9-2017

To Cut Pay or Lay Off: Exploring a Vexing HR Challenge

Yeong Joon Yoon
Texas A&M University - Central Texas

To Cut Pay or Lay Off: Exploring a Vexing HR Challenge

Abstract
Key Findings:

In today's turbulent business environment the need to reduce payroll costs can arise at any time. Generally, this means resorting to one of two agonizing options: cutting pay or engaging in layoffs. The challenge, of course, is to select the option that meets the firm's financial needs while minimizing the potential downsides involved. Several studies have examined the negative effects of cutbacks on employees. The results of these studies are of limited value to decision-makers, however, since overwhelmingly they focus either on pay cuts or on layoffs while making no attempt to compare the two. Here we report on a series of three studies that extends previous research in a couple of ways. Initially, by examining pay cuts versus layoffs to test their comparative effects. And then by explicitly considering the ways in which these effects vary depending on the context in which they are executed.

Keywords
human resources, layoffs, paycuts

Disciplines
Human Resources Management

Comments

Recommended Citation
Yoon, Y. (2017, September). *To cut pay or lay off: Exploring a vexing HR challenge* (CAHRS ResearchLink No. 6). Ithaca, NY: Cornell University, ILR School, Center for Advanced Human Resource Studies.

CAHRS ResearchLink
No. 6 September 2017

To Cut Pay or Lay Off: Exploring a Vexing HR Challenge

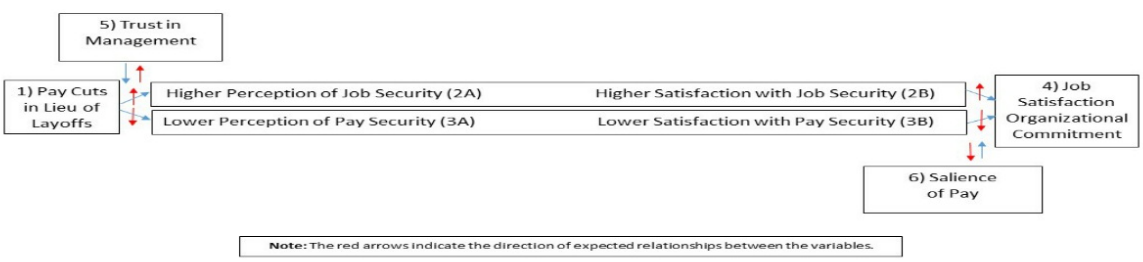
Key Findings

In today's turbulent business environment the need to reduce payroll costs can arise at any time. Generally, this means resorting to one of two agonizing options: cutting pay or engaging in layoffs. The challenge, of course, is to select the option that meets the firm's financial needs while minimizing the potential downsides involved. Several studies have examined the negative effects of cutbacks on employees. The results of these studies are of limited value to decision-makers, however, since overwhelmingly they focus either on pay cuts or on layoffs while making no attempt to compare the two. Here we report on a series of three studies that extends previous research in a couple of ways. Initially, by examining pay cuts versus layoffs to test their comparative effects. And then by explicitly considering the ways in which these effects vary depending on the context in which they are executed.

Overview of Key Findings and Implications for Practice

Figure 1 below provides an overview of the model that guided the studies. Pay cuts (in lieu of layoffs) (Box 1) were expected to have positive effects on workers' perceptions of and attitudes toward job security (Box 2) and negative effects on workers' perceptions of and attitudes toward pay (Box 3). It was anticipated that in most cases the negative effects would be stronger, and, thus, that pay cuts would be inferior to layoffs when it came to sustaining overall levels of job satisfaction and organizational commitment among employees (Box 4). But the model also suggests the possibility of exceptions, depending on the extent to which workers express trust in management (Box 5) and/or the importance they place on pay (versus other factors such as job security) (Box 6). What follows is a distillation of the studies' major findings, along with their implications for practice. (Subsequent sections go into the methodology, the formal hypotheses, and more about the results.)

Figure 1: Overview Model of Research



1 No one likes pay cuts. But when they are undertaken in lieu of layoffs, workers come to have a heightened sense of and satisfaction with job security and this, in turn, somewhat mitigates the negative effects the cuts might otherwise have had on their job satisfaction and organizational commitment.

2 At the same time, however, workers can interpret pay cuts (in lieu of layoffs) as a breach of the assumed psychological contract they have with their employers about pay. This perceived violation fosters negative perceptions and attitudes related to pay and these, in turn, engender lower levels of job satisfaction and organizational commitment.

