The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper By

Tibor Scitovsky

How Our Economy Stands Up To Scrutiny

Award Bestowed September 26, 1990

RHODES COLLEGE
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THE FRANK E. SEIDMAN DISTINGUISHED AWARD IN POLITICAL ECONOMY

The Frank E. Seidman Distinguished Award in Political Economy was established in memory of Frank E. Seidman by Mr and Mrs. P.K. Seidman. The host college for the Award is Rhodes College, a liberal arts college established in 1848. An honorarium of fifteen thousand dollars will be given to an economist who has distinguished himself or herself internationally by contributing, in the judgment of his or her peers, to the advancement of economic thought along interdisciplinary lines and to its implementation through public policy.

The purpose of the Award is to recognize and encourage economists who are attempting to extend their work into the interdependent areas of the other social sciences. The Award is established with the expectation that social welfare will be advanced when proper cognizance is given to environmental and institutional influences upon the economic behavior of individuals and groups. The basis for evaluation will encompass both the synthesis of existing thought in political economy and the pathbreaking development of new concepts. The recipient of the award is chosen by the Board of Trustees upon the recommendation of a rotating Selection Committee composed of eminent economists.

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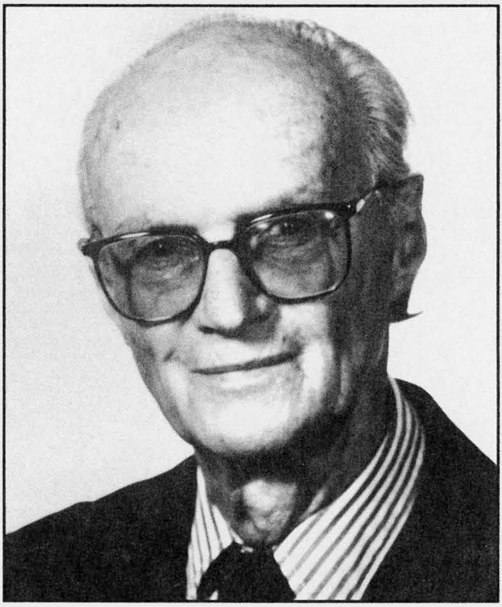

TIBOR SCITOVSKY
Recipient of 1990
Frank E. Seidman Distinguished Award
In Political Economy

INTRODUCTION OF THE 1990 RECIPIENT, TIBOR SCITOVSKY, AND PRESENTATION OF THE AWARD

by
C. Louise Nelson*

In 1964, Tibor Scitovsky gave a memorial lecture at Princeton University He began it with the statement, "To be invited to deliver this year's Frank Graham Memorial Lecture was not only an honor, but also a benefit. It made me read Graham's work...."[1] I am impelled to paraphrase this statement: to be invited to introduce Tibor Scitovsky to you was not only an honor but also a benefit. It made me read more of his work and realize anew the extent of his contributions.

I believe that rarely has a scholar published as much on as large a number of subjects over as long a period of time. According to a directory of economists, he completed a dissertation, "The Significance of the Gold Clause in Commercial Contracts," in 1933. A few months ago, he published "The Benefits of Asymmetric Markets."[2] During the intervening fifty-seven years, he published several books and scores of articles in professional journals.

Despite these enviable achievements, this prolific scholar tells us, "I never felt an irresistible call to economics and only took it up because I was anxious to stand on my own feet, prove my own worth ...academic economics seemed my best way to earn a living and earn it my own way "[3]

After coming to the United States on a fellowship in 1939, he elected to remain in this country. He served in the United States Army from 1943 to 1946 (and was decorated with the Bronze Star). He worked outside of academic economics from time to time, for the London and Cambridge Economic Service, the OECD and the Department of Commerce in Washington. But in accordance with his original plan, he devoted most of his career to elegant, lucid writing and inspired teaching—academic economics at its best—at the London School of Economics, Yale University, the University of California at Berkeley and Stanford University

**Professor Emeritus Department of Economics, Davidson College, past President, Omicron Delta Epsilon, International Honor Society in Economics, member of 1990 Award Selection Committee.*

The breadth of his scholarship is remarkable, reaching as it does into welfare economics, free trade and tariffs, international finance and the balance of payments, economics integration, pricing under various competitive and monopolistic conditions and economic development. He is renown for his technical competence in working with pure economic theory, but he also addresses significant policy problems as well.

