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Shirking or work morale?
The impact of regulating

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Standard economics assumes that rational agents shirk, and that they have to be disciplined by monitoring and regulating. However, under specific circumstances regulating systematically worsens workers' morale and thereby negatively affects their behavior. When a principal attributes a lower work morale to the agents than they actually have, an implicit contract is unilaterally violated and agents reduce their 'excess morale'. This reaction is theoretically and empirically well supported by the notions of reciprocity and of overjustification. The theoretical propositions are applied to a specific employment relationship but hold more generally. They are consistent with empirical observations.

1. Views on shirking

In mainstream economics, shirking is seen as a ubiquitous and highly relevant activity in all principal–agent relationships where, owing to problems of information, contracts are incomplete and monitoring is costly [see Alchian and Demsetz (1972) and for a recent survey Baron (1989)]. Accordingly, economists have devoted much attention to finding out how shirkers can be 'disciplined', e.g. by unemployment [Shapiro and Stiglitz (1984)], or by other means [see e.g. Becker and Stigler (1974), Lazear (1979), or Carlin (1989)].

Following Williamson (1975, p. 256), '... much of what economists do is to

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rationalize how human behavior is to be understood in net gain terms, and to debunk such relatively loose concepts as atmosphere'.

There have always been economists, however, who have paid attention to such 'atmospheric' aspects. Recent examples are Akerlof (1982, 1989), Akerlof and Yellen (1990), or Frank (1988), which deal extensively with the role of norms and similar concepts in economic theory. According to Simon (1990, p. 14) 'organizational identification becomes a major motivation for employees to work actively for organizational goals, quite apart from the mechanisms of reward or the ease with which authority can be policed'. Human capital theory [Becker (1985)], industrial relations research [Kaufman (1989)] and transaction cost economics have also acknowledged the potential importance of non-opportunistic behavior, but both have stressed that 'the problem in all this is to identify when such attitudinal considerations operate strongly and when they can safely be neglected'. [Williamson (1975, p. 256)]. In practice, these aspects have been given short shrift; it has implicitly been assumed that they are unimportant as long as their importance has not been demonstrated.

This note intends to show that a particular aspect of 'atmosphere', namely work morale, plays an important role when principals attempt to influence the economic behavior of agents by imposing regulations. Regulations may, under realistic conditions, crowd out agents' work morale. It is indicated under what conditions, and what kind of regulations are likely to be successful in raising worker effort and productivity and to identify those which may lead to increased shirking – the opposite of what is desired by the principal. The analysis points to the importance of targeting regulations according to the specific work morale of the individual agents, thus focusing on quite a different aspect of targeting than that normally considered by economists.

Section 2 discusses the importance of work morale in employment relations, and section 3 presents the misattribution effect, which under identifiable conditions causes regulations to crowd out work morale. In section 4 the conditions for classical and counterproductive effects of regulating are identified. Section 5 provides applications of crowding out morale, and the final section offers concluding remarks.

2. Importance of work morale

The extent of work effort applied by an individual depends on a great number of different factors, one of which is, of course, the monetary compensation (wage rate) received. Beyond this determinant, which has been well studied in economics, work morale (an 'intrinsic' factor) has been shown to significantly and systematically influence work effort [see e.g. the massive research results collected and critically surveyed in Lawler (1971, 1973), or Beer et al. (1984)]. In the following, the wage rate will be assumed to be constant; our attention will be directed to the relationship between work morale and regulations.

Morale is an important determinant of behavior compared to regulations in areas where it is particularly costly to influence behavior by external action. Four such areas may be distinguished.

(1) It is difficult to formulate regulations and, more importantly, to monitor whether they are being followed. Individuals have little incentive to follow them, as such negligence does not entail any cost. In addition to many work conditions, this applies to areas such as family life or isolated actions of individuals, such as spitting on the streets or littering in public places [see the discussion of empirical cases in Baumol and Oates (1979, ch. 19)].
(2) Regulations are, compared to morally guided behavior, relatively ineffective where the quality of a performance is difficult to observe. Examples, are the relationship between patients and doctors or lawyers and clients which are strongly based on trust (i.e. a 'moral' guiding principle).
(3) Wherever decisions are made collectively, it is difficult to evaluate the performance of a particular individual [see e.g. Donaldson (1980); Reber and van Gilder (1982)].
(4) Regulations are relatively ineffective in improving behavior according to a principal's desires where the activities require a high degree of discretionary decision-making. Examples are management, many financial services, advanced teaching, or complex tasks such as research and invention where factors such as 'intuition' or 'judgment' are crucial [Kornhauser (1962)]. Indeed, empirical evidence suggests that external incentives are little used 'in situations where human capital, creativity and unstructured environment are particularly important in the production process' [Baker et al. (1988, p. 604)].