3 On balance, the mitigating effects of pay cuts (in lieu of layoffs) lack sufficient strength to offset the negative dynamics the cuts set in motion. This most likely reflects the fact that pay cuts only indirectly affect perceptions of job security whereas they directly affect perception of pay security. In general, then, when it comes to reducing payroll costs, it is best to avoid pay cuts – at least when organizations wish to minimize the negative effects on employee morale.

4 But this is not always the case. One important consideration is the extent to which workers trust management. No question, pay cuts are especially detrimental where such trust is lacking. In situations where trust levels are high, however, pay cuts can send a very strong signal to workers that management cares about and is committed to their job security. This mitigates the negative consequences of pay cuts to a point where they are no worse than layoffs when it comes to affecting job satisfaction and organizational commitment.

5 The importance workers place on pay is another important consideration. Overall, pay cuts affect the perceptions and attitudes of workers in the private and public sectors pretty much the same way. But these initial reactions are less likely to translate into lower levels of job satisfaction and organizational commitment among those in the public sector, most likely because pay is a less salient outcome among these workers. Thus, in situations where pay is valued less than other work outcomes such as altruism and job security, pay cuts may be no more deleterious than layoffs when it comes to the bottom-line impact on employee morale.

Implications for Practice

These findings apply most directly to organizations that must reduce payroll costs but desire to do so with a minimum of damage to employee satisfaction and dedication. In most cases, as conventional wisdom suggests, this means eschewing pay cuts that affect a wide swath of workers in favor of layoffs that generally involve much smaller segments of the workforce (assuming, of course, that the layoffs are thoughtfully implemented). There may be situations, however, in which pay cuts are the preferred, most feasible, or only possible solution (e.g. in organizations committed, morally or contractually, to no-layoff policies). This may not be particularly problematic in situations where workers have a high level of trust in management or when they place a relatively low value on pay vis-à-vis other returns to employment (especially job security). But the case for pay cuts is likely to be very difficult to make when employees distrust managements' motives and/or are working mostly for the money. Faced with these situations, managements may find it necessary to engage in considerable communication with employees not only to explain clearly why cost-cutting is essential, but also to reassure them that, however regrettable pay cuts may be, they are the only practicable option for saving jobs.

Specifics of the Studies

Background: This research consisted of a series of three studies, each consisting of two or three sub-analyses used to cross-test the validity of the results.

Study one, which examined the effects of pay cuts (in lieu of layoffs) on various employee perceptions and attitudes, consisted of two parts. Part A was an online experiment involving 128 subjects recruited through Amazon's Mechanical Turk. The experiment involved two randomly-ordered scenarios – one involving a 10% pay cut and the other involving a 10% reduction in headcount (respondents were told to assume they had survived the layoffs and still had their jobs) – and assessed respondents' reactions to each. Part B involved a secondary analysis of data from the Workplace Employee Relations Survey (WERS) conducted in Britain in 2011. The survey involved 15,366 employees from 1,866 workplaces who had been asked a series of questions concerning workplace events and their reactions thereto. In this survey, 58% of the respondents indicated that they had experienced pay cuts, downsizings, or both at some point "during the recent recession".

Study two, where the focus was on the moderating effect of trust in management, had three parts. Part A also consisted of an online experiment, this time involving 138 subjects recruited through Amazon's Mechanical Turk. This experiment was identical to the one previously conducted except for the addition of the trust measure. Similarly, Part B involved a secondary analysis of data from the WERS. Part C, in turn, involved a secondary analysis of data derived from an online survey conducted in 2010 – the Wage Indicator Survey – which elicited responses from 15,840 employees from 17 countries, 64% of whom had experienced wage cuts, downsizings, or both during the previous year.

Study three, which examined the moderating effect of sector, had three parts. Part A involved a secondary analysis of data derived from the National Workplace Survey conducted in Ireland in 2009. This survey had usable responses from 4,359 employees, 65% of whom had experienced pay cuts, downsizings, or both in their organizations during the previous two years. The advantage of this survey was that it included respondents from both the private and public sectors. Part B, then, was conducted to see if the psychological process theorized in Part A was valid. Once again it involved an online experiment similar to the one used in studies one and two. This time there were 123 respondents, split roughly two-to-one between those employed in the private and public sectors. Based on what was observed in Part B, Part C then went back to the National Workplace Survey sample to test a more sophisticated psychological model that shows how work sector moderates the effects of pay cuts (in lieu of layoffs) on work attitudes.