Those who are familiar with his work cannot fail to observe that analyses of policy issues in his earlier publications are as relevant today as when they were first written. For example, his 1958 study of European integration analyzes the problems inherent in using a common Western European currency, in particular, the problems with an integrated capital market and an integrated employment policy.[4] These are, of course, issues of considerable current interest as Western European nations begin to implement plans for economic integration by 1992.

Much of Professor Scitovsky's work emphasizes that neoclassical equilibrium analysis is somewhat removed from economic reality. He is critical of well-trained and technically proficient economists who do not ask simple questions such as what can and cannot be achieved by a market economy. He admonishes us not to read more into the theory than what it says. He aspires "to bridge the gaping gulf between beautiful economic theory and ugly economic reality."[5] The conviction that sustains him when he deals with ugly economic reality is that "to provide partial answers to vital problems is at least as important as it is to provide complete answers to lesser questions."[6]

Invariably, he insists upon adequate evaluation of implicit value judgments and policy implications in economic analysis. His extensive work in welfare economics emphasizes the necessary involvement of value judgments in policy evaluations *viz a viz* the distribution of income. His classic article, "A Note on Welfare Propositions in Economics," published in 1941, is a standard reference in the literature of welfare economics.[7] His well-known textbook, *Welfare and Competition*, challenges arguments in support of the efficiency of competition and the distortions caused by monopoly.[8] Among other questions addressed in this book, as well as in a number of his journal articles, is whether equity in income distribution is a desirable national economic objective.

In 1974, Professor Scitovsky was selected to receive the Distinguished Fellow Award from The American Economic Association. In the award citation, his ability to assimilate insights in other sciences was noted. This admirable ability is amply demonstrated in *The Joyless Economy* as he utilizes psychologists' concepts of satisfaction related to comfort, stimulation and pleasure in his investigation of why young Americans were disaffected with the economic achievements of their parents.[9] This ability is also demonstrated in his recent volume of collected papers which "specify, question, go beyond or try to extend the conventional limits of economics."[10]

Among the criteria established for selection of a recipient of the Frank E. Seidman Distinguished Award in Political Economy is that the individual have a record of outstanding achievement both in quality and importance in the particular discipline which interrelates analytical economics with social aims whose formulation lies outside of economics. Obviously, in addition to his general qualifications, Professor Scitovsky is eminently and uniquely qualified in relation to this specific criterion.

It is a great privilege for me to read the citation of the seventeenth Frank E. Seidman Distinguished Award in Political Economy:

The Board of Trustees and Rhodes College bestow upon Tibor Scitovsky this award in recognition of your career as a distinguished scholar and teacher; for your commitment and efforts as a social scientist; for your widely heralded literature devoted to the improvement of the human condition, for your examination of the monopolistic market and its departure from economic efficiency; for your contribution to international trade theory which has added to our understanding of the consequences of trade restrictions; and for your accomplishments as a teacher who has prepared others to add their own dimension in the advancement of knowledge.

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2. Scitovsky, Tibor, "The Benefits of Asymmetric Markets," The Journal of Economic Perspectives, Winter, 1990, 135-48.

3. Scitovsky, Tibor, Human Desire and Economic Satisfaction: Essays on the Frontiers of Economics. New York: New York University Press, 1986, vii.

