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Wage Flexibility in the U.S.: Lessons from the Past

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ABSTRACT

Statistical evidence suggests that wage flexibility was greater in the U.S. in the 1920s than after World War II. This decline in flexibility is associated with the increased threat of unionization which developed in the 1930s and 1940s, and a change in the legislative and social climate. Expectations about the appropriate conduct of employers were altered.

Gain-sharing arrangements such as profit sharing could have become substitutes for wage unresponsiveness to demand. However, the macroeconomic benefits of gain sharing are externalities which do not affect employer (or union) decisions. Although profit sharing proponents emphasize micro benefits such as building employee loyalty and increasing productivity, employers had alternative devices for such goals. In addition, profit sharing became associated with paternalistic and anti-union employer policies, thus making it unappealing to unions.

Some recent union wage concessions have included gain-sharing arrangements. Thus, there is currently an opportunity to foster such plans through tax incentives and other promotional devices. Social subsidies to promote gain sharing can be justified by the potential macroeconomic external benefits.

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Recently, various macroeconomic arguments for promoting wage flexibility and/or gain-sharing plans (such as profit sharing) have been developed (Weitzman; Mitchell, 1982). This paper explores why -- despite such arguments -- wage flexibility declined historically and profit-sharing type arrangements have not covered most workers.

I. Past Wage Flexibility.

In another paper, I have contrasted wage setting in the 1920s with that of the post World War II period (Mitchell, forthcoming). During the 1920s and early 1930s, the U.S. Bureau of Labor Statistics published an incomplete sample of reported wage-change decisions at the establishment level. Perhaps the best way to summarize the results is to direct attention to Table 1, which presents the distribution of manufacturing wage-change decisions during 1924 and 1925, years in which consumer price inflation was, respectively, -.2 and +4.0 percent on a December to December basis.

The table shows a wide array of wage-change decisions ranging from cuts of over 20 percent to increases of similar magnitude. This spread of decisions is remarkable by post World War II standards, even apart from the frequency of nominal wage cuts. The postwar evidence suggests that nominal wage cuts are a rarity, even in periods of low inflation. When they do occur, as in some recent union wage concessions, they result from a painful negotiations process against a background of threatened or actual mass layoffs. And the postwar dispersion of wage decisions is decidedly narrower.

By the 1920s, many features of modern corporate enterprise were present. But unions were of little significance in most sectors, including manufacturing, the result of a sustained "open shop" campaign by employers after World War I. Moreover, there was little labor-market intervention by government. Workers resented wage cuts -- during periods of generalized wage cutting such reductions became important causes of

Table 1

Distribution of Manufacturing Wage-Change Decisions, 1924-1925

Category of Wage-Change Decisions	1924	1925
-20% or less	2%	1%
-19.9 to -16%	*	*
-15.9 to -12%	4	2
-11.9 to -8%	37	18
-7.9 to -4%	8	6
-3.9 to -.1%	4	3
.1 to 4%	4	11
4.1 to 8%	21	26
8.1 to 12%	14	25
12.1 to 16%	2	4
16.1 to 20%	2	2
Over 20%	1	2
All decisions	100%	100%

*Less than 0.5 percent.

Note: Details need not sum to totals due to rounding. Unit of observation is the establishment.

Source: U.S. Bureau of Labor Statistics. See Mitchell (forthcoming) for detailed references.

strikes -- but employers implemented them anyway. And when employers did not want to take the blame for wage cuts, they used "company unions" to "negotiate" reductions (Dunn, pp. 21-23).

In short, in the absence of unions or other institutional constraints, the implicit contracts offered by employers in the 1920s provided substantially more wage flexibility than existed after World War II. The wage-setting mechanisms of the 1920s did not approach the flexibility of a classical auction market, a fact of some comfort to implicit-contract theorists. However, it is unclear that one needs to go much beyond simple explanations of why wage cuts (or even relative wage slippage) would lead to worker resentment and management caution.

II. Why Did Wage Flexibility Diminish?

Implicit contract theories have emphasized worker risk aversion and/or turnover costs to explain wage unresponsiveness. Perhaps risk aversion and turnover costs increased after the 1920s. But the most significant changes which occurred involved unionization, new public policies, and changing social expectations.

In an important forthcoming book, Sanford Jacoby documents the development of internal personnel policy of American employers during the first half of this century. Jacoby points out that until World War I, employers were content to leave personnel policy to foremen. But during World War I, the budding field of personnel management -- linked to other social welfare movements -- took root. Employers created personnel departments to handle industrial relations on a centralized basis and to engage in "welfare work" among their employees. Their impetus was a combination of war-related labor shortages and rapid growth in unionization which reflected various government policies aimed at achieving industrial peace and uninterrupted war production.

