Employment and Profit-Sharing

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The Irish economy today is a hostage to stagflation. While unemployment is at levels not seen since the Great Depression, policy-makers are scared of precipitously reflating the economy lest inflation once again should rear its ugly head. Pessimism is rampant. People do not have confidence that there actually exists some workable long-term strategy for reconciling full employment with low inflation.

The biggest single issue in the 'future of employment' is making sure that employment *has* a future. At present many 'European-style' economies seem unable to reconcile reasonably full employment with reasonable price stability. Expansionary policies dissipate themselves, to an excessive degree, in too large wage and price increases rather than in expanded employment and output.

One school of thought blames the adverse situation on a high 'natural rate of unemployment'. For reasons no one has been able to make clear, the 'non-accelerating-inflation-rate-of-unemployment' has apparently deteriorated. This explanation amounts to a tautology. It is tantamount to saying that the unemployment rate is high because the unemployment rate is high.

Another non-starter is the *au courant* explanation that European-style unemployment is of the classical rather than Keynesian variety, caused by 'too high' *real* wages. The problem with this argument is that real wages no more cause employment levels than the other way around. Both are simultaneously determined within the economic system. Given money wages and aggregate demand, companies *choose* employment levels and prices. Hence, the real wage (the money wage divided by the price level) is no less determined by the decisions of firms than is employment.

What, then, is causing the unemployment? There is only one answer, but, like a coin, the answer has two sides. Side one is that unemployment is caused by insufficient aggregate demand (relative to money wages). Side two is that unemployment is caused by too high money wages (relative to aggregate demand). Sometimes it is useful to stress one side of the coin; sometimes the other. But it is always the same coin. In either case, the key to non-inflationary full employment is an economic expansion that holds down the marginal cost to the firm of acquiring more labour. Pure macroeconomic policy alone — the purposeful manipulation of financial aggregates — is no longer sufficient to guarantee full employment without inflation because labour costs begin to rise well before the economy starts to strain at full capacity.

How did we get into this impasse, and what is the way out? For answers it is necessary to turn back to the Great Depression of the 1930s and the towering influence on economic thought of John Maynard Keynes's *The General Theory of Employment, Interest and Money,* published in 1936.

Economic theory

Before the Depression, mainstream economic theory held mass unemployment to be impossible. When the impossible actually happened, the most common response of economists to an obvious malfunctioning of the labour market was to declare, somewhat antiseptically, that the supply of labour exceeded demand because the price of labour was stuck at 'too-high' levels. The complacent implication was that there is not much more to do than sit around waiting for wages to come down.

Keynes disagreed fundamentally, almost violently, with the classical approach. While it is logically equivalent to describe unemployment as being caused by 'too high money wages relative to aggregate demand' or by 'too low aggregate demand relative to money wages', there is, Keynes pointed out, a world of practical difference between the policy implications of the two viewpoints. Changing wage contracts is at best a slow and unreliable way of maintaining full employment. Discretionary fiscal and monetary policy represents a far more useful approach. Thus was born one of the most spectacular disappearing acts in history. Like a great magician, Keynes removed the malfunctioning labour market from everone's eyes and replaced it with discretionary government policy to manage aggregate demand.

When, after an initial period of success, Keynesian policies for spending ourselves into full employment were blamed, rightly or wrongly, for the double-digit inflation of the 1970s, the stage was set for the monetarist version of what is essentially a very similar optical illusion. The basic message of monetarism is that, if the economy concentrates on achieving price stability by rigidly controlling the supply of money, at worst there may be a few awkward transition years when slightly less ambitious targets for full employment will have to be accepted. But when the system finally settles down at a stable low rate of inflation, a steady slow growth of the money supply will yield no more unemployment over the long run than discretionary Keynesian interventionism. Aside from the incredible difficulty of relying on unstable monetary aggregates in a technology that includes plastic and electronic money tied to deregulated financial institutions, the deep recession of 1981–83 is widely viewed, rightly or wrongly, as discrediting simple-minded monetarism.

