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The Share Economy Symposium: A Reply

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I am pleased to be given the opportunity to respond to The Share Economy Symposium held at Yale University in June 1985. I try to be relatively brief here. The symposium covered a wide range and included some divergent, and even contradictory, viewpoints. It would be inefficient, and boring, to try to cover all the ground. Instead I pick up a few themes and attempt to make some sparce comments about them.

First of all it is important to be clear about the message. The background is the presently unsatisfactory situation which finds the economics profession unable to reach a consensus about what is causing the current stagflation impasse or to project a coherent account about what is to be done about it.

The key to noninflationary full employment is an economic expansion that holds down the marginal cost to the firm of acquiring more labor. Pure macroeconomic policy alone, the purposeful manipulation of financial aggregates, is no longer sufficient to guarantee full employment without inflation because labor costs begin to rise well before the economy starts to strain at full capacity.

At this point the honest Keynesian puts in the awkward if obligatory footnote about the need for some form of incomes policy. But this phrase is usually added rather mechanically, as an afterthought, with little enthusiasm or follow-up. I think it may be time to reverse the emphasis. In countries like Britain and France or, for that matter, Argentina and Israel, today the main operational issue is how to introduce greater wage restraint and "flexibility" into the labor market, especially as it starts to become tight. Compared with this issue the nuances of how best to reflate the economy are relatively straightforward. Although the dilemma being described is currently seen most starkly in some European economies, the same basic issues are involved almost everywhere. Things have reached a point where a surprising number of mac-

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roeconomists of Keynesian or classical persuasion have essentially abandoned the hope that traditional macroeconomic policies can do a great deal to promote prosperity. I would argue, as a general proposition, that implementable structural changes in the labor market should be a relatively more pressing concern than the demand management policies currently occupying the attention of most macroeconomists.

There should be more focus on the labor market itself, on measures to build in automatic flexibility and to reform out structural rigidities, not so much to replace traditional macroeconomic policies as to enable them to better deliver noninflationary full employment. What is required is bold institutional change in incentive structures to make it in employers' strong self-interest to automatically maintain high levels of output and to keep prices low. There are many possibilities here, including tax-based incomes policies, multitiered pay systems, employee ownership or control, profit sharing, and several others. I am in favor of maintaining a positive and constructive attitude toward all measures that might improve the employment–inflation tradeoff. But in my opinion profit sharing is the most solidly based of the alternatives and, I believe, holds by far the most promise.

The form of the case for widespread profit sharing is like the form of the case for free trade. It is not true that free trade benefits every individual. It is not even true, in a realistic world of increasing returns to scale and imperfect competition, that free trade must benefit the community as a whole. Yet, when all is said and done, when the possible costs and benefits of alternative trade policies have been calculated, weighted by the relevant probabilities, and then added up, most economists agree that free trade is the best policy. The argument for profit sharing is of this same form. It is possible to dream up unlikely counterexamples and to interpret the existing evidence perversely. But the bulk of economic theory, empirical evidence, and common sense argues that widespread profit sharing will help to improve macroeconomic performance. The bottom line is that it is easy to envision situations where profit sharing helps economic performance while it is difficult to imagine scenarios where profit sharing damages an economy, which is as much as can be claimed for any economic idea.

It is no mystery why profit sharing makes the employer view things as fundamentally different. In a profit-sharing system the young school graduate looking for work comes to the employer with an implicit message saying, "Hire me. I am reasonable. Your only absolute commitment is to pay me the base wage. That is my marginal cost to you. The profit-sharing bonus is like a variable cost, depending to some extent on how well the company is doing. So you have a built-in cushion or shock absorber if something should go wrong." By contrast, the young British school leaver looking for work in the current wage system comes to a potential employer with the implicit message, "Think very carefully before you hire me. I am expensive and inflexible. You will have to pay me a fixed wage independent of whether your company is doing well or poorly, and you will not easily be able to lay me off if your business goes badly." Is it difficult to deduce in which situation companies might be expected to more eagerly recruit new hires and in which situation new hiring commitments are likely to be avoided when at all possible? The essence of the case for profit sharing is the basic idea that on the margin, the profit-sharing firm is more willing than the wage firm to hire new workers during good times and to lay off fewer workers during bad times.

William Nordhaus takes issue with the basic propositions about "excess demand for labor." All I can say is that excess demand for labor is meant as a heuristic device that most people find useful as a way of thinking about what is happening in a share economy. But absolutely nothing substantive depends on using this phrase or even understanding what it means. The 1983 *Economic Journal* article, for example, is, I hope, quite clear on this. A short-run equilibrium is defined for a situation where pay parameters are quasi-fixed and every other variable in the system, including labor, is free to change. Then a long-run equilibrium, where pay parameters are also free to vary, is defined. The basic result is that small changes in the neighborhood of a long-run equilibrium will produce short-run unemployment in a wage system but not in a share system. This result is robust to various assumptions about labor mobility and survives a number of other alterations.

Some of Merton J. Peck's remarks about the Japanese bonus as a form of a disguised wage have, I believe, been superseded by time. I think he would now agree there is very little doubt that the bonus to base wage ratio is procyclical at a statistically significant level. This result has been found by several researchers, myself included, and I think we can accept it as a stylized fact. There are some legitimate and not-easy-to-answer questions about what all of this signifies for Japanese economic performance. To say that the bonus system has nothing to do with Japanese employment stability is, I believe, a much too extreme interpretation.

