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UNEMPLOYMENT AND THE SHARE ECONOMY: A SCEPTICAL NOTE

by

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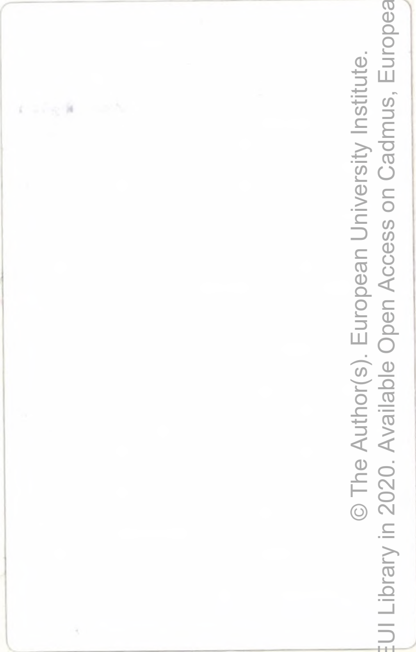

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Abstract

Various versions of the Vanek-Weitzman-Meade share economy require workers and unions to accept at least initial pay cuts or unequal pay for similar work. *If* such flexibility were acceptable, then wage cuts or two-tier systems, together with appropriate government policy, could presumably also solve the problems of unemployment and stagflation. Weitzman's permanent excess demand for labor depends on positive pure profits and neglect of the intensive margin as well as of efficient contract considerations, and is thus quite implausible. Finally, work sharing rather than profit sharing seems to be the main reason for low unemployment in Japan.

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Politicians and journalists looking for easy 'solutions' to outstanding problems have welcomed the latest quick fix for unemployment and stagflation. This practical enthusiasm is largely restricted to the U.K., which is perhaps understandable, because Britain's problems are among the most acute in Europe. Furthermore, in this case the suggested solution comes from a noted American expert on the Soviet economy, and has even attracted favorable reviews from normally sceptical economists of repute. In technical and popular writings, Martin L. Weitzman (1983, 1984, 1985) has proposed to abolish inflation and unemployment by the simple device of replacing wages (in part) by profit or revenue shares. Even without an initial pay cut, earnings per worker and hence marginal labor cost should decline when the share component is 'diluted' by expanding employment, so that a permanent excess demand for labor is supposed to result. The essential idea is thus to achieve a reduction of nominal pay per worker while expanding employment, in the hope that increasing returns to scale will generate greater per capita output and higher real wages when full employment has been reached (and is maintained by excess demand). Even under the doubtful assumption of predominantly increasing returns there are major problems with this approach which are not discussed by Weitzman.[1]

Perhaps the most serious problem is the rather obvious point that workers and unions are usually adamantly opposed to pay cuts in any form. If they were not, then flexible wages could presumably solve the unemployment problem when wages are excessive, even without sharing schemes. Thus, Weitzman's scheme is most unlikely

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to work in practice, and if it did, it would probably be unnecessary. In any case, excess demand for labor would surely lead to higher pay, at least for newly hired employees (two-tier pay plans[2]), as well as declining effort, until equilibrium was re-established. These points as well as various more technical assumptions on the role of pure profits underlying Weitzman's model are discussed in more detail below. Meade's (1986) related model of a "discriminating partnership" suffers from some similar problems, and is also discussed in conclusion.

1. The Role of Profits

If pure profits are zero in equilibrium, revenue sharing is appropriate (and anyway easier to monitor), so assume a net revenue function $R(L)$, where L is the laborforce, and initial equilibrium at wage W_0 and L_0. Profit is

$$\pi_0(L_0) = R(L_0) - W_0 L_0 = 0 \quad (1)$$

and

$$\pi_0'(L_0) = R' - W_0 = 0. \quad (2)$$

Now replace the per capita wage W_0 by a new wage W and a share, $\lambda R/L$, to maintain total earnings at initial employment, so that

$$W + \lambda R(L_0)/L_0 = W_0. \quad (3)$$

But then from the zero-profit condition (1) we get $W=(1-\lambda)W_0$ and the new profit function at L_0 is (with a given share)

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$$\pi(L_0) = (1-\lambda) R (L_0) - WL_0 = (1-\lambda) (R-W_0L_0). \qquad (4)$$

But then by (2) we have $\pi'(L_0)=0$, so there is no incentive to expand employment for any share-wage combination which maintains initial earnings. Thus with zero profits it is necessary to reduce initial pay to expand employment.

