Journal of Economic Behavior & Organization 134 (2017) 228–239

Contents lists available at ScienceDirect

Journal of Economic Behavior & Organization

journal homepage: www.elsevier.com/locate/jebo

In good times and bad – Reciprocal behavior at the workplace in times of economic crises☆

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ARTICLE INFO

Article history:
Received 11 December 2015
Received in revised form
13 December 2016
Accepted 22 December 2016
Available online 29 December 2016

JEL classification:
C9
J3
M5

Keywords:
Gift-exchange
Wage cuts
Exogenous shock
Reciprocity

ABSTRACT

This laboratory experiment analyzes employer–employee relations in the face of an exogenous shock. We implement a two-period gift-exchange game in which the employer can be hit by an adverse shock in the second period. We find that the mere possibility of the shock encourages employers to pay significantly higher wages in the first period. These higher first period wages translate into increased effort levels in the second period, independent of the actual occurrence of the shock. Our results suggest that the mere possibility of an exogenous shock strengthens the cooperation between individuals, which can ultimately mitigate its negative impact on total profits.

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> *"When written in Chinese the word crisis is composed of two characters. One represents danger, and the other represents opportunity."*
>
> John F. Kennedy (1959)[1]

1. Introduction

In the presence of incomplete contracts, work morale, that is, the employees' voluntary cooperation with their employers, crucially determines the success of employment relationships. In particular during economic downturns, this mechanism

☆ This work was financially supported by Goethe University Frankfurt. We would like to thank Johannes Abeler, Arno Apffelstaedt, Iwan Barankay, Leonie Baumann, Gary Charness, Ruben Durante, Florian Englmaier, Armin Falk, Guido Friebel, Simon Gächter, Lorenz Götte, Georg Kirchsteiger, Alexander Koch, Joep Konings, Michael Kosfeld, Julia Nafziger, Gerd Mühlheußer, Daniel Schunk, Heiner Schumacher, Ferdinand von Siemens, Joël van der Weele, and seminar participants at the MPI for Research on Collective Goods in Bonn as well as the conference audiences at the European Economic Association Meeting in Oslo 2011, at the Workshop on Behavioral Personnel Economics in Mannheim 2011 and at the Colloquium of Personnel Economics in Vienna 2015. Finally, we would like to thank the referees and editors whose comments allowed us to greatly improve the manuscript.

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[1] Quote taken from Shapiro (2006).

http://dx.doi.org/10.1016/j.jebo.2016.12.021
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seems to be of utmost importance. In this paper we study whether reciprocal gift-exchange between firms and workers can help to overcome the negative effects of adverse economic shocks by sustaining cooperation in the face of rough times.

We consider shocks that hit firms through no fault of their own. Examples are increasing input prices for raw materials, demand drops caused by political conflicts or terroristic attacks or decreases in selling prices due to over-capacities on the global market. Earlier interview studies, conducted with both managers and employees suggest that workers are willing to help their firms by accepting wage cuts in these kind of situations (see Agell and Lundborg, 1995; Bewley, 1999, 2005; Blinder and Choi, 1990; Campbell and Kamlani, 1997; Charness and Levine, 2002; Kahneman et al., 1986). The interview studies, however, also report that firms can only count on support from their workers after a wage cut if they are in severe trouble. This, in turn, disciplines their employers not to reduce wages in more stable economic times, leading to the aggregate phenomenon of wage rigidity.

In our laboratory experiment, we implement the adverse shock as a clearly exogenous event that has a substantial impact on employers' profits. While previous studies considered reciprocal gift-exchange as a means to overcome shocks, we study if and how (the possibility of) exogenous shocks affect gift-exchange. In particular, we analyze how the *mere possibility* of a shock that can hit the employer influences employment relations. We set out to answer the following questions: How do employers adjust their wages if they are facing the possibility of an adverse shock? How do their employees respond? And lastly, does reciprocal gift-exchange have the potential to mitigate the negative payoff consequences of a shock?

