Profit Sharing as Macroeconomic Policy

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When Keynes came to sum up the central message of the *General Theory* for the economics profession, in a remarkable but by now long-forgotten *QJE* article of 1937, he began with a "general, philosophical disquisition on the behavior of mankind"—under uncertainty. Here as elsewhere, Keynes made it abundantly clear that he shared Frank Knight's distinction. "Uncertainty" did not mean "risk"—that which is, at least in principle, reducible to well-defined actuarial probabilities. By uncertainty Keynes intended, I believe, to convey the idea of "ignorance"—that which is essentially due to insufficient or precarious knowledge of the mechanism by which the future is generated out of the past.

The Keynesian scenario looks out over an economic world that is rife with uncertainty. In that world, expectations play an important dual role as both a manifestation of uncertainty and a cause of it. Such expectations are arbitrary to some degree because they can be based on almost anything, including self-fulfilling expectations of the behavior and expectations of others. And, as Keynes pointed out, "being based on so flimsy a foundation," these expectations of expectations are "subject to sudden and violent changes."

It follows that while there may ultimately be some long-run forces drawing it toward full employment, capitalism may also have some deep-seated tendencies toward short-run instability. Unadulterated *laissez-faire* is likely to be out of equilibrium much of the time, and even when it is in equilibrium there is no guarantee of being in a "good" equilibrium. Whether in a state of "bad" equilibrium or merely in disequilibrium, such coordination failures generate undesirable macroeconomic consequences like unemployment which can cause very significant welfare losses. By the ultimate logic of this Keynesian worldview, then, the stage is set for some form of government intervention to recoordinate the economy into a better configuration. Any such government policy will inevitably introduce some microeconomic distortions, but as an empirical matter such losses tend to be small, relative to the enormous welfare gains from having an economy operate at its full-employment level.

Such general considerations do not indicate the best *form* of government intervention to stabilize the macroeconomy. Indeed, we do not currently have a general, realistic framework within which a meta-issue like that might be properly addressed. Nevertheless it is possible, I believe, to give some common sense criteria for desirable forms of government intervention. It is my contention that economists have not been sufficiently imaginative in devising operational mechanisms or systems possessing advantageous macroeconomic properties. The usual fiscal and monetary policies are, to my mind, sledgehammer-like tactics for controlling unemployment and inflation. They do the job, but clumsily, by brute force—and they can leave a big mess afterwards. I think it is possible to find subtler alternatives that operate more cleanly and with a softer touch by taking a page from the book of Adam Smith.

A good mechanism for fighting unemployment and inflation should have several noteworthy characteristics. It should be decentralized, based on the natural microeconomic incentives of a market-like environment. It should work more or less automatically, keeping to a minimum the need for using discretionary government policy. And, in a highly uncertain world, it should be robust in retaining its desirable macroeconomic characteristics over a wide range of possible situations or circumstances—including some that are currently unforseen.

I want to argue that a superior form of government policy for combating unemploy-

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ment and inflation is to encourage, through exhortation and special tax privilages, the widespread use of profit sharing. A profit-sharing system has the potential to automatically counteract contractionary or inflationary shocks—while maintaining the advantages of decentralized decision making. And these desirable properties are robustly preserved throughout a variety of economic environments. At the very least, widespread profit sharing can be a valuable adjunct to traditional monetary and fiscal policies.

I believe we should seriously consider some new ideas about basic reform of the economic mechanism because our old ways of doing things are no longer adequate. The premier economic malady of our time is stagflation. Despite some abatement of its virulence in the immediate present, we still seem to be unable to reconcile, over a reasonably sustained period, high employment with low inflation. Even when economic conditions are on the upswing, significant pockets of unemployed workers remain throughout the Western capitalist countries. Right now, for example, we are afraid to aggressively push unemployment down to more humane levels for fear of re-igniting inflation. The policy-induced recession remains our only reliable method for lowering inflation rates. It is difficult to imagine a more costly, inefficient, or unjust waste of economic resources and human potential. Profit sharing represents a way of building into the system the kind of natural resistance to unemployment and inflation that could really disarm stagflation at its source.

Our macroeconomic problems trace back, ultimately, to the wage system of paying labor. 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 wage independent of the health of their company, while the company chooses the employment level. That stabilizes the money income of whomever is hired, but only at the considerable cost of loading unemployment on low-seniority workers and inflation on everybody —a socially inferior risk-sharing arrangement that both diminishes and makes more variable the real income of the working class as a whole.

