

How New Is the “New Employment Contract”? Evidence from North American Pay Practices

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Ch. 1 - Introduction

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During the 1990s, the media announced the death of the “old” employment contract that promised to exchange hard work for employment security. In its place, the media proclaimed the birth of a new implicit contract based more on market forces: *Fortune* wrote of “the end of traditional notions of corporate loyalty” (Kiechel 1987); *Training* described “a dwindling sense of job security among middle managers and professionals” (Lee 1987); while *Executive Excellence* explained there had been a “dramatic breakdown of [the] tacit agreement [to] exchange of hard work and loyalty for security” (Cashman and Feldman 1995). In short, these and many other sources explained that employers no longer reward employees’ loyalty to the company with loyalty and employment security from the company; instead, employers now reward each employee’s skills as valued by the labor market this year.

So far, the evidence of any large-scale shift from the old to the new model is suggestive, but not conclusive. For example, there has been a decline in job stability for prime-aged men (Farber, Haltiwanger, and Abraham 1997). At the same time, average tenure has not declined much (e.g., Farber 1995; Neumark, Polsky, and Hansen 2000). On the one hand, employees report lower average perceptions of job security and believe employers are less loyal than they used to be (Cappelli et al. 1997). On the other hand, Americans did not report lower trust in their employer in 1997 than in 1989 (Kruse and Blasi 1998, pp. 22– 23). Several prominent large employers such as IBM and Kodak have weakened their commitment to long-term employment, and human resource executives at many large employers report a shift from the stereotypical old employment contract to the new (Hackett 1996). At the same time, commitments for long-term employment never covered more than a few percent of the workforce (Foulkes 1980). (These dimensions of the old and new employment contract are reviewed in more detail in Chapter 3.)

The employment contract involves the terms of an exchange: quantities of employees’ time for a certain price (that is, the wage). Past research on the employment contract have emphasized rigidities in the quantity side of the employment relationship, looking for changes in the distribution of job tenure and of rates of displacement. This study focuses on rigidities in the price side, with a focus

on whether wage structures are more “flexible.” There are many possible dimensions of wage flexibility, and we examine a number of them.

The Old Employment Contract

In 1971, Doeringer and Piore published an influential account of how wages are set at large U.S. employers. The internal labor markets they described had a number of wage rigidities. These rigidities, in turn, were due to a range of causes such as long-term commitments between workers and employers, defined career paths, limited ports of entry, and institutions of pay determination such as job evaluation. Most directly, the desire to satisfy norms of constant relative pay kept relative wages rigid. Among the important rigidities they cited were that larger firms paid higher wages; large employers paid similar workers similar wages, even when the employees were in regions with quite different local labor markets; and relative pay between occupations did not vary much over time.

Internal labor markets largely tied wages to job titles and, in most cases, did not rely much on performance evaluation or other forms of incentive pay to determine pay levels within a detailed occupation at an employer. That is, high performance might lead to a promotion, but usually would not increase pay much at the current job title.

Theories of internal labor markets were related to theories of segmented (or “balkanized”) labor markets (Kerr 1954) in that they assumed barriers to entry slowed or halted the operation of market forces. Employees who were hired by firms with high ability to pay (for example, larger firms with oligopoly power in the product market) earned above-market wages. These high wages were supported in part because the limited entry ports and traditional patterns of hiring excluded women and minorities from most jobs at high-wage employers.

The New (?) Employment Contract

Each facet of the old employment contract becomes a testable hypothesis for changes in the employment contract. For example, assume the old employment contract had large differences in pay depending on the employer (for similar employees). The new contract should then have less variance of pay among employers. Assume the old employment contract had distinctive internal labor market wage structures that differed among employers. Then the new contract should then have all employers paying more-similar relative wages across occupations. Moreover, deviations from the market average in both wage levels and internal wage structures should largely reflect accidents and measurement error, not policy. Thus, both employer wage levels and within-employer wage patterns should have become less persistent. We examine these hypotheses in the Cleveland Salary Survey, a

survey of employers' internal wage structures dating back to 1955 (see Chapter 4).

If the old contract had little pay variation within a job title, the new contract should have more reliance on merit pay and bonuses (although perhaps lower variation due to seniority). We examine this hypothesis in the Cleveland Salary Survey and in the Hay Survey, a survey by the nation's largest compensation consultant.

If the old employment contract had large differences in pay depending on employer size and the old contract has declined, the new contract should have a smaller size-wage effect. Moreover, the distinctive pay patterns (such as higher returns to education) at larger employers should have eroded. Finally, wages at large firms should be more responsive to local labor markets. We examine these hypotheses using the 1979 and 1993 Current Population Surveys, nationally representative samples of the population (see Chapter 5).

The old contract's rigidities were motivated in part by people's perceptions of what is fair. If the new contract has become widely accepted, people will be more accepting of pay flexibility. Conversely, limits on acceptance of pay flexibility may have limited the spread of any new contract. Thus, we also examine changes in attitudes toward pay cuts (see Chapter 6). Separate from an analysis of changes in the contract, we also examine when people perceive layoffs as being fair. We compare responses with models of traditional and new employment contracts.

Complementing and often building on this descriptive theory of wage determination, economists have developed a number of theories that attempt to explain the observed wage differentials and related institutions (Chapter 2 reviews these theories at more length). Human capital theory suggests that high-wage firms hire more capable workers. The theory of compensating differences argues that undesirable nonpecuniary characteristics of some jobs lead to high wages. Efficiency wage theory argues that high-wage firms paid above-market wages to increase effort, reduce turnover, and achieve other benefits. Rent-sharing theories suggest that wage differentials are due to the market power in the product market. Finally, incentive theorists say that variations on the theme of piece rates increase effort and productivity and, thus, wages.

