Non-Technical Summary in “The Equilibrium Effects of Pay Transparency in a Simple Labor Market”

Summary

Most pro-transparency initiatives are based on the notion that transparency gives workers more bargaining power: workers can use salary data to negotiate fairer and better pay. Our study shows that this is only the first half of the story. We study the effects of transparency using a theoretical model and data from real wage negotiations under transparency, and find that increasing transparency actually increases employers’ bargaining power, which ultimately leads to more equal but lower wages.

How Transparency Favors Workers (The First Half of the Story)

To explain our results, let’s start with the story about transparency you’ve probably heard before. Suppose you’re a long-tenured worker in a firm and you don’t know anyone’s salary but your own. One day, you happen to learn that your three colleagues all make 20% more than you do. Their jobs are identical to yours. This is valuable information: it tells you how much value your employer gets from the labor performed by people in this position. Clearly, he can profitably afford to pay you 20% more. Armed with this knowledge, you confront your boss and request a raise, demanding to be paid as much as your peers. He readily agrees to the raise. Why? This information has given you a new advantage. Without knowing your colleagues’ salaries, you might never have asked for a raise at all; if you had asked for one, your boss could easily have denied your request. Now, however, you know that you earn less than your peers, and your boss fears embarrassment or even a lawsuit. So, at first glance, it seems that transparency not only increases your pay, but also promotes equity. After all, now all the people doing the same job receive the same wage.

What Happens Next (The Missing Second Half of the Story)

Since a little transparency helped you successfully renegotiate your salary in the story above, you might think that more transparency will help more workers (that’s the reasoning behind transparency mandates). But that story doesn’t look at what happens next: if we increase transparency, what are the downstream (or “equilibrium”) effects? How will the employer make decisions about wages and hiring when they anticipate this information will become widely known?

Full Transparency

As we mentioned before, the first half of the story is that workers can use salary data to negotiate fairer and better pay. Now, to see the second half, imagine a scenario with maximum salary transparency. Suppose you work in a firm in which all salaries are disclosed, and suppose your job is identical to that of a number of other employees— you all have the same title, job description, and responsibilities. If you ask your boss for a raise, he can very credibly claim that he can’t afford to do so, on the grounds that if he raises your salary, all of your peers will demand commensurate raises as soon as they hear about it. No one will want to be paid any less than the highest-paid worker. In a less salary-transparent firm, you might be skeptical of an employer who claimed he couldn’t pay you more without paying everyone else more. But
in this case, you fully grasp the costly ramifications of demanding more than the maximum—and you refuse to settle for less than the maximum. In fact, the initial salary negotiation at the time of hiring goes rather smoothly: you avoid asking for more than the firm can offer, and you believe that the firm is offering you the best they can. You don’t need to renegotiate after meeting your co-workers and learning their salaries because that information was public from the start.

This scenario of maximum transparency leads to an unintended side effect: if workers all get the same wage and can’t negotiate this wage upward, then the firm gets the power to set the wage. In order to maximize its profit, the firm will act like a monopsonist and set a very low wage. Thus maximum transparency, rather than increasing the bargaining power of employees, instead benefits the employer, becoming the enforcement mechanism for a low wage.

Partial Transparency

Many settings are cases of de facto partial transparency, depending on how willing the employees are to discuss their pay with you or how open the managers are to communicating pay information.

Suppose you apply for a job (again, one of many identical positions) at a firm in which salaries are not posted publicly, but in which there is a culture of transparency among employees. You know that employees often discuss salaries with one another, and it’s no secret what people earn inside this firm. The employer knows that if they pay you more than your colleagues, your colleagues are bound to find out eventually and ask for a raise. For this reason, your boss still bargains aggressively with you at the time of hire, and considers how his one-off negotiation with you will affect his negotiations with everyone else.

It occurs to you, however, that even if your boss underpays you to begin with, you can expect to learn your colleagues’ salaries once you start work, and will have a better chance of negotiating a higher salary at that point, once your bargaining power has been improved by this evidence of inequity. So you may consider saying yes to a lowball offer, whereas previously you might have been wary that a low starting offer would forever put you on a low-earning trajectory.

In cases of partial salary transparency, then, starting salaries are lower (because employers bargain more aggressively and employees are more willing to accept lowball offers), but salary renegotiations are more common (because employees share salary information and ask for parity from their employer). In other words, the bargaining power is more evenly split between employer and employee in partial transparency than it is in minimal transparency (in which the employee has greater bargaining power) or in full transparency (in which the employer has all of the bargaining power).