As for the fact that Japanese output fluctuates a lot, I do not think this contradicts share economy-type interpretations. First of all there is a question of whether Japanese output is or is not more unstable than that of other countries. It all depends on how output is detrended from its high growth rates. Japan has the steadiest growth rate among all OECD countries over the past quarter century if it is measured by relative deviations from a standardized mean of one. In terms of absolute deviations, Japanese growth shows much more cyclical variability than most other coutries. Note that, with a sprinkling of temporary price stickiness, the relevant model of a profit-sharing economy would predict relatively full employment but some building up of inventories, make-work, or labor hoarding during slack periods. Thus, the large Okun coefficient for Japan is not in itself a theoretical contradiction with share economy-like interpretations.

Finally, let me turn to the issue of how a share economy might affect the NAIRU. Much of the formal analysis has been based on short-run disequilibrium considerations, when pay parameters are quasi-fixed. But would widespread profit sharing lower the NAIRU?

The answer is yes, it presumably would. Furthermore, the short-run and long-run unemployment problems are probably related.

To talk meaningfully about the effects of profit sharing on the NAIRU, one first has to have some idea about what is causing such a high NAIRU. There are several theories. Some are more persuasive than others, and they are not mutually exclusive.

A leading theory contends that long-term unemployment is largely inertial or hysteresis-like. Whatever initial disequilibrium caused the increased unemployment in the first place, once unemployment continues long enough it almost gets built into the system. Perhaps this is because the long-term unemployed outsiders cannot or do not act effectively as a disciplining force in wage setting, perhaps because working skills atrophy without work, perhaps because the plight of the long-term unemployed gets forgotten by the electorate, or perhaps for other reasons. In this view the rate of change of unemployment typically has a more powerful effect on wage settlements than the absolute level of unemployment.

If this kind of inertial effect lies behind the too-high NAIRU, then presumably widespread profit sharing would lower or eliminate it. The long-term unemployment would have difficulty developing in the first place out of an initial contractionary shock because profit-sharing firms are reluctant to let go of workers. Taking as given this kind of NAIRU, leaving aside how it got started in the past, the natural expansionary bias of a profit-sharing system would act as a built-in counterforce to "gobble up" the unemployed. The "gobbling up" process could of course be speeded by traditional expansionary macroeconomic policies which, under profit sharing, pose less danger of causing prices to accelerate because the employment–inflation tradeoff has been improved. So any way you look at it, profit sharing should definitely help to diminish long-term inertial unemployment.

Another theory of why the NAIRU is so high is that labor has too much bargaining power. Whether a switch from a wage system to profit sharing would lower this kind of NAIRU depends on what it is that labor and management bargain over. If they bargain over pay parameters, but management controls the employment decisions, then a switch to profit sharing would lower the NAIRU. If labor and management bargain over both pay parameters and employment levels, then the NAIRU would be the same under either system. In-between bargaining would yield in-between results, with the NAIRU then being somewhat lower under profit sharing than under a wage system.

A third class of theories, based on the so-called "efficiency wage hypothesis," holds that long-term unemployment is caused by companies themselves choosing to pay above market-clearing wages because otherwise workers would shirk too much on the job. Within this kind of model, which has limited, if any, relevance for understanding the worldwide rise of unemployment, the "natural rate" would be the same under a wage or a profit-sharing system.

To the extent that too-high unemployment in European-style economies is aided by overly generous unemployment and welfare benefits, which creates some voluntary unemployment, presumably the labor payment mechanism per se makes little or no difference. So the "revenge of the welfare state" kind of unemployment would not be affected by a switch to profit sharing.

Finally, there is the long-standing identification of the natural rate with semipermanent frictional or structural unemployment, due to continuously occurring microeconomic changes. This kind of unemployment, it is usually said, cannot be reduced by pure macroeconomic policies except temporarily and at the cost of increasing inflation. As with inertial unemployment, however, the wage system is heavily implicated in frictional or structural concepts of the NAIRU. After all, both wage and profit-sharing systems respond to shifts in relative demands by sending a signal that eventually transfers workers out of a losing firm or sector and over to a winner. With a wage system the signal to a worker that his firm is a loser in the game of capitalist roulette, and that it is time to look for a new job with a winning firm, is the boot. The worker is laid off and must suffer through an unemployment spell of some duration while searching for a new job. Under a profit-sharing system, the firm does not voluntarily let go of a worker because of weak demand. Instead it is the worker who chooses to leave because pay is too low relative to what is readily available elsewhere at successful firms eager to include new workers into their current profit-sharing payment plans.

Summing up, in none of the standard scenarios does a profit-sharing system cause a higher NAIRU than does a wage system, and in most of the more reasonable descriptions a profit-sharing system generates a lower NAIRU than does a wage system. In addition, of course, the profit-sharing system has better disequilibrium properties when pay parameters are sticky in the neighborhood of the NAIRU unemployment rate.

From all of these theoretical exercises considered together it seems difficult not to draw the conclusion that a profit-sharing economy is more likely to have lower unemployment than a wage economy.