If initial profit is positive, it is easy to verify (as in (6) below) that $\pi'(L_0)>0$, so profits can be raised by expanding employment and earnings will then decline by the usual concavity condition on the revenue function, as proposed by Weitzman. However, he nowhere considers the probable reaction of workers to declining pay in the initial stage of expansion by a particular firm. As long as the marginal profitability of labor remains positive, workers can reduce their effort with little fear of dismissal. The traditional opposition of organized labor to pay cuts of any kind (unless jobs are threatened by closedown) also suggests that workers or their unions will demand compensating increases of their wage component to maintain nominal earnings. Then any increase of employment beyond initially optimal L_0 is inefficient at total pay W_0 and so will reduce profit. Thus in either case, if firms plausibly expect less effort or compensating wage claims, they will not wish to increase employment from an initial optimum merely because a share component has been introduced. On the other hand, if opposition to pay cuts could be overcome, then there should be no problem in the first place, and wages should adjust to ensure full employment. (For qualifications, see fn. 5 below.)

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2. Increasing Returns and Flexibility

Now it is true that if a substantial majority of all firms were initially operating under increasing returns to scale, and if the opposition of employees to initial pay cuts could be overcome, then output per capita could be increased as employment expanded, and real earnings of all workers should be ultimately higher.[3] Not only the second assumption is doubtful however, for it is by no means obvious that increasing returns are predominant in this sense.[4] Bottlenecks and shortages in some sectors or firms could lead to cost increases which more than compensated for reductions elsewhere, even in the presence of substantial initial underemployment. If the workers in the sharing firms had any (quite rational) doubts that their real earnings would ultimately bounce back, then again they are unlikely to allow the initial decline in earnings on which the smooth functioning of a share economy envisaged by Weitzman hinges.

The basic philosophy of organized labor in most European countries presently plagued with excessive unemployment is that of "wage solidarity" or equal pay for the same job irrespective of the employer's prosperity or any other local conditions. Centralized bargaining allows this philosophy to be enforced, although major employment gains are likely to require much more flexibility in pay and working conditions (OECD, 1986). Small and new firms (which have provided most of the new jobs in the United States in recent years) are particularly handicapped by uniformly high wages (and non-wage costs) in Europe. The argument that sharing provides "built-in" flexibility misses the point that the desirability of

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flexibility *per se* must first be recognized politically and by organized labor. But then, many of the macroeconomic objectives of sharing could be attained by decentralized wage bargaining which is responsive to firm-specific conditions, and would thus automatically involve an *implicit* element of sharing.[5]

3. Long-Run Equilibrium and Efficiency

The long-run "equilibrium"[6] properties of a share economy as expounded by Weitzman are, if anything, even less persuasive than the short-run process of adjustment and "wage dilution". Weitzman envisages an equilibrium with total pay equal to marginal revenue product, but permanent excess demand for labor in a full-employment economy with a large enough share component. Apart from the obvious point that excess demand for labor should generate a reduction of effort or in intensity of work, and increased pay for new hires, until equilibrium was attained at both the intensive and extensive margins of the labor market, there is another problem which has not been noticed by Weitzman. As will now be shown, positive excess demand for labor depends crucially on the existence of positive pure profits, although in long-run equilibrium with free entry, pure profits should be competed away or captured by trade unions, whose role is ignored by Weitzman.[7]

Thus suppose that equilibrium earnings equal marginal revenue product for optimal allocation of labor, so

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$$W + \lambda R/L = R'(L), \tag{5}$$

and then write marginal profitability as

$$\pi' = (1-\lambda)R' - W = \lambda[(1-\lambda)R-LW]/L$$
$$= \lambda\pi/L, \tag{6}$$

which is positive if and only if $\pi>0$. Conversely, if $\pi=\pi'=0$, which is the usual condition for long-run equilibrium with free entry, then (and only then) does the condition (5) for efficient employment follow, since we can write

$$W + \lambda R/L = W + \lambda W/(1-\lambda) \quad \text{(since } \pi=0\text{)},$$
$$= W/(1-\lambda) = R'(L) \quad \text{(from } \pi'=0\text{)}. \tag{7}$$

On a more practical level, it is scarcely conceivable that new accessions would not demand better job classifications and pay scales in a tight labor market, and thus raise the marginal cost of labor to attain equilibrium.

Of course, these arguments and Weitzman's theory all assume simple, static profit maximizing, although labor-market competition should lead to efficient employment contracts and allocation of labor, whatever the precise form of payment.[8] In some contract models, a fixed wage is then optimal as a form of insurance for risk-averse workers, and in general both hours or intensity of work and employment will vary in response to shocks (FitzRoy and Hart, 1985; FitzRoy, 1987). Efficiency-wage theories consider the costs of monitoring or contract enforcement, which can be reduced

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by higher pay (Shapiro and Stiglitz, 1984, 1985; Bulow and Summers, 1986; FitzRoy, 1987). These theories can be used to reinforce our argument above that pay cuts by means of increased employment with a share component may be counter-productive in the face of individually rational worker response.[9]

