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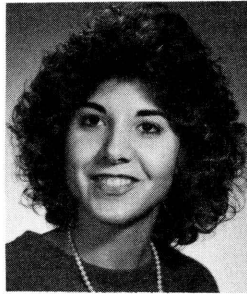
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THE SHARE ECONOMY: UTOPIA OR SOCIALIZED CAPITALISM?

Susan Armento



Introduction

“Are you better off today than you were four years ago?” “Will you be better off four years from now?” These questions are asked prior to almost any national election. It is difficult to frame a positive answer to these questions when one views the economic performance of the last two decades. The 1980s have witnessed a stark leveling off of productive investment and, hence, productivity growth. This has been accompanied by increasing rates of both inflation and unemployment while economic policies seem unable to ameliorate one without worsening the other. Although the current rate of unemployment is as low as it has been in 15 years and the inflation rate is also moderate, this has been accomplished at the enormous cost of well over one trillion dollars of deficit spending during the past seven years. The need for an innovative policy is undeniable; perhaps there is a better way. Profit sharing might be able to provide the cure for “stagflation”—the simultaneous occurrence of stagnation and inflation.

To evaluate the potential benefits of profit sharing, I will first review the history of profit sharing in America. Next, I will explain the macroeconomic benefits that could be derived from a profit sharing economy of the type proposed by Martin L. Weitzman, an MIT economist. Following this I will present a case study of the Dupont Co., which has recently employed a profit sharing system. Finally, I will analyze some criticisms of Weitzman’s theory and make suggestions for future research on a “share economy.”

History of Profit Sharing

Historically, profit sharing has gone through varying phases of popularity. It first received serious attention in 1889 in several books by J.P. Gilman and was proposed as a means of conquering the social ills resulting from industrialization. Gilman also established the Association for the Promotion of Profit Sharing in 1892 and identified 34 firms which employed profit sharing plans (Gilman, pp. 386–87). This organization was important in its role as the

first concerted effort to introduce profit sharing to the public. Following its introduction, profit sharing received considerable attention during the first two decades of the twentieth century. Its main function was to serve as a mechanism to avert labor unrest and thus aid in avoiding the establishment of unions. The number of plans did increase slightly between 1910 and 1920. However, a study by the U.S. Bureau of Labor Statistics could still only find approximately 60 plans in existence in 1916 (Emmet, p. 9). Moreover, the term profit sharing itself was used loosely during this period. It was defined as any payment beyond that of a cash wage, such as fringe benefits, bonuses or pension plans. Few of the so-called profit sharing firms actually paid wages based on the firm's profits.

With the coming of the Great Depression, there was a decrease in the relatively small number of profit sharing plans already in existence. This was due mainly to the large number of business failures. In the late 1930s, though, profit sharing enjoyed a revival, as noted in a U.S. Senate survey of 1939 entitled "Survey of Experiences in Profit Sharing and Possibilities of Incentive Taxation." And according to the Vandenberg Herring Subcommittee of the Senate Committee on Finance, 728 of 9,000 firms surveyed employed some form of profit sharing. Most were only pension or bonus programs bearing little direct relationship to profits, however. But the survey declared profit sharing to be associated with "labor peace, employee security and business success" (Senate Finance Subcommittee, pp. 159-60). The Senate's survey also created greater interest on the part of both management and the public in profit sharing, and convinced Congress to pass legislation giving a tax advantage to those companies using profit sharing plans. During World War II, profit sharing continued to receive a fair amount of attention. The Federal Government was attempting at the time to control wages, and thus encouraged the use of deferred profit sharing plans.

The number of plans continued to rise from the late '40s until the early '70s when a decline in stock market values caused a slowing in the rate of establishment of new plans

(Latta, p. 18). In periods of uncertain market conditions, employers tend to oppose risk taking. For many companies profit sharing was a relatively new phenomenon and thus was perceived to involve considerable risk. By 1978, though, the trend had once again reversed itself and the number of profit sharing plans in existence reached a record high number of 28,634.

