnaire sent to human resource managers at large companies that asked respondents to say when a senior employee would be laid off in preference to a more junior employee. Even in nonunion settings, a large majority of respondents who had experienced layoffs said that senior employees were let go only when the junior employees were believed to be worth *significantly* more on net (Abraham and Medoff 1984). Although the different tenor of Bewley's findings as compared to ours may reflect both the sample of companies represented and the timing of data collection, how the question about selecting employees for layoff was framed seems likely also to have been important..

The research approach Bewley has adopted arguably is best suited for generating plausible empirical hypotheses that, in turn, may become the grist for further theoretical or quantitative analysis. If I had a stable of graduate students interested in the labor market and seeking dissertation topics, I might well encourage them to read Bewley's book and think about how they could investigate one or more of the interesting hypotheses it advances. Such hypothesis testing itself could rest on data collected from managers, though the sample of managers to be interviewed or surveyed would need to be more scientifically selected and the questioning to which these managers were subject would need to be more structured than were Bewley's interviews. And for the reasons given above, an analysis that supplements managers' reports with empirical analyses of data from other sources is likely to be more persuasive than one that relies on managers' reports alone.

Having said this, Bewley is right in saying that when we know so little about a subject as we do about many aspects of labor market behavior, there is no substitute for starting by talking with the people engaged in that behavior.

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