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"PROFIT-RELATED PAY -SOME RESERVATIONS
NEW DIRECTIONS IN ECONOMIC POLICY"

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A consensus of sorts would appear to have been reached in the UK that the control of pay is central to the achievement of a return to full employment. This is explicit in the Alliance proposals for a tax-based incomes policy and implicit in the Labour Party's requirement of voluntary cooperation from unions in any future expansionary measures. For the government it has until recently taken the form of deregulating the labour market and leaving the discipline of competition to control pay. More recently they have embarked on a course, charted by Professor Weitzman, to change the institutional basis of the remuneration system itself. The consensus is obviously far flung but certainly gone are the heady days of Orthodox Keynesian economics when unemployment could be mopped up by a general reflation of demand alone. Gone also are the lofty pretensions of Monetarists that following a prescribed growth in the money supply path will suffice to ensure stable growth of nominal demand and permit full employment at stable prices. The 1970's experience of fuelled (only partially carbon-based) inflation hit the first one on the head and the 1980's experience of sustained high unemployment within a setting of substantially steady growth in nominal demand (and of course unsteady growth of money supply measured by the broad aggregate £M3) has caused a rethink of the second. If we split the growth of nominal GDP into its real and inflation components for recent years it is clear that it has been quite sufficient to rapidly reduce unemployment were it not for the fact that wage rises stubbornly persist at over 7% per annum and hence channel demand into higher pay and prices rather than into extra employment and output growth.

The New Keynesianism has eschewed fine tuning of demand for employment purposes for a steady and moderate growth of money expenditures. This is no different to the objectives of the MTFS but with the operational difference that monetary control is no more than a component of the package that does not subordinate fiscal policy. This is married with a wide range of wage fixing policies to restrain money costs and channel the money demand growth into output and employment growth. This is a reversal of the previous assignment in which demand was to be varied to sustain full employment and incomes policies were brought in to hold inflation under control. It is on the need for wage fixing policies that has marred a full reconciliation of government and opposition views.

Indeed in recent years the popular debate has been remarkably polarised with the Chancellors assertion that the real wage is too high to make extra output profitable for firms and that a 1% reduction in it would result, in time, with a 1% expansion in employment. For him unemployment is classical and not demand deficient. New Keynesians would counter that it is the rapid growth of money wages that limits a demand expansion and gives us a high NAIRU and that slowing this down...
would not materially affect real wages. For them the money wage is the outcome of collective bargaining and real wages are determined by the ensuing price markup. It is the level of unemployment that ensures that the real wage demanded by workers is consistent with the real wage determined in this way. The real wage is not determined within the labour market and it is anyway of only secondary importance because it is endogeneous to the interaction of markets along with the level of output which it is purported by the Chancellor to explain. In this the New Keynesians are most certainly right. A reduction in money wages (or more realistically their rate of growth) is anyway the only practicable means available to the present government of reducing real wages (their rate of growth) since a rise in the price level rather conflicts with their objectives on inflation control. Apart from reducing the component due to inflationary expectations it is clear that the government has not presided over a moderation in money wage growth. A Treasury simulation suggests that if it could then real wages would be lower and employment higher given a constant level of money demand. But the main drive comes from the higher real demand because of the consequent fall in prices. In combination with a higher monetary demand the same simulation generates a far stronger reduction in unemployment.

In his 1986 budget Nigel Lawson made a declaration of intent to free up the labour market. In it he embraced the ideas of Martin Weitzman - outlined in his book the share economy. The fact that Weitzman is a reconstructed Keynesian further emphasises the convergence in thinking previously mentioned but in contrast Weitzman does not see the adoption of his plan as leading to a reduction in real wages under present circumstances. The fact that Weitzman is an American economist (hailed by the New York Times as providing possibly 'the most important contribution to economic thought since John Maynard Keynes's General Theory') interestingly continues a tradition of applying the ideas of American Guru's to policy making in the United Kingdom. The notable thing about the 1987 budget statement for me was the way Weitzman stepped in and Milton Friedman was thrown out. Who said there is no alternative? Let us now turn to the ideas of the share economy.

