At Last, A Modern Theory of Wages

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Consider two facts about textbook wage theory. First, it is little changed from its original construction by the great 19th century marginalists. Second, for at least 100 years, mainstream thinking has been badly out of step with the actual behavior of labor pricing. The GEM Project identifies the problem to be the consensus coherent market-centric DSGE model's inherent suppression of rational nonmarket labor-pricing that occurs in large, specialized firms. The mainstream inability to coherently restrict wage recontracting in a large class of employers prevents a causal link from nominal disturbances to involuntary job loss. (Chapter 6)

Coase pioneered the rational boundaries between the market and the firm around the time the *General Theory* was being written. Decades later, Simon and Williamson closely modeled rational behavior inside large corporations. Throughout the middle 20th century, Kerr, Dunlop, and other on-site labor economists were carefully documenting the objectives and transaction mechanisms governing large-establishment employee-employer exchange. It is deeply problematic that Coase, Simon, Williamson, Kerr, Dunlop, and their colleagues never gained much traction in mainstream macro thinking.

Notwithstanding macroeconomists' inattention, firm size-heterogeneity has exerted crucial influence on macro performance since the Second Industrial Revolution. Generalized exchange draws on the profound transformation of the production landscape to bifurcate labor pricing, one branch located in the marketplace and the other in the large workplace. The result is the first coherent, stabilization-relevant theory of wages in a more than a century.

In the small-establishment venue (SEV, subscripted K), cost-effective employee oversight allows market-centric DSGE modeling to satisfactorily explain labor pricing. Employer profit-seeking and employee utility-maximization combine to produce the beautiful equality among the nominal wage paid, the value of labor's marginal product (Keynes's First Classical Postulate), and labor's marginal disutility of work (Keynes's Second Classical Postulate): $W_K=VMPL_K=VMRS_K=W^m$. Firms and workers can do no better than being market-price takers.

In the large-establishment venue (LEV, subscripted J) employers and employees confront greater complexity, largely because worker oversight is restricted by costly, asymmetric information. Labor input ($\acute{E}_J$), demonstrating 1:1 correspondence with production, cannot be measured or priced in the marketplace. Firms must construct their own labor-pricing apparatus. Moreover, the evolution of best-practices compensation systems soon made it clear that workers' preference for equitable treatment by management, suppressed in competitive-market exchange, significantly influences on-the-job behavior (OJB) and must be carefully factored into rational workplace exchange. (Chapter 2)

LEV management of labor input is separable into two parts. The crucial step is sufficient identification of the Workplace Exchange Relation (WER) to enable labor pricing consistent with unit-cost-minimizing employee behavior: $W_J=W^n_J=\max(\acute{Z}_J/W_J)$ and $\acute{Z}_J=\acute{Z}^n_J=(\acute{E}_J/H_J)^n$. The derivation in Chapter 2 of the robust nonconvex WER class illustrated in Figure 2.1 (reproduced below) microfounds the equality of the wage paid (W), the employer's efficiency wage (W^n), and the employees' reference wage ($W^{\acute{n}}$), which locates the critical unit-cost-minimizing WER discontinuity: $W_J=W^n_J=\max(\acute{Z}_J/W_J)=W^{\acute{n}}_J=\sup \mathbb{K}_J > W^m$ where $\mathbb{K}_J$ denotes employee equity-based reference standards. (Chapter 2) Keynes's Second Classical Postulate is eliminated and replaced by the workplace optimization of cooperative labor productivity ($\acute{Z}_J=\acute{E}_J/H_J$), a practitioner-recognizable process that yields chronic labor rents and, over the business cycle, downward wage inflexibility.

LEV management's second objective is to assure an adequately sized workforce, a task that is not difficult. Continuous-equilibrium labor pricing ($W_J=W^n_J=W^{\acute{n}}_J>W^m$) combines with the substantial pool of SEV employees to produce an elastic market-supply schedule at W^n_J. Firms specify production schedules (with particular levels of labor hours, capital services, and material input) as an increasing function of expected product demand. Labor demand is consistent with the model's overall reorientation to Keynesian causation from nominal demand to employment/output.

The cost-effective symmetric workplace information needed to enable neoclassical textbook equality between the wage paid and marginal disutility of work is an untenable universal assumption, making room for Keynes's shrewd rejection of his Second Classical Postulate in the context of large corporations and routinized jobs. Say's Law is, once and for all, scrapped. Add to the mix workers' axiomatic preference for fair treatment, and the stage is set for a necessary revolution in the treatment of rational labor supply.

Generalized exchange features the nonconvex Workplace Exchange Relation derived from model primitives in Chapters 2 and 3 and, as noted, captured in its baseline form by Figure 2.1. The WER supplies labor input that has 1:1 correspondence with production and is governed by axiomatic employee preferences and technological constraints.. It is the most serious exercise in writing down labor-supply functions since the Second Industrial Revolution. The crucial WER, present (but not microfounded) in the macro literature since Annable (1977, 1980), is now best understood as a heretofore unappreciated fundamental law of modern macroeconomics, uniquely enabling coherent theory to be stabilization relevant. Once a substantial share of workers are rationally pushed off their neoclassical labor-supply schedule, continuous-equilibrium macro modeling can answer important, previously unanswerable questions and explain significant, previously inexplicable evidence.

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