Where do we go from here? To begin with, it is high time to recognise that, for all the wealth of practical and theoretical insights they may have inspired, for all the approximate truths their doctrines contain and the actual ways they might (or might not) have improved past or present economic performance, both the Keynesian policy revolution and the monetarist counter-revolution are essentially dazzling digressions from the main problem. The common defect of both is the vain hope of successfully skirting the key market that is malfunctioning — the labour market — by skilfully adjusting one or another financial aggregate, whether the money supply, government spending, tax receipts, or something else. This detour around the main problem may be perfectly justified as a temporary expedient, but it hardly commends itself as a long-term solution.

The major macroeconomic problems of our day can be traced back to the wage system of paying labour. We try to award every employed worker a predetermined piece of the income pie before it is out of the oven, before the size of the pie is even known. Our 'social contract' promises workers a fixed number of green pieces of paper, independent of the health of their company, while the company chooses the employment level. This stabilises the money income of whomever is hired, but only at the considerable cost of loading unemployment on lowseniority workers and inflation on everybody — a socially inferior, risk-sharing arrangement that both diminishes and makes more variable the real income of workers as a whole. An inflexible money wage system throws the entire burden of economic adjustment on employment and the price level.

Economic policy should focus more directly on the labour market itself, to build in automatic flexibility and to remove structural rigidities, so that we do not have to rely so exclusively on macroeconomic sledgehammer cures to maintain non-inflationary full emloyment. What is required is a bold institutional change in incentive structures to make it strongly in an employer's self-interest automatically to maintain high levels of output and to keep down prices. There are many possibilities here, including two-tiered wage systems, employee ownership and profit-sharing. I am in favour of maintaining a positive attitude towards all these measures, but as an economist I must say that profit-sharing is the most solidly based of the options and, I belive, holds by far the most promise.

Share economy

A profit-sharing system, where some part of a worker's pay is tied to the firm's profitability per employee, puts in place exactly the right incentives to resist unemployment and inflation. If workers were to allow their pay to be more flexible by sharing profits with their company, this would improve macroeconomic performance by directly attacking the economy's central structural rigidity. The superiority of a profit-sharing system is that it has enough built-in flexibility to maintain full employment even when the economy is out of balance. If workers' compensation were shifted to a lower component of base wages and a higher component of profit-sharing, then an employee's average cost (or pay) could stay the same, while the employer's marginal cost of hiring another worker would be lowered. Because of the automatic profit-sharing cushion, employers are slower to lay off workers during a recession and quicker to hire more of them when conditions are good. A profit-sharing system is not anti-labour and does not rely for its beneficial effects on lowering workers' pay. The key thing is not to reduce total worker pay — it could even go up — but to lower the base wage or marginal cost component while raising the profit-sharing component accordingly.

Let me give a concrete example. Suppose that Irish Widgets Ltd (IWL) is paying wages plus fringe benefits of £6 per hour. IWL will then be motivated to take on (or lay off) workers to the point where the *additional* value added per worker is no more nor less than £6. *Average* value added per worker will naturally be higher — say £9 per hour — to provide a margin for covering overheads, depreciation, interest, profits, and so on.

Now change the labour contract to a form where IWL workers are receiving a base wage of £5 per hour and a 25 per cent share of the gross operating profits of £4 (=£9–£5) per worker-hour. It looks as if everything is the same as before. Yet IWL's incentive to hire or fire is subtly but dramatically altered. If IWL now hires an extra worker, its value added goes up by £6 as before, but its total labour cost only increases by £5 plus 25 per cent of *incremental* gross operating profits of £1 (= £6 – £5), or a total of £5.25. IWL thus clears a profit of 75 pence per hour on the extra worker, and understandably is more eager to hire and less eager to fire. There is a secondary effect: in order to sell the extra widgets, IWL has to reduce its prices.

In a profit-sharing economy, firms acting in their own self-interest will tend automatically to create a tight labour market, high output, and low prices. This will not happen overnight. But if the incremental, hardly noticed decision at the margin has more of a bias, under profit-sharing, to lean towards letting go of fewer workers during bad times and taking on more of them during good times, then gradually the system will ratchet itself toward an ever-tighter labour market. Moreover, standard macroeconomic policy is much more effective in an environment of widespread profit-sharing because it is essentially the base wage, not total pay, that in conjunction with the usual macroeconomic policy variables, determines the essential characteristics of the system such as unemployment and the price level.