THE SHARE ECONOMY

In common with other Keynesians Weitzman sees the economy as behaving badly in response to a shock in demand of the kind experienced in the UK in 1980/81 (when there was a very sharp reduction in the rate of growth of nominal GDP). Rigidity in money wages (or their rate of growth) causes predominantly quantity rather than price adjustments in the short run (which might be quite extended). But he argues that this result arises because of the remuneration system employed - the wage system - in which a workers income is predetermined and independent of any index of a firms well-being. Should remuneration be tied to such an index then a capitalist economy would function at full employment, impervious to such shocks, - indeed a Keynesian economy
would be transformed into one simulating Classical behaviour!

To get the flavour of his argument, and perhaps to appreciate its origins, it is useful to consider the theoretical framework in his book and his 1985 AER article. This is one of an imperfectly competitive set of firms in goods markets, each facing a perfectly elastic supply of labour.

![Diagram showing supply and demand curves with excess supply and marginal cost and revenue points.]

Being imperfectly competitive profit maximising firms will equate MR to MC at a level of output for which price exceeds marginal cost. Each firm would like to sell more at its profit-maximising price but is constrained by a lack of buyers. Such a firm does not have a supply curve in the usual sense but it is as though it experiences an excess supply of output. It will not be profitable for it to eliminate this excess supply by price adjustment but instead it will court the consumer by advertising and cultivating brand loyalty through customer friendly policies (‘the customer is always right’). Indeed although the consumer is sovereign in a perfectly competitive world insofar as consumers dictate the structure of output, he is much more royally treated in an imperfectly competitive world because a red carpet is thrown out to greet him. Workers on the other hand are paid their MRP and are treated with some indifference by employers because at the margin they contribute to the firm exactly what they take from it. Fluctuations in product demand will be met by hiring and firing of workers as MRP varies against the fixed wage. If, as many studies suggest, MC is constant over a wide range of output and also demand is iso-elastic then fluctuations in product demand will be met by varying output at an unchanged market price. We have the simple orthodox Keynesian model in microcosm. As the composition of consumer budgets change so firms in declining markets will lay off workers who will be absorbed by firms in expanding markets. Labour is reallocated, as Reddaway found, predominately by job availability. Some categories of worker may find themselves in excess supply if their relative wages do not adjust but the mechanism does work well and reallocated labour on a massive scale throughout the prosperous 1950’s and 1960’s. But in the face of a fall in aggregate demand many firms would be laying off workers and reducing
output until the multiplier process was exhausted in some new under-employment equilibrium. In that state firms would still be indifferent to their workforces ($W = MRP$) at the margin but a fortiori they would be unaffected by the availability of the unemployed. Only when wages have fallen will individual employers wish to hire more workers. Of course the usual reservations apply namely the redistribution of income involved may further weaken aggregate demand and hence individual firm demands and anyway money wages may take some time to adjust.

So how can a simple change in the remuneration system fundamentally alter these response characteristics? As a student of planned economies Weitzman was well aware of the contrast between the excess demand for consumer goods in soviet economies and the excess supply that characterises the west. If you want to make firms queue up for labour rather than see a dole queue of workers then you must make the marginal cost of labour low relative to its $MRP$, preferably zero. Of course this would involve a massive increase in realised profits if only demand held up to buy the same output and workers could be induced to supply the same labour. Both could be assured if a pure profits tax could be levied on firms and redistributed in favour of workers in proportion to their former earnings. Unlikely as this may seem it is isomorphic to a pure profit-related pay scheme - a watered down example of which was introduced by Nigel Lawson in his 1987 budget proposals. Like other schemes that have gone before it designed to give workers a stake in their firm, this one might be expected to promote an identification of workers with their firms and improve motivation and productivity but more importantly it removes the indifference of employers to their workforce. Some share ownership schemes can provide a source of finance for firms and workers as capitalists will be courted but in this scheme they will be desired in their role as workers. If all firms paid only profit shares then, at full employment, they would each have an excess demand for workers.

