Mitchell's Musings 3-25-2013: Shock Absorbers

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Earlier this month, the UCLA Anderson Forecast held its quarterly conference. A day before the public event, there was a special private seminar for selected Forecast supporters which dealt in part with the California state budget. I was a panelist in one session and an interesting point was made. The state budget projections that have been made by the relevant state agencies assume continued economic recovery over the next few years, albeit not a stellar recovery by past standards. However, the post-World War II record of the U.S. business cycle suggests that there is a recession at least every ten years or so and often more frequently. The Great Recession officially bottomed out (ended) in 2008 and we are now in 2013, i.e., we are getting to the midpoint of the ten-year period.

The UCLA Forecast did not project a recession in the next few years and there is nothing sacred about the ten-year limit. On the other hand, one can easily tell stories about conditions currently present or on the horizon that could conceivably evolve into a recession. There is the ongoing euro austerity and periodic crises in the EU. Negative shocks could thus come from abroad, not only through the export channel but also possibly affecting financial institutions. There is the ongoing political gridlock in Washington that could block an adequate response to such a shock, even if it were initially mild. The Federal Reserve will also come under new management when Ben Bernanke's term expires; under the next regime, we may not see Bernanke's aggressive willingness at the Fed to try and offset negative shocks.

Roughly coincident with the UCLA Forecast, the National Center for Employee Ownership (NCEO) recently released a study indicating that layoff rates seem to be lower in firms characterized by employee share ownership compared with other firms: http://www.nceo.org/assets/pdf/articles/EO_Costs_of_Unemployment.pdf. It is unclear what the cause of the difference is between share firms and others. NCEO would naturally like to attribute lower layoffs to the institution of share ownership. Its study provides a bit of control by looking just at layoff rates among employees with more than one year of tenure and finds the same difference, i.e., lower layoff rates among share ownership firms. However, the study does not break down the degree of share ownership or the type of ownership plan. For example, lower layoffs might well be a feature of 100% employee-owned firms since employee-owners might well not want to lay themselves off. But the same behavior might not occur in firms with only minor portions of outstanding shares in employee hands.

However, the NCEO study is a reminder of the 1980s literature and debate over whether alternative pay systems might act as shock absorbers, reducing the tendency to lay off workers when demand falls. That literature is identified with Martin Weitzman whose book, *The Share Economy*, presented an argument the profit sharing – particularly on a large scale – could be a shock absorber.[1] In the

[1] Martin L. Weitzman, *The Share Economy: Conquering Stagflation* (Cambridge, MA: Harvard University Press, 1984).

Weitzman model, profit sharing firms operate in a labor shortage mode compared with conventional firms with fixed pay. A negative demand shock, therefore, tended to result in a layoff of vacancies rather than of real people.

Simpler versions of the story involved pay systems with some kind of bonus related to firm performance. Conventional firms (without such bonuses) react to a negative demand shock by reducing labor, first overtime and weekly hours and then employees. Bonus-type firms could respond by shrinking the bonus to reduce costs and leaving hours and employees as they are, at least in the face of mild shocks that did not drive the bonus to zero.[2] With 100% employee-owned firms, pay is a mix of wage plus dividend or share value so it is possible that such firms would also be less layoff-prone than others. As noted above, however, a small proportion of shares in the hands of workers might not have the same effect.

In a later literature, Chris Erickson and I noted that the 1990s literature on labor market monopsony had a macro implication.[3] There would be a tendency, particularly in the largely nonunion labor market that existed by that time, for employers to operate under monopsonistic conditions which implied they would often function in a labor shortage environment similar to Weitzman's profit sharers. So there would be a shock absorbing feature even without profit sharing. Even so, it could be the case that particular pay systems, be they of the profit sharing or share ownership variety, could enhance the shock absorber effect.

It needs to be emphasized that with a large enough negative shock, there will be layoffs and a recession regardless of the pay system. If your car hits a deep enough pothole, you will feel it as a driver or passenger, no matter how well your shock absorber works. But that fact doesn't mean that shock absorbers are useless. Even if there is a recession in the next few years, it might not be as severe as the Great Recession of 2008. It might be of the relatively mild type seen in the early 1990s or the early 2000s. Or there might simply be a growth pause not sharp enough to be formerly classified as a recession but sufficient to provoke increased layoffs.

The NCEO report purports to calculate the saving to the federal government of reduced layoffs which are attributed to share ownership. Again, since there is insufficient control in the study to imply causation – and no formal modeling – one can be skeptical of those particular results. But the larger message remains. The interest in pay systems – and in public policies that encouraged particular systems which could act as shock absorbers – seems to have largely died. Understandably, much of the

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[2] The case of Lincoln Electric is often cited. See http://www.youtube.com/watch?v=EftYWQOs_cU and http://www.youtube.com/watch?v=H8gioKjrFwk.

[3] Monopoly power involves price setting discretion on the part of the seller. Monopsony involves price setting discretion on the part of the buyer. In the labor market, the buyer of labor is the employer and the price being set is the wage. There were several Erickson-Mitchell articles. See , for example, http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_erickson_monopsony.pdf

discussion remains focused on what to do about the still-widespread unemployment problem that lingers after the Great Recession.

Unfortunately, the historical record suggests that it's time to think about how the economy might react to the next recession which will increasingly become overdue compared with past norms. And it's time to revive discussion about whether there are alternative pay systems that could moderate the impact of the coming recession. The road ahead could be bumpy so checking our shock absorbers would be smart. If you don't think so, keep in mind the fate of those commentators who, in the rush of the dot-com boom of the late 1990s, proclaimed there was a new economy to which the business cycle no longer applied. Those folks don't look so good now.