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Headline: Cutting wages may not be the best way to save costs
Source: *The Straits Times,* pA26
Date: 8 November 2012

ASK: NUS ECONOMISTS

Cutting wages may not be the best way to save costs

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FOR THE STRAITS TIMES

Does a pay cut always reduce labour cost?

WHENEVER a firm faces financial difficulties, reducing labour cost is always one of the most frequently considered options. But does it always serve the purpose?

If an employer cares only about the amount of money paid to his employees, then the answer is obviously "yes". However, the answer is less straightforward if he cares about unit cost – or the cost of producing one unit of output.

The difference is largely because a salary cut generally has a negative effect on an employee's work effort. The essential question here is whether the cost savings accrued from a reduction in salary is large enough to compensate for the reduction in labour productivity.

Let's use a specific example. Consider a computer store that hires only one worker, Peter, and pays him a monthly salary of $2,700. He is happy with his current pay. On average, he sells 100 computers a month. The labour cost for each computer is $27.

Seeing that the business of selling computers is highly profitable, a rival firm opens a new store nearby. As a result of the increased competition, Peter can sell only 90 computers a month. The labour cost of selling one computer has increased to $30. As such, can Peter's boss benefit from cutting his monthly salary to $2,430 (90 computers multiplied by $27)?

If Peter can still sell 90 computers a month after the salary cut, then the cost of selling one computer will be reduced to its previous level of $27.

However, if Peter is unhappy about the salary cut, he will be less enthusiastic about his job. As a result, he might be able to sell only 60 computers a month. In this case, a salary cut actually increases the labour cost of selling one computer from $30 to $40.50.

To make things worse, an unhappy Peter might quit his job, and the salary cut makes his job search easier. This is because finding a job that pays more than $2,430 a month is much easier than finding one that pays more than $2,700. To fill the vacancy, his boss will have to spend extra time and money to look for a replacement.

For firms with many employees, a salary cut also puts them at the risk of losing their most productive employees, a phenomenon called "negative selection" in economics. This is because the most productive employees also have the best options waiting for them outside the firm.

Using salary cuts as a cost-saving device also hurts a firm's reputation, particularly in the information age, when bad news can spread quickly. Nobody wants to work for firms that tend to cut their employees' salaries. Therefore, firms with a bad reputation generally have to pay higher salaries than their competitors as and when they need to hire again.

In economics, "efficiency wage" theories analyse the impact of wages on labour productivity. While the theory sounds reasonable on paper, one might wonder whether it applies in the real world.

A textbook example of the efficiency wage theory can be found in the early success story of the Ford Motor Company.

In 1914, the Ford Motor Company reduced the length of its workday from nine to eight hours, and more than doubled the wage from US$2.34 to US$5 a day.

As a result of these changes, the turnover rate dropped from 370 per cent in 1913 to 16 per cent in 1915, the absenteeism rate fell to 2.5 per cent, productivity per worker increased between 40 per cent and 70 per cent, and profits rose by about 20 per cent.

In addition to increasing worker productivity and reducing labour turnover, paying a higher wage may also reduce a firm's monitoring cost.

It is not rare to see a manager monitoring two or three workers at the workplace. If these workers are paid higher salaries, extensive monitoring might become unnecessary.

This is because the higher the salaries, the higher the cost of losing their jobs. As long as workers know they might be caught and fired for shirking work, the higher pay could potentially prevent them from doing so. Consequently, salaries and the need for monitoring are negatively correlated. The savings from reduced monitoring could potentially exceed the increase in workers' salaries.

Moreover, since most people dislike being constantly monitored, a reduction in monitoring could have a direct positive effect on workers' productivity as well.

So when your business faces unusually strong headwinds in the future, rushing to cut your employees' salaries might not be the most effective way to save the boat. It might make more sense to raise them instead.

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