As noted earlier, J.P. Gilman was the first to describe some of the socially beneficial effects of profit sharing on the economy. But it was not until the mid-1960s that a new theory of profit sharing was expounded. An economist named Jaroslav Vanek proposed that by lowering the wage rate and giving workers additional income based on the profits of the firm, profit sharing could actually increase the level of employment. This would in turn cause the share of national income going to labor to increase. There would then be an increase in aggregate demand resulting from the high propensity for workers to consume the portion of profits which had been distributed to them. This process would, finally, stimulate capital formation and technological advance, causing an increase in the country's rate of economic growth (Nuti, pp. 18-21). In this way Vanek provided the foundation for Weitzman's idea of the "share economy."

The Share Economy

Until recently, there has not been much attention devoted by economists to profit sharing theories. In the midst of "Keynesian" versus "supply side" economics and the usual concerns about the relationship between unemployment and inflation, profit sharing has been viewed mainly as a tool to improve productivity and labor-management relations. However, in his book *The Share Economy*, Martin L. Weitzman proposes profit or revenue sharing as an almost certain path to full employment and as a vigorous policy to combat inflation.

The simultaneous existence of the twin spectres of inflation and unemployment is a relatively new (i.e., post Vietnam War) threat to the economy. The fiscal and monetary policies developed by John Maynard Keynes are no longer

effective in an era of stagflation. Keynes subscribed to the classical economic theory that unemployment meant that the wage rate was too high. However, he refused to believe a market economy was self-regulating and that all that was needed was time for Adam Smith's "Invisible Hand" to slowly bring wages into balance with full employment. Keynes, being fully aware of the stickiness of wages, encouraged government fiscal and monetary policy to drive unemployment down. In the development of his policies, he paid little attention to inflation, assuming, as did his contemporaries, that inflation would be negligible until full employment was reached.

Today, the Keynesian cure for unemployment can be viewed as an anachronism. His demand-side approach to lowering unemployment is for the government to pursue an expansionary policy: an increased money supply, low interest rates, high government spending and/or low taxes. This approach lowers unemployment but can give the stagflation pendulum a shove in the other direction, resulting in a cost-push, wage-price spiral and the concomitant dramatic rise in inflation.

As is well known, inflation redistributes wealth, a benefit to some (e.g., holders of fixed rate loans) and a detriment to others (e.g., retirees). Further, the entire economy must bear the burden of added information costs due to monetary uncertainty and a foreshortened financial planning horizon. In the United States, the electorate abhors inflation almost as much as it abhors recession and unemployment. The government, always operating with the next election in mind, is necessarily committed to fighting both. And since the basic causality of stagflation is poorly understood (it is possibly a serious long term side effect of Keynes' full employment prescription), victory is elusive.

Weitzman proposes that stagflation cannot be fought on the macroeconomic level. Recognizing the macro failures, he advocates action at the micro level and calls for "micro-political reform . . . and the institution of incentives to induce better output, employment, and pricing decisions at the level of the firm" (Weitzman, p. 27). Most economists realize ag-

gregate microeconomic policy can have a significant effect on the macroeconomy, but question whether it can be the predominant factor.

In response, Weitzman reviews the decision processes followed by profit-maximizing firms and the coordination processes of a market economy. The decision process can be simply stated in three steps. First, a firm selects the profit maximizing level of its output such that marginal revenue is equal to marginal cost. Second, a sufficient amount of labor is hired to produce the selected output level. Finally, price is set by multiplying marginal cost by some factor related to the price responsiveness (elasticity) of demand. As such, the price markup is usually quite low when the quantity sold is very responsive to the selling price of a product (elastic demand). Conversely, the markup factor will be considerably higher for a product with an inelastic demand (Weitzman, p. 17).

Based on these decisions, a firm has essentially two alternatives when faced with a decrease in demand for its product. It can cut prices to the level at which production can be maintained or it can cut production. The first alternative normally leads to significant losses for the firm. However, in a market economy, the traditional and usually necessary response to demand fluctuations is to vary quantities, not price. It naturally follows that if production is cut, workers will lose their jobs. Similarly, if production costs rise, prices must also rise and quantities sold will decrease. Again, output must decrease and workers are laid off. In a wage system, laying off workers is the only option open to firms when there is a production cutback.