Paradoxically the government that has most laid to rest the concept of full employment as a policy objective is flirting with a proposal which, if taken to the limit would provide full employment in a sense never really experienced in the UK even during the prosperous 1950's and 60's. William Beveridge argued that “full employment... means always having more vacant jobs than unemployed men... It means that the jobs are at fair wages, of such a kind, and so located that the unemployed men can reasonably be expected to take them; it means by consequence, that the normal lag between losing ones job and finding another will be very short. The proposition... means that the labour market should always be a sellers market rather than a buyers market” (Full Employment in a Free Society, 1945). The average duration of unemployment has been in excess of one year even during the ‘full employment’ 1950’s and 60’s in the UK!

A fall in the demand for an individual firms output would not
cause it to lay off workers because its shareholders would lose a part of any value-added that was lost. Instead it would cut its prices so long as the MRP was still positive. Workers remuneration would fall since they have a fixed share of a declining pie and they are the same in number. Hence some of them will voluntarily leave to join other firms that are eager to employ them at the competitive remuneration. This process will continue until the MRP and remuneration in the declining firm was restored. Labour will voluntarily reallocate itself in response to the changed product demand. Utopian isn't it!

The result does not hang on going fully over to a share system, it occurs wherever a significant part of a workers remuneration is tied to the fortunes of the firm. For example if workers in a firm receive £100 per week under a standard wage contract and the average revenue product of labour is £200 (value added per man) then a switch to a base wage of say £50 plus a 50% share of operating profits (£100 per worker) to be split up amongst the workforce will leave workers indifferent between the two contracts. Remuneration per worker is now equal to:

\[ B + s \left( R - B \cdot E \right) / E \]

where 
- \( B \) = base wage
- \( s \) = the negotiated profit share
- \( R \) = firm revenue
- \( E \) = employment

But from the firms point of view an extra worker will now add £100 to revenues but only £75 to costs (£50 base wage + 50% of the extra operating profits of £50). It can therefore add £25 to shareholders profits by taking

on an extra man and increasing output. Notice that total shareholder profits now equal \( R - B \cdot E - s(R - B \cdot E) = (1-s)(R - B \cdot E) \). They are at a maximum when \( \frac{d \text{PROFIT}}{dE} = (1-s)((dR/dE)-B)=0 \) ie when \( dR/dE = B \)

In the above example \( B=£50 \) so employment will be extended until \( \text{MRP}=£50 \). Note the irrelevance of the share coefficient 's' in this - a pure profits tax does not affect the behaviour of the firm.
We can look more formally at the macroeconomics of sharing with Weitzman's 1985 AER model--

Let aggregate demand be given by $V = \alpha A + \beta \frac{M}{P}$ where $\alpha$, $\beta$ are the usual multipliers

Let aggregate output be given by $Y = \xi(L-F)$ where $\xi$ = MPL, $L$ = employment

(Each firm is a microcosm of this).

Let $V*$ and $L*$ be fixed levels of full employment output and employment respectively so that $Y \leq V*$ and $L \leq L*$

For simplicity let $\mu$ be the common mark-up coefficient for each firm ($= e/(e-1)$)

Let $W$ be the wage paid. For a wage system this is total remuneration but for a share system it is the lower base wage.

For each firm $MR = P/\mu$ and $MC = W/\xi$. Profit maximisation requires $P = \mu W/\xi$.

Define the tautness of the system as $t \equiv Y-V*$ where $t > 0$ represents excess demand for labour

and $t < 0$ represents excess supply.

Note that for positive tautness the economy behaves classically with $P$ determined by putting $Y*$ into the aggregate demand equation. For negative tautness we have a Keynesian underemployment equilibrium where $P$ unaffected by $\alpha \beta$ instead via wages.

