THE SHARE ECONOMY

CONQUERING STAGFLATION

Martin L. Weitzman

THE SHARE Economy

CONQUERING STAGFLATION

Martin L. Weitzman

HARVARD UNIVERSITY PRESS
Cambridge, Massachusetts
and London, England
1984

Printed in the United States of America
10 9 8 7 6 5 4 3 2 1

This book is printed on acid-free paper,
and its binding materials have been chosen
for strength and durability.

Library of Congress Cataloging in Publication Data

Weitzman, Martin L., 1942–
The share economy.

Bibliography: p.
Includes index.
1. Unemployment. 2. Business cycles.
3. Profit-sharing. I. Title
HD5710.W45 1984 339.5 84-665
ISBN 0-674-80582-8 (alk. paper)

Designed by Gwen Frankfeldt

Preface

BECAUSE I BELIEVE THE message of this book is important, I have endeavored to make it accessible to a wide audience. We do not have to live with stagflation if we do not want to. The essential idea of the book — the share economy is a robust natural enemy of unemployment and inflation — is actually quite simple. My intention is that a motivated reader with some background in elementary economics should be able to understand the basic principle of the share economy, and even some of the fine points. For the trained economist in a hurry, chapters 7 through 9 contain the gist of what is original, the central theme being that any compensation system possesses significant macroeconomic externalities. I like to think, however, that there are pertinent novelties of interpretation, exposition, and emphasis sprinkled throughout the book that are also of professional interest.

The subject of economics, especially macroeconomics, is currently in a state of disarray and controversy to a degree that the profession has not witnessed for a long time. Far from trying to smooth over these turbulent waters, I hope in passing to convey some flavor of the excitement—and vitality—of political economy today. I also wish to affirm, by example, the central relevance of down-to-earth economic theory for dealing with crucial issues.

Several colleagues kindly gave me detailed comments on an earlier version. I am especially grateful to James S. Earley, Evsey D. Domar, Jon Cohen, James E. Meade, Tibor Scitovsky, John Roemer, Lester C. Thurow, Mervyn King, Carl Lundgren, Tsuneo Ishikawa, and Staffan Burenstam-Linder. Their views, of course, need not coincide with my own.

Excellent assistance was provided by MIT graduate students Michael Kuelwein, Eduardo Borenstein, Christine Roemer, and Mark Bils. The research was aided by a grant from the National Science Foundation.

At Harvard University Press I have been blessed with the editorial skills of Michael Aronson and Joyce Backman, who worked with me as an effective team to improve the manuscript.

To my family I am grateful for tolerating the long nights and disrupted days which this effort entailed. I hope that my activist wife Dorothy approves the message of the book and that my daughter Rodica is placated by seeing her name in print.

Contents

1
There Is a Better Way

THE MARKET ECONOMIES have long been racked by serious episodes of persistent unemployment and slow growth. Following Keynes, governments learned to combat depressions through expansionary monetary and fiscal policies. Although this approach was reasonably successful after World War II, especially in the earlier decades 1945–1965, throughout the last two decades unemployment and inflation have become more and more tightly intertwined. Periods of high joblessness and periods of high inflation now alternate, and both frequently occur simultaneously.

The reasons for this worsening economic performance are not yet fully understood. But ironically they may have something to do with the very expectation that Keynesian policies and other humane measures will be used to help unemployed people and bankrupt businesses in a faltering economy. The nasty combination of prolonged stagnation and inflation has been given an equally unpleasant name: stagflation.[1]

Stagflation is an especially difficult disease to cure because the macroeconomic treatment for one symptom of the malady aggravates the other. The basic way to lower unemployment and speed growth is to stimulate the economy by expansionary fiscal and monetary policy. But the heating-up process seems to accelerate an inflationary momentum that becomes difficult to choke off. And, unfortunately, the basic course of treatment for inflation is to cool down the economy by contractionary policies that cause mass unemployment, slow growth, low productivity, budget deficits, debt crises, and trade imbalances. The result is a "political business cycle" in which countries with mixed economies tend to lurch back and forth from one policy extreme to the other, polarizing the electorate and preventing society from dealing effectively with its underlying real problems. By any reckoning, the direct and indirect costs of stagflation are immense. It seems clear by now that we need new approaches and that the economic system itself is due for a fundamental overhaul.