What is the ultimate outcome of this more even split in bargaining power: does the employer’s increased bargaining power in the initial negotiation dominate, leading to lower salaries; or does the employee’s ability to more quickly renegotiate, leading to higher salaries? We supplement our model with evidence of employees’ actual bargaining tactics, specifically, people ask for markups above their outside option in a systematic way which doesn’t depend on the exact value of the outside option. This pattern has been shown in different settings. Using this important fact, we can show that the employer’s advantage in bargaining power trumps the
employee’s advantage in subsequent renegotiations. Ultimately, increasing transparency does make salaries more equal, but it also lowers average salaries.

What is the effect on the overall rate of hiring at the firm? Two countervailing forces lead to a rise in employment under partial transparency when bargaining power is more evenly split. The weaker initial bargaining stance of the worker increases employment, because fewer workers demand starting salaries high enough to drive the firm away from initial negotiations. The expectation of renegotiations after joining the firm decreases employment, because the firm becomes unwilling to hire at wages above their (now lower) maximum wage, which excludes the highest outside option workers (i.e., workers with the greatest access to better paid employment elsewhere). Which one dominates? In our model, in which different workers bargain in similar ways, hiring is non-monotonic in transparency. This is because with very unequal bargaining power, employment is lower: when one party has substantially higher bargaining power than the other, their offer is more likely to be excessively high or low, and a match between employer and employee is less likely. The intuition is similar to the way in which a monopolist/monopsonist optimally reduces the number of transactions. When workers have a lot of the bargaining power, they act like monopolists, and when the firm has a lot of the bargaining power, it acts like a monopsonist.

Heterogeneous Effects

Everything up to this point deals with the average effect of salary transparency, i.e., the effect of increased transparency on the average firm and the average employee. But the effects of transparency aren’t the same for all types of firms and employees.

Renegotiations lead to large wage increases for employees who have relatively low-paying outside options and negotiate low initial wages at the firm. Increasing the rate of renegotiations by increasing transparency benefits these workers much more than workers who initially negotiate wages close to the maximum wage the firm is willing to pay. In other words, increased transparency makes the firm a better bargainer against the average worker, but workers who negotiate especially low wages are happy to give up the bargaining power for the opportunity to renegotiate to the maximum wage more quickly. We would expect these employees to be in favor of transparency. As we mentioned, high levels of transparency might price out of the market some workers whose outside options are higher than the low internal cap the firm sets under higher transparency. In this way, transparency has an equalizing effect on wages, but leads to very unequal benefits to different types of employees.

Similarly, an increase in transparency can hurt some firm types. Firms with a high value for labor are willing to hire some employees at very high salaries, and therefore have to greatly increase salaries across the board through renegotiations when existing employees demand equity with the new hires. The renegotiation impact for these firms dominates under higher transparency, leading to lower profits.

On the other hand, low-value firms—those that do not earn a lot of revenue from each employee and therefore really cannot afford to pay high wages, such as startups—often lose out on employees who bargain too aggressively or have high (or even average) expectations about what the firm can pay. For these low-value firms, announcing a transparent wage they are willing to pay actually helps the most to increase employment and profits.
Firm’s Choice to Go Transparent

In the real world, employers have some choice about how transparent to be. Given the asymmetric effect of transparency on different firms, we might expect different firms to choose different transparency policies. But the choice of transparency can also signal a firm’s value to potential employees. Firms don’t necessarily want to reveal their value, because then they are at a disadvantage in future negotiations.

In a simple marketplace (without regulations or non-pecuniary benefits), we find that over time, all firms will start to choose transparency. This is because their choice of transparency is a very clear signal of about how much they value labor. Since a firm with a very low value will fail to hire employees unless it makes its low wage fully transparent, potential employees infer that transparent firms are more likely to pay lower salaries. Conversely, current and potential employees believe a low transparency firm has a high value, which induces them to bargain more aggressively. To stymie these newly aggressive employees, higher-value firms will go fully transparent. We predict that this unravels upward: as the lowest-value firms choose full transparency out of necessity, firms a tier higher in value will be pressured to go transparent as well, leading to a domino effect that will continue until the highest-value firms have chosen full transparency.

Perhaps this story sounds a little farfetched, but we find supporting evidence. We evaluate the choices of thousands of employers who search for temp workers via an online platform. Transparency is affected by the number of workers on a particular job, how long they overlap in the same location, but also by specific choices the employers can make through the platform; employers can choose the privately bargain with individual workers for a wage, or they can select full transparency by posting a public wage for any worker who considers the job. Over time, employers select full transparency more and more often. The following figure speaks to that, where the age of the platform in a city is strongly positively correlated with the proportion of employers who choose full transparency. (In the paper, we study this in more detail, and argue that the patters we see are not consistent with alternative theories.)