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David G. Blanchflower; Andrew J. Oswald

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PROFIT-RELATED PAY: PROSE DISCOVERED?*

David G. Blanchflower and Andrew J. Oswald

M. Jourdain: 'Good heavens. For more than forty years I have been speaking prose without knowing it.'
(Molière, *Le Bourgeois Gentilhomme*, 1670)

The case for profit sharing has attracted much recent attention, and the UK Spring Budget of 1987 offered tax relief on 'profit-related pay'. Nevertheless, economic research on the issue has been predominantly theoretical¹ (Blanchflower and Oswald (1987*b*) and Estrin *et al.* (1987) provide surveys). Weitzman (1983; 1984; 1987) and Meade (1986) have been especially influential.

The object of this paper is threefold. First, in Section I the Workplace Industrial Relations Surveys (WIRS) of 1980 and 1984 are used to calculate the extent of income-sharing schemes in Great Britain. Second, Section II attempts to test the hypothesis that profit-related pay produces greater company prosperity. As claimed in a recent Green Paper:

Profit Related Pay schemes should lead to a closer identification of employees with the companies in which they work ... The most important consequence ... is likely to be enhanced competitiveness and better business performance.
(*Profit Related Pay*, 1986, Cmnd. 9835, p. 3)

Section III examines tabulated evidence on the growth rate of, and quality of industrial relations within, sharing and non-sharing establishments. This was simulated by, *inter alia*, the following sentence taken from the Green Paper:

The Government believes that the spread of Profit Related Pay would be beneficial ... for industrial relations, for productivity, for growth and for employment.
(*Profit Related Pay*, 1986, Cmnd. 9835, p. 7)

Section IV summarises the paper's findings.

I. THE EXTENT OF PROFIT-RELATED PAY

In earlier work (Blanchflower and Oswald, 1986, 1987*a, b*) we reported on the extent to which share ownership schemes operate in British industry. Using data from the 1980 Workplace Industrial Relations Survey (WIRS₁), we

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¹ Exceptions include Conte and Tannenbaum (1978), Estrin and Wilson (1986), Richardson and Nejad (1986) and Wadhvani (1985).

found that, in 1980, just under 10% of all private-sector employees (in establishments of at least 25 employees) were eligible to participate in these schemes. Half of these individuals, or approximately half-a-million workers, actually did participate. There was also evidence that there had been a considerable growth, in the late 1970s, in the numbers of individuals participating in share ownership programmes. It is likely that this occurred primarily because of the introduction of a series of tax incentives.

The newly available 1984 Workplace Industrial Relations Survey (WIRS₂) means we are able to examine changes in the number and distribution of share ownership programmes in Great Britain since 1980. In addition, WIRS₂ contains information on both profit sharing and value-added bonus schemes² (figures on these were not available in WIRS₁). The Appendix describes the Survey.

Table 1 shows a remarkable increase in employee share ownership between 1980 and 1984. It also makes clear that profit-related pay (broadly defined) is not at all uncommon in British establishments. Table 2 describes the incidence, across private manufacturing and private non-manufacturing industry,³ of the three types of sharing scheme.

The tables contain various kinds of information, but one result stands out. *More than 40% of all establishments in 1984 operated at least one form of income sharing*

Table 1
Industrial Distribution of Profit-Related Pay (%)

	Share ownership		Profit sharing 1984	Value-added bonus 1984
	1980	1984		
Energy	*	*	*	*
Minerals and chemicals	12	23	32	17
Metals, engineering and vehicles	9	14	11	15
Other manufacturing	8	13	14	18
Total manufacturing	9	15	16	16
Construction	9	17	18	25
Distribution, hotels and catering	18	29	18	18
Transport	11	18	12	8
Banking, insurance, finance and business services	32	44	39	10
Other services	2	14	5	7
Total non-manufacturing	17	29	21	14
Private sector	14	25	20	15

Source: 1984 Workplace Industrial Relations Survey.

Base: All private-sector establishments.

* Too few observations for percentages.

² A value-added bonus scheme ties payments to value-added rather than to profits *per se*.

³ See also Smith (1986) who examined the extent of profit sharing and employee share ownership using a survey (conducted between March and May 1985) of 1,125 companies with turnover in excess of three-quarters of a million pounds. 303 companies were subsequently interviewed in greater depth. Smith found that 15% of companies had an Inland Revenue approved share scheme; 6% had profit sharing. A further 9% of companies had a scheme only for selected employees (1986, p. 381). Unfortunately, the number of employees participating in these schemes is not reported.