The thesis of this book is simple. A basic change in employee-compensation arrangements is required to assure that reasonable price stability is compatible with reasonably full employment. So long as we persist in restricting policy options to the usual measures of aggregate fiscal and monetary policy, we will not be able to conquer stagflation. That task is well beyond the range of conventional tools of macroeconomic management.

The principal economic problems of our day have at their core not *macro* but profoundly *micro* behaviors, institutions, and policies. The war against stagflation cannot be won at the lofty antiseptic plane of pure macroeconomic management. Instead, it must be fought out in the muddy trenches of fundamental micropolitical reform. What is most desperately needed is an improved framework of incentives to induce better output, employment, and pricing decisions at the level of the firm.

Stagflation is not inherent in laissez-faire private enterprise per se. Rather, it is caused by one particular way of paying labor: namely, the compensation of a firm's employees is tied to an outside unit of account (typically money, or perhaps a cost-of-living index) whose value is independent of the firm's well being and of anything the firm does or can do. Stagflation is an unfortunate consequence of the wage-payment system that may sometimes be temporarily offset by good luck or by judicious macroeconomic policy, but eventually necessitates basic reform of the economic mechanism.

The lasting solution to stagflation requires going inside the workings of a modern capitalist economy and correcting the underlying structural flaw directly at the level of the individual firm by changing the nature of labor remuneration. An alternative payment system where it is considered perfectly normal for a worker's pay to be tied to an appropriate index of the firm's performance, say a share of its revenues or profits, puts in place exactly the right incentives automatically to resist unemployment and inflation. Furthermore, it is high time we introduced just such a "natural enemy" and went right after stagflation instead of beating around the bush with clumsy, unreliable macroeconomic instruments whose scope is limited, at best, to shifting between symptoms.

4
The Share Economy

The nature of the required wage reform is not terribly complicated. Essentially the issue is to turn a wage system (which has the underlying attribute of few or no job vacancies at any time) into a share system (having the basic property that there always exists a significant number of unfilled job vacancies). These two systems possess fundamentally different dynamic characteristics. The principal secret for fighting stagflation lies in taking advantage of the vastly superior natural macroeconomic properties of a share system.

To focus the reader's attention, at some risk of oversimplification, let me at once give a concrete if highly idealized example of what I have in mind.

Suppose that wages plus fringe benefits of the average General Motors automobile worker come to $24 per hour. This means that the cost to GM of hiring one additional hour of labor is $24. The extra hour of labor is used to produce more automobiles, which are then sold to yield increased revenue. If the increased revenue exceeds the increased cost, more workers will be hired; in the opposite case, workers will be laid off. Since GM is trying to maximize profits, it will take on (or lay off) workers to the point where the *additional* revenue created by the extra hour of labor is neither more nor less than the additional cost, in this case $24. (The *average* revenue per hour of labor will naturally be higher, say $36, to cover overhead, capital, profits, and the like.)

So far the story is standard. Now imagine that the United Automobile Workers Union decides to try for a somewhat unorthodox labor contract. Instead of having each employed worker receive a wage of $24 per hour, the UAW and GM agree that each of the (say) 500,000 employees will receive as compensation a two-thirds share of GM's average revenue per worker. In effect, the UAW is allowing GM's revenue pie to be sliced into two pieces, a two-thirds piece going to labor and a one-third piece to management. (In this example, GM's revenue pie is $18 million per hour ($36 × 500,000), while the total share going to labor is $12 million per hour ($24 × 500,000 or 2/3 × $18 million).) At first glance there seems to be no difference: in both cases the employed worker is compensated $24 per hour while management receives $12 per worker-hour to cover other costs and obligations.