For negative tautness it is demand that determines output and the lower is the base wage the greater the desired output of firms. If the base wage is sufficiently low and most firms use a share system then the economy will typically operate at full employment with excess demand for labour. A wage system will typically operate in the negative tautness region where manipulation of 'A' and 'M' will allow a boost to real output if only the money wage could be taken as given. Wage push (or adverse supply) shocks will raise prices and reduce real demand and output. Under a share system, with positive tautness, successful wage push in an individual firm will cause it to expand its employment and output. This is because it experiences an excess demand for labour (making it want to suck in more workers) and the higher than competitive wage now being offered acts as a
magnet to workers in other share firms. The higher output must be sold at a lower price and the process will continue until workers total remuneration is reduced to the competitive level. Note the contrast. Wage push in a wage system will not raise the real wage but it is individually rational for any one group of workers to attempt it (since if others do not the pushing group would experience higher real wages). In a share system wage push by an individual group of workers is irrational. It will be undermined by dilution of the profit share and will only weaken the firm. But if all workers did it in tandem they would arguably succeed.

Short -run behaviour of both systems.

<table>
<thead>
<tr>
<th>Variable</th>
<th>( t &lt; 0 )</th>
<th>( t &gt; 0 )</th>
</tr>
</thead>
<tbody>
<tr>
<td>( Y ) (both systems)</td>
<td>( \alpha A + \beta M \frac{\delta}{\mu W} )</td>
<td>( Y^* )</td>
</tr>
<tr>
<td>( P ) (both systems)</td>
<td>( \frac{\mu W}{\delta} )</td>
<td>( \frac{\beta M}{(Y^* - \alpha A)} )</td>
</tr>
<tr>
<td>( W/P ) (wage system)</td>
<td>( \frac{\delta}{\mu} )</td>
<td>( \frac{W(Y^* - \alpha A)}{\beta M} )</td>
</tr>
<tr>
<td>( W/P ) (profit-sharing system)</td>
<td>( \frac{(1 - s)\delta + sY}{\mu L} )</td>
<td>( \frac{(1 - s)W(Y^* - \alpha A) + sY^<em>}{\beta M L^</em>} )</td>
</tr>
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</table>

In the long run both systems converge to the same full employment level of output, employment and real wages (money wages on the one hand and base wages and share parameters on the other will adjust to remove any disequilibrium). This seems plausible enough and will not be considered here. One qualification is that if the share system enhances identification of workers with their firms and is more prone to be at full employment the n investment might be higher with the long run consequences that this entails.

THE LAWSON PROPOSALS.

IN THE BUDGET OF MARCH 1987 the Chancellor proposed that half of profit-related pay (PRP) will be free of income tax up to the point where PRP is 20% of pay or £3000 pa, whichever is lower. For a married man on average pay the relief would add about £6 per week to take-home pay*, equivalent to 4p off the basic rate of income tax. The relief will be available to all private sector employees paying income tax through PAYE provided that they are included in a PRP scheme registered by their employer with the Inland Revenue. For a scheme to qualify for tax relief it must (a) show a clear link between audited profits and PRP.

* 30% of £10,000 - £2000 PRP, £2000 would be exempt from income tax at 27%, making a tax saving of £270 pa.
(b) New recruits and part-timers may be excluded, but at least 80% of the other employees in the employment unit must be covered by the PRP scheme.
(c) Prospective PRP must be at least 5% of the total pay of participating employees.
(d) A scheme must last for at least one year.

The proposals mooted by the Chancellor at the NEDC meeting of May 1986 had involved a significant proportion of income being profit-related in order to get tax relief (a Weitzman sized 20% being quoted in an example) and hence involved a wholesale conversion of remuneration from a wage system to a share system. This was dropped in the face of a widely held view amongst employers and industrial relations experts that it was unworkable. The Green Paper of July 1986 allowed a minimum of 5% to be profit-related. This was a significant innovation since it will permit the conversion of annual pay rises to PRP bonuses. Over 3 or 4 years these may compound until some 20% of pay is profit-related.