Japan

Japan has a significant bonus system with strong profit-sharing overtones. A typical Japanese worker in an average year receives a bonus that constitutes about one-third of the base wage. While it is difficult to quantify the exact magnitude of its contribution out of a host of reinforcing tendencies, the bonus system is probably one major reason (although far from the only one) why Japanese firms are able to maintain such consistently high employment rates; and, as a very import side-benefit, Japanese workers have a direct incentive to increase their firm's productivity and profitability because part of their salary depends on it. (This pattern of profit-sharing workers being more motivated than wage workers to cooperate with their company in order to improve its economic performance has been observed almost universally.)

In Japan young school leavers are being readily recruited by companies, while in Ireland they are not. Why? This is a complicated issue, with many answers, but one of them is almost surely that the method of labour payment is very different in the two countries. In Japan, regular workers receive about 25 per cent of their total pay in the form of a bonus with strong profit-sharing overtones. The young Japanese school graduate looking for work comes with an implicit message to the employer saying: 'Employ me. I am reasonable. Your only absolute commitment is to pay me the base wage. This is my marginal cost to you. The bonus is a variable cost, depending to some extent on how well the company is doing.' By contrast, the young Irish school leaver looking for work comes to a potential employer with the implicit message: 'Think very carefully before you employ 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 bad.' Is it difficult to deduce in which country companies eagerly recruit new employees and in which country new employees are avoided if at all possible?

I believe that we in the West should consciously tilt our economies toward the superior profit-sharing variant of capitalism. We ought to adopt a new social contract that promises our working people full employment without inflation but asks, in return, that workers receive a significant fraction of their pay in the form of a profit-sharing bonus. Ireland is in great need of such measures.

Any economy is full of uncertainty. There are no absolute guarantees, and if the uncertainty does not come out in one place, it will show up in another. I am saying that it is much better, much healthier, if everyone shares just a little bit of that uncertainty right at the beginning rather than letting it all fall on an unfortunate minority of unemployed workers who are drafted to serve as unpaid soldiers in the war against inflation. It is much better if people will agree that only 80 per cent of their pay is going to be tied directly to the funny looking pieces of paper currency — which are themselves an illusion, although a very useful illusion — and 20 per cent will be tied to company profits per employee. Then the economy can be much more easily controlled to have full employment *and* stable prices. Society will be producing, and hence consuming, at its full potential. If people will face up to the uncertainty at the beginning, and if everyone accepts some small part of it, then society as a whole will end up with higher income and less uncertainty.

This much-needed reform will not come about easily. Persuading workers and companies to change fundamentally the way labour is paid, in the name of the public interest, will demand political leadership of a very high order. Cooperation among people of differing political views will be indispensable. Material incentives, such as favourable tax treatment of the profit-sharing component of a worker's pay, will probably be required to persuade existing employees to acquiesce in a profit-sharing scheme with no restrictions on hiring. (Once a labour contract is agreed upon, insider workers should not have the right to block unemployed outsiders from joining the firm if management wishes to expand employment.) Calculations show that even a quite ambitious tax break for profit-sharing income would more than pay for itself if it reduced unemployment by just one or two percentage points.

Conclusion

When all is said and done, no matter how well designed are the incentives, such change will require genuine consensus, cutting across left-right political lines, that the broad social gains of permanent full employment without inflation are worth more than the narrow private losses that inevitably will be incurred here and there. Yet the benefits of inflation-free full employment are so enormous, the increased national income is so great, that my recommendation is to move decisively in the direction of profit-sharing. If these ideas are wrong, little will have been lost by trying them out. At least, we shall be able to say to future generations that we were not so paralysed by fear of the unknown that we did nothing. And if the ideas are correct, a serious move toward widespread profit-sharing would help greatly to make involuntary unemployment an obsolete concept.