Can the Unemployed Price Themselves into Jobs ?

by

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August 1980

"I do want to emphasise that just as people can price themselves out of jobs, they can price themselves into jobs ... it is in the interests of the people out of work to offer a contribution to employers even at a slightly lower unit labour cost figure."

The Right Hon. Sir Keith Joseph, M.P.
B.B.C Radio 4, June 29th, 1980.

1. Introduction

Britain's unemployment rate is currently at the highest level achieved since the depression of the 1930s. An argument frequently levelled at workers is that much of this unemployment is self inflicted and that if the rate of wages demanded were lower fewer people would be unemployed. Indeed, the recent comments of the Secretary of State for Industry presume that if those who are unemployed were prepared to work at a lower level of money wages than the rate currently prevailing then more of them would be offered jobs and the unemployment total would decline. This line of reasoning is well in keeping with the academic literature concerned with the downward stickiness of money wages in times of aggregate demand where it is argued that the ratchet effect on wages is produced by the supply side of the labour market. In other words workers are not prepared to accept a fall in money wages in times of recession and so prevent firms from hiring more employees at a lower level of wages.

The discussion of the labour market in these terms fundamentally presupposes that it would be rational for firms to change employment contracts and to offer lower wages in times of declining demand (when they do not individually take account of the macroeconomic impact of lower wages on the demand for goods). By a more careful examination of the employment relationship, however, it becomes clear that firms may have no tendency to want to reduce wages to hire all the workers conjectured to be available at lower rates. There is, moreover, a strong case for arguing that downward wage rigidity stems from the demand side of the labour market. Even if unemployed workers could make their offers of willingness to work at lower money wages known to firms, employers might reject such offers in order to preserve the long run profitability of their enterprises.

The rest of the paper is set out as follows. Section 2 is a brief review of the standard labour market model where wage stickiness originates from the supply side. Section 3 considers the nature of frequently identified employment relationships and the characteristics of idiosyncratic exchange within firms. This leads directly to section 4 where it is argued that firms may have good reasons for believing that to accept offers of lower wages from unemployed workers will have the paradoxical result of increasing their unit costs. They will thus have good reason to refuse to attempt to revise their employment contracts. Section 5 gives a summary and offers some conclusions.

2. The Naïve View of the Labour Market

The conventional, textbook treatment of the labour market has a firm accepting the market determined wage rate and hiring workers up to the point where the marginal revenue product of labour equals the wage rate, i.e. the net contribution to the firm's revenue of the last man employed equals the wage rate of all the workers employed in the same kind of job. It is implicitly assumed that the labour market is a spot or auction market where short term bargains are struck which fully specify the nature of the work. To say that an employment contract is fully specified means that it gives precise details of the facilities with which the worker is to be provided and of the outputs expected of the worker at each point during the operative period of the contract. If, in the next period, a different set of workers offer their labour at a lower wage rate than that which prevailed in the previous hiring period employers will have no compunction in hiring these workers at the lower wage, even if their entire labour force changes in the process and the fall in wages is not expected to be permanent.

This obviously presupposes a naïve employment relationship. The productivity of the worker is specified precisely in the contract's description of the task with the consequence that in regard to a particular contract current and former employees are considered to be no more productive than any new workers. If any learning from former employment <u>is</u> included a worker

will be performing a differently specified task and will be paid in accordance with his higher marginal revenue product. The employment contract is for a limited period and the workers effecfively return to the labour market when their contracts expire. For reasons discussed in section 3 an economy would only operate like this if there were no information and transactions costs. The only way wage stickiness could creep into this model would be from the supply side. Indeed, Keynes (1936) based his model on the postulate that the wage is equal to the marginal product of labour and discussed only supply side reasons for downward money wage stickiness. As Keynes pointed out it is important to understand that a <u>general</u> money wage reduction could not do anything directly to make higher levels of employment viable because it would, through its effect on aggregate demand, be associated with an equal fall in the price level. Firms would contract employment if their expectations of marginal revenue products were continually being falsified even if wages generally were falling.

3. Uncertainty and the Employment Relationship

This section considers how the specifications of employment relationships are affected by the incompleteness of information that is neglected in the conventional 'as if' analysis. It should be pointed out that these are three basic kinds of informational inadequacy which may affect the workings of an economic system. Firstly there is the problem of bounded rationality[1]: an inability to cope perfectly with information

that could be supplied to economic agents. Secondly, the information necessary for rational choice may exist nowhere in the system. For example, when an agent commits himself to a particular employment offer he has no way of knowing whether, and when, he may be promoted if decisions about his career path have not yet been taken by his new superiors, even supposing that they would tell him - which leads directly to the third kind of problem. Relevant information may exist somewhere in the system but this does not ensure that it will be available to people taking decisions. Often a situation of information impactedness exists[2]: while knowledge is available to some parties they do not or cannot dispense it freely to others, unless they pay uncertain search costs or can overcome institutional barriers.