The original NEDC scheme also envisaged giving tax concessions only to schemes lasting for three years. This was cut back in the green paper and the budget to one year - although the government expressly hoped that schemes would last for several years. I will argue below that relating pay to profits for a period of only one year is counter productive to the scheme although, in conjunction with the low 5% threshold level for PRP, it undoubtedly makes it more likely to be taken up.

The exemption of new recruits (for up to three years) was in response to the expressed view that employees would resist recruitment under a share scheme since it dilutes their remuneration. It therefore introduces a discriminatory element along the lines of Meade and is discussed below.

CRITICISMS OF THE SHARE ECONOMY AND PRP PROPOSALS.

Informal evidence supporting Weitzman has so far only come from his critics! Saul Estrin’s estimate of the labour demand equation for the John Lewis Partnership found a wage elasticity of demand of -0.66 (this is from 1970-1985 data). He entered wages and bonus separately and the coefficient on the bonus was insignificant, as it should be since it is the base wage according to Weitzman that fixes the marginal cost of labour. The bonus currently amounts to 20% of remuneration. “ If John Lewis is paying average wages some 20% below the market rate and making up the remainder in bonus, that would imply an augmentation of employment in the order of 13% of the labour force, some 4000 additional jobs.”

However the JLP was easily the high paying firm in the retail store sector, paying some 7% above the mean on wages alone and 23% higher inclusive of bonus. Furthermore Estrin’s study could find no significant differences between the process driving hiring decisions in John Lewis and in the rest of the sample (Tesco’s, Marks and Spencer, Sainsbury’s, GUS) and treating JLP as just one observation he found that
the elasticity of demand for labour was negligible. He viewed the bonus as "a dividend payment to the collective equity holders in the partnership." In a normal wage capitalist firm profit is a residual and it does not determine employment except in the long run- hence its lack of a role in the employment function.

In a study of UK engineering and metal working firms (1978-82) Estrin and Wilson did however tentatively find that profit sharing firms (21 out of a sample of 52) had ceterus paribus 13% higher employment and 4% lower pay. Blanchflower and Oswald (from where I took these results) are doubtful of them since bonuses were typically only 3% of pay for share firms. But their own research suggests that profit sharing of a share kind has no employment effects so that Estrin and Wilson's result, if it is not a statistical illusion, must come from the cash based schemes, as advocated by Weitzman.

Wadhani found that Japanese bonuses were related to base wages, to corporate profits and also to bonuses in the previous year (indicating a bonus smoothing policy). However he doubted that the profit sharing that appeared to be taking place could explain the consistently low unemployment rate in Japan. Whereas for Weitzman Japanese firms do not shed labour in response to adverse shocks because labour is predominantly in excess demand Wadhani holds

(a) that the 'lifetime employment system' is more a consequence of substantial government subsidies to retained regular workers who are temporarily made idle.
(b) part-time workers who are laid off tend not to enter the unemployment figures
(c) there is considerable evidence that labour is hoarded rather than profitably utilised in recessions. (Deviations in labour productivity growth from suggesting in the mid 1970,s some 5 to 15% being surplus to requirements).
(d) survey results suggest that the proportion of Japanese firms who report a shortage of skilled labour is typically much less than that in the UK.

More formally he tested the following predictions of Weitzman's model:

(1) Deviations of actual output from potential output do not depend on aggregate demand.
(2) Inflation is independent of import price shocks and of wage push.

Actually he tested considerably weaker versions in which these tendencies were held to be greater for Japan than for the main wage system countries and for pre-war Japan- which did not possess a bonus system. Broadly he finds that Japan does not differ significantly in these respects from wage countries and where differences do occur they are perversely at odds with a model share economy.

As for the PRP proposals themselves it seems to me that the original NEDC scheme was much better in one important respect than those
that followed. Fixing the profit share for one year ahead does not seem enough. It is not hard to forecast profits that far and it leaves scope for a cosmetic scheme to be drawn up in which remuneration is determined by collective bargaining as before but it is broken down into a base and a share component which will gain tax exemption with the worker bearing no real risk and the firm regarding the marginal cost of labour as total remuneration and not just the base wage. Presumably the scheme can be drawn up each year with different parameters that de facto preserve the wage system but take advantage of the public purse.

