# Insider Privatization and the Labor Market Performance under Competitive and Monopsonistic Conditions

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## SUMMARY

### Part I. Insider privatization, the pricing of goods and the labor market performance under competitive conditions: The general equilibrium approach

From this part of the Project has emerged in the paper 'When does Privatization Work: A General Equilibrium View'.

As a preface, we stress that <u>both</u> results of this part - contained in the Project proposal and obtained by using specific functional forms - have now been <u>fully</u> extended to the general case.

The first result, initially obtained by using Cobb-Douglas specification of production and utility functions, has indicated the instability of the Walrasian tâtonnement in an economy populated by (supposedly) wage-maximizing, insider-privatized firms, in situations when an economy composed of profit-maximizing, outsider-privatized firms displays (local) stability. This instability result has now been extended to refer to any well-behaved convex technology.

The second result, obtained for the same Cobb-Douglas economy, is about detecting the possibility of the deeply anomalous, pro-scarcity pricing by insider-privatized wage-maximizing firms, in situations when outsider-privatized, profit-maximizing firms adhere to common sense, counter-scarcity price setting. This pricing paradox has now also been extended to cover the general case of well-behaved convex economies.

The importance of this defective pricing result is that it reveals the ultimate and the most profound microeconomic implication of the notorious Ward (1958) effect or paradox, where such a perverse price setting is exactly the general equilibrium analogue of this, partial equilibrium Ward effect.

However, we have also found a rather unexpected, if not striking, possible <u>macroeconomic</u> <u>policy</u> implication of the pro-scarcity price setting by insider-controlled firms.

Thus, the revealed increase in the equilibrium output and employment, caused by an autonomous increase in demand, suggests that demand expanding fiscal or monetary policies

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[1] Please note that in publications Djordje Suvakovic also uses his mother's name, Olgin, and the abbreviated form, D. S. Olgin.

are likely to *increase* (aggregate) employment and output, which contradicts the classical and never opposed conclusion by Meade (1972) and Vanek (1970; 1977), on the counterproductive nature of such policies in economies composed of insider-controlled firms.

In fact, the working of such policies has been demonstrated, within the fixprice macromodels, by Neary (1990) and Saldanha (1989). However, in these models the barrier to a successful demand management, in the form of the Ward effect, is absent by the very (fixprice) assumption, never used by Meade and Vanek.

Also, the revealed fall in the equilibrium price, caused by an autonomous demand increase, suggests that in an economy populated by wage-maximizing, insider-privatized firms demand expanding policies, along with increasing employment and output, may also generate *deflationary effects*, contrary to the inflationary outcomes, predicted in the cited contributions by Meade (1972) and Vanek (1977).

To sum up, this provoking macroeconomic possibility scenario apart, our results further suggest that the majority employee ownership - *if* followed by wage maximization, and judged by the standards of equilibrium analysis - turns out, at least on average, to be inferior to conventional outside wealth holding arrangements.

**Part II. Insider privatization, the pricing of labour, and welfare losses under monopsonistic conditions**

This part of the Project has resulted in the paper 'Labor-Managed vs Profit-Maximizing Monopsony in the Labor Market'.

As in part I of this Summary, we emphasize that the basic result contained in the Project Proposal and obtained there for linear inverse labor supply or wage functions and concave (polynomial) labor's marginal productivity, has been successfully extended to the general case of <u>any</u> convex wage function, and <u>any</u> decreasing labor's marginal product function, provided that these functions are diferentiable.

The basic finding contained in this part of the Project Proposal has reduced to the insight that for a relatively wide range of labor shortage the insider-privatized, wage-maximizing monopsony efficiency dominates its profit-maximizing twin.

To obtain this result in the general case we have first defined the <u>local</u> efficiency dominance, according to which one firm dominates the other when, for a single inverse labor supply or wage function, the former produces more output than the latter, provided that both firms are able to make no losses.

For the above specified (typical) wage function, we have then systematically varied a suitably defined index of labor shortage, or labor scarcity parameter, from zero to its zero-

profit level. Given a turned U-shaped income-per-worker schedule, the latter level defines the steepest wage curve that yields zero profit both to an insider-controlled or labor-managed firm (LMF) and its conventional profit-maximizing twin (PMF), and thus have the tangency point with the above schedule.

The varying of labor scarcity has generated the continuous family of wage functions, which all ensure nonnegative profit to a LMF and a PMF and where, by definition, the number of such functions is infinite.

Finally, we have demonstrated that this family is always divided by, some neutral member-function, in its upper and lower subfamily, where for any function of the former a LMF (locally) dominates a PMF, while for any function of the latter the converse is true.

Thus, we have also shown that, on the level of a single wage function, a LMF can efficiency dominate a PMF, and vice versa.

After detecting this alternating LMF/PMF dominance relation, we have focused on getting the idea about the relative size of the LMF and the PMF dominance regions, identified with the ratio of shares of the corresponding subfamilies in the above defined family of wage functions.

Also, this has required to establishing the (novel) concept of <u>global dominance</u> - not contained in the Project Proposal - where one firm is defined to globally dominate the other when the former locally dominates the latter for more than a half of all wage functions which constitute the (entire) family.

We have then run 27 (carefully selected) numerical simulations, which combine three types of technology, three types of wage functions, and three levels of the entry-wage at the monopsonistic labor market.

The somewhat (unexpected) result of the performed simulations is that, on average, a LMF <u>strongly</u> globally dominates a PMF, where the average size of the LMF dominance region amounts to 94% of <u>all considered</u> wage functions, and where just one of 27 simulations yields a (relatively weak) PMF's dominance.

Finally, we conclude by the remark that may be of relevance for the policy of privatizing non-wage-taking firms. If, say, in the context of post-socialist transition, the econometric evidence reveals the <u>local dominance</u> of some insider-privatized firm (assumed to behave like a canonical LMF) over the corresponding outsider-privatized PMF, a higher local efficiency of the former - due to its objective of wage maximization - ought to be weighed against the possibly superior technical productivity of the latter, observed, for

example, in the case of the outsider-privatized firms across Central-Europe.[2] This, among other things, should be necessarily taken into account when defining the strategy of how to privatize a non-wage-taking firm.

## Cited References

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[2] See Frydman, Gray, Hessel and Rapaczynski (1999), where the revenue performance of such firms, not of interest on the present occasion, has also been analyzed.