# How Higher Wages Can Increase Profits

Many companies have cut or frozen employees' pay during the pandemic, but research shows that paying workers more can boost the bottom line.

By Ray Fisman and Michael Luca in the Wall Street Journal

Illustration: Robert Neubecker

Pay cuts and salary freezes have become an unfortunate hallmark of the Covid-19 recession. Over seven million employees have seen their wages drop since March, and a great many others have had their pay frozen. But a handful of companies have bucked this trend and increased pay despite the economic crisis. In November, yogurt maker Chobani announced that it was raising its workers' lowest hourly wage from $13 to $15; the floor was set at $18 in high-cost centers like New York. E-furniture retailer Wayfair followed suit last week with a $15 minimum.

These and other companies present such wage hikes as enlightened capitalism—a way to help employees during difficult times while also buying loyalty and goodwill that translate into higher productivity and lower turnover. It's the latest entry in a century-old debate over whether companies can improve productivity and profits by paying their workers more. Economists refer to this possibility as the efficiency-wage theory: the idea that wages increased to above market level can effectively pay for themselves through increased worker motivation and retention. There is increasing evidence that efficiency-wage proponents may be right: Higher wages can at times boost the bottom line and—crucially for the current moment—pay cuts can elicit employee backlash and even sabotage.

The 'gift-exchange' theory says that if employers pay above-market wages, workers will reciprocate by being more productive than is required merely to keep their jobs.

The simple economics of efficiency wages were intuited by Henry Ford in 1914 with his idea of the $5 daily wage—more than double the pay at neighboring factories—for an eight-hour shift (down from the then-standard nine hours). Ford expected the high wages to make employees more engaged and harder-working, and if they couldn't meet his exacting standards, there was a long line of job-seekers outside the Highland Park, Mich., plant waiting to take their place.

Modern efficiency-wage theory is more subtle. For example, Nobel laureate George Akerlof (husband of incoming Treasury Secretary Janet Yellen, herself a pioneer in the study of efficiency wages) introduced the notion of "gift exchange": If employers are "nicer" than they need to be—by paying above-market wages, for example—workers will reciprocate by being more productive than is required merely to keep their jobs.

Some of the best evidence for the benefits of higher pay appears in a recently released working paper by Harvard University doctoral students Natalia Emanuel and Emma Harrington that examined wages and productivity among warehouse workers at a Fortune 500 online retailer (kept anonymous in the study). The researchers looked at the effects of a 2019 pay increase that looks a lot like the ones recently announced by Chobani and Wayfair—from about $16 an hour to $18. Prior to the increase, employees moved an average of 4.92 boxes per hour. A $1 pay increase boosted this figure by a third of a box. Higher wages also led to a large drop in employee turnover: a $1 increase reduced the quit rate by 19%.

Given the cost savings from not having to hire and train new employees, combined with improved productivity, the raise more than paid for itself, boosting the company's bottom line in addition to improving employees' lives. The result wasn't only true for warehouse workers: The study found similar productivity and turnover improvements from higher wages for the company's customer service representatives as well.

The win-win of higher wages for this particular company suggests that pay had been set inefficiently low prior to the 2019 pay hike. If this mistake could be made by a Fortune 500 business, other businesses might do well to consider whether they could benefit from a similar policy.

Other research has found that the impact of pay increases depends in part on how they are communicated to employees. In work by one of us published in the journal Management Science in 2016 (with coauthors Duncan Gilchrist and Deepak Malhotra ), we set out to understand why such pay raises have the potential to increase productivity. In an experiment conducted via the freelancing platform oDesk (now called Upwork), we found that workers hired for $4 an hour worked no harder than those hired for $3 an hour. (At the time, oDesk drew its largest share of freelancers from India, and both rates in the experiment were high compared to similar jobs on the platform.) However, giving employees an unexpected raise from $3 an hour to $4 after they were hired elicited greater effort.

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For managers who are tempted to take advantage of slack in the labor market to cut wages to the bare minimum, it's worth considering evidence on the effects of pay cuts. A forthcoming paper in Management Science by Jason Sandvik, Richard Saouma, Nathan Seegert and Christopher Stanton looks at one company's decision to rebalance compensation in a way that ended up cutting pay for a subset of employees at one division. Other divisions did not rebalance their compensation at the same time and thus acted as a "control group" in the study.

The researchers obtained the human resources records of over 2,033 sales agents at the company (again kept anonymous by the researchers). Consistent with the findings of the Harvard study on warehouse workers, the authors found that employees who received pay cuts were more likely to leave the company. More troubling for company profits, the ones who left had been the most productive salespeople. So just as higher pay can pay for itself, lowering pay may have costs that offset much or all of the savings.

A recent working paper by Decio Coviello, Erika Deserranno and Nicola Persico offered evidence that pay cuts may even lead employees to be deliberately unproductive. The researchers found that phone sales representatives at a large U.S. retailer reacted to a 2014 pay cut by peddling items that customers didn't really want. How did they know? Because the drop in pay was accompanied by an increase in sales of items that were ultimately returned for refunds. Whether it was due to carelessness or sabotage, company revenues suffered.

Of course, not all firms can raise their wages in 2021. For businesses that are struggling to stay afloat, like the many mom-and-pop shops that have been hit hard by the Covid-19 recession, pay cuts may ultimately be the only option. And some businesses might choose to rely on extensive monitoring or complicated performance contracts to motivate workers instead.

But when times are tough, it's especially important to think carefully about both the costs and the benefits of higher wages. There's been considerable discussion about the moral case for higher wages, but there is a strong business case as well, since high wages have the potential to increase productivity and ultimately profits. In the transition to the new economic normal after the pandemic, doing what's right may also be what's best for the bottom line.

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