Only over several years is there the uncertainty which characterises the problem to be solved. If the share coefficient is fixed for a five year span then firms will have in mind a time path of profits (as does the stock market when it values its equity) and of the profit component it will be paying its workforce. In negotiating its base wage it will have to bear this profile in mind. It may wish to engage in bonus smoothing according to some prearranged formula but, and this is the important point, it can't ignore that, if it is to stabilise remuneration, it must fix its base wage in some manner countercyclical to profits. In good times then it would have to set base wages low and vice versa. Paradoxically this would make the economy oscillate between a share system in buoyant times and a wage system otherwise. However this would be to go too far. So long as workers can engage in term borrowing reasonably easily short term variability of income is less of a worry and tax incentives will persuade some to take the risk. Firms will not be keen to vary base wages in response to profits because of the usual difficulty of getting them to go down at the right time. Hence participant firms would be less likely to provide cosmetic schemes over five years and are declaring their willingness to allow pay to vary with profitability. This would answer somewhat the most powerful criticism of the share economy- that firms choose to pay the going rate to a worker because not to do so undermines internal morale and productivity. In this case the pay structure itself enters the production function and there is some 'fair' set of differentials that maximises output for any given labour and capital inputs. Were this not so, as I have shown, a share firm will find it more profitable to maintain employment (and output and drop price) than to cut it in the face of declining demand for its own product. With an efficiency wage imposing a constraint the firm will restore normal remuneration as soon as possible and will not be content to see its workers voluntarily drift off until a competitive remuneration is restored by the automatic processes of a share economy. For here the marginal productivity of labour will itself decline and impose losses on the firm. Weitzman recognises the force of efficiency wages to undermine his system but points out that in the interim, with pay parameters fixed, the disequilibrium response of a share system is still to stay at full employment output. When the base and share parameters are reset to preserve some given remuneration W, though, the firm is effectively maximising :
\[
\pi = (1-S)(R-B) \\
S.T. W = B + S(R-B) \\
\]

which is equivalent to the maximand of wage firm facing a fixed wage \( W \),
\[
\text{Max } \pi = (R - W).
\]

Providing firms do not feel compelled to maintain remuneration and \( S \) is fixed remuneration will automatically fall and the firm will have an incentive to raise the base wage only insofar as it wishes to moderate the outflow of workers from its plants as it adjusts to a new lower level of output.

Fixing the share parameter though raises problems of its own, as Meade points out.

**MEADE'S LABOUR-CAPITAL PARTNERSHIP**

The whole focus of Meade's contribution is to convert any zero sum game elements between labour and capital into cooperative elements by changes in the institutional structure of the firm. Like Weitzman he sees the wage firm as involving conflict of interest since for a given size of pie labour can only have more at the expense of capital (although there a possibilities of shifting the incidence on to consumers and, in the case of nationalised industries, actually creating cooperative strategies playing jointly with management against the taxpayer). Similarly having a fixed slice provides no incentive for labour to cooperate with capital in increasing the size of the pie.

Moving in the Weitzman direction eliminates this basic conflict in much the same way that giving tax advantages to encourage ESOPS would appear to do. A common interest in profits is cultivated. However ESOPS do not lower the marginal cost of labour to the firm and hence lack the direct employment creating effects of Weitzman.

Surely, if profit-sharing offers such favourable macroeconomic performance then it should be relatively easy to foster its implementation?
Unfortunately this is not the case because although advantageous to firms and to workers as a whole it is not nearly so attractive to existing job incumbents. For them a firm specific fall in demand will result in an automatic cut in real pay. This may be only a temporary disequilibrium phenomena (since in the longer run mobility of workers will restore equalisation of net advantages) but it is non the less real for all that. Also a small group of profit-sharing firms in an ocean of wage firms will become the residual employers if the economy is depressed. Recruitment dilutes the profit-share of existing workers but is profitable for the firms involved.