3. Implicit contract and the misattribution effect

The employment relationship can be considered to contain an implicit contract. Industrial psychologists speak indeed of a 'psychological contract' to which the supervisor and the workers consent [see e.g. Ribeaux and Poppleton (1978, p. 302) or Beer et al. (1984, p. 113)]. The principal offers recognition to his employee by acknowledging his or her work morale. The agent who values positively such recognition is prepared to put in more work effort compared to a situation where less recognition is forthcoming: he or she receives a non-monetary reward in the form of higher recognition.

When agents are monitored (regulated) more tightly by their principals, this action indicates that the principals do not trust the agents to perform in a satisfactory way. The principals in effect *attribute* a particular morale to them. Agents who, owing to a high morale, do not shirk are therefore attributed a lower morale than they actually have. These agents feel that their high morale is not acknowledged by their principal, and that it is therefore redundant. The implicit contract between principal and agent is unilaterally broken by the principal, and rational agents respond by reducing their work morale. As a consequence of tighter monitoring and regulating, shirking ceteris paribus increases, and the behavior desired by the principals is reduced. This may be called the *misattribution effect*: monitoring crowds out morale.

Circumstances in which tighter regulations lead to a notable decrease in (work) morale have been identified and empirically supported by two strands of psychological theories.

(1) A basic *norm of reciprocity* [see e.g. Gouldner (1960)] is violated, or, in other words, the equilibrium of recognition and work morale included in the implicit contract is disrupted. According to 'equity theory' [Walster et al., (1977)] as well as 'social exchange theory' [Homans (1950), Blau (1964)], an interaction between people will only continue as long as all parties derive net benefits from it. Gross benefit may consist of factors such as approval or agreement of support, and the cost of factors such as disapproval or the expense of time and effort. Approval and disapproval, even if only implicit, thus represent forms of reward and punishment [Simon (1957)]. In the context of the employment relation considered here, the employees with high work morale feel that the interaction with their superiors no longer yields positive net benefits for them as their special dedication to work is not appreciated. In industrial psychology 'much research shows that unless they are rewarded more highly, people who have high inputs tend to be most dissatisfied' [Lawler (1973, p. 140)] and accordingly reduce their work morale. They respond by cutting back their work effort (or by reducing their cost) to what is expected of them, namely one appropriate to the attributed level of morale. Akerlof (1982) suggests for a similar situation that a 'gift' is offered by the employees but not accepted by the employers.

(2) *Overjustification* is reduced. This psychological effect states that when people are extrinsically rewarded for a task which they are ready to undertake for their own satisfaction, the intrinsic reason is negatively affected or crowded out (so-called 'hidden costs of reward'). As a result, when the extrinsic reward is discontinued, less of the task will be performed [for surveys and experimental evidence see McGraw (1978); Deci and Ryan (1985)]. Agents with excess morale may be taken to feel 'overjustified' when the (high) morale they have is not required because the regulations force a particular behavior upon them anyway. Research has also shown that not only the interest in, but also the quality of work is reduced [Kruglanski et al. (1971)].

The misattribution effect is further strengthened by the fact that most individuals believe their performance is *better than average* [a phenomenon which may be called 'ipsative'; see Frey (1988)]. Thus, a study of 1,088 managerial and professional employees found that 47 percent rated their own performance in the top 5 percent, 83 percent in the top 10 percent, and no one rated his or her performance below the 75th percentile. The same held for white-collar clerical and technical workers: 58 percent of the sample rated their own performance as falling within the top 10 percent of their peers in comparable jobs, 81 percent ranked themselves in the top 20 percent. Only about 1 percent rated themselves below the median [see Meyer (1975)]. This 'ipsative' misperception results in workers feeling that their work morale (performance) is underrated even if the evaluation is objectively correct. As a result of this supposed 'misattribution', the employees tend to reduce work morale and increase shirking.