4. Scitovsky, Tibor, Economic Theory and Western European Integration. London: Unwin University Books, 1958.

5. Scitovsky, Tibor, Human Desire and Economic Satisfaction. viii.

6. Scitovsky, Tibor, Welfare and Competition (Revised Edition). Homewood: Richard D. Irwin, Inc., 1971, xi.

7 Scitovsky, Tibor, "A Note on Welfare Propositions in Economics," Review of Economic Studies, November, 1941, 77-88.

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10. Scitovsky, Tibor, Human Desire and Economic Satisfaction. ix.

HOW OUR ECONOMY STANDS UP TO SCRUTINY*

by

Tibor Scitovsky

Now, when the shortcomings of socialist State enterprise are widely admitted and most of the world seems to have come around to believing in the superior advantages of democracy and private enterprise, is a good time to ask what exactly it is that the free enterprise market economy accomplishes and what, ideally, it might accomplish.

Those questions, of course, have often been dealt with before, but mostly in an incomplete, one sided way, because welfare economists, whose job it is to raise such questions, are perfectionists. We are very good at showing how perfect competition would accomplish a limited number of market functions to perfection, not so good at judging what the real-world economy's imperfect performance of many more functions adds up to. For several important economic functions happen to be mutually incompatible, in the sense that the perfect accomplishment of one would prevent the accomplishment of another. When we focus on the abstract model of perfect competition, we ignore or abstract from such incompatibilities and so tend to overlook our real economy's great merit, which is that it resolves those incompatibilities by effecting a compromise between them when it performs all functions imperfectly.

For example, we have long realized the difficulty of weighing the conflicting merits of economic efficiency and equity against one another and used to dodge the issue by analyzing efficiency in depth, while leaving equity and social justice to be dealt with by philosophers, moralists and politicians.

Similarly, the better to understand the workings of the market economy, we developed the simplified unrealistic model of perfect competition, which was most helpful in clarifying the role of prices in coordinating different people's activities but hid from view the role of monopoly and monopolistic competition in encouraging technical and economic progress, because perfect competition has no room for monopoly and monopolistic competition.[1]

Fortunately, such outstanding economists as Amartya Sen, John Harsanyi

* I wish to thank Professors Lorie Tarshis and Moses Abramovitz for their constructive suggestions on their reading of an early draft of this paper.

and Partha Dasgupta are bringing equity back into the purview of economic theory; and I shall try in this paper to carry on their good work by rounding out the picture of our economy just a little further. I shall try to list some of its neglected and seldom mentioned benefits and stress its worst imperfections.

Probably the most important advantage of our economy is a political one: its tolerance of human diversity. It provides people with a livelihood whatever the ideology and opinions they hold or express. I am not saying that it provides a livelihood to everybody; that question I will take up at the end of this paper. Nor am I saying that it always provides the same livelihood for the same accomplishment, because there is plenty of discrimination, by race, sex and color. Indeed, this is one of the many functions our market economy performs imperfectly; but it is valuable nonetheless and as such an essential condition of the freedoms we expect to enjoy in a democracy.

Among the economic merits of free enterprise, the first, perhaps, is its encouragement of technical and economic progress. It finances and rewards innovation, the introduction of new goods and services and of cheaper ways of providing existing goods and services. All that raises the standard of living and usually enhances equity as well, because most innovation consists in making generally available what previously was the privilege of the few.

To create and accomplish things others haven't and haven't even thought of gives people a feeling of superiority whose enjoyment is part of human nature; but the desire for superiority can assume very destructive forms and it takes monopolistic competition to channel it into socially useful innovation. Moreover, to research, develop and put into practice new ideas is usually a lengthy, costly and risky undertaking, which needs financing from the outset; and our economy provides that mainly out of the profits of monopolistic enterprise.

A related if less spectacular feature of our economy is its rewarding the introduction of every minor improvement, refinement and embellishment of the merchandise offered and in the way in which it is offered. That explains our ever-changing fashions, our beautiful shops and shopping centers with their dazzling array of every conceivable good, enticingly displayed and instantly available in all forms, colors, sizes and quantities, offered in an environment so attractive, an atmosphere so polite and friendly that shopping has become many people's favorite pastime. All those amenities result from nonprice competition, the favored form of monopolistic competition.