In our two-period gift-exchange game, in each period, the employer first sets a wage and the employee subsequently chooses an effort level. Both wages and effort levels are costly and not contractible. Across treatments we vary the probability with which the employer is hit by an exogenous shock in the second period. Our first benchmark treatment, the *Prob0* treatment, is a twice repeated standard gift-exchange game. Employers and employees simply take their respective wage and effort choices twice, in two subsequent periods. In our second benchmark treatment, the *Prob100* treatments, the payoff functions in the first period are the same as in the *Prob0* treatment. In the second period, conversely, the employer is hit by an exogenous shock which implies a reduction of the worker's marginal productivity in the employer's payoff function. In the main treatment, the *Prob50* treatment, the exogenous shock occurs in the second period with 50% probability. If the shock hits the employer, the payoff functions are the same as in the *Prob100* treatment. Otherwise, they are the same as in the *Prob0* treatment. In all treatments both parties have full information about the probabilities and the actual realization of the shock.

Our main findings can be summarized as follows: The mere possibility of an adverse shock (in the *Prob50* and *Prob100* treatment) encourages the employers to pay on average higher wages in the first period – irrespective of whether the shock later occurs with 50% probability or for certain. When the employers actually experience the shock in the second period, they pay comparably lower wages. Their employees nevertheless keep up reciprocity. Interestingly, we generally find that in all treatment variants, in which the employer faced the exogenous shock (with their treatment-specific probabilities) in the first period, their employees behave on average significantly more reciprocal in the second period

Taken as a whole, our results suggest that the possibility of an exogenous shock can strengthen reciprocal gift-exchange between firms and workers. Ultimately, our findings can provide guidance for firms on how to establish a cooperative relationship with their workers that they can reap in times of economic distress. This seems particularly important for firms that operate in volatile markets. We discuss several policy implications of our findings in the conclusion of this paper.

This paper contributes to various fields of research. First, our paper relates to the literature on employees' reactions to wage cuts. Several field experiments and field studies show that employees decrease their performance as a response to a wage reduction (see for instance Cohn et al., 2014; Kube et al., 2013; Krüger and Friebel, 2016). However, this literature mainly studies employees' reactions to wage cuts where the employer either does not explain the reasons for the wage reduction or where the reasons are arguably perceived as unfair. Our experiment, on the other hand, focuses on employees' responses to lowered wages that can be attributed to worsened economic conditions. Consistent with previous interview studies (Agell and Lundborg, 1995; Bewley, 1999, 2005; Blinder and Choi, 1990; Campbell and Kamlani, 1997; Charness and Levine, 2002; Kahneman et al., 1986), we find that this type of justifiable wage cuts seems to trigger less negative reactions from the employees' side.

Furthermore, our study corroborates and extends findings from the literature on reciprocity based on Akerlof's (1982) gift-exchange model showing that reciprocity is an effective contract enforcement device in the presence of incomplete contracts (see among others Fehr et al., 1993, 1997). The main result from these studies is that workers' efforts are positively related to the positive wages provided. For employers who anticipate that a non-negligible proportion of the population is endowed with reciprocal preferences, it hence pays off to choose generous wages. Recent experiments have extended this workhorse model by introducing economic crises in the lab. Kocher and Strasser (2011), for instance, consider a 15-periods labor market and model economic cycles by varying the employees' productivity over periods. They show that, despite the fact that firms cut wages in times of economic distress, workers reduce effort levels in these periods only slightly. In Linardi and Camerer's (2012) setup, firms and workers interact on a 30-periods labor market. In each of the periods the firms can be hit by a publicly observable stochastic shock, which prevents hiring for the coming three periods. Similar to Kocher and Strasser (2011), they find that the implemented stochastic shocks do not have significant negative effects on wages and effort levels. The employment relations are found to be rather long-lasting and to be characterized by reciprocal gift-exchange of high efforts, high wages and job security in times of economic distress.

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