Table 2
The Incidence of Sharing Schemes in 1984 (%)

	Private manufacturing	Private non- manufacturing	All private sector
Type 1 only	10.0	13.9	12.6
Type 2 only	7.4	6.5	6.7
Type 3 only	11.6	7.9	9.2
Type 1 and 2	4.4	10.9	8.7
Type 1 and 3	0.5	2.3	1.7
Type 2 and 3	2.8	1.4	1.9
Type 1, 2 and 3	1.2	2.4	2.0
Any scheme	37.9	45.3	42.7
Number of observations	432	834	1,266

Notes: Type 1 = Share ownership scheme. Type 2 = Profit-sharing scheme. Type 3 = Value-added bonus scheme.

Base: All private-sector establishments.

programme.⁴ Moreover, these schemes were not restricted to small numbers of managerial staff. WIRS2 reveals, for example, that in the case of establishments with employee share ownership schemes, the majority of workers were eligible to participate.

We now come to a central issue. The data set contains managers' assessments of their own establishment's financial performance. They were asked the question

How would you assess the financial performance of this establishment compared to other establishments in the same industry?

(Q. 14a – management questionnaire, p. 8)

and could answer

- (i) better than average,
- (ii) about average,
- (iii) below average,
- (iv) no comparison possible.

There are obvious difficulties with such responses; but they provide a broad ordinal ranking, and at the establishment level (where genuine profit data are routinely unavailable) this is probably the most for which one can hope.

Table 3 sets out the raw data. It shows that there is no strong correlation between the existence of sharing programmes and the reported financial performance of Britain's private-sector establishments. However, this is only a gross correlation. In the next part of the paper we adopt a multivariate procedure which permits us to identify the major influences on the probability of a manager reporting that financial performance at the establishment was above average. This is an attempt to test the hypothesis that profit-related pay improves performance.

⁴ Hence our title.

Table 3
Financial Performance of the Establishment (%)

	1980		1984			
	Share scheme	Total sample	Share scheme	Profit sharing	Value-added bonuses	Total sample
Performance						
Above average	53	46	41	44	43	42
Below average	3	6	8	3	7	6
Average	40	45	42	46	37	41
No comparison possible	3	3	9	7	14	11
No. of observations	176	1,138	307	242	188	1,209

Base: All private-sector establishments.

II. ECONOMETRIC RESULTS

Let the profit of an establishment be

$$P = R(q, n, k, a^h, a^f, t) - wn - rk,$$

where $R()$ is revenue, q is workers' effort or productivity, n is employment, k is capital, a^h is a demand shift parameter for the home market, a^f is a demand shift parameter for foreign markets, t is technology, w is the wage and r is the rental rate or price of capital.

To follow the form of the WIRS2 questionnaire it is necessary to normalise on industry profits, P^* . Before that, however, we define the maximum profit function as:

$$\begin{aligned} P^a &= \max_{n, k} R(q, n, k, a^h, a^f, t) - wn - rk \\ &= P^a(q, a^h, a^f, t, w, r). \end{aligned}$$

Then the relevant dependent variable is, for the i th establishment, the term measured by P^{ai}/P^* . Because of its (effectively) bivariate nature in the survey we estimate a binomial Probit equation.

Effort, q , is unobservable, but we assume it depends on whether or not there exists a profit-related pay scheme. Three kinds of schemes are reported in the 1984 Workplace Industrial Relations Survey (employee share ownership, profit sharing, and value-added bonuses), and three dummy variables are therefore used. Domestic demand shocks, a^h , are entered by including dummy variables for 'falling demand' and 'stable demand'. The category 'rising demand' is the base. Foreign demand pressure, a^f , is captured more crudely, by a dummy for establishments which traded primarily in international markets.

Technology, t , and wage rates, w , are more problematic, and some experimentation was done. We decided to use a number of proxies for these two variables, namely, the percentage of labour costs to total turnover, the size of the establishment and two unionisation variables. The unionisation dummies

might be thought of as affecting q , or as a measure of technology and work practices, or both.

The cost of capital, r , can reasonably be taken to be the same across all sectors, and thus is assigned to the constant term. As the dependent variable is a relative profitability measure, the sectoral profits denominator, P^* , must also be included. It is exogenous to each establishment, and the same across the industry in which establishment i appears, so we capture P^* by a set of 59 industry and 11 regional dummy variables. Those variables will also pick up any other industry or region-specific forces.