A parallel but much lesser and slower improvement in the amenities of the workplace has made working conditions safer, cleaner, lighter and healthier, thanks mainly to bargaining by labor unions but also to employers' nonprice competition for workers.

Note that to secure those benefits requires both competition and monopoly profits. That is not as contradictory as it may sound, because monopolistic competition provides both. To secure them, we only have to combat pure monopoly, being in no danger of competition's ever becoming perfect. Monopolistic competition, of course, comes in many gradations; but we have no way of ascertaining the optimum mix of competition and monopoly profits.

I now come to the traditional subjects of welfare economics. One is competition's tendency to curb profits. Profit has long been a dirty word and still is that for people who think of it as easy gain, obtained by outwitting others or exploiting the advantages of superior wealth, power or knowledge. Adam Smith made profit respectable by showing that competition harnesses its selfish pursuit to serving society's interests and curbing the very profits pursued. 150 years later, Joseph Schumpeter strengthened his first point by adding that progress and innovation depend on monopolistic competition and its profits.[2]

But the most remarkable feature of the market economy is its ability to coordinate the independent economic activities of millions of people and thousands of firms more efficiently than any of the attempts at central planning so far made. Coordination in this context means four different things. (1) Distributing goods and services according to consumers' differing needs and tastes as well as in proportion to their spending; (2) allocating resources to the production of various goods so that the latter's output will match consumers' demand for them and be produced at minimum cost; (3) guiding people in their choice of what talents and skills to develop, what competencies to acquire, what jobs to accept and undertakings to invest in so as to match those requirements; and (4) persuading consumers to utilize as fully as possible whatever productive capacities and human skills and proficiencies are already in existence.

Markets perform those functions by equating supply and demand and generating prices that show what others pay and charge for various goods and services, thereby making generally known the opportunities that each market offers to potential entrants. Under perfect competition, all markets would be cleared and competitive pressures would compel all the sellers of each item to charge the identical price and all its buyers to pay that same price; and that single price of each product would accurately reflect its equal cost to all its producers and equal worth to all its consumers.

The ideal situation that perfect competition in every market would bring about we call Pareto optimality and visualize it as one in which the transactions already concluded in existing markets would leave no unexploited opportunity of making anyone better off without having to make someone else worse off. That is why we infer the inefficiency of centrally planned economies from their having black markets.

Real-world markets, of course, are imperfectly competitive, imperfectly coordinated, and the information their prices convey is only more or less reliable, depending on the competitiveness of the markets that generate them. We cannot measure the extent to which those imperfections detract from the Pareto optimality of perfect competition; but we would not know what degree of efficiency to aim for even if we could.

For remember that innovation and progress depend on monopolistic competition and monopoly profits, which perfect competition would eliminate. The perfect economy, therefore, has to be imperfectly competitive and sacrifice some of its coordinating and allocating efficiency for the sake of growth. We may not know where the best compromise between those conflicting goals lies, but the conflict and need for compromise can be reduced by appropriate government policies in the same way in which social insurance, social services, low-cost public housing and progressive taxation reduce the conflict between efficiency and equity.

Governments subsidise basic research in universities and research institutes; patent laws encourage innovation by assuring temporary monopoly profits to innovators or their firms; whereas anti-trust legislation, state employment agencies and laws requiring truth in lending and selling and the full disclosure of food ingredients improve the competitiveness of markets.

But while we have no measure of Pareto efficiency, we do know something about how well our markets perform their specific coordinating functions. Statistics of unemployment and capacity utilization show the extent to which resources are utilized, which is one of the economy's most important functions, considering that the unemployment of labor is the greatest and most hurtful form of waste. We have no comparable estimates of the efficiency with which markets allocate resources and distribute goods and jobs; but we know the conditions necessary for their efficiency and from the way those conditions are fulfilled, we can infer what functions a particular market performs best. We know, for example, that our consumer markets, while imperfectly competitive from the sellers' point of view, are nearly perfect on the buyers' side, because buyers have access to the same shops, face the same prices, which they regard as given, and usually can distill enough useful information from the media and competitive advertising to make intelligent choices. That suggests that our markets distribute consumer goods with reasonable efficiency.