The conflict of interest over recruitment might appear to be alleviated if the workers themselves were the shareholders—perhaps if their pension fund were mobilised to purchase the equity. However it would then seem logical for the trustees to pursue a policy of dividend maximisation (where dividend = surplus per member + wage per member). If this were done the resulting cooperative would have an incentive to reduce its membership by not replacing natural wastage.

For any given wage dividend per worker is maximised when surplus per worker is at a maximum. Therefore the maximand for a producer cooperative would be:

Maximise  \( S = (PQ-QL+K) \) subject to the production function, \( Q=f(K,L) \). 

\[
\begin{bmatrix}
\frac{\partial S}{\partial L} \\
\frac{\partial S}{\partial K}
\end{bmatrix}_{P,K} = 0 \quad \text{where } PQ = S + W.
\]

Thus in the special case of \( W=0 \) (pure profit-sharing but here in a cooperative) the firm will wish to extend employment until MRP was equated to surplus per member. For any positive \( W \) it would fall short of this with MRP=S.

If wages are set at the competitive level (as with the Mondragon cooperatives) then employment would fall short of that in a capitalist firm.\(^*\)

A labour managed cooperative then would appear to offer less scope for employment than a capitalist firm and this less in turn, during depressed times, than a Weitzman share firm so long as insider workers cannot totally block new recruitment. ESOPS function like a capitalist wage firm unless a critical block of votes is secured by workers and it flips into concern for maximising surplus per worker.

Moving partially in the ESOPS direction will be beneficial to productivity (though there are limits for large enterprises) and industrial relations. Moving in the Weitzman direction has the added promise of beneficial employment effects but it introduces new conflicts which were

\(^*\) The fact that it is not so with Mondragon (which deliberately ploughs surplus back in with the express object of employment creation) pushes one to the question of whether or not cultural factors are dominant in explaining the success of both Mondragon and Japan.
not formerly present, between workers and capital concerning recruitment and new investment. Going too far in either direction will be counterproductive...............so the only way is up!

Meade suggests as a tantalising alternative the possibility of a labour capital partnership in which a capitalist wage firm whose net revenues are split 80:20 between labour and capital are similarly divided by giving labour share certificates to the former and capital share certificates to the latter (we haven't gone up yet). Both would carry rights to an equal dividend but the latter would be encashable whereas the former are to be held until retirement age unless the worker voluntarily quits beforehand.

With fixed shares the firm is reluctant to engage in new investment because it would finance the whole of it but only receive 20% of the returns. But if new capital certificates could be issued to raise funds and the ensuing dividends were less than the marginal revenue product of new capital then all pre-existing shareholders would gain. Symmetrically if an extra worker could be hired by being offered sufficient labour certificates and the dividends on these were less than the marginal revenue product of labour then again all pre-existing shareholders would benefit. The word sufficient is important. If each worker received the same number of certificates then, with declining MRP, an extra worker would gain a share that exceeded his contribution to output. But if the necessary number of shares to induce him to offer his services were sufficiently low then he would be welcomed into the enterprise by capital and labour shareholders alike. In particular conflict between insider and outsider workers would be removed. The price of course is that equivalent workers will be receiving different rates of pay! We have a discriminating labour-capital partnership. The logic is that capitalists get different returns on their invested funds depending on when they buy newly issued shares from the firm. The value of the equity of a successful venture will rise in price as its future dividends are discounted by the market rate of return. New comers will only be offered the market rate of return and so their funds will buy less shares than before (though each will receive the going dividend). So why not treat workers differently too, depending that is on the going wage rate rather than the existing remuneration of present incumbents. From the firm's point of view as workers retire and are replaced by new workers with a competitive number of labour share certificates then it will receive in the long run all the profits of its success for its capital shareholders.

CONCLUDING COMMENTS.