Why does a profit-sharing system possess superior macroeconomic properties that help to automatically stabilize output at the full-employment level and make it easier to deal with inflation? There is not sufficient space in this condensed paper to give a detailed answer, so the true seeker must be prepared to fight through the longer and more technical pieces listed as references (1983, 1984). But a shorter heuristic story, a kind of summary, can be briefly told here.

Consider a typical monopolistically competitive firm in a partial equilibrium setting. Suppose the wage is treated as a quasi-fixed parameter in the short run. If the firm can hire as much labor as it wants, it will employ workers to the point where the marginal revenue product of labor equals the wage rate. This is familiar enough. Consider, though, what happens with a profit-sharing contract that names a base wage and a certain fraction of profits per worker to be paid to each worker. Suppose these two pay parameters are treated as quasi fixed in the short run. A little reflection reveals that if the profit-sharing firm can hire as much labor as it wants, it will employ workers to the point where the marginal revenue product of labor equals the base wage, independent of the value of the profit-sharing parameter. (Note, though, that what the worker is actually paid depends very much on the value of the profit-sharing coefficient.) When a standard $IS-LM$-type macro model is constructed around such a model of the firm, the following isomorphism emerges. A profit-sharing macroeconomy will find itself with the same output, employment, and price level as the corresponding wage economy whose wage is set at the profit-sharing economy's base-wage level. In other words, the aggregate macroeconomic characteristics of a profit-sharing economy, excepting the distribution of income, are determined (on the cost side) by its base wage alone. The profit-sharing parameter does not influence output, employment, or prices, although it does influence the distribution of income. If the employed workers can be persuaded to take more of their income in the form of profit shares and less in

the form of base wages, that can result in a Pareto improvement—with increased aggregate output and employment, lower prices, and higher real pay.

When identical-twin wage and profit-sharing economies are placed in the same stationary environment, with competitive labor markets, both economies will gravitate toward the same long-run full-employment equilibrium. But, then perform the following thought experiment. In the typical style of disequilibrium analysis, disturb each economy and observe the short-run reaction when pay parameters are quasi fixed but everything else is allowed to vary. The profit-sharing economy will remain at full employment after a disturbance, while a contractionary shock will cause a wage economy to disemploy labor. It should not be hard to imagine why such characteristics make a profit-sharing system more resistant to stagflation.

This same point can be made yet another way. Consider the standard textbook *IS–LM*-type model. Aggregate demand is determined, via the appropriate multipliers, as a function of autonomous spending injections and real money balances. The price level is determined as a degree-of-monopoly-power markup over wages. Wages are treated as exogenously fixed in the short run. Given the standard *IS–LM*-type specification, the model grinds out (as a parametric function of the wage level) output, employment, and the price level. It is clear what happens within such a model if there is a *ceterus paribus* money-wage cut. Output and employment are higher, while prices are lower. Yet this is exactly what occurs when an economy shifts toward profit sharing. The base wage determines the fundamental macroeconomic characteristics of the system—when there is an increase in profit shares at the expense of base wages, macroeconomic performance improves without loss of real labor income.

I am aware that such short-run, fixed-pay-parameter, disequilibrium models will be unsatisfying to the economic theory purist who will want a full-blown account of why one payment mechanism rather than another has been selected by society in the first place, and who will not rest content without understanding on a more fundamental level why pay parameters should be sticky in the short run. Such concerns have a legitimate place. But I do not think they should be taken to such an extreme that we are inhibited from examining what would happen in disequilibrium under alternative payment systems before first having firmly in hand a general, all-encompassing theory of economic systems and disequilibrium-like behavior.