Near perfect competition on the buyers' side of consumer markets also makes goods' prices reflect their worth to buyers fairly accurately, which renders the pattern of prices and purchases a reliable reflection of the public's wants and a good basis for the production and investment plans of producers and would-be producers.

At the same time, oligopolistic competition on the sellers' side of the same markets keeps prices from reflecting production costs accurately and so prevents the public's choosing the expenditure pattern that would satisfy its wants at minimum social cost. In addition, monopolistic obstacles to newcomers' entry to some industries prevents minimizing the cost of producing those industries' output.

In labor markets, both sides' good access to market information enables employers to match human aptitudes to the economy's needs and job seekers to choose the jobs that best suits them and decide what occupations to enter and skills to develop. (Today, only very few jobs have restricted entry.) On the other hand, imperfect competition on the employers' side makes both wage and job discrimination possible by color, race, gender, and keeps wages below what labor's contribution is worth, which creates inequities and is a further obstacle to the minimizing of social costs.

To summarize, the market economy seems to perform all but two of its coordinating functions quite well, the exceptions being failure to minimize the social cost of output and inability to maintain full employment and full utilization of capacity.

The first is due to the padding of prices with (and abridgment of wages by) monopoly profits, which also increases the inequality of incomes. But progress, innovation and novelty are encouraged and financed by those monopoly profits, which means that our society pays for its progress by accepting higher than minimal costs of production and inequalities of income.

That brings us to the last and most problematic of the market economy's potential advantages: the clearing of markets and the full employment of human and other resources. For it is one thing to guide people to the occupations that best suit their abilities and to allocate available jobs according to people's abilities; it is quite another thing to provide suitable jobs to all who seek them.

In the socialist countries, people's euphoria over the impending reform of their economies is marred by one fear: they look upon unemployment as the inevitable cost of enjoying the advantages of the market economy; and the experience of the West's economies seems to justify that fear. Yet, why should the market economy be less good at maintaining full employment than it is at its other coordinating functions? It is pretty good at catering to new or increased demands, because rising prices do cause industries to expand, new ones to be created and new skills to be learned. Why cannot falling prices persuade consumers to make their purchases conform to whatever productive capacities and skills are already available, thereby to keep our workforce employed and equipment utilized? After all, consumers' spending seems just as malleable as the economy's productive capabilities. Why cannot price changes harmonize supply and demand by prompting adjustments in both?

There seem to be two answers to that. First, prices are not nearly as flexible downwards as upwards, for reasons I shall deal with presently, which means that they put much less pressure on consumers to buy than on suppliers to produce. However, since flexible prices would only cure pockets of unemployment, localized in particular industries or sectors, a second condition of full employment in market economies is a well-functioning macroeconomic stabilization policy to offset the cumulative changes in aggregate demand created by multiplier processes and self-fulfilling price expectations. Such policies are needed to forestall both recessionary general unemployment and inflationary (or deflationary) wealth redistributions; but they have proved unable to control inflation without also creating unemployment in the process when prices are inflexible downward. In short, prices would have to be more symmetrically flexible not only for maintaining employment in declining sectors but for the proper functioning of stabilization policies as well.

What, then, keeps prices from being flexible downwards? We know that most sellers are afraid to reduce their list prices lest competitors follow suit and precipitate a general reduction of prices and profits, which is difficult to undo; but that can be (and usually is) guarded against by hidden and implicit price concessions, such as temporary rebates, bonuses, increased recourse to sales, greater use of discount outlets and stepped up nonprice competition. The main impediment to flexible prices are price floors that keep prices from falling below a certain level, and as a rule it is the too-high price floors of products that create involuntary unemployment.

