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Wage rigidity and tax structure

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Abstract

We show that wage rigidity is high if a wage cut involves no change in the taxes rate or if replacement ratios are high. These factors can help to explain the finding that wage rigidity is less intense among high-income earners than among low-income earners.

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1. Introduction

To investigate wage rigidity, firms have been asked to assess if their employees would prefer a real wage cut to a higher risk of being unemployed.¹ Campbell and Kamlani (1997) presented firms with the following question (p. 783): “Suppose the economy were in a recession and you gave your workers the following choice: A. a 10% wage cut, B. a 10% chance of losing their jobs and a 90% chance of remaining with your firm with no pay cut. Which do you think most of your employees would choose?” They found that a sizable number of respondents view their workers as preferring employment cuts.

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¹ These include among others Blinder and Choi (1990), Agell and Lundborg (2003), Campbell and Kamlani (1997), and Bewley (1999).

Around 40% claimed that their employees would accept the risk of losing their jobs, another 40% claimed employees would choose the wage cut, while the remaining respondents were uncertain.²

Another finding is that resistance to cut wages is perceived to be less intense in firms with a larger share of white-collar workers. While no statistical significance tests are reported, firms in this sample claim that 50.8% of white-collar workers would opt for the wage cut while only 44.1% of blue-collar workers and 44.9% of less skilled workers would choose a wage reduction.³ In this paper, we study formally how a worker is likely to react to wage cut proposals and ask how wage rigidity is affected by taxes and transfers.

2. Wage rigidity in firms in crisis

Raising firms' profitability by cutting wages is an option primarily discussed in recessions. We assume a general recession by implicitly imposing price stability. We normalize the actual and expected price level to unity, implying that the real wage, w , always equals the nominal wage. Thus, wage rigidity refers to both nominal and real wages.

Imagine a crisis in a single firm whose prices are constant. Management calls for a meeting with their employees to discuss the fact that, profitability cannot be maintained unless workers are laid off or wages cut. All workers are identical and face layoffs with the same probability. Management presents the employees with the following alternatives: "Either you agree to lower your wages collectively by α percent, or a share Π of the staff has to leave the firm."

We assume that utility is a function $u(\dots)$ of the real income that the workers may have in different states. Let b represent the replacement ratio.⁴ The tax rate is t if employed at the wage w and t^α applies at the wage level after the cut is accepted, $w(1-\alpha)$. The lowest tax, $\underline{t}$, applies to income if unemployed, bw . Tax rates are higher, the higher is the income, so that $t > t^\alpha > \underline{t}$.

Consider now the decision rule for a representative worker. This worker does *not* agree to the wage cut if

$$(1 - \Pi)u[w(1 - t)] + \Pi u[bw(1 - \underline{t})] - u[w(1 - \alpha)(1 - t^\alpha)] > 0, \quad (1)$$

else the worker agrees. The first two terms represent utility when the individual rejects a wage cut. With probability $(1 - \Pi)$ the worker stays employed at wage w and receives the net-of-tax wage $w(1 - t)$. With probability Π , the worker becomes unemployed and ends up with the net-of-tax income level $bw(1 - \underline{t})$. The third term represents the utility level reached if the worker agrees to the proportional wage cut α , where a net-of-tax income of $w(1 - \alpha)(1 - t^\alpha)$ is offered. Only if this last term is larger than the sum of the first two, i.e., if the utility of accepting the wage cut is higher than the expected utility of refusing the wage cut, will the employee agree to a wage cut and hence exert downward wage flexibility.

Assume that the firm proposes a wage cut but claims that no jobs are threatened, i.e., $\alpha > 0$, $\Pi = 0$. The second term vanishes. Eq. (1) is then always positive, i.e., no worker agrees to a wage cut, as expected. Secondly, if management announces that every job will be lost, i.e., $\Pi = 1$, everyone will agree, unless

² Similar results were obtained in studies by Agell and Lundborg (2003).

³ For more evidence, see Agell and Lundborg (1999).

⁴ The share of benefits to wages.

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