THE FREEMAN
IDEAS ON LIBERTY

Should Profits Be Shared with Workers?

by Dwight R. Lee

When most people argue that firms should share profits with workers, they are not interested in the general distribution of business receipts.[1] Rather, they are pointing to firms experiencing exceptionally high profits and claiming that fairness requires that most of those profits be passed on to workers. For example, management consultant Alfie Kohn states, "If a company has had a profitable year, I see no reason those gains should not be distributed to the employees; after all, their work is what produced the profits."[2]

At a superficial level, it may seem only right that when a firm is doing well, its good fortune should be shared with the workers who made it possible. And, indeed, workers do benefit when their firms are profitable and expanding because their jobs are more secure and opportunities for promotion are greater. But shouldn't firms making high profits directly share some of those profits with their workers by increasing their wages much more than in leaner times? Workers and their union representatives are frequently quick to use high profits as justification for demanding large wage increases, but is it wise to acquiesce?

It is generally true that those fortunate enough to work for highly profitable firms receive higher wages than those who work for barely profitable firms.[3] But this is not the same as a firm giving its workers a large wage increase whenever it experiences a large profit increase. Firms seldom do this for reasons of efficiency, fairness, and the best interests of their workers.

Dr. Lee is Ramsey Professor of Economics at the University of Georgia.

Efficiency

Consider first the efficiency of sharing profits with workers. Although many people see profits as nothing more than rich people accumulating more wealth, profits serve a vital function in creating wealth by allowing consumers to communicate how they want scarce resources allocated among competing productive activities. A firm earning a large profit is using resources to create more value (as measured by what it sells its output for) than those resources could create elsewhere in the economy (as measured by what the firm has to pay for its inputs). The total value of production can then be increased, with the same use of resources, by reallocating resources to highly profitable firms and away from less profitable firms elsewhere in the economy. And this is exactly the reallocation of productive resources financed and motivated by high profits. Firms typically reinvest high profits right back into the productive activity that generated them by bidding resources, both human and non-human, away from less profitable activities. Output expands in the high-profit firms (driving their rate of return down) and contracts in the low-profit firms (driving their rate of return up) until additional inputs are worth no more in the former than in the latter.

This efficient reallocation would be impossible if a firm that began making high profits, say because of an increase in the demand for its product, used those profits to increase the wages of its workers. Firms are forced by competition to pay their workers at least as much as they are worth in their best alternative employments. If a firm devoted its high profits to paying its current workers more than is justified by their productivity, it would be unable to attract the additional resources it needs to expand. The workers receiving the higher wages would be obviously better off in the short run, but their gains would be more than offset by the losses (forgone opportunities) suffered by others in the economy.

Fairness

Quite apart from the adverse effects on efficiency, paying workers higher wages when the profits of the firm they work for are high forces firms to behave in ways that will be widely seen as unfair. If, because of high profits, a firm offers wages well in excess of their opportunity cost (the amount needed to attract workers with the appropriate skills from other employments), more people will want to work for that firm than it can afford to hire. This creates a situation where firms find themselves having to choose workers on the basis of non-economic considerations. Regardless of how firms make those choices, they will be criticized for practicing favoritism and unfair discrimination by those who are not chosen, and maybe with justification. Certainly the fairest approach, and the one that penalizes discriminating on non-economic grounds, is to give all workers the opportunity to compete for jobs on the basis of their productive ability. This opportunity is denied to most workers when some are being paid more than their productivity warrants.

But even those who would get large wage increases because they work for firms creating high profits would probably not benefit from a policy of sharing in those profits, and certainly not if the policy were fairly implemented. If workers receive large wage increases when their firm is making large profits, then fairness would require that they also receive wage cuts when profits decline. Indeed, if workers favored a consistent policy of sharing in the profits, then they should be prepared to give money back (receive negative wages) when their firm (as firms often do) loses money. But workers obviously would not be happy with such a policy. It would expose them to all the risks that confront the owners of the firm, risks that few workers are willing to bear. People willing to accept large risks typically start their own businesses, or invest in businesses that others start, in return for a higher average, but very uncertain, return. Workers are typically more risk averse, as evidenced by the fact that they choose to work for others for a lower average, but more certain, return in the form of a fixed salary or wage.