Let me start, however, with the exception: the government-imposed minimum wage, which constitutes the wage floor of unskilled labor. We have often been told that perfect competition would assure full employment but no one has ever asserted that it would assure everybody's employment *at a living* wage. The market economy does much for efficiency, much less for equity. Since society also wants equity, Government has to intervene to assure a decent living for the poor by providing a safety net and setting a minimum wage to keep unskilled workers from being exploited. But a minimum wage also has an undesired side effect on those whose work is worth less than the minimum wage: they get fired or fail to get employed. That accounts for most of the shockingly high unemployment rate of black youths and males in our country; and its best, if very difficult, remedy is to reduce the supply of unskilled workers by improving our schools, raising literacy standards and reducing the number of school dropouts.

Skilled and semi-skilled workers' and professional people's earnings have a higher and very different kind of pay floor. They made an investment in the human capital of their special skills, training and knowledge, on which they expect to get a fair return in the long haul and good annual earnings most of the time. But since every investment is a gamble whose cost is irrevocably sunk, it involves the risk of yielding reduced earnings during recessions or periods of diminished demand for their particular specialty, which they must and usually do accept. They would look for another job only if their present and expected future earnings fell below what they could earn elsewhere, which at times could be quite low, perhaps only what they would earn outside of their specialty, in a semi-skilled or unskilled job. That level of earnings is their pay floor, because below it they would voluntarily quit.

Producers have an investment in their plant and equipment; and they price each of their products by adding to its current out-of-pocket costs a profit-maximizing markup, which pays for overhead costs, depreciation and usually yields a good return on their investment in addition. When business is bad, the profit-maximizing or loss-minimizing markup shrinks, to judge by the increased use of sales, rebates, discount outlets and other such hidden price reductions common at such times;[3] and producers accept the reduced return on their investment as the inevitable risk that investment involves. They will not, however, reduce the price of a product below its price floor, which is set by the minimum out-of-pocket expenses they believe necessary to assure the services of their employees and deliveries from the subcontractors and suppliers that provide the product's inputs. They will rather close down its production than reduce its price below that point.

It should now be obvious that if the price floor of every product were no higher than the sum of the payfloors of its inputs, then a fall in demand for a product would not cause the employees providing its inputs to be fired or laid off. Instead, its price, along with the pay of all those who contribute inputs would be reduced, making all of them shoulder part of the loss caused by the fall in demand. Only if worst came to the worst and the producer decided that the product was not worth producing, would he and all but his unskilled employees (and perhaps some of his subcontractors and their employees) quit voluntarily, because their earnings would reach their respective floors at the same time that the product's price reached its floor.

In our society, however, the necessary conditions for such a situation are seldom fulfilled, first, because producers usually overestimate the payfloors of their inputs; and second, because to avoid the danger of bankruptcy, the firm's total receipts from all its operations must be sufficient to pay not only the out-of-pocket costs of all its products' inputs but its out-of-pocket overhead costs as well— and those can be high when its bank debts and bonded debt are high.

As to the first, employees, suppliers and subcontractors don't tell the producer what their payfloors are. They don't want him to know their willingness, in worsened circumstances, to continue working for less pay, partly for fear of his abusing that knowledge to exploit them, partly in an attempt to shift their share of the product's eventual loss of revenue onto other people's shoulders. That is why producers tend to set their product's price floor at the level of their *actual* out-of-pocket expenses and, on reaching that, to reduce output rather than price in response to a further fall in demand, creating redundancies and involuntary unemployment.