As can be seen from Table 3 above, managers reported that, on the whole, establishments in the sample performed better than average. This kind of over-estimation is common in sample surveys. Managers in 42% of private-sector establishments reported 'above average' financial performance whilst 41% reported that performance was 'average' and a further 6% that it was 'below average'. 11% of managers reported that no comparison was possible.⁵ Because so few managers classified their establishment's performance in the lowest category we decided to group the data into two, namely, 'above average' and 'other' (excluding 'no comparison').

The existence of profit-related pay could itself be a function of financial performance: workers in booming establishments may press for a share of the profits. In practice, however, it is unlikely that many of the sharing schemes in our data set were initiated by financial performance in 1984. Moreover, there are no variables which could serve as convincing instruments in simultaneous estimation. Hence our work uses single equation techniques.

Table 4 reports our empirical results obtained using Probit analysis. The dependent variable was set equal to 1 if the personnel manager reported that financial performance was 'above average', and to zero otherwise. In equation 1 of the Table we include three dummy variables to indicate if an establishment operated one or more of the following – a share ownership scheme, a profit-sharing scheme, a value-added bonus scheme. As noted in Section I, a number of establishments operated more than one of these schemes at any one time. We decided, therefore, to include four interaction terms to test for differential effects (see Table 2 for further details). The results are reported in equation 2. Industry and regional dummies are excluded (on a Chi-squared test). Means and standard deviations are presented in Table 5.

The Probit results of Table 4 must be interpreted with care. But a principal finding is that, at normal confidence levels, we cannot reject the hypothesis that sharing schemes have no effect upon (our measure of) financial performance. Share ownership, in fact, enters negatively, so fails even to have the 'correct' sign. Nevertheless, both the profit sharing and value-added bonus dummy variables enter positively and have t-statistics around 1.4. Whilst undoubtedly weak these effects appeared to be worth checking, so we examined their quantitative importance. Table 6 is the result: it tabulates how the probability

⁵ In our empirical analysis we exclude the 'no-comparison' category. We exclude a further 58 observations from these calculations where managers did not answer (22 cases) or reported that the relevant data were unavailable (36 cases).

Table 4
The Determinants of Financial Performance

Variable	Probit equation 1		Probit equation 2	
	Coefficient	Standard error	Coefficient	Standard error
50-99 employees	0.2241	0.1339	0.2095	0.1344
100-199 employees	0.2149	0.1405	0.1994	0.1411
200-499 employees	0.4089*	0.1431	0.3876*	0.1440
500+ employees	0.4411*	0.1375	0.4228*	0.1382
International market	0.0538	0.1511	0.0517	0.1516
Falling demand	-0.5487*	0.1354	-0.5573*	0.1356
Stable demand	-0.4170*	0.0966	-0.4244*	0.0969
Labour 25-49 %	-0.2428*	0.0954	-0.2391*	0.0957
Labour 50-74 %	-0.1103	0.1218	-0.0984	0.1224
Labour 75 % and over	-0.5340*	0.2585	-0.5350*	0.2598
Union recognition	-0.3997*	0.1023	-0.3870*	0.1027
Closed shop	-0.5259*	0.1202	-0.5196*	0.1205
Share ownership	-0.0594	0.0974	-0.0580	0.1157
Profit sharing	0.1473	0.1059	0.2612	0.1620
Value-added	0.1906	0.1299	0.0716	0.1750
Share and profit	—	—	-0.2109	0.2261
Share and value-added	—	—	0.4085	0.3446
Profit and value-added	—	—	-0.1650	0.4260
All three	—	—	0.1965	0.4177
Constant	0.2586	0.1219	0.2670	0.1238
Deviance	1232.0		1228.8	
Degrees of freedom	933		929	

Base: Private-sector establishments (unweighted).

Notes: Significant at 1% level on a two-tailed test.

Dependent variable is equal to unity for above average performance (zero otherwise).

The regressions used the GLIM package (see Baker and Nelder (1978)).

of reporting 'above-average performance' is affected, around the means, by the existence of sharing schemes. Probabilities are reported across different size bands (by numbers of employees). The implication of the Table is broadly that suggested by the regression equation. There is no evidence of marked effects from profit-related pay. At the very best, any effect is small and statistically significant at only approximately the 15% level.