4. Empirical Evidence

Turning finally to empirical evidence, Weitzman frequently appeals to the experience of Japan where performance-related bonus payments are a significant component of most workers' pay, and measured unemployment has been low by Western standards. However, Weitzman fails to point out that work sharing or variation of hours per worker is much more prevalent in Japan (FitzRoy, 1981, 1987; Tachibanaki, 1987), and this represents an alternative to cyclical unemployment. In addition to observed work sharing, Odagiri (1986) argues that 'invisible work sharing' or labor hoarding in long-term employment relationships may also be a major reason for low unemployment in Japan. The prevalence of enduring employment relationships in all kinds of firms in Japan (Hashimoto and Raisian, 1985), as well as the lack of evidence for short-run profit maximization, both suggest that labor allocation is unlikely to be influenced by the (still controversial) nature of bonus payments, but is more likely to be determined by efficient implicit contractual relationships (FitzRoy, 1987). In Britain, Blanchflower and Oswald (1986) have found no convincing evidence of any employment effects of profit sharing.

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On the other hand, there is a rigorous theoretical foundation as well as empirical evidence for microeconomic, motivating effects of profit sharing, which seems to be associated with both enhanced productivity and profitability, although causality remains unproven (FitzRoy and Kraft, 1985, 1986). Ironically, Weitzman regards such microeconomic benefits as of less importance than hypothetical employment gains, although the case for such gains purely through changes in the composition of earnings is, as argued above, far from persuasive.

5. Discriminating Partnerships

Meade (1986) has developed the Vanek-Weitzman model and other related ideas in various ways, including capital which raises additional problems. At one point (p. 109) he recognizes, in contrast to Weitzman, that existing workers would resist share (and pay) dilution by expanding employment. However, like Weitzman, he does not make it clear that the macro benefits of a share economy depend upon explicitly overcoming this resistance. But if this were feasible, then why not just lower wages?

Meade's final (Chap. VI) and preferred model of a "discriminating labor-capital partnership" comes closer to a cooperative with equity capital. The "discriminating" feature is a sort of two-tier pay scheme, with smaller shares for new partners in recessions as the key to reducing unemployment by avoiding the "insider-outsider" conflict which is inevitable when equal pay for all is demanded. Again it could be argued that if the inequality

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in pay inherent in two-tier schemes was acceptable to (organized) labor, then an extension of the (few) existing schemes with lower wages for "new hands" should also be able to solve the problem of unemployment.

Models of the conflict between employed (insiders) and unemployed (outsiders) which can block general wage reductions, such as Solow (1985) and Lindbeck and Snower (1986), do not actually consider the possibility of two-tier plans. There is of course a serious problem: employers can demand concessions from existing employees, or at least those without specific skills, by threatening dismissal and rehire at lower rates. Doubtless to avoid this kind of situation as well as for equity reasons, European unions have strenuously resisted "concession bargaining" or any other deviations from their policy of uniform pay or "wage solidarity".

Meade proposes an incentive for permanent employment to mitigate this problem. Redundant worker partners would retain their shares unless discharged "for cause", while voluntary quitters would forfeit theirs. Meade recognizes the moral hazard problem caused by the resulting preference for involuntary redundancy. If practicable, his scheme should generate worksharing instead of layoffs in cyclical downturns, but (like Weitzman) Meade does not discuss the intensive margin of employment. In fact, worksharing could also be encouraged by experience rating of unemployment insurance or "firm-based insurance" in a wage system, and worksharing is the main response to fluctuation in Japan. Worksharing also defuses the insider-outsider conflict in recession, because all existing employees on short time have an incentive to moderate

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wage claims to accelerate return to full-time work. A layoff response, in contrast, leaves still-employed (senior) workers with little motivation to reduce their claims for the benefit of (unemployed) former employees.[10]

Meade discusses some of the distributional conflicts which are likely to arise in the discriminating partnership. However, he does not consider the fundamental tensions and internal asymmetries due to differing mobility costs (or asset specificity) which arguably motivate capitalist contractual organization.[11] Caveats notwithstanding, Meade's addition of discrimination to the Ward-Domar-Vanek cooperative framework is an interesting idea which merits further study, perhaps more so than the rather unrealistic egalitarian cooperative which has received disproportionate attention in the literature.

Meade (1986, p. 135) notes that an "atmosphere of mutual trust" would be necessary for his partnerships to work. But such an atmosphere seems to be associated with long-term employment, worksharing and other features of Japanese industrial relations.[12] In general it is not clear why the employment and other benefits claimed by Meade cannot be obtained under less radical changes, provided the political preconditions for Meade's own proposal to work are fulfilled.

