

## **Downward wage flexibility can reduce unemployment during Recession and aid Recovery**

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**Abstract:** *Recessions in an economy are as guaranteed as a bout of cold for human body. Now there is no known solution for bout of cold known to medical science and opinions of economist seems to suggest that there is no known solution to recession, which actually is not surprising because economists rarely agree. The author here suggests that instead of Keynesian approach or Freidmanite method, a better way to tackle pangs of recession is to enforce downward wage flexibility. This will not only ensure that unemployment is contained and does not escalate, but will also help in recovery reducing the duration of recession.*

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### **I. Introduction**

I was working for Mastek when the 2008-2009 recessions took place. Obviously Mastek like almost every company got hit and more so because Mastek was in International Market. This meant that revenue started to dry up as project pipeline did not materialize to the extent expected. Hence the management was forced to put a substantial number of employees on bench. This meant that they were not fired, but their salaries were almost completely on hold but they could seek jobs elsewhere.

In a company meeting, however some employees said that instead of some of employees having to take an almost complete wage cut, was it possible for all employees to take some wage cut. What this essentially meant that instead of say 20% of employees taking almost 100% wage cut, would it not be better for 100% of employees to take a 20% wage cut.

The management dismissed the idea as socialistic and impractical. However that set me thinking.

#### **What is so wrong with Recession anyway?**

Recession is defined as downturn in economic activity over two quarters which can be measured in decline in GDP – Gross Domestic Product. The bad news is that economies do go into recession once in a while. The good news is that economies bounce back. The bad news is that it can take long to bounce back.

The worse news is that government cannot do anything about recession. The conventional Keynesian solution is to reduce taxes, increase government spending. These have been debated for at least past 80 years and the very fact that there is little agreement on the matter, causes one to suspect the effectiveness of it. At any rate what is almost universally agreed is that government effort to combat recession has a time lag and it takes time for economy to correct itself.

If the Keynesian solution of government intervention is not satisfactory, the Freidmanite solution of allowing economy to correct itself is not very inspiring either. Because there is so much pain in economy, with rising unemployment and businesses downsizing, that for government to do nothing seems callous and careless.

Of course, a devil's advocate might ask what is wrong with recession anyway. After all if in a 10 year period for 8 years the economy has been growing at say 5% per annum, even if the economy declines at 5% per annum for 2 years, that still means that on an average the economy has been growing at 4% per annum for the 10 year period.

#### **Problem is not recession; problem is unemployment**

The logic that recession is not so bad is not entirely wrong. After all the goods and services are still being produced. And why should economy always grow. Why should the amount of goods and services being produced always grow. Just as humans take rest, here is the case economy is taking rest. And just as humans recover from rest, the economy also would recover, eventually.

The problem is not so much the recession per se, but the massive increase in unemployment during recession. For instance during the great depression in 1929, unemployment rose to almost 25% and above. And that can be a problem.

Firstly unemployment in itself is a problem. Then since the unemployed people have very little spending power, this will reduce demand, thus making recovery extremely difficult and certainly prolonged.

So the problem is Unemployment. And if we can contain and check unemployment in bud, firstly the pain of recession would be reduced. Secondly since the unemployed will have spending power, the demand will not reduce so much but the savings will reduce and thus the saving investment mismatch will diminish.

#### **How can we check unemployment during recession?**

Let us start at the very beginning. The story of Mastek where 20% of employees were benched, which is a nice way of saying they were fired. Now had Mastek reduced salaries of all 100% employees by 20%, then those 20% of Mastek employees would not be unemployed.

So if wages go down during recession, just as wages go up during boom, well then unemployment will not increase significantly. After all labour, similar to goods is subject to demand and supply curves. And at a lower price there will be greater demand for labour.

The key in reducing the increase in unemployment seems to be in reducing wages.

However there is downward flexibility in wages.

Culturally wages are not permitted downward movement. Hence it is almost impossible for businesses to reduce wages of employees. The most that businesses can do during recession is to reduce increase in wages.

#### **Culture of Downward Flexibility of Wages can and must be Introduced**

But the lack of culture of downward flexibility of wages is not a law that cannot be altered. Just as governments introduced family planning and thus reduced the number of children in a family from almost 7 to 2 over a period, it should be also possible for governments to enforce, if not by law, then by persuasion, a culture of downward flexibility in wages.

After all businesses suffer decline in profits during recession. Rents reduce during recession. Interest rates go down during recession. Then why should wages be any different.

After all there are 4 factors of production

1. Entrepreneur
2. Land
3. Capital
4. Labour.

Now during a recession, entrepreneur faces decline in profits. During recession, land gets lower return in terms of sale value or rent. Capital gets lower interest rates. Then why is this son in law preferential and differential treatment being meted out to labour?

Especially because the pain of recession – both in terms of increase in unemployment and delay in recovery is largely due to lack of downward flexibility in wages which contrasts to downward flexibility in profits, rents and interest rates.

Instead of governments taking the risk of spending more during recession, and thus risking inflation without guaranteeing growth, isn't it better for governments to persuade all employees of the nation to immediately take a 10% wage cut, thus obviating the need for escalation of unemployment, which will not only reduce pain of unemployment, but also ensure rapid recovery for recession.

The advantage with reducing wages is that besides reducing unemployment it will also reduce savings, thus reducing saving investment mismatch, which is one of the causes of recession to start with. By introducing downward flexibility in wages it is possible for recession to self-correct rapidly.

## **II. Conclusion**

The world has been wasting almost 100 years debating the Keynesian solution versus Friedmanite solution for recession, when the obvious solution stares in front of our eyes – downward flexibility in wages during recession. Admittedly downward flexibility in wages is not part of human culture. But if human culture of more children could be reduced by government, even when that matter is rather personal, is it so difficult for government to persuade employees to accept downward flexibility of wages, especially when the alternative is being unemployed.

Employees will readily agree to downward flexibility in wages, because they know that if they do not accept downward flexibility in wages, they could be forced to go without any wage at all. And downward flexibility of wages is certainly lesser of the evil.

This is an obvious solution that should have been thought of at least 100 years ago. But it is not too late. Let us discard both Keynesian activism and Friedmanite passivism and instead adopt the natural downward flexibility of wages which resonates with downward flexibility in profits, rents and interest rates during recession.