Of course, some firms have attempted to motivate workers to be more productive through arrangements that give them some ownership in the firm. But these plans are not what those calling for sharing high profits with workers have in mind, since they can impose losses on workers when profits decline. For this reason, these profit-sharing plans are not widespread. Furthermore, when they do exist, profit-sharing plans are typically rather limited because even under the best of circumstances they do little to motivate workers to be more productive.

The Free-Rider Temptation

Profit-sharing arrangements are easily frustrated by the free-rider temptation. Although it is *collectively* rational for all employees to work harder in response to profit sharing, it is not *individually* rational to do so. Each worker will recognize that if others work harder, that he will reap the benefits from higher profits without extra effort. Each worker also recognizes that if others don't work harder, then his share of the additional profit generated by extra effort is too small to be worth the effort.

For example, assume that there are 1,000 workers in a firm, each earning $15.00 per hour. Also assume a profit-sharing plan is established that would increase total worker productivity, and therefore worker compen-

Unless workers are willing to take the losses that are inevitable in business activity, as well as the gains, the argument that fairness requires that workers share in the profits of their firms is an empty one.

sation, by $40,000 per week if all workers reduce their shirking on the job by one hour per week. This is clearly a good deal for the workers, since each one stands to receive $40 for putting in just one more hour of genuine effort. But consider the payoff each individual would realize from his decision to shirk an hour less. The individual who puts in one more hour of work would be responsible for increasing total compensation by $40 (assuming that each individual's impact on productivity is the same as everyone else's, and independent of what others do). But since the additional $40 is spread over all 1,000 workers, his share, in the form of higher wages is only $.04. How many would be willing to give up an hour of on-the-job leisure for $.04? At that hourly rate a person would have to work an entire 40-hour week to make enough to buy a small box of popcorn at the movies.

So having workers share consistently in the profits of their firm is not a policy many workers would find attractive. Such profit-sharing arrangements do little to motivate more productive effort, while imposing risk on workers that few are comfortable accepting. This explains why profit-sharing arrangements are often short-lived.

Consider the experience of Du Pont's fibers division. In 1988, Du Pont began an incentive pay plan for its fibers division workers. Workers were to commit some of their annual pay increases to an "at risk pot" until it contained 6 percent of their annual compensation. They were to share in the profits through bonuses based on how well the division did compared to a target of a 4 percent real growth in profits. If, for example, profits increased by 5 percent, then workers would be paid the 6 percent of the pay they contributed plus another 6 percent. If profits increased by 6 percent, workers would be paid their 6 percent plus the maximum bonus of 12 percent. On the other hand, if the division just made its profit target of 4 percent, the workers would get just their 6 percent back, with no bonus. And if the division's profits fell to 80 percent or less of its profit target, then the workers lost the 6 percent of the pay they put at risk.[4]

Even though the risk the Du Pont plan imposed on its workers was less than a complete profit-sharing plan would have imposed, some workers expressed concern about gambling with a significant amount of their annual pay before the plan went into effect.[5] This concern was temporarily disregarded, however, when in 1989 profits exceeded the target and workers received $19 million in bonuses. Few people complain about the risk when they are holding a winning hand. But in the 1990 recession, the fibers division's profits were not meeting the target and workers were going to lose some of their at-risk pay under the incentive pay plan. The prospect of this loss did not sit well with the division's 20,000 workers, most of whom took something other than an entrepreneurial attitude toward the downside of risk. Faced with complaints and problems with worker morale, Du Pont canceled the incentive plan, letting the workers avoid the type of loss that those who want to share in profits have to be willing to accept.[6]

More recently, Wal-Mart Stores has experienced some difficulties with its profit-sharing plan. Probably no other U.S. company has used stock incentives more than Wal-Mart to motivate hard work and loyalty from its workers. And for years it worked as Wal-Mart stock steadily increased in value (100 shares of Wal-Mart stock, which cost $1,650 in 1970 when it first went public, were worth $3.5 million in February 1993). But then the stock experienced a decline, going from $34.125 a share in February 1993 to $20.875 on the first trading day in 1995. During this decline, the profit-sharing plan became a source of worker complaints and demands for more pay and union representation. As reported in the *Wall Street Journal*, "The world's largest retailer is also discovering the risks in a profit-sharing plan heavily invested in its own stocks."[7]