But how does GM see things now? Under the old contract, the company had no incentive to expand employment because the cost of an extra worker equaled the additional revenue that worker brought in: $24 per hour. Under the new contract, if GM hires an extra worker its total revenue pie goes up as before by $24 per hour (from $18 million to $18,000,024), but its total labor cost (the slice going to labor) now increases by only two-thirds of $24, or $16 per hour (from $12 million to $12,000,016 = 2/3 × $18,000,024). If the company can find an extra worker to hire, it now stands to clear a profit of $8 per hour. (This comes about because the hourly pay of each of the 500,001 GM employees declines by $8/500,001, from $24 to $23.99998.) Under the new contract GM has an incentive to resist layoffs and, with available unemployed labor, to expand production. As production is expanded, GM automobile prices must come down because more Chevrolets can be sold only if their price is lowered relative to Fords, Toyotas, and the rest.

Next suppose that not only GM but all of the Fortune 500 companies go onto the new contract system. Now as each firm expands, its new workers spend their wages on the products of other firms, creating new demand for autos, enlarging the size of GM's revenue pie, increasing each GM worker's remuneration back up to $24 per hour (or even above $24, since revenues typically expand faster then employment in a recovery) and encouraging further economic expansion.

The expansion ends when every qualified person in the economy seeking work has a job. In each industry the invisible hand of competition and the visible hand of collective bargaining determine compensation and employment levels, just as they have always been determined. The only difference is that now there is full employment, and labor and management are negotiating about the "sharing ratio" (2/3 in the example) instead of the money wage ($24). The average worker, as well as the economy as a whole, is better off under a revenue-sharing system because of its built-in bias toward eliminating unemployment, expanding output, and lowering prices.

Back in our world, follow that new Chevrolet as it rolls off the Detroit assembly line toward its destination in a Philadelphia dealer's parking lot. The GM dealership itself is housed in a simple one-story building internally bisected by a cinderblock wall. The front part of the building is the customer showroom. On the other side of the wall, in the back of the building, is the service department. They are connected by a single unobtrusive wooden or metal door, rarely used. Most of the traffic goes through the large inviting glass doors of the customer showroom and of the service department waiting room which directly, and separately, connect each of them to the outside world.

If not an aesthetic masterpiece, the customer showroom is at least clean and pleasant. It is well lighted, with large picture windows and nice drapes. The walls are freshly painted. Temperatures are comfortably maintained year round by a good heating and air-conditioning system. Carpets and plush armchairs are strategically placed in areas where the conversation might turn to talk of a purchase. Perhaps there is free coffee and doughnuts. We are so accustomed to this sort of physical environment that we hardly take notice of it or think twice about the effort required to maintain it. Even the washrooms are scrubbed clean.

The customer is well treated by the salesperson, with prompt, courteous service given in an almost ingratiating manner. If the buyer's financial situation is a relevant consideration, the salesperson is understanding and really tries to help by putting together a sufficiently flexible time payment plan to meet the appropriate constraints. An entire organization, euphemistically designated the "General Motors Acceptance Corporation," has been especially created to aid the customer in such matters. Then there is the product itself. The automobiles are available in a wide variety of models and colors, with a great many special options. The salesperson appears to be genuinely interested in explaining the options and helping buyers to choose just what they want. There are so many different combinations that it seems overwhelming at times, even with the assistance of that beautifully illustrated glossy brochure. Certainly the General Motors Corporation has gone out of its way to anticipate what its customers might want and to help them take prompt delivery of a fine product that is well suited to their particular needs and desires.

Now pass through the inconspicuous, infrequently used door that directly connects the customer showroom with the service department. The first thing to notice is that the two sides of the separating wall look quite different. The showroom side was clean and freshly painted. The back side is so dirty that it's unclear when it was last painted. All the working areas of the service department look filthy; obviously no one places much priority on keeping the place clean at all. There are a couple of small windows whose cracked panes of glass are opaque with accumulated dust. Bare lightbulbs provide glaring illumination in what is generally a dim environment with pockets of semidarkness everywhere. This part of the building has no air conditioning and the heating doesn't function very well—so it is hot in the summer and cold in the winter. The service department washroom is grimy and unkept.