These informational problems provide the starting point for behavioural theories of the firm and the key to seeing why downwards money wage stickiness might arise from the demand side of the labour market - even when firms do not have to consider factors such as the present value of profits lost when wage cuts are resisted by a union-sponsored strike.

The difficulties over information mean that it will not be optimal for production to be organized through completely specified contracts. If an environment is constantly being disturbed such contracts would either have to be so detailed as to be able to cope with every contingency that they were never inappropriate to achieving the best result, or would have frequently to be redrawn in the light of new environmental and product market information. These would be very costly ways of running an economy and it is

often cheaper to leave things rather loosely specified and use organizational rather than market means to adjust to changing circumstances. Instead of changing contracts or having unwieldy catch-all contracts to control activities managers decide what workers should best do as the situation changes, within the broad limits specified in the employment contracts, and the workers likewise decide how to respond to these instructions.

Williamson *et al*.(1975) have recently noticed that the idiosyncracies specific to particular jobs prevent tasks from being specified perfectly even in stable environments. A worker's output consists not merely in his physical contribution to the firm's production but also in the information he passes on to his colleagues. The idiosyncratic nature of his particular job means that he alone can know for sure what his output actually is.[3] If it is not possible, for this reason, to specify fully the output that the worker is prepared to offer for a particular wage then it cannot be possible for his colleagues to enjoy fully specified employment contacts either. Such employment contracts have to give details of the resources the worker will be able to use to generate his output, but they include the informational resources that are part of the outputs of his colleagues, should they choose to provide them.

Fully specified contracts can only be used if they exclude the idiosyncratic features that would otherwise be associated with jobs. To arrange production in this way would not only rule out scope for using managerial instructions to adapt to changing circumstances without paying the costs of forming new contracts, it would also

remove the potential for extra output that a worker would be prepared to contribute at the going wage but which could not be specified in the employment contract owing to its idiosyncratic origins. However, once the managers of a firm have decided to use instead loosely specified contracts in an attempt to extract performance in excess of the minimum they will be wary of engaging in individualistic negotiations with particular workers over hiring contracts. The reason for this is that the specialized knowledge arising from experience of working in particular jobs would put incumbents in a position to ask for higher wages at contract reappraisal points since if they left and had to be replaced by raw recruits these would be less productive. If the incumbents gained higher wages they might gain still further by acting with opportunism[4]: they could promise to continue to provide their previous output and then deliberately fail to do so because it suited them, blaming the poor productivity of the group on the quality of their colleagues and any new recruits. Because of its idiosyncratic nature their output, particularly of information, could not be written into the employment contracts and, similarly, hard evidence could not be obtained to dispute the honesty of the incumbent workers.

The upshot of Williamson *et al.*'s argument is that individualistic bargaining contracts will have unacceptable properties where task idiosyncracies occur and that a more effective arrangement will exist within an internal labour market structure where systems concerns are made to prevail.

Wage rates are attached to job slots rather than to workers with arguments commonly reached collectively,[5] thus foreclosing individual wage bargaining. If workers are made to bargain as a team attention is focused upon the fact that the size of the product of their (sub)system depends on how willing they are to cooperate instead of exploiting their positions.

With wage rates attached to job slots workers must perform as well as or better than their rivals in similar job slots in order to demonstrate that they deserve higher remuneration. They will then warrant consideration for one of a limited number of jobs further up the promotion hierarchy. This aspect of the rat race, which may be termed 'internal competition', thus restricts opportunities for the pursuit of sub-goals and if workers are to obtain promotion they may have to perform above the minimum level for a number of years in their present job slot, during which their employers enjoy the benefit of their contributions to output in excess of the minimum acceptable level.

4. The Effects of Wage Reductions on Profits

With the arguments of the previous section in mind it is now necessary to examine how changes in wage rates may affect firm costs and thus see whether profits will be increased by firms accepting offers of lower wages should these be forthcoming from unemployed workers. Firms will only wish to break existing employment contracts and lower wage rates for job slots if they

expect that this will reduce the costs of producing their present levels of output or make a higher output viable where previously it was unprofitable.

With supply side flexibility in labour markets the possibilities of offering lower wages may exist for firms that are enjoying periods of expansion as well as for those who are finding it harder to sell their products. The latter firms will have to decide whether their falling sales are due to a loss of goodwill, a fall in demand due to a structural shift against their industries or an overall economic downturn. Perceptions about product market conditions will affect their conjectures about the states of their labour markets, internal and external, and hence their willingness to consider trying to break existing employment contracts to obtain lower wages.

Firms can only observe the current state of the labour market at the existing wage configuration by looking at employment statistics and the number of applicants for job slots at ports of entry to their internal labour markets that have been vacated by promotions or natural wastage. External applicants may beg to work for wages below the going rate but otherwise (short of 'Jarrow Marches' or demonstrations outside factory gates) firms have no idea of the ease of obtaining workers at any particular lower wage. A higher level of unemployment recorded by government statistics could even really represent an increase in voluntary unemployment at the existing real wage configuration rather than involuntary unemployment.