What about the possible objections to profit sharing? Several are frequently voiced. I believe the objections can be successfully rebutted, but here I deal with only one, and that skimpily. The objection to profit sharing one hears most often from economists is that, compared with a wage system, it represents a socially inefficient method of risk sharing. (Isn't it obvious that under a wage system, the firm bears the risk, while under a profit-sharing system, the worker bears the risk?) In my opinion the reasoning traditionally put forward to support this "insurance" argument is fallacious, being based on a partial equilibrium view that does not take into account the radically different macroeconomic consequences of the two systems for overall employment and aggregate output. The fixed wage does not stabilize labor income. What is true for the individual tenured worker is not true for labor as a whole. When a more complete analysis is performed, which considers the situation not as seen by a tenured, high-seniority worker who already has job security, but by a neutral observor with a reasonably specified social welfare function defined over the entire population, it becomes clear that the welfare advantages of a profit-sharing system (that delivers permanent full employment) are enormously greater than a wage system (that permits unemployment). The basic reason is not difficult to understand. A wage system allows huge first-order Okun-gap losses of output and welfare to open up when a significant slice of the national income pie evaporates. A profit-sharing system stabilizes aggregate output at the full-employment level, creating the biggest possible national income pie, while permitting only small second-order Harberger-triangle losses to arise because some crumbs have been randomly

redistributed from a worker in one firm to a worker in another. Here is a friendly challenge to would-be critics. I challenge anyone to cook up an empirical real world scenario, with reasonable numbers and specifications, where a profit-sharing system does not deliver significantly greater social welfare than a wage system.

The superior profit-sharing variant of capitalism is practiced, to some extent, in the immensely successful economies of Japan, Korea, and Taiwan. While these countries are not identical clones, their economies do share certain important characteristics. In each case workers receive a significant fraction of their pay in the form of a bonus. The bonuses are large, averaging over good years and bad about 25 percent of a worker's total pay in Japan, and about 15 percent in Korea and Taiwan. The degree to which the bonus is actually determined as a function of current profits per worker varies from firm to firm, and depends upon the country. (For example, in some Japanese companies the bonus is almost a disguised wage, but this is not true for most Japanese companies, and it appears to be hardly true for any Korean companies.) Bonuses, like dividends, respond to corporate earnings, but with a complicated lag structure not easy to quantify by any rigidly prescribed rule. Overall, there is very little question that profit sharing is a significant feature of the industrial landscapes of these "Japanese-style" economies.

While it is difficult to quantify the exact magnitude of its contribution out of a host of reinforcing tendencies, the bonus system is almost surely one major reason (although, most likely, far from the only reason) for the outstanding economic performances of Japan, Korea, and Taiwan. Their flexible payment system helps these economies to ride out the business cycle with relatively high, stable levels of employment and output. Their governments enjoy greater leeway for fighting inflation without causing unemployment. The variability of real pay per member of the potential labor force has actually been reduced. Over time, a more equitable distribution of income has emerged than is found in other capitalist countries.

I believe that we in the West, instead of giving lessons as we are accustomed to doing, now must be prepared to take a lesson from the East. We should consciously tilt our economies toward this superior 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.

But, the typical economist will ask, why if a profit-sharing system represents a far better way of operating a market economy than a wage system don't we see more examples of share economies? After all, even in Japan, Korea, and Taiwan only modest (although significant) steps have been taken in this direction. The rest of the advanced capitalist countries are predominantly wage economies. Why, if profit sharing is so beneficial, does not self-interest automatically lead firms and workers in this direction?

The answer involves an externality or market failure of enormous magnitude. In choosing a particular contract form, the firm and its workers only calculate the effects on themselves. They take no account whatsoever of the possible effects on the rest of the economy. When a firm and its workers select a labor contract with a strong profit-sharing component, they are contributing to an atmosphere of full employment and brisk aggregate demand without inflation because the firm is then more willing to hire new "outsider" workers and to expand output by riding down its demand curve, lowering its price. But these macroeconomic advantages to the outsiders do not properly accrue to those insiders who make the decision. Like clean air, the benefits are spread throughout the community. The wage firm and its workers do not have the proper incentives to cease polluting the macroeconomic environment by converting to a share contract. The essence of the public good aspect of the problem is that, in choosing between contract forms, the firm and its workers do not take into account the employment effects on the labor market as a whole and the consequent spending implications for aggregate

demand. The macroeconomic externality of a tight labor market is helped by a share contract and hurt by a wage contract, but the difference is uncompensated. In such situations there can be no presumption that the economy is optimally organized and society-wide reform may be needed to nudge firms and workers towards increased profit sharing.

This much-needed reform will not come about easily. Persuading workers and companies to change fundamentally the way labor is paid, in the name of the public interest, will demand political leadership of a very high order. Material incentives will probably be required, such as favorable tax treatment of the profit-sharing component of a worker's pay. Yet the benefits of full employment without inflation are so enormous and the increased income is so great, that we cannot afford not to move in this direction.

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