The major influences on the probability of reporting 'above average' performance were instead:

(1) the size of establishment (the larger the establishment the higher the probability of reporting 'above-average' performance),

(2) increases in the value of sales of the main products or services of the establishment over the preceding twelve months (the higher the demand the higher the probability),

(3) the proportion of turnover accounted for by wages and salaries (the smaller the proportion of turnover accounted for by wages and salaries, the higher the probability),

(4) whether or not there were recognised manual unions at the establishment

Table 5
Means and Standard Deviations

Variable	Mean	Standard deviation
50-99 employees	0.2630	0.4410
100-199 employees	0.1210	0.3260
200-499 employees	0.0620	0.2420
500+ employees	0.0150	0.1230
International market	0.0510	0.2200
Falling demand	0.1060	0.3070
Stable demand	0.2960	0.4570
Labour 25-49 %	0.3720	0.4840
Labour 50-74 %	0.1940	0.3950
Labour 75 % and over	0.0310	0.1720
Union recognition	0.3450	0.4760
Closed shop	0.1380	0.3460
Share ownership	0.2490	0.4330
Profit sharing	0.2030	0.4020
Value-added	0.1460	0.3530
Share and profit	0.0850	0.2780
Share and value-added	0.0120	0.1110
Profit and value-added	0.0230	0.1500
All three	0.0210	0.1440

Base: Private-sector establishments (weighted).

Table 6
Probability of Above-average Performance (%)

	Establishment size				
	25-49	50-99	99-199	200-499	500+
Non-union	50	59	58	66	67
Union recognition	34	43	42	50	51
Closed shop	18	24	24	30	31
No profit related pay	40	49	48	56	57
Profit sharing	46	54	54	62	63
All three	49	60	59	67	68

Notes: All other variables set to their means. Estimates obtained using Probit Equation 1, Table 4.
Base: Private-sector establishments.

— especially if there was a closed shop (the presence of a recognised manual union/closed shop lowered the probability).

Number 4, the effect of a trade union, is a particularly notable result. Moreover, Table 6 reveals its quantitative importance.⁶ Non-union establishments were more than twice as likely to report above average financial performance than were closed shop establishments.

⁶ It was David Metcalf who suggested that we do this calculation.

III. EMPLOYMENT GROWTH AND INDUSTRIAL RELATIONS

Finally, we consider the issue of whether profit-related pay affects employment growth or the quality of industrial relations. Table 7 documents, for the years 1980-4, the distribution of employment changes both for private-sector establishments without profit-related pay and with profit-related pay. The

Table 7
Employment Change, 1980-4 (%)

	Without profit sharing	With profit sharing	Without share scheme	With share scheme	Without value- added bonus	With value- added bonus
Increase of 20% or more	25	24	25	24	23	32
Increase of 5 to 20%	16	19	18	12	16	16
Stable	15	16	14	16	16	9
Decrease of 5 to 20%	22	24	23	23	22	29
Decrease of 20% or more	23	17	20	26	23	14
Number of observations	834	210	787	257	884	160

Base: Private-sector establishments.

tables are broken down by type of profit-related pay. Although these are only cross-tabulations, they reveal that even at this level there is little indication of a correlation between employment behaviour and the existence of a sharing scheme. For example, 25% of establishments without profit sharing grew by more than one fifth over the period, while 24% of establishments with profit sharing grew by that amount. Establishments with share ownership grew less, if anything, than those without. The only indication of an obvious positive effect is in the data on value-added sharing schemes. Although still not large, it raises a glimmer of possibility for further more detailed research.

Table 8 attempts to discover whether establishments with profit-related pay have an above-average quality of industrial relations, which is clearly a difficult hypothesis to test. Here we used the answers in WIRS2 to the question

May I ask you your opinion of the general state of relations between management and workers at this establishment?

(Q. 169 management questionnaire, p. 77),

where managers' answers were taken down verbatim and coded as in the Table. The cross-tabulations show a very similar pattern both for sharing and non-sharing establishments. For share ownership and profit sharing it would be hard to make a case for the effectiveness of profit-related pay. The third category, value-added bonus establishments, shows up interesting differences in the reporting of 'very good' and 'good'. Even here, however, one can argue that the differences are slight. Of establishments without value-added bonuses 86% reported either 'good' or 'very good' compared with 84% for establishments with such schemes.

Table 8
State of Industrial Relations (%)

	Without profit sharing	With profit sharing	Without share scheme	With share scheme	Without value- added bonus	With value- added bonus
Very good	44	39	44	42	41	56
Good	40	51	41	47	45	28
Quite good	10	9	10	9	9	14
Neither good/bad	3	0	3	1	3	2
Quite bad/bad/very bad	2	2	2	2	2	0
Number of observations	834	210	787	257	884	160

Base: Private-sector establishments.

Cross-tabulations of this kind cannot be conclusive. We include them only to show that, even before a full set of control variables is taken into account, the perceived quality of industrial relations and the rate of employment growth both appear to be largely uncorrelated with the existence of profit-related pay. With such small *gross* differences between sharing and non-sharing establishments, the return to econometric investigation is unlikely to be large.