Higher recorded unemployment does not mean a complete absence of voluntary quits from firms by workers other than those who are not leaving the labour force to retire or to have children. Despite the prevalence of internal labour markets workers who have not achieved promotion may cut their losses and more elsewhere to obtain higher expected lifetime incomes and join other firms at ports of entry for job slots vacated by workers leaving the labour force or just moving around like themselves. The labour market should be thought of as being in a state of constant disequilibrium even with a given configuration of wages, just like product markets affected by shifting tastes,population movements and flows of information. Because workers can move between jobs from positions of employment even if unemployment is mounting (indeed, given uncertainty about the quality of potential employees, this may be more effective than off-the-job search for greener pastures) firms have to form conjectures about the responses of their internal labour markets to offers of lower wages in addition to their conjectures about the external labour market supply function.

If a firm lowers wages for given job slots it faces the possibility that its idiosyncratically skilled workers, who have up to that point been engaging in internal competition and recognizing that the size of the corporate pie depends on cooperation, may either leave for other firms or reduce cooperation and engage in perfunctory behaviour, producing the minimum acceptable output. Lower wages reduce the present values of jobs further up the hierarchy while increasing turnover and thus also

the possibility of promotion, given the level of employment in the firm. This will mean that effort outputs in the process of internal competition may decline. Voluntary quits mean that people have to be promoted more rapidly and/or new workers, lacking the idiosyncratic skills of incumbents, have to be hired in job slots that are ports of entry. This leads to the central point. Lowering wages because the external labour market is believed to be slack entails the risk of losing experienced workers (or their cooperation) who have been contributing to output in excess of their cost or of having to promote them faster than would usually be necessary in order to keep them. Lower wages for particular job slots may be accompanied by lower productivity and if productivity falls by more than wage rates units costs will rise and profits will fall. Firms who expect this to happen will therefore have no wish to break existing employment contracts and accept offers of lower wages from unemployed workers. Moreover, the fewer the firms that are attempting to cut wages the fewer will wish to for the greater will be the conjectured disruptive effects on their internal labour markets.

The same argument may be used to explain why firms in difficulties may prefer to make workers redundant without attempting to negotiate lower wages. Firing workers while keeping the existing wage configuration enables such firms to choose which of its workers it keeps at particular levels in its hierarchy and avoid in large measure possible productivity

losses due to disgruntled workers removing cooperation and moving elsewhere. Firms fortunate enough not to be afflicted by falling sales could be in complete conjectural equilibrium despite mounting unemployment if they had no reason to change their views of the supply curve for labour. They would have no necessary reason to consider changing their wage offers to workers were it not for the constant disequilibrium in labour markets that causes them constantly to have to be hiring new recruits, or their observations of changing employment statistics. Having thus detected an eased labour market such firms then have to decide whether to offer lower wages while keeping output constant or while using lower wages to permit lower prices and increased quantities sold. Having considered the effects of lower wages on their internal labour markets they will only break existing employment contracts if detrimental effects on productivity are less in proportion than the attainable fall in wage rates. There is no necessary reason to suppose this to be the case.

5. Summary and Conclusion

The ability of unemployed individuals to obtain employment by offering their services for a reward below the currently prevailing rate may be frustrated by employers acting in their own best interests. A decision by a firm to reduce the money wage rate in response to offers made by the unemployed may so disrupt the firm's internal labour market, for example, by

causing experienced workers to quit or to act in a non-cooperative manner with the newly employed, that the prosperity of the firm may be considerably harmed. In such circumstances resistance to wage cuts would come from the demand side of the labour market and individuals would have extreme difficulty in securing employment by attempting to 'price themselves into jobs' (even supposing such individuals were able to make known their wishes to prospective employers).

This is not to deny that coalitions of incumbent workers may be prepared collectively to vote for a lowering of wages in order to keep an enterprise viable and that the firm would readily accept. But this notion of cost reduction is far removed from the belief that the employment relationship is one where firms would readily employ individuals prepared to exchange their services at a lower cost than that previously contracted by firms. This surely presupposes that the labour market is a very simple trading post. It is not.

Footnotes

1. Bounded rationality has been described by H A Simon (1957) as follows:

   'The capability of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behabiour in the real world.'

   It refers to both neurophysiological limits and language limits.

2. Information impactedness is a derived condition due mainly to uncertainty and opportunism.

3. As B J Loasby (1976, p.139) puts it, "... it is almost impossible to review a decision made by a specialist - and still more impossible to review a decision made by a group of specialists - without having the decision made afresh by another specialist or group of specialists."

4. Opportunism is self interest seeking with guile.

5. A Trade Union will facilitate this but one is not necessary.

References

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