Major Hypothesis and Results

Again, the major variables studied are shown in Figure 1. Box 1 shows the independent variable: pay cuts (in lieu of layoffs). Boxes 2 and 3 show the mediating variables: perceived security of job (2A) and satisfaction with employment prospects (2B), perceived security of pay (3A) and satisfaction with pay prospects (3B). Box 4 depicts the dependent variables: overall job satisfaction and level of organizational commitment. Finally, there are two moderating variables: level of trust in management (Box 5) and relative value of pay (vis-à-vis other returns to employment such as job security) (Box 6).

Based on the foregoing, the study examined four specific hypotheses.

1

Hypothesis 1: Pay cuts (in lieu of layoffs) will exert positive effects on perceptions of and attitudes about job security which, in turn, will have positive effects on overall job satisfaction and organizational commitment. Study one provided strong support for this hypothesis. All paths between the independent, mediator, and dependent variables were in the expected directions and there was a high degree of fit between the guiding model and the data.

2

Hypothesis 2: Pay cuts (in lieu of layoffs) will exert negative effects on perceptions of and attitudes about pay which, in turn, will have negative effects on overall job satisfaction and organizational commitment. Study one provided strong support for this hypothesis. Pay cuts were negatively related to perceptions of pay security and satisfaction with pay prospects. Respondents who expressed relative dissatisfaction with their pay prospects, in turn, were inclined to be less satisfied with their jobs and less committed to their organizations. Here, too, there was good fit between the postulated model and the data.

No hypothesis was proposed regarding the relative effects of pay cuts and layoffs on the mediating and independent variables of interest because prior theory and research were too thin to warrant one. Study one, however, clearly showed that pay cuts (in lieu of layoffs) had a strong negative effect on perceived security of pay that carried through to the remaining attitudes and outcomes. In contrast, pay cuts (in lieu of layoffs) had a slight positive effect on perceived security of employment and this, too, carried through to the remaining attitudes and outcomes. Overall, however, the negative effects were much stronger than the positive effects which means that pay cuts delivered a particularly damaging blow to employee morale.

3

Hypothesis 3: The effects of pay cuts (in lieu of layoffs) on work-related attitudes and outcomes is moderated by level of trust in management such that pay cuts have relatively modest negative effects when the level of trust is high. Study two provided strong support for this hypothesis. Trust in management strengthened the positive effects of pay cuts (in lieu of layoffs) on perceptions of and satisfaction with job security (while not weakening the negative effects of pay cuts [in lieu of layoffs] on perceptions of and satisfaction with pay prospects). So, bottom line, when trust in management was high, pay cuts and layoffs were about equal in their ultimate effects on overall levels of job satisfaction and organizational commitment.

4

Hypothesis 4: The effects of pay cuts (in lieu of layoffs) on work-related attitudes and outcomes is moderated by the salience of pay to employees such that pay cuts (in lieu of layoffs) have relatively modest negative effects when the salience of pay is low. Study three provides some support for this hypothesis. This study used employment sector as a proxy for salience of pay. An initial analysis showed that respondents in the public sector placed considerably less importance on pay (vs. other work-related returns) than did respondents in the private sector. Notwithstanding, the implementation of pay cuts (in lieu of layoffs) induced fairly strong negative perceptions of pay satisfaction among the both sets of respondents. But among those in the public sector, these perceptions and attitudes translated into much weaker relationships with overall levels of job satisfaction and organizational commitment. This supports the notion that in circumstances where pay is relatively less important to workers, pay cuts may be less damaging than layoffs to employee morale.

Future Research

Of course, these studies have limitations that raise questions about the generalizability and utility of the results. The data herein derived from simulations involving self-selected respondents on Amazon's Mechanical Turk and from surveys were conducted for only somewhat related purposes. The reliance on complementarity data sources certainly strengthens confidence in the results obtained, although further research in actual organizations would help clarify the generalizability of the results obtained. Thus, firms faced with the need to reduce payroll costs are strongly encouraged to study the effects of the option(s) chosen not only on employees' perceptions, attitudes, and mindsets, but also on behavioral indicators such as absenteeism, turnover and performance. In the right circumstances, it may even be possible to conduct cost-benefit analyses that would provide particularly definitive evidence to guide future decision-making. CAHRS partner companies that lack the internal research expertise to conduct these types of studies can always call upon CAHRS researchers for guidance, assistance, and even collaboration.

Researcher

YeongJoon (YJ) Yoon, Ph.D.
Assistant Professor of Human Resource Management, College of Business Administration, Texas A&M University - Central Texas

Cornell University
ILR School