IV. CONCLUSIONS

Although the Chancellor of the Exchequer recently outlined plans for the encouragement of 'profit-related pay', there is little empirical evidence either for or against such a policy. This paper uses a nationally representative 1984 microeconomic data set in an attempt to fill this void.

There are three conclusions. First, profit sharing (broadly defined) appears to be much more common than has been popularly realised. Second, we have not found evidence, at conventional confidence levels, that establishments with profit-related pay have superior financial performance.⁷ Third, cross-tabulations suggest that sharing and non-sharing establishments have similar employment growth rates and approximately the same quality of industrial relations. Whilst our findings must be interpreted cautiously,⁸ they do not provide obvious support for recent government initiatives.

University of Surrey and London School of Economics

London School of Economics

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⁷ However, Estrin and Wilson (1986) find a small positive effect for a sample of metal-working firms, and Richardson and Nejad (1986) identify an effect on share valuation. Fitzroy and Kraft (1986) also find a positive effect on profitability using West German data of a kind similar to that in Estrin and Wilson (1986). All three studies are based on sample sizes of less than 100.

⁸ Proponents of profit-related pay can quite reasonably stress, first, that it would be desirable to rely less on self-assessed data and, second, that we have found some weakly significant coefficients.

APPENDIX I. THE SURVEYS

The WIRS₂ survey was sponsored by the same bodies as were responsible for the 1980 survey, namely, the Department of Employment, the Policy Studies Institute and the Economic and Social Research Council, with an additional sponsor, the Advisory, Conciliation and Arbitration Service. The sampling frame used was the 1981 Census of Employment. To be included in the survey an establishment had to have at least 25 employees (full or part-time) in both 1980 and 1984. The survey covered England, Scotland and Wales and its industrial coverage was all manufacturing and services, both public and private sectors.

A sample of 2,019 establishments (defined as 'places of employment at a single address or site') was drawn. Establishments were selected differentially across establishment size bands, with large establishments over-sampled. Hence, the data must be weighted to compensate for these inequalities of selection. For convenience, the results have been weighted to a base of 2,000 establishments. The survey incorporated interviews with the senior manager responsible for dealing with employee relations, industrial relations or personnel matters, plus interviews with worker representatives and, where appropriate, with works managers. This paper restricts itself to data obtained from the senior personnel manager's interview. For further details of the weighting scheme, as well as the design and selection of the sample, see Millward and Stevens (1986, Technical Appendix).

APPENDIX 2. VARIABLES' DEFINITIONS

25-49 employees	establishment employed 25-49 employees (full or part-time) - excluded category;
50-99 employees	a dummy variable where the establishment employed 50-99 employees (full or part-time);
100-199 employees	a dummy variable where the establishment employed 100-199 employees (full or part-time);
200-499 employees	a dummy variable where the establishment employed 200-499 employees (full or part-time);
500+ employees	a dummy variable where the establishment employed at least 500 employees (full or part-time);
International market	a dummy variable if the market for the main product or service was primarily international;
Falling demand	a dummy variable if the value of sales of the main products or services of the establishment had been falling over the preceding 12 months;
Stable demand	a dummy variable if the value of sales of the main products or services of the establishment had been stable over the preceding 12 months;
Rising demand	a dummy variable if the value of sales of the main products or services of the establishment had been rising over preceding 12 months - excluded category;
Labour below 25%	a dummy variable if wages, salaries and other labour costs like pensions and national insurance accounted for less than 25% of the establishment's sales revenue (turnover) - excluded category;
Labour 25-49%	a dummy variable if wages, salaries and other labour costs like pensions and national insurance accounted for 25-49% of the establishment's sales revenue (turnover);

Labour 50–75 %	a dummy variable if wages, salaries and other labour costs like pensions and national insurance accounted for 50–75 % of the establishment's sales revenue (turnover);
Labour 75 % and over	a dummy variable if wages, salaries and other labour costs like pensions and national insurance accounted for at least 75 % of the establishment's sales revenue (turnover);
Union recognition	a dummy variable if any trade unions (manual or non-manual) were recognised by management for negotiating pay and conditions;
Closed shop	a dummy variable if there was a closed shop (manual or non-manual) for all or some workers at the establishment;
Share ownership	a dummy variable if the establishment operated a share-ownership or share-option scheme;
Profit sharing	a dummy variable if the establishment operated a profit-sharing scheme;
Value-added	a dummy variable if the establishment operated a value-added bonus scheme.

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