Human relations are fair here, but the employer clearly does not go out of his way to please the employee—if anything it is the other way round. There is no thought about how to make the work more interesting or better suited to the employee's wants. Hiring and firing decisions are made almost exclusively on the basis of narrow economic considerations. The special financial need of an employee or the idea of using more flexible time payment plans (such as the possibility of employees' borrowing money) never even enters the employer's mind.

The artificial cinderblock wall does more than physically divide the dealership building. It separates two different worlds of human relations. The automobile dealer acts as if he really cares about his customers. But he doesn't seem to care at all about his workers.

The essence of the contrast is epitomized by the following thought experiment. Suppose a man, who happens to be a qualified mechanic, enters the front of the dealership building intending to purchase an automobile. In all likelihood he will be eagerly sold as many cars as he wants to buy at the going price. But if that same man goes to the back of the building—or to the GM plant—seeking a job at the current wage, chances are he will be turned down.

The difference between the treatment of consumers and workers is not accidental. Although naturally modified by circumstances of time and place, the observation that consumers are more highly favored than workers reflects a deeply ingrained pattern characteristic of advanced capitalist countries (with the conceivable exception of Japan). That this is hardly a feature of all economic systems is immediately demonstrated by the example of socialist countries, where the pattern is reversed: there consumers are less gratified than workers.

A strong economic determinism underlies this striking asymmetry of relations in the capitalist system. And, as will be shown, it is very much connected to the form of labor payment. Just as a wage system exhibits weak resistance to unemployment and inflation in the economy at large, so it demonstrates a pronounced discrepancy between the treatment of workers and of consumers on the microeconomic level. In contrast, the share macroeconomy exhibits strong natural tendencies toward full employment and price stability, while its microeconomic counterpart turns out to be a firm whose managers lavish as much attention on pleasing their workers as on satisfying their customers.

These are strong claims that at this stage must sound strange or even astounding. How can it possibly be that a mere change in the formula by which labor is paid can have such profound economic and social consequences?

2
Three Major Decisions of the Firm

To understand what stagflation is really about and why wage reform is likely to be a crucial component of any genuine solution, it is useful to comprehend more fully how a market economy works—and sometimes doesn't work. The first step in that direction is to cut in at the micro level and analyze the way a firm makes three major economic decisions: (1) how much output to produce; (2) how much labor to hire; (3) what price to charge.

Because all important economic actions originate here, the firm is the vital unit of an economy. Actually, the firm *is* the economy in a microcosm. So anyone who wants to comprehend the functioning of an economic system should begin with a thorough understanding of how a typical firm operates.[1]

At the center of modern industrial capitalism is a relatively small number of large-scale firms that set the tone for the entire system. I have in mind such companies as the Fortune 500, a group that accounts for over 80 percent of sales in the industrial sector. If these big corporations are doing well, so is the economy, and vice versa. Neither pure monopolists nor perfect competitors, these "competitive monopolists" or "monopolistic competitors" cover the product spectrum with a shingle-like pattern of overlapping market areas within which they compete vigorously for customers.

For a variety of reasons, including dynamic learning effects, modern mass-production methods tend to be characterized by economies of scale or average costs that decline as output is expanded over the long run. In most industries the cost per unit of output is less for a high-volume producer than for a low-volume producer. From automobiles to books to computers—and on through the product alphabet—every business person knows that unit costs typically go down with the size of the production run.

The propensity for unit costs to decline with volume creates a strong tendency toward concentration of ever bigger firms producing larger outputs. Counteracting this tendency toward bigness is the fact that not all people want exactly the same thing—some may prefer one firm's particular product, while others like what is offered by a rival firm. You may like the peppiness of a Ford Mustang while I want the service reliability of a Toyota Corolla. A Maytag washing machine is initially more expensive to buy than a Whirlpool, but it saves on future energy and maintenance costs. The IBM computer is better for business uses, but the