

How bad is a pay cut?

And why?

Miriam I. Krueger (Goethe University Frankfurt, and Deutsche Bundesbank)

and

Guido Friebel (Goethe University Frankfurt, CEPR and IZA)

December 2015

Preliminary and incomplete, please do not circulate

Abstract

Pay cuts are believed to be detrimental for firms, but field evidence is scarce. We examine employees' response to a permanent pay cut in an internationally operating personnel search firm. The pay cut was introduced by the firm's headquarter with a view to standardizing the reward system across divisions in Germany, but it only affected some of the divisions, while the reward system in others remained unchanged. This pseudo-experimental setting allows to identify strong negative effects in employees' output (the number and value of contracts sold) in the range of 30% and higher. The effect is much stronger for the historically more productive employees while the less productive employees show no reaction. The pay cut also resulted in increased turnover of the more productive employees and more absenteeism. Using data of the management information system that registers the employees' activities, we document the mechanisms: the affected employees reduce effort along almost all dimensions of activities such as client meetings, vacancies and candidates identified.

Keywords: wage cut, compensation scheme, fairness, quits, churn, work moral

JEL Classification Numbers: D3, D6, J3, J6, M5