In general, the predictions of human capital theory differ along most of these dimensions. Human capital theory posits that wage differentials proxy for skills. Unexplained wage differentials, such as those between employers in general or between large and small employers in particular, are assumed to be due to unmeasured skills. Moreover, a number of studies have found that the returns to skills have risen from the 1970s to the 1990s. Thus, wage variation among employers and between large and small employers should have increased. Moreover, good measures of skills

should be increasingly useful in predicting wage differentials both within and between employers. We test these hypotheses with the Hay data set, which includes a remarkably good measure of skills and responsibility, as well as with a pair of data sets collected in Indiana and in Japan in the early 1980s.

The Data

A unique aspect of this study is the many sources of data examined, a total of five in all. Table 1.1 briefly describes the five data sets; Chapter 4 contains more detail.

Table 1.1 The Five Data Sets

Data set	Dimensions	Distinctive features
Current Population Survey with benefits supplements	Roughly 60,000 people per year in 1979 and in 1993	Nationally representative sample of employees; information on employer size and benefits
Hay Consulting Group	Over 50,000 managers and professionals at 39 firms in 1986 and 1992	A measure of skill and responsibility that correlates 0.80 with wages
Cleveland Salary Survey	Roughly 80 staff occupations at 80 employers per year, 1955-95	Survey with the longest time period with wage structures; occupations explain 80% of wage differences
Indiana/Japan Data Set	2000 employees at 48 manufacturing establishments in the U.S.A. and 38 in Japan in 1982-83	Measures of training, skill, autonomy, and responsibility
Fairness Survey	Several hundred Canadians in 1985, and 950 Canadians and 1059 U.S. residents in 1997-98	Updating and extension of quasi-experimental survey of fairness in the employment relationship by Kahneman, Knetsch, and Thaler (1986)

It is difficult to study wage structures within enterprises because public data sources do not have information on multiple employees per employer. Thus, in addition to the standard Current Population Survey, we analyze two proprietary data sets (Hay and Cleveland Salary Survey), a unique data set with information on employers and employees in both the United States and Japan, and a survey on fairness in employment relations that was collected specifically for this study. Of the five data sets, three have data on the wages of employees and employers (Hay, CSS,

and Indiana/Japan). Among the few sets with employee/employer data, even fewer are longitudinal. In this study, two of the data sets are longitudinal (Hay and CSS) and a further two are repeated cross sections (Current Population Survey and the portion of the Fairness Survey concerning pay cuts).

Three of the data sets contain distinctive measures of skills and working conditions. For example, in addition to standard controls such as age and education, the Indiana/Japan data sets also include multiple measures of job characteristics such as autonomy and complexity. The CSS includes a complete set of detailed occupation codes. These occupation controls explain several times the variation of wages than do standard human capital and demographics controls. For the Hay data set, we have a unique measure of skill and responsibility that is constructed from a detailed job evaluation. This measure correlates more highly with wages than any other skill or responsibility measure we know.

The topics of the book follow the data sets fairly well: that is, we use the CPS to examine whether large and small employers have become more similar to each other. We then look at the Cleveland and Hay data sets for changes among large employers. Thus, each chapter largely presents results from a single data set. At the same time, some substantive issues can be addressed by using multiple data sets. In such cases, results from other data sets may be presented, with a reference to a later chapter's description of the data.

Overview of Results

The contributions of the study are several. First, we document in quite novel data sets the rising overall inequality in wages that others have observed. Importantly, we decompose the rising overall inequality into rising inequality within an employer and rising inequality for similar workers at different employers (Hay and CSS). This decomposition has not been carried out with such detailed microdata or for such a long time span.

We also document the rising returns on skill that others have found. Two of our data sets (Hay and CSS) contain extremely good measures of skills and responsibility. Thus, if rising returns on skill are the main change in the labor market, we should see a particular pattern of changes in returns within and among employers as well as among occupations. For example, the rising inequality among occupations appears highly related to the years of education normally needed by that occupation (CSS) and to the Hay points allocated to the job (Hay). In contrast, rising returns to skills do not explain rising inequality among employers (Hay), in contrast to the predictions of human capital theory.

We also test whether shocks to product markets (deregulation and rising imports) or to labor markets (local unemployment rates and local wage rates) affect the level of wages paid by large employers or the rigidities over time and space at large employers. To our surprise, we found little evidence that these factors affect either wage levels or rigidities.

The use of multiple data sets permits us to replicate some results and use multiple data sets to fill in gaps in each alone. As an example of replication, the cross-sectional analysis of whether job characteristics explain why some employers pay high or low wages is carried out in both the Hay and the Indiana/Japan data sets. As an example of complementary analyses, the CSS and Hay data sets permit us to investigate changes in pay practices at large employers. The CPS data set provides a complementary analysis of how pay practices at large and small employers are diverging.

While most existing studies emphasize changes in job tenure and displacement (the “quantity” side of the employment relationship), we present data on the structure of wages (the “price” side). We complement the data on wages with an attitude survey that examines when people feel layoffs and pay cuts are fair. Importantly, the questions on pay cuts repeat many questions that Kahneman, Knetsch, and Thaler (1986) asked in the mid 1980s, so it is possible to look for changes over time in the fairness of wage flexibility.

In short, the book contributes a description of changing wage structures over four decades. We relate these changes to economic and other theories of wages and careers, and we use these facts and theories to understand the changing employment relationship at large employers in the United States. The result will be a better understanding of what internal labor markets have been and the extent to which they still exist or have been superseded by a “new employment contract.” Our results also shed light on human capital and other explanations of internal labor markets.