A logical conclusion drawn from the above discussion is that the demand for labor varies directly with the demand for a firm's output. This is due to the condition that in a competitive wage economy the marginal cost of labor (cost of one additional unit of labor) is equal to the marginal revenue product of labor (revenue from the output of one additional unit of labor). Now consider what would happen in the same firm if an invisible hand suddenly changes the firm's method of worker remuneration from a

wage system to a "share system," with workers receiving part of their salary in wages and part in a year-end bonus based on profits. In a share system, there is no necessity for the firm to lower its output in the event of a decline in demand. Instead, guided by the elasticity of its product demand, it lowers prices to a point where the output level can be maintained. Naturally, lower prices mean lower profits, and worker compensation must thereby be reduced. As such a share economy does not put workers out on the street. In fact, in Weitzman's share system, the marginal cost of labor is less than the marginal revenue product of labor, and as a result there is always an excess demand for labor! (Weitzman, p. 23).

It is immediately obvious that in a share firm, compensation is inversely proportional to the level of employment. Of course, this would be hard on the firm's labor force if it were the only share firm in town. But if all firms participated in a share system, "something like a balanced expansion of the economy would take place with increased demand from higher spending of newly employed workers feeding back to keep prices, revenues per worker, and labor remuneration more or less steady. . . [while] the economy. . . [goes] to a higher employment level" (Weitzman, p. 88). This is the crux of the Weitzman theory.

Before addressing inflation, I will present a short numerical example which should drive home the efficacy of the share system. In a wage system, if a firm incurs a 10 percent decrease in demand, the usual response is to cut output by 10 percent. Of course, this means that the firm will lay off approximately 10 percent of its workforce and will also suffer a 10 percent loss of revenue and profits. In a share economy, however, the response would be markedly different.

Let us say that the firm manufactures a product whose price elasticity of demand has a magnitude of -3 . As noted previously, elasticity is a measure of the price responsiveness of changes in the quantity demanded of a particular product. It is the percentage increase (decrease) in the number of items sold that would result from a one percent decrease (increase) in the price. The quantity demanded

can be brought back to its original level by lowering price by a percentage equal to the decrease in demand divided by the price elasticity:

$$\text{Price Cut} = 10\% \div 3 = 3\frac{1}{3}\%$$

Thus full output is maintained and employee compensation would be reduced by an amount determined by whatever profit sharing formula is used—but by no more than $3\frac{1}{3}$ percent in any case. Although Weitzman states that a precise formula for total compensation is the subject of further study, he uses as an example a worker compensation package of which $\frac{2}{3}$ is fixed wages and $\frac{1}{3}$ share wages (wages dependent on the degree to which profit goals are met). With this package, the effect of the price cut described above is a decrease of $3\frac{1}{3}$ percent of the $\frac{1}{3}$ share—only 1.1 percent of total compensation. This 1.1 percent loss in total compensation can be compared to the 10 percent loss (by layoff) which would be suffered by the aggregate workforce in a traditional wage system should demand fall by 10 percent (Weitzman, pp. 100–107).

Finally, a brief word about inflation is appropriate. Weitzman postulates that with full employment guaranteed by the expected excess demand for labor in a share economy, the government has more freedom to pursue anti-inflationary policies. It can do so relatively assured that its action will not cause unemployment. In addition, aggregate wage flexibility is desirable in itself because it eliminates the stickiness experienced in a wage economy. As such, the economy's self-correcting mechanism is allowed to function more efficiently, thereby automatically moderating inflation (a truly dexterous invisible hand).

A Case Study of a Profit Sharing Plan: DuPont

Many companies are just now discovering how powerful a mechanism profit sharing can be in improving productivity. These include General Motors, Ford, USX, Hewlett Packard Co., AT&T, and DuPont Co. (Schroeder, p. 134). In this section, I will focus on DuPont as a case study. In 1989, DuPont will begin a profit sharing plan in its fibers division. DuPont is an extremely aggressive competitor in the chemi-

cal industry, and its fibers business is one of its most profitable divisions with profits in 1987 of \$624 million. DuPont is the first company of its kind to introduce such a plan of great size during a time when profits are high and growing rapidly. It plans to tie the wages of all its workers, from the hourly worker to the vice president of its fibers business, directly to the company's profitability.