More intensive monitoring and regulating does not always result in destroying excess morale. In particular, the agents do not feel that they have excess morale if monitoring and regulating clearly and exclusively serve to prevent *others* from shirking [Alchian and Demsetz (1972, p. 781)]. Non-shirkers have an interest in other agents not shirking for equity reasons; they feel it to be unjust if the others get the same wage for less effort.

In some cases, regulating may even raise an individual's work morale, in particular when the agent expects that the principal therewith detects his or her superior work morale, and only then is able to positively acknowledge it. The same effect may take place when regulations are capable of establishing a commonly accepted standard of work morale which is higher than the prevailing one. This is, of course, hard to achieve, and is in general not possible. Those agents to whom a higher work morale is attributed than they actually have will only slowly adjust their morale upwards, if at all. Psychological experiments have shown that when people feel overrewarded, the effect on work morale and effort is either ambiguous [Walster et al. (1977)] or clearly smaller than when they are underrewarded [for empirical evidence from industrial psychology see Ribeaux and Poppleton (1978, ch. 7)]. One factor which contributes to the asymmetric reaction of employees adjusting work morale and effort downwards when experiencing 'excess morale', but not upwards when being attributed a higher morale than they actually have, may be due to the well-known influence of peer pressure or solidarity among workers [for an extensive discussion and evidence in the organizational context see e.g. Lawler (1971, pp. 49–51, 1973)].

4. Uniformity of regulations

A counterproductive effect of increased monitoring is the more likely to obtain, the more uniform the regulations applied are. The question is whether monitoring directed exclusively at the shirkers is feasible. It is extremely difficult to obtain the information required for this policy because the shirkers have a well-defined interest to conceal their activities. The principals are unlikely to be able to establish regulations directed only at the shirkers. Rather, they are liable to err. Following statistical theory, it is useful to distinguish between two types of error:

(1) Agents who shirk are not monitored and regulated. The cost consists mainly of the negative effects upon the non-shirkers who feel unjustly treated.
(2) Agents who do not shirk are monitored. Even if they are not punished, they still feel badly treated because of the mistrust signalled. While designing regulations to better correspond to the different morale of agents would improve behavior, and thus result in a benefit for the principals, an attempt to do so is costly and may well result in a failure, so that perfect targeting is certainly not achieved and a positive, and often large, extent of misattribution of morale prevails.

The cost to the regulators of taking into account differences in morale varies between institutional settings. In the context of shirking on the job within organizations, a relevant distinction is between private and public organizations.

(1) *Private institutions.* Under competition, the managers as principals are obliged to use their workforce as effectively as possible. This obligation may lead to errors, but the successful – and therefore more rapidly growing – firms will endeavor to differentiate their policies in order to fit better the work morale of their employees. Being subject to the market test, such firms will benefit directly from a more desired behavior and less shirking of their employees, and it is therefore worthwhile to expend considerable cost in keeping misattributions of work morale down.
(2) *Public institutions.* The situation is quite different in state enterprises and organizations and, in particular, in the public administration itself [see Rose-Ackerman (1986)]. Public bureaucracy is committed to the notion of uniformity which may be seen as a typical aspect of 'administrative rationality'. Regulations are typically uniform; bureaucratic principles abhor exceptions, especially when they are based on such vague, and often not directly observable notions, as work morale. One instance of this tendency to treat employees uniformly – even if they have quite different productivity and work morale – is the slightness of wage differentiation: the best workers are paid much less, and the worst workers more, than in a corresponding occupation in the private sector.

It may be argued that a self-selection effect works in the opposite direction.[1] There are cases in which individuals make financial sacrifices to

[1]This has been suggested by one of the anonymous referees.

work in public (or private non-profit) organizations such as hospitals. They are expected to have a particularly high *level* of work morale based on their belief that they are engaged in worthwhile activities. As a result, such individuals work harder than comparable individuals in the private sector. Nevertheless, they are likely to respond marginally in an even more negative way to monitoring and regulating by superiors. Even small amounts of misattributions strongly crowd out their work morale exactly because they have made a monetary sacrifice to extend their specific variant of work morale [see e.g. Reber and van Gilder (1982), Groshen and Krueger (1990)]. Under these circumstances, principals should be even more careful to try to raise work effort via regulations.

