Better Microeconomics

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The great achievement of generalizing rational exchange from the marketplace to the large-establishment workplace is the derivation, from axiomatic model primitives, of meaningful wage rigidity. MWR demonstrates both downward nominal inflexibility over the business cycle and chronic time-varying labor rents. It crucial suppresses wage recontracting. (Chapter 1)

Continuous-equilibrium MWR is the keystone of the GEM Project's reconstruction of macro theory to be simultaneously coherent and stabilization-relevant. In particular, such wage rigidity uniquely enables causality from adverse nominal demand disturbances (NDD) to involuntary job loss. Given MWR, NDD induces same-direction movement in employment, output, pure profit, and investment. Microfounded macroeconomics becomes, at long last, consistent with the most critical cyclical evidence. The story, however, does not end there. Generalized-exchange modeling also enhances textbook microeconomics. The core micro innovation is the introduction of axiomatic characteristics of large establishment (LE) production of goods and services – i.e., costly, asymmetric workplace information and routinized jobs – that enable micro textbooks to adequately capture labor pricing in highly specialized economies. Profit-maximizing LE wage setting augments standard competitive-market labor pricing, which is henceforth confined to the representative small firm that features cost-effective employee oversight.

Micro labor pricing. LE labor input ($\acute{E}$) demonstrating 1:1 correspondence with production cannot be measured or priced in the marketplace. Management must construct its own wage-setting apparatus. Moreover, as a consequence of the evolution of best-practices human-resource systems over time, management knows that employees' preference for equitable treatment, suppressed in competitive-market exchange, significantly influences on-the-job behavior and must be carefully factored into rational workplace exchange. (Chapter 2)

LE labor-input management separates into two parts. The crucial step is sufficient identification of the firm's Workplace Exchange Relation (WER) to enable labor pricing consistent with unit-cost-minimizing employee behavior: $W=W^n=\max\ (\acute{Z}/W)$ and $\acute{Z}=\acute{Z}^n=(\acute{E}/H)^n$. The GEM Project derives the relevant nonconvex WER, establishing the equality of the wage paid (W), the employer's efficiency wage (W^n), and the employees' reference wage ($W^{\acute{n}}$) at the unit-cost-minimizing WER discontinuity: $W=W^n=\max\ (\acute{Z}/W)=W^{\acute{n}}=\sup$ ₭$>W^m$ where ₭ denotes employee equity-based reference standards and W^m is the market rate. (Chapter 2) Keynes's Second Classical Postulate is scrapped and replaced by employees' workplace optimization of labor's cooperative productivity ($\acute{Z}=\acute{E}/H$), practitioner-recognized behavior that generates both chronic labor rents and significant periods of downward nominal wage rigidity.

The second step is to assure an adequate workforce, a task that is relatively easy. Continuous-equilibrium labor pricing ($W=W^n=W^{\acute{n}}>W^m$) combines with the huge pool of small-firm workers being paid the market wage to produce an elastic market-supply schedule at W^n. The LE production schedule (with particular levels of labor hours, capital services, and material input) is increasing in management's rational expectations of product demand. The reconstructed labor demand is consistent with the GEM Project's reorientation of coherent economic theory around Keynesian causation from nominal demand to employment and output.

Chronic labor rents. The most broadly consequential micro innovation resulting from generalized-exchange labor pricing is the ubiquity of continuous-equilibrium wage rents. Such rents have been apparent in the evidence for a long time, but the workplace-marketplace synthesis was needed before $W^n>W^m$ could rewrite neoclassical microeconomics.

In an outcome that is familiar to everybody but market-centric economists, the GEM Project partitions employment into "good" (rent-paying) jobs, which must be rationed, and plentiful "bad" (no-rent) jobs, with inter-venue labor flows governed by well-established Harris-Todaro mechanics. LE firm equilibrium, featuring $W=W^n>MRS=W^m$, pushes employees off the textbook labor-market supply curve. Payment of wage rents permits management to unilaterally set the workweek, preventing most employees from working the number of hours desired. In the profit-seeking large establishment, rational labor pricing suppresses employee work-leisure choice and generates long-tenured employment. Worker attention centers on optimizing discretionary on-the-job behavior. Outside LE firms, labor optimization is constrained by workers' frustrated desire to obtain rationed high-wage jobs for which they are qualified, reconciling market supply-demand disequilibrium and continuous, constrained decision-rule equilibrium. In the small firm, employees are rationally paid their marketopportunity costs, restricting their rational decision-making to work-leisure choice and the on-going quest for rent-paying jobs. The small firm experiences substantial job churning.

Chronic labor rents alter neoclassical textbook analysis on a broad variety of fronts. A sample of the sundry implications will be used to illustrate the microeconomic criticality of the generalization of rational price-mediated exchange:

- Central public-finance theorems associated with the taxation of labor-income are invalidated. Given the payment of wage premiums over the market rate, tax changes induce much smaller effects on the willingness to work than predicted by neoclassical knife-edge labor supply.
- The generalized-exchange model class improves the calibration of general human capital in empirical investigations of wage determinants. Given its rational payment of wage rents, the profit-seeking large establishment can and does cream its excess supply of job applicants, implying that familiar market-centric empirical analyses systematically overestimate the true return on investment in general human capital.
- Rational time-varying labor rents mandate the long overdue reconstruction of the textbook treatment of factor-income distribution. Jensen's (2000) residual-surplus model replaces the elegant Wicksell-Wicksteed analysis, paving the way for the critical reintroduction of pure profit into mainstream economic theory. (Chapter 3)
- Emphasizing a point made above, LE management's rational expectations of product demand plays a central role in determining the firm's demand for labor. (Chapter 6)
- For highly specialized economies, the analysis of market monopoly and its familiar variations must be reworked.
- Typical textbook analysis of economic rent, rooted in Edgeworth's theory of the bargain and applied to union-management negotiations, is considerably enriched by the generalized-exchange provision of a determinant outcome.

The examples provide some feel for the numerous micro implications produced by the GEM Project's derivation of continuous-equilibrium MWR. By far the most important outcome, however, is the great blurring of distinction between micro and macro analyses that results from the workplace-marketplace synthesis. Given the uncomplex aggregation enabled by two-venue rational exchange, policy-relevant coherent modeling easily moves between micro and macro perspectives – an outcome that is not feasible in mainstream market-centric thinking. (Chapter 5)

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