Unless workers are willing to take the losses that are inevitable in business activity, as well as the gains, the argument that fairness requires that workers share in the profits of their firms is an empty one. Many workers, and their representatives who call for sharing profits with workers, seem to believe that fairness means "Heads I win, tails you lose." All workers are better off, and treated more fairly, when most profits are retained by firms to expand the production of goods and services that consumers are communicating with those profits that they want more of. □

1. At one level the answer to the question in the title of this paper is, of course profits should be shared with workers. The only durable source of compensation for any worker (whether in the private or public sector) is the revenue earned by profitable businesses. Indeed, by a wide margin, most of the national income goes to pay workers. In 1994, for example, employee compensation made up 73.4 percent of the national income, with corporate profits coming to 9.9 percent and proprietors' and rental income (not all of which can be counted as business profits) amounting to 9.2 percent. The rest of the national income in 1994, or 7.5 percent, went to net interest. These figures are found on page 39 of Herbert Stein and Murray Foss, *The New Illustrated Guide to the American Economy* (Washington, D.C.: The American Enterprise Institute Press, 1995).

2. See page 183 of Alfie Kohn, *Punished by Rewards* (Boston: Houghton Mifflin Company, 1993).

3. This does not necessarily mean, however, that highly profitable firms are more generous in sharing profits with their workers than are less profitable firms. More likely, highly profitable firms are paying higher wages to attract workers more skilled than those working for less profitable firms.

4. For more details on the plan, see Nancy L. Perry, "Here Come Richer, Riskier Pay Plans," *Fortune*, December 19, 1988, pp. 50–58.

5. See "All Eyes on Du Pont's Incentive Pay Plan," *Wall Street Journal*, December 5, 1988, p. A-1.

6. Richard Koenig, "Du Pont Plan Linking Pay to Fibers Profit Unravels," *Wall Street Journal*, October 25, 1990, p. B-1.

7. See Bob Ortega, "What Does Wal-Mart Do If Stock Drops Cuts Into Workers' Morale?" *Wall Street Journal*, January 4, 1995, p. A1.

The Futility of Class Warfare

With the collapse of socialism both as a theory and as a practical system of economic organization the world over, one might expect the rhetoric of class warfare to subside as well. But class warfare is alive and well in prominent academic circles and the mainstream national media.

It's a familiar refrain: capitalism is doing itself in by concentrating wealth in the hands of a few. Saving the system from its own sins requires an activist government to intervene to make sure more people get their share of the economic pie.

In a recent issue of *America* magazine, Jeffrey R. Gates bemoans the fact that too many Americans have too little wealth. The solution, he says, is for the government to devise a grand plan, a "national ownership strategy" that will spread the people's wealth around according to some centrally planned formula.

Imagine that. The same government that can't manage its own fiscal affairs, that squanders billions of other people's dollars in subsidies for corporations and foreign regimes, that wasted a trillion more in a counterproductive war on poverty, is now supposed to preside over what Mr. Gates calls a "national ownership strategy" for the American people.

Gates cites, among other sources, a 1995 study of New York University professor Edward Wolff, who argued that wealth is more concentrated in the hands of a few than at any time since the 1920s. Wolff's study was severely flawed, however, because of its false assumptions and many omissions. For example, it gave little attention to the shifting patterns within income categories.

In an economy with great mobility, people simply do not remain in the same top and bottom income categories over time. Treasury Department data show that of the U.S. households in the bottom one-fifth of incomes in 1979, only 14 percent remained there by 1988. Meanwhile, 35 percent of 1979's top one-fifth had fallen from the top by 1988.

Wolff's study found a widening gap in the distribution of wealth in part because, amazingly, it excluded the value of pension plans! When wealth is measured more broadly, as it should be, to include pension benefits, home equity, and autos, the "wealth gap" reduces to a tempest in a teapot.

Many recent economic studies refute the "rich are getting richer while the poor are getting poorer" scenario that Gates, Wolff, and others present as fact:

- John Weicher of the American Enterprise Institute has shown that the portion of the country's total wealth owned by the richest one percent of Americans remains virtually unchanged since 1963. Ownership of mutual funds and retirement accounts among average households has soared in the last 20 years.
- Kenneth Deavers of the Employment Policy Foundation has shown that between 1970 and 1990, the share of families with real

Lawrence W. Reed, economist and author, is president of the Mackinac Center for Public Policy, a free-market research and educational organization headquartered in Midland, Michigan.