The plan will work in the following manner. Base salaries will be cut by 6 percent as compared to those of workers doing the exact same jobs in DuPont's other areas of business. If the fibers business achieves 100 percent of its profit goals, the workers will recoup this 6 percent. If the unit meets less than 80 percent of its goals, the entire 6 percent difference will be lost. If the group meets exactly 80 percent of its goals, the employees will receive a 3 percent increase in salary. On the other hand, during profitable times, if the fibers group meets 150 percent of its goals, employees will receive a maximum increase of 18 percent.

To use a concrete example, a manager earning \$94,000 in the fibers business has a counterpart elsewhere in the company earning \$100,000. The manager in the fibers business will earn \$100,000 only if the fibers group achieves its anticipated profitability goal. If profits are less than 80 percent of the level originally forecast, the manager stands to lose \$6,000 and will only earn \$94,000. If on the other hand the group meets 150 percent of its original goal, the manager will gain an extra \$12,000 in wages and have a total salary of \$112,000. When one considers DuPont's wage bill, the profit sharing plan will mean a savings of \$36 million if less than 80 percent of the profitability is achieved and a \$72 million payout in cash bonuses if 150 percent of the goal is realized. With after-tax operating profits of \$624 million in 1987, a 4 percent increase in profits is expected over the next 5-10 years. Profitability goals in future years will be set according to these figures (excluding inflation).

The extra pay earned will be distributed in February of the following year rather than being paid as increases in base salary. The fibers group workers will in fact receive raises in salary just as their counterparts in DuPont's other busi-

ness, but fibers group raises will represent only 94 percent of all others. In other words, a 6 percent base pay difference will be maintained (Hays, p. A4).

The plan encourages employees to work harder, but it also allows them to share in the benefits of their extra labor. The purpose is to convince employees that they have a stake in the business and that they can as individuals affect the company's production capacity. Workers may, for example, find ways to eliminate material waste or save on repairs that would be needed on equipment. Management-worker communication is thus central to the success of the plan. It is extremely important that the employees understand that they are not receiving a pay cut in disguise.

The pay cut does, in fact, help keep down labor costs in a recession. According to the Profit Sharing Research Foundation, it also helps workers to perform better, allows turnover rates to decline, and makes wages more flexible (Schroeder, p. 134). In one study of small manufacturers, it was concluded that companies using profit sharing plans had a 10 percent higher average productivity growth rate than that of competitors who did not use profit sharing plans. Those companies using profit sharing plans also had $\frac{1}{3}$ fewer layoffs because during economic downturns their labor costs contracted automatically (Schroeder, p. 136). Of course, profit sharing does involve considerable risk, but the benefits are undeniable. Workers and management alike are asked to share in this risk and are given the incentive to "watch the bottom line." Profit sharing thus fosters a feeling of cooperation between employee and employer as both work together to improve productivity.

Criticisms of the Share Economy

It has been difficult to find a ground swell of support for Weitzman in the economic community. Some of his strongest supporters are Robert Solow, who states that *The Share Economy* is "marvellous," and James Meade, who praises Weitzman's book as "important, stimulating, readable and persuasive." However, most reviewers of Weitzman's book have tended to be at best ambivalent. Their usual responses

seem to be that Weitzman's profit sharing scheme will not be accepted by either labor or management and that, in any case, it cannot drive the economy to full employment while containing inflation.

Critics make a valid point regarding worker opposition to a share economy. That is, workers will demand to participate in decision making. The demand for co-determination of wages between workers and management, for example, would cause considerable debate and could possibly lead to employee determined ratios of share wages to fixed wages. Weitzman has recognized this possibility and has stated that co-determination must be avoided. It should be noted that empirical studies of cooperative firms reveal no evidence in favor of this because this tendency is probably offset by workers realizing they are gaining other advantages such as job security (Nuti, p. 28). This evidence, however, does not sway the critics from advocating co-determination in decision making.

Another reason why workers may not accept a share economy is that they are already accustomed to a system of fixed wages. In fact, wage rigidity is a "legitimate" desire of both risk-averse employees and risk/profit oriented employers (Rothschild, p. 209). Workers have a need for a dependable source of income, and many use income as an indicator of their position on the corporate ladder. Some critics feel that, from the employer's point of view, there is a need for fixed wages in order to establish a hierarchy within the company.