One may well ask why employers could not rely on factor markets to negotiate an equitable distribution between themselves and their employees of the gains and losses that ever-changing market conditions create? They could if employees and workplaces could be changed as easily as shoppers switch from one store to another in search for the best price or product. But employees, especially professionals, skilled and semi-skilled workers, prefer stable employment, just as employers prefer stable employees, because the firm-specific skill, knowledge and experience that people accumulate in the course of their work are valuable assets that get lost and must be relearned and retaught with every change of worker and workplace, hurting employers and employees alike.[4]

That renders labor contracts very different from sales contracts, making them resemble marriage contracts instead. Just as there, the parties usually expect a fair deal when they sign the contract; but they also commit themselves for better for worse, for richer for poorer times to come; and if circumstances have changed to the worse by then, only the parties' decency, honesty and mutual trust can assure the continued fairness of the contract – qualities rarer in labor relations than in marriage.

How then is the unemployment problem handled? With ease and to mutual satisfaction only when perfect trust and honesty prevail. There are such cases. I have in mind one-man workshops and partnerships of solicitors, public accountants, physicians, where labor, capital and management are merely different hats on the same person's head and inputs of intermediate goods are insignificant. Owners of one-man shops and members of partnerships normally price their services so as to pay for their work and sundry minor expenses and yield a good return on the human capital of their skill or professional education and their investment in premises and equipment.

When demand declines, they lower their fees if they expect that to stimulate demand sufficiently to increase earnings; if not, they accept their lighter workload and reduced income but stay in business as long as earnings cover running expenses and the opportunity cost (pay floor) of their labor. Only in the extreme case of receipts' falling below that minimum would they quit to accept a salaried job or look for another location or occupation. In short, they may fall on lean times but are fairly well protected against unemployment. That is why accumulating enough savings to start a small store or workshop of their own has long been the ambition of all industrial workers in France and many other Continental countries as well. They knew that that was the best insurance for old age and unemployment, even if no cure for poverty.

Much the same is also true of small family firms whose members trust one another and probably of all small firms in which employers and employees have close friendly contacts and learn to be fair to one another and trust each other's fairness. Activity levels in such firms tend to be fairly stable because prices fluctuate instead; and the rare incidence of unemployment is due to quitting, more than to being laid off.

Bear in mind also that until the end of the 19th century, a large part of Continental Europe's labor force was employed in small family firms. In France, according to their 1906 census, 59 percent of the non-agricultural working population was its own boss or had jobs in firms with no more than 10 employees. Unemployment statistics were non-existent at the time; but that itself is suggestive. Awareness of unemployment as a social problem certainly came hand-in-hand with the emergence of large firms.

Let me also mention a suggestive present-day example. The two fastest developing countries of the postwar period are Taiwan and South Korea, always mentioned together, owing partly to their identical development policies and almost identical growth rates, and partly also to the great similarity of their race, culture, recent history, and social, political and economic structure. The one great difference between them was their monetary policies, which in Taiwan kept the average firm and its work force small, facilitated the establishment of new firms and led to growth mainly through a phenomenally fast, almost 10% annual increase in the number of manufacturing firms. Korean policy, by contrast, encouraged existing firms to expand, often to giant size and on average by an almost 23% annual increase in output, while the number of firms increased by less than 1% annually.[5]

The consequences of those different monetary policies were, first, the ever-increasing disparity in the size of the two counties' firms; and second, the very much higher debt ratios of Korean than of Taiwanese firms. It should be obvious from the foregoing that both those differences tend to make Korean firms the more vulnerable to involuntary unemployment; and the data bear that out. In South Korea, unemployment over the past 20 years ranged between 3.1 and 5.1% of the labor force, averaging 4.2%; in Taiwan, it ranged between 1.2 and 2.9%, averaging 1.9%

Economies of scale, however, are putting an end to the era of the small firm even in Taiwan, which raises the question what happens in large firms that employ much labor and capital, whose relations to management are more or less impersonal. Management can obtain capital either by borrowing, which adds a predetermined cash flow to its out-of-pocket expenses and so detracts from the price flexibility of its products; or it can issue stock, which leaves price flexibilities undiminished but involves relinquishing part of ownership.