During the 1920s, in contrast, the labor shortage ended and government withdrew from the labor market. Unions were defeated as a threat. Firms downgraded their personnel departments, returned authority to foremen, and lost interest in workplace changes advocated by softminded reformers. When the union threat, supported by New Deal policies and later World War II controls, reappeared, the process reversed. Firms upgraded their personnel departments, downgraded foremen, and undertook various "progressive" personnel policies.

With the Great Depression came a purchasing power theory of wages which had a profound effect on public policy. Under this theory, depressions occurred if wages received too small a share of income. Low wages led to underconsumption. Thus, maintaining wages, not cutting them, was seen as the appropriate policy for business downturns. President Hoover urged firms not to cut wages at the onset of the depression (National Industrial Conference Board, 1932, p. 3). And until 1931, his injunction seemed to have some effect. Pre-New Deal legislation, such as the Davis-Bacon Act (1931), reflected the wage-underconsumption idea. But the New Deal itself represented the high point of this theory, a theory supported by prominent economists of the time such as Paul H. Douglas (pp. 212, 223-26), later a president of the American Economic Association.

The centerpiece of the early New Deal was the National Industrial Recovery Act (1933) which sought to boost business confidence by applying cartel-type codes on an industry basis. Code labor provisions set minimum wages, provided guides to wage differentials, and regulated other workplace conditions. Collective bargaining was also encouraged. At the bottom of a severe depression, a rash of wage INCREASES suddenly developed as the result of these codes and wage cuts became the exception (Marshall; National Industrial Conference Board, 1935).

Although the NIRA was declared unconstitutional in 1935, elements were retained in as the Wagner Act of 1935 (which contains the wage-underconsumption theory in its preamble) and the Fair Labor Standards Act (1938). Unemployment insurance, established by the Social Security Act of 1935, is premised on layoffs rather than wage cuts as the response to falling demand. And since UI is not completely experience rated, it contains a net subsidy to layoff adjustments. Wage cuts can also have an adverse effect on future Social Security benefits received by workers. And they can adversely affect benefits to be paid under private (tax-code supported) pension plans.

More generally, the social ethos was changed by the depression. "Good" employers did not cut wages. To do so invited employee resentment and, possibly, unionization. Layoffs by seniority, tightly enforced in the union sector, less rigidly followed but still influential in the nonunion sector, became the basic mode of adjustment. And lest employers slip, they now have the Age Discrimination in Employment Act (1967, 1978) -- age and seniority are highly correlated -- to remind them to respect seniority.

After the 1940s, government programs created a "third wave" of pressures strengthening centralized employer personnel policies, which today often go under the heading "human resource management." The tax code was amended to favor a variety of employer-provided fringe benefits requiring expertise in administration. In the 1960s, various federal and state "equal employment opportunity" programs further elevated the control of personnel departments. And the 1970s, saw new legislation in occupational safety and health, pension plan regulation, and other areas which continued the trend. Centralized personnel bureaucracies are not conducive to flexible wage decisions.

In short, there is considerable evidence that what changed since the 1920s was, first, the union threat and, second, a variety of public policies and expectations. Modern unionized firms exhibit wage unresponsiveness because of strategic factors (e.g., strike costs) involved in negotiations -- which lead to averaging out the business cycle under long-term contracts -- and because "median voter" tastes and seniority systems lead to a preference for layoffs rather than wage cuts. Nonunion firms have historically been concerned about the union threat and have evolved strong personnel bureaucracies to administer "unionesque" employee-welfare programs.

III. Why Don't We Have More Profit Sharing?

The tendency toward unresponsive wage rates could be overcome by gain-sharing arrangements such as profit sharing. Obviously, if profit sharing has macroeconomic benefits, it will be used less than is socially optimal since employers (and unions) will not take account of the externalities. Current wage practices are far removed from a gain-sharing economy.

Although externalities will be ignored, employers (and unions) might establish profit sharing based on private incentives. Why haven't these incentives inspired more widespread use of profit sharing? The answer cannot be that the technology is new. Modern profit sharing began in France in the 1840s and then spread to other countries (Cooper). The first profit-sharing plan in the U.S. appeared in 1867; by 1916, the U.S. Bureau of Labor Statistics undertook a study of profit-sharing plans and found a total of sixty in operation covering about 30,000 workers (Emmet, 1917a, 1917b). Profit sharing provoked academic interest as early as 1887, when a debate on the issue appeared in the QUARTERLY JOURNAL OF ECONOMICS (Aldrich, Giddings), and continued into the 1920s (Wolfe).