The scheme is cheap, even allowing for no feedback effects from higher employment. It is estimated to cost only £50m in the forthcoming full financial year. This might suggest an estimate of £75m taking up the minimum 5%. But even if pay increases were consolidated into profit shares over 3 or 4 years and a sizeable number of workers (say
half of those eligible - 6m) were to engage in it with 20% PRP then it would still only cost £1.6bn, assuming each worker is on average pay of £10000. For it to achieve benefits though to set against these costs the scheme must be extensive both in its coverage and in its proportion of PRP to total remuneration. Cosmetic schemes are less likely to occur if profit schemes are fixed more infrequently than for just one year and efficiency wage reservations are likely to be less forceful the more extensive is coverage. A single profit sharing firm would itself impose limits on employment expansion because the perceived low marginal cost of labour understates the true costs when demotivation occurs through dilution of existing workers pay. A critical mass of such firms would not face this problem because as each edges in this direction to the limits of its own prudence they would find that the constraint was not there. As all firms expand real pay should rise.

Discriminatory provisions would be useful to remove insider-outsider conflict and encourage existing workers to welcome new comers from the ranks of the unemployed. But the less extensive the coverage of PRP the more discriminatory these terms would have to be for scattered seeds of PRP to become established and the more unions, with their egalitarian tendencies, would oppose them.

Coverage is a fortiori more essential given that, at the level of the individual firm, changes in the cost of labour are likely to have little effect on employment even if the firm does not take demotivational effects seriously. Labour demand is likely to be quite inelastic. This may seem paradoxical given that product demand is likely to be highly elastic for the firm. But as Meade points out if, say, 10% of the price to the consumer of the final product represented value added, and all of this were labour cost, a 10% cut in the cost of labour would lead to only a 1% cut in price to the final consumer and the elasticity of demand for labour would be only 10% of the elasticity of demand for the final product. Only if firms producing the intermediate goods were to participate would employment be seriously stimulated.

However herein lies the Achilles heel of profit-sharing. Weitzman feels so confidently about the lack of negative elements to his scheme that he has thrown down the gauntlet to anyone who can find unfavourable effects flowing from it. The scheme will either stimulate employment or stall in the face of entrenched positions - at a small cost to the Exchequer. Wadhani has taken up the gauntlet and cogently points out that (a) in a union monopoly model, since the elasticity of labour demand is lower for the firm than for the industry it is to be expected that that unions would bid wages up higher if bargaining was at that level.²

² On the other hand R. Jackman of the LSE argues that profit-sharing is a form of wage tax. If the elasticity of demand for labour were then by pushing up wages by 1% in a wage system a union would face a 1% employment loss. Under profit-sharing a 1% rise in the lower base wage would
(b) since each group of core workers would gain from a successful wage push, assuming others did not push - whereas all would gain nothing but suffer the ensuing inflation if they all did so the prisoners dilemma model operates to give us the worst of all possible worlds.

(d) empirically decentralised wage-fixing is associated with an inferior inflation unemployment performance (Bruno and Sachs).

This is less of a point against profit-sharing than a point for the 2nd law of thermodynamics. Achievement of critical mass would bring about an explosion of wage push that causes a degeneration to a wage system again as firms would eventually renegotiate share parameters and take the line of least resistance by reducing the profit element.

Tax benefits are essential for the PRP proposal to fully take off. How substantial they must be to overcome the externalities involved is another matter but I doubt if there is any point in a half way house. Without the critical mass we will only have succeeded in building in yet one more distortion into the tax.

In the process of building up a share system the transition will be unstable if eligibility for tax relief requires only a one year profit-sharing contract put up. A parallel can be drawn with the attempt to get a share owning popular capitalism. Big discounts encourage sizeable numbers of people to take the step and stag new issues. But once released on to the market and shorn of their special attractions they shed their stocks rapidly. In a bull market many will hang on convinced they have found the philosophers stone but when the market turns disillusionment will set in. And so it is with profit sharing. A variable income stream is valued less then a fixed one by risk averse individuals and hence needs a tax break to make it attractive. A falling one will make them regret taking Margaret Thatcher's shilling and desert - or at least not reinstat.