Management's position in the labor market is much stronger than in the capital market, because while stockholders' have the right to supervise and fire them, it is they who exercise those rights over their employees. But their choice of terms on which they hire labor is similar to that on which they obtain capital. They can hire workers at a fixed wage, which restricts the downward flexibility of their prices and offers workers a stable income (often with merit and seniority increases) at the cost of job security; or they can keep their prices flexible and offer workers job security at the cost of wage stability — or they can offer some compromise between those two.

The general rule in this and most other countries has long been to sacrifice employment security for the sake of fixed, pre-set wages. Yet, that goes against both parties' interests, because employer and employees alike have an investment in the latter's job-specific skills and experience, which get lost with every change of worker and workplace. Why then has it been the predominant choice? The reason usually given is that it avoids creating ill will and distrust between the parties. For an employer who cites bad business for cutting wages would be suspect, because he could be giving an excuse rather than a reason. But when he uses the same justification for firing workers, he creates no ill will, because the workers fired know that the firm gets no value out of them and so cannot be benefiting at their expense.[6]

In short, employees' distrust of their employer makes both of them prefer a form of contract that is harmful to both — a paradoxical situation that resembles the Prisoners' Dilemma. Only very recently, during the depression of the 1970s, did labor and management begin to realize that both could benefit if they changed their priorities and opted for greater employment stability by settling for more flexible wages and more variable workweeks and work years.

To find a good way of doing that is one of today's most challenging tasks in economics, because substitutes and guarantees for plain honesty and mutual trust are hard to find. But Japan has had much success with the bonus system, which splits workers remuneration into a fixed and a variable part;[7] in West Germany, co-determination, which is mandatory for firms with 300 or more employees and puts workers on the firm's board of supervisors, is also promising; U.S. firms have successfully experimented with a combination of fixed hourly wages and flexible workweeks;[8] and an eminent economist is working on the economic theory of cooperatives and partnerships, trying to retain their merits while eliminating the shortcomings.[9]

Macroeconomic employment policy must, of course, have primary responsibility for mitigating fluctuations in aggregate demand; but given its severe limitations, more flexible prices and wages would greatly contribute to maintaining stable employment and a stable work force, along with such concomitant benefits as increased output and faster growth of productivity.

Endnotes

[1] Cf. my "The benefits of asymmetric markets" J.Econ. Perspectives 1990 4 pp.. 135-48, for a detailed discussion of why perfect competition is NOT conducive to technical and economic progress.

[2] Cf. Joseph Schumpeter Theorie der Wirtschaftlichen Entwicklung (*Duncker & Humblot, 1926, Munich)

[3] For a theoretical explanation of why markups shrink see R.F Harrod's "the law of diminishing elasticity of demand" in his The Trade Cycle (Oxford U. Press, 1936, Oxford) pp. 17-22

[4] Estimates of the employer's investment in his workers' job-specific skills range from 1 to 2 months' wages. See my "Asymmetries in economics" Scott. J. of Pol. Econ. 1978 25 p.231

[5] Cf. my "Economic development in Taiwan and South Korea: 1965-81" in Food Research Institute Studies, 1985, XIX, pp. 215-64; also in Lawrence J Lau (ed.) Models of Development. A Comparative Study of Economic Growth in South Korea and Taiwan (ICS Press, 1986, San Francisco), pp. 135-95.

[6] Cf. Arthur M. Okun, Prices & Quantities (Basil Blackwell, 1981, Oxford) p. 58.

[7] Cf. Martin Weitzman, The Share Economy (Harvard U Press, 1984, Cambridge, MA) and M. Aoki, Information, Incentive, and Bargaining in the Japanese Economy (Cambridge U. Press, 1988, Cambridge)

[8] Cf. S. D. Nollen New Work Schedules in Practice: Managing Time in a Changing Society (Van Nostrand, 1982, New York)

[9] Cf. J. E. Meade, Agathotopia: The Economics of Partnership (Aberdeen U. Press, 1989, Aberdeen)

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