There were three initial motivations for installing profit sharing. Some employers saw such plans in moral or religious terms; one employer characterized his plan as an application of "divine law" which "ushered in love, contentment, cooperation, and happiness (and) cast out hell..." ("Application..."). However, such employers were rare. More commonly, employers saw profit sharing as a way of building employee loyalty, thus avoiding industrial unrest and unions. Finally, profit sharing was advocated as a way of putting the employee on the side of management, thereby boosting production and efficiency (Bloomfield and Bloomfield, p. 59).

For employers interested in building a cooperative, loyal, and nonunion workforce, various alternatives to profit sharing were available. Company unions and employee representation plans could be created. During World War I, the federal government fostered such "works councils", some of which persisted into the 1920s and beyond. These arrangements sometimes had "collective economy dividend" plans attached as a form of gain sharing (National Industrial Conference Board, 1922, p. 2). But employers often found that profit sharing was not sufficiently appreciated or understood by workers.

It is not surprising that profit sharing came to be unpopular with unions ("The Stetson..."). Where it was used, it was often billed as an anti-union tool. And terminology was loose; employers often referred to paternalistic bonus arrangements as "profit sharing" even if they bore no relation to profits. At Ford, for example, a bonus unrelated to profits -- but termed "profit sharing" -- was distributed to workers who met company standards of morality as determined through home visits by company investigators. Thus, until the post-1979 concession bargains, profit-sharing plans have been rare among unionized workers ~~(Thompson, pp. 43-55)~~.

As an incentive system, profit sharing competed against a plethora of alternative arrangements. The 1920s was a period of widespread use of piece rates and other incentive plans, reflecting the earlier development of "scientific management." Roughly half of production workers were covered by incentive rates and bonuses. In contrast, a survey in the early 1960s found the fraction at about one fourth (Mitchell, forthcoming). These incentive programs were closely related to individual or group effort. But profit sharing was remote from the effort of the individual worker. Moreover, profits could be affected by influences other than worker effort, so that bonuses appeared unrelated to employee achievement (Watkins, p. 517).

Thus, profit sharing had difficulty competing, either as a loyalty generator or an incentive system. It initially received unfavorable tax treatment; employee distributions from profits were considered non-expensable "gratuities" (Emmet, 1917a, p. 6). Finally, profit sharing -- with its variable compensation element -- was the antithesis of the New Deal's emphasis on income security and stability.

After World War II, unions pushed for still more income stability through a "guaranteed annual wage." One union did suggest that a profit sharing fund could be used to finance a guaranteed annual wage (Frutkin and Farwell, p. 133). But such programs came to be financed through fixed employer contributions to supplemental unemployment benefit funds rather than through profit-related systems.

IV. Current Opportunities.

If profit-sharing plans, or other forms of gain sharing, have desirable, external macroeconomic effects, a case can be made for subsidizing their use. At present, the tax code offers favorable treatment only to profit-sharing plans which place their bonuses into deferred, i.e., retirement, funds. Cash distributions receive no advantageous treatment. Moreover, qualified profit-sharing plans need not specify a fixed formula by which the bonus is determined. Thus, many profit-sharing plans are really ersatz pensions which escape the more rigorous government regulation applied to ~~more~~ formalized pension programs.

Historically, employers who were persuaded that giving their employees a "stake" in the firm's welfare would contribute to worker loyalty, often chose various forms of employee stock ownership plans (ESOPs) instead of profit sharing. Except in the extreme cases in which the workers own all the shares, such arrangements will not have the desirable macroeconomic effects of gain sharing. Congress, however, has been persuaded to bestow favorable tax treatment on ESOPs, in response to "every worker a capitalist" arguments.

It is not just incentives (such as risk aversion and turnover costs) which determine firm wage policies; changes in institutions and social expectations also play a role. The wave of union wage concessions since 1979 has created an historical opportunity to promote gain sharing. Although most concessions have not involved installation of profit or other forms of gain sharing, some prominent bargains in autos, airlines, and other industries have moved in this direction. Tax incentives tailored to those forms of gain sharing which provide macroeconomic benefits -- and other forms of promotion of gain sharing -- could take advantage of the change in climate and promote a more stable economy.

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