

COMMENT ON "CAN THE SHARE ECONOMY CONQUER STAGFLATION?"

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The main thrust of Nordhaus' paper seems to me to be the following. There is no such thing as an "excess demand for labor" in a share economy, and any propositions following from such an idea are at least suspect and probably wrong.

In my view, the concept of "excess demand for labor" is merely a heuristic device that many people find useful as a way of thinking about what is happening in a share economy in a short run when pay parameters are quasi-fixed relative to everything else. But absolutely nothing substantive depends on using this phrase or even understanding what it means. A reader of my *Economic Journal* article [1983] should understand this point quite clearly. A short-run equilibrium is there defined for a situation where pay parameters are quasi-fixed, and every other variable in the system, including labor, can be freely changed. 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 may produce short-run unemployment in a quasi-fixed wage system but not in a quasi-fixed share system. This result is robust to various assumptions about labor mobility and survives a number of other alterations.

Let me rephrase the basic argument without ever making use of the concept of "excess demand for labor." Suppose that there are two kingdoms, Old Lakeland and New Lakeland, which are physically identical in every way. The economies of both identical-twin kingdoms consist exclusively of fishing from the numerous privately owned lakes and exporting all of the fish at given world prices.

In Old Lakeland the monarch has decreed that the money wages to be paid throughout the year at each lake are to be posted on January 1 of that year and cannot be altered until January 1 of the next year. In New Lakeland the monarch has decreed that payment at each lake shall consist of a share of the value of the fish caught per worker; the share fraction applying throughout the year is to be posted on January 1 of that year and cannot be altered until January 1 of the next year. In both economies, once the pay parameters (wages or share fractions) are posted, workers are free to migrate to that highest-paying lake which will employ them.

Suppose that the world price of fish has been steady for as long

as anyone cares to remember. Then Old Lakeland and New Lakeland will settle into a (long-run) competitive equilibrium that is exactly identical in every respect except that pay is called "wages" in Old Lakeland and "shares" in New Lakeland.

Suppose next that, suddenly and without warning, in the middle of one year the world price of fish drops. By royal decree, pay parameters cannot be changed to reflect the new situation until January 1. What happens in this (short-run) disequilibrium? Lake owners in Old Lakeland will choose to lay off workers, so that Old Lakeland exhibits unemployment. But at the same time New Lakeland remains at full employment.

This basic parable can be amended in various ways, including alternative labor supply assumptions, without destroying its essential message. A share economy will have a tendency to remain at full employment after contractionary shocks, because employers want to retain workers, while a wage economy will likely exhibit unemployment, because firms wish to shed labor. Nordhaus is mistaken when he asserts, as an intended *reductio ad absurdum*, that I am claiming that, because the degree of sharing nowhere enters the argument, one drop of share compensation will miraculously cure the disease of stagflation. The size of contractionary shock that can be absorbed without causing unemployment in a share economy is a continuous function of the degree of sharing, as is explicitly discussed in my 1983 article [p. 776] and my 1985 article [p. 948].

Let me turn finally to the issue of how a share economy might affect the NAIRU. In a highly idealized frictionless world of perfect information, long-run equilibrium is the same under wage and share systems. In an idealized long run, Old Lakeland and New Lakeland are isomorphic, and both have zero rates of unemployment. But what about somewhat more realistic situations. Is the "share natural rate" of unemployment lower than the "wage natural rate"? The formal analysis of unemployment comparisons between Old Lakeland and New Lakeland has been based on short-run disequilibrium considerations, when pay parameters are quasi-fixed. But might widespread sharing also lower the natural rate under a more realistic concept of long-run equilibrium than was treated in the Lakeland example?

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

In order to talk meaningfully about the effects of profit sharing on the natural rate of unemployment, one has first to have some

idea about what is causing a positive natural rate in the first place. 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 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, 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 natural rate, 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 natural rate unemployment, leaving aside how it got started in the past, the ingrained expansionary bias of a profit-sharing system should act as a built-in counterforce to help absorb the unemployed. The absorption process could of course be speeded up by traditional expansionary macroeconomic policies which, under profit sharing, presumably 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 looks as if it ought to help diminish long-term inertial unemployment.

Another theory of why the natural rate 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 decision, a switch to profit sharing would lower the NAIRU. If labor and management bargain over both pay parameters and employment levels, 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 the natural rate would be the same under a wage or profit-sharing system.

To the extent that too-high unemployment in some 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 should 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 macroeconomics 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 workers that their firm is a loser in the game of capitalist roulette, and 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 the 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 available elsewhere at relatively more successful firms.

Summing up, in none of the standard scenarios does a profit-sharing system cause a higher NAIRU than a wage system, and in most of the more reasonable descriptions a profit-sharing system generates a lower NAIRU than 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.

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