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6. Conclusions

The very different proposals to stabilize high employment by Meade and Vanek-Weitzman are both subject to the same kind of basic objection. To expand employment in Meade's partnerships, unequal compensation for the same work must be acceptable. But then a combination of two-tier wages and permanent employment should also be acceptable, and protect insiders in the same way. Worksharing instead of layoffs should then defuse the insider-outsider conflict under cyclical fluctuation, though senior workers would lose their relative advantage.

The working of the capitalist share economy depends on pay reduction through share dilution, at least in short-run expansion and adjustment. Automatic adjustment of "indexed compensation" under macroshocks in a share economy might reduce the transaction costs of bargaining over new wage rates.[13] However Weitzman himself regards this possibility as unimportant compared to the effects of his hypothetical permanent excess demand for labor. But this depends on the willingness of workers to take reductions for the benefit of outsiders, and there is little evidence for such an attitude even toward short-run pay cuts. Some kind of 'share illusion' might conceivably operate to save the scheme, based on the more impersonal nature of the adjustment process compared to discrete wage cuts, but this would be a weak foundation indeed for the strong claims which have been made in connection with the capitalist share economy.

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Footnotes

1. The basic idea (though with less extravagant claims) actually goes back to Vanek (1965), as Nuti (1986) has explained, but Weitzman does not acknowledge this prior work. D.M. Nuti (1985, 1986, 1987), has also provided careful critique from somewhat different (though complementary) points of view. Nordhaus (1986) and Rothschild (1986) have emphasized the implausibility of Weitzman's short-run adjustment with decreasing pay and expanding employment; this point is developed below. In contrast, reviewers such as Azardiadis (1985) make no mention of most of the problems with Weitzman's claims.

2. See Jacoby and Mitchell (1986) for such schemes, and Meade (1986) for a similar suggestion applied to sharing firms. Unions of course oppose lower pay scales for newly hired workers in existing two-tier schemes, and would undoubtedly demand universal increases under permanent excess demand and positive pure profits, even if employment were then to be reduced. Even without unions, individual workers could quit and accept (possibly covert) bribes or pay increases to rejoin their firms, until excess demand and pure profits were eliminated.

3. A general equilibrium model of monopolistic competition with this result is developed in FitzRoy (1986).

4. Hall (1986) actually finds predominantly constant returns in U.S. manufacturing.

5. See Nordhaus (1986) and Rothschild (1986). The benefits of aggregate wage flexibility are admittedly controversial (Beckerman, 1986), and permanent excess demand for labor in a share economy could _theoretically_ do more than such flexibility in absorbing any unemployment created by macroshocks or structural change. However, for rather obvious reasons developed below, the notion of permanent positive excess demand (which also implies positive pure profit), is not a very plausible state of the world, to put it mildly.

6. Positive excess demand is usually described as a disequilibrium, and thus _a priori_ expected to be transitory rather than permanent. Many reasons for this have been spelled out here; see also Nuti (1985, 1986, 1987) and Nordhaus (1986).

7. Strong evidence for union capture of monopoly rents in the U.S. is provided by Salinger (1984). Furthermore, wages for non-union workers in U.S. manufacturing are positively related to profits even when a large number of individual and industry characteristics are controlled for (Dickens and Katz, 1986). This suggests that some kind of implicit rent sharing is already operating.

8. Tracy (1986) provides an example of a union bargain where sharing has _no_ real effects.

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9. In his response to symposium critiques, Weitzman (1986) misrepresents and then dismisses efficiency wage theories. He also provides no reply to the point made by Nordhaus (1986) and also Nuti (1985, 1986), which is developed above, that incumbent workers are most unlikely to accept lower pay through share dilution due to new hiring. Nor does he (anywhere) face up to the logical sequal: if they would accept cuts, then why not wage cuts?

10. See FitzRoy (1981, 1987) for development of this idea.

11. See FitzRoy and Mueller (1984).

12. See Tachibanaki (1987) and FitzRoy (1987).

13. As pointed out by FitzRoy (1980) and others.

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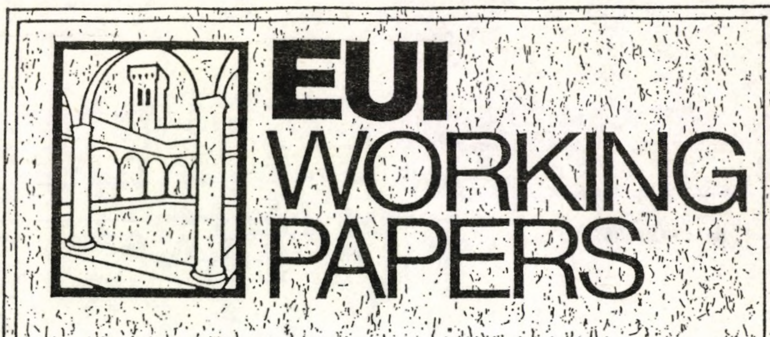

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