5. Application

For the purpose of illustration, possible counterproductive effects of tightening regulations are discussed for a specific employment relation in academia.

Professors at Swiss universities (which are part of the public bureaucracy) have a teaching load of eight hours per week. Many teach more, although they do not get additional payment, presumably because they have a high work ethic. A few professors teach less than the required eight hours. A typical response by the ministry of education (which has been under discussion and has partly been implemented) is to follow bureaucratic procedures and introduce *uniform* controls and regulations, applicable to *everyone*. (Those who teach less than required are, in principle, identifiable, but the cost of monitoring is high.) The superior teaching morale of some professors is thus (implicitly) rejected by the principal. The imposition of uniform regulations constitutes a clear signal to these professors that their high work morale is not appreciated by the ministry. As a reaction, the professors teaching more than required feel that an implicit contract, where they 'buy' the ministry's special recognition in exchange for a higher work effort, has been unilaterally violated. They reduce their excess morale, and many of them will only teach the necessary eight hours. On the other hand, the controls and regulations introduced will force most of the professors who neglected their teaching duties to conform to the eight-hour requirement. The perverse effect may dominate, and the introduction of controls and regulations would therefore *reduce* the total number of hours taught (as well as the quality exerted) by the body of professors. These observations are consistent with the analysis undertaken as well as with empirical research on the supervision of scientists [e.g. Moore and Renk (1955); Kornhauser (1962); Pfiffner and Fels (1964, ch. 24)]. In an academic setting it is almost infeasible to regulate teaching effectively because the professors have the option of adjusting the quality. It is less costly to rely on the work morale of the individual academics. This makes regulations a relatively ineffective determinant of behavior compared to work morale.

The propositions advanced may also be observed in employment relationships outside academia. Thus, for example, Japanese firms are characterized by a high level of trust between workers and principals [see Aoki (1990) and the literature cited therein]. A tightening of uniformly applied regulations would be considered a breach of an implicit contract, resulting in a strong reduction of work morale [see e.g. Dickens et al. (1989)]. It may therefore be expected that a regulation of the type described tends to lead to a less desirable behavior in a typical Japanese firm and will consequently be less implemented than in a corresponding American firm.

6. Concluding remarks

Economics is based on the premise that rational, opportunistic agents shirk wherever possible. Much effort has therefore been devoted to how the work force can be 'disciplined' by monitoring and regulating. This note argues that this policy approach overlooks an important side-effect on the agents' morale. Work morale need not be taken into account as long as it is unaffected by monitoring and regulatory intervention. However, under the circumstances identified here, monitoring and regulation systematically affect agents' morale, and thereby their behavior. When, through intervention, the principals attribute a lower morale to the agents than they actually have, an implicit contract between principal and agent is unilaterally violated, and the agents reduce what they consider to be their 'excess morale' to the level attributed to them. Crowding out of morale is theoretically and empirically strongly supported by the (psychological) notions of reciprocity (equity, social exchange) and overjustification but may also be explained by an economizing approach. A counterproductive effect of regulating is the more likely to obtain (a) the marginally less effective monitoring and regulation are compared to work morale in influencing behavior; (b) the more strongly work morale is decreased by an external intervention; and (c) the more uniform the regulations applied are, i.e. the more misattribution takes place.

The analysis undertaken here helps to explain further puzzles found in positive economic theory. One is why bondage of agents (employees) is 'virtually never' [Baker et al. (1988, p. 613)] observed in reality.[2] Conventional theory would suggest that bondage is often used in order to make 'credible commitments' and to therewith support exchange [Williamson (1983)]. According to our model, to ask for bondage (hostages) is to openly signal that not much faith is put in the other contract party, a fact which induces morale to be lowered, and the breaking of the contract becomes

[2]This application has been suggested to the author by George Akerlof.

more likely. Another question is why the distribution of wages is more compressed in the public than in the private sector. Owing to the greater uniformity of regulations in the public sector, there is a stronger tendency for work morale to converge to an average which corresponds to these uniform regulations. As a result, in the public sector (as opposed to the private sector), the distribution of work effort and wages is more compressed than the underlying distribution of skills.

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