Still another theoretical objection to Weitzman's proposal has significant credibility. It is the uncertainty that, in the face of economic difficulties, firms will actually follow the Weitzman formula and lower their prices, thus causing an increase in cash balances and an increase in demand. In fact, it is widely held that even in the face of prosperity firms will be tempted to replace the popular game of tax avoidance and evasion with "wage avoidance and evasion." There is the potential that firms will exploit the risk aversion of workers and experiment with alternate pay formulas until they drive the share portion to zero, thereby returning completely to a wage economy (Nuti, p. 23).

However, some criticisms of Weitzman's share economy seem unfair or misguided, and some are even based on misinterpretations of what he has actually said. For example, Weitzman has been criticized for not offering specific values for what proportion of the wage is to be fixed and what proportion is to be share-determined. Yet Weitzman repeatedly emphasizes that the "ideal" compensation formula is yet to be developed. Other critics argue that stagflation will not be eliminated if the number of firms implementing a share system is not large. In reality, though, there is no basis for this criticism since Weitzman specifically states the need for an essentially economy-wide share system of wages if his plan is to be effective.

In spite of the criticism and doubts about a share system's macroeconomic benefits, most critics temper their criticisms by at least admitting the need for further research and analytic evaluation of *The Share Economy*. Many feel that unemployment poses such a grave threat to the U.S. economy that any potential remedy should be seriously considered (Blinder, p. 51). The added job security which Weitzman's plan promises might well provide greater efficiency and productivity, greater social equality, and less resistance to technical change. Weitzman's plan is undoubtedly socially beneficial but it must be proven privately beneficial as well. Workers (especially those with seniority) must be convinced of the benefits because it is they who will assume most of the risk. Even then, a share economy would probably require government sponsored incentives along with government oversight of implementation.

A Proposal for Future Research on the Share Economy

The share economy is worth continued serious study as a means to full employment without inflation. There are four key areas to be more fully addressed: the compensation formula and its microeconomic effects, the attitudes of workers, the macroeconomic effects, and the implementation process.

The selected method of compensation is the key to initiating a share economy and determining its microeconomic effect on the firm.

Weitzman's example assumes a linear relationship between output and the number of workers, and it does not address the additional overhead and required capital to support each extra hour of labor. In addition, he assumes a constant value for demand elasticity. I would recommend the development of a model of various profit-and/or revenue-sharing formulas which include capital, output, and revenue. This model should be related to the number of workers and based on a demand elasticity function supported by empirical data.

In addition, the attitudes of workers must be carefully considered. Management must be successful in shaping the psychological well-being of workers in convincing them that the share system is not a pay cut in disguise. Employers must also educate workers on how the system would work and perhaps even let them have a voice in setting profitability goals. Furthermore, employers might consider offering job guarantees, which would secure a worker's job for a specified period of time, as a way to compensate workers for assuming compensation risk.

The share economy would seem to have the best chance of working if the entire workforce were involved in the production of goods. However, a major part of the U.S. labor force is engaged in the service sector; and the demand for services is somewhat price inelastic. For example, consider the demand for the services of people who repair televisions, refrigerators, and other appliances. Since there are only a certain number of appliances in need of repair at any given time, a decline in the price of repair costs will have little or no effect on demand for the service.

A final matter which must be taken into consideration is the implementation process used. To make profit sharing attractive to both owners and workers, Weitzman proposes a tax break for those companies and workers participating in profit sharing plans. This could have a dramatic negative effect on the government's budget in the short run due to a decrease in tax revenues. Ideally, the increase in employment might eventually stimulate the economy enough to compensate for the loss of tax revenue. Unfortunately, Weitzman's proposed full employment economy could take a while to come about. In any case, an incentive must be considered with regard to its macroeconomic effect.

Conclusion

There is little doubt that a share economy holds considerable promise — higher employee morale, improved labor-management relations, and an employee sense of "ownership." It also has been postulated by such noted economists as Sir John Hicks that wage flexibility, a cornerstone of the share economy, is desirable per se. Nevertheless, there are serious doubts as to its acceptability to labor and management, along with considerable debate about its macroeconomic effect. The theory which Weitzman proposes is attractive, but in practice it may be difficult for both labor and management to accept this theory on a sufficiently large scale. If a way is found to implement the plan, however, the net result could be "more economic prosperity and social progress than are to be found in the wildest visions of national planners or cultural revolutionaries" (Weitzman, p. 146).

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