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SOCIAL PREFERENCES IN WAGE BARGAINING: A NEOCORPORATIST APPROACH

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Abstract

The starting point in this paper is based on the strand of the literature on corporatist systems stressing the role of co-operation and consensus in wage bargaining in order to reach better economic performances. In order to model a co-operative regime in the classical framework in which the monopoly union controls wages and the firm controls employment, we introduce social preferences with some degree of other-regarding concern(ORC) such that each agent's objective function is a linear combination of her own welfare and the other's. The results show that under specific conditions concerning the degree of ORC, one may obtain an employment level higher than in the selfish case and wage moderation.

1. Introduction[*]

Since the seminal paper by Calmfors and Driffil (1988), there has been an ongoing debate focusing on the impact of industrial-relations *organisational form* on labour market performance mainly in terms of wage, inflation and unemployment. The well-known distinction characterising industrial relations is decentralisation versus a centralised bargaining setting as the extreme organisational solutions. In this context the distinguishing institutional features of neocorporatism have initially been identified as centralised monopolistic union federations and employer associations underpinning centralised collective bargaining (Schmitter, 1981). The development of the debate has led to considering neocorporatism as characterised by a high level of co-ordination. Co-ordination is meant as a broader institutional characteristic which encompasses not only formal bargaining centralisation but also state-imposed centralisation, informal centralisation or the pattern-setting of a powerful economic sector (Kenworthy, 2001). The outgrowth of the emphasis on co-ordination has been the shift of attention on to the importance of consensus and co-operation in fostering co-ordination. In particular, the role played by inter partes and intra partes co-ordination - within unions and firm organisations- along with consensus in the decision making process of wage bargaining has drawn some interest (Soskice, 1990; Hartog e Teulings, 1998; Nickell, 1997). Moreover, Pohjola when pointing to some key-aspects of neocorporatism, has defined it as 'one in which the interest organisations either share a vision of economic policy similar to that of government or, through interest intermediation, reach outcomes which are essentially similar to the ones obtainable under *the sharing of objectives*' (Pohjola, 1992: 58**,** *emphasis added*). What seems to follow is that an important role in macroeconomic performance is not only played by the bargaining

structure but also by the degree of co-operation and consensus among the relevant groupings (Pohjola, *idem*).

Thus, the evolution of the debate has contributed to a further development of the definition of a neocorporatist system, which has freed it from the link with the centralisation of the bargaining structure. This implies that when one addresses the issue of which bargaining systems attains a better macroeconomic performance, the organisational solution *along* with the presence of co-operation and consensus among the main stakeholders (unions, firms and government) in the bargaining process, have to be taken into consideration. Co-operation and consensus can, in fact, be enhanced by the *sharing of objectives*, which may ultimately lead to co-ordination. In this respect Pohjola (*idem*) again provides a useful insight by considering nominal wage control as a public good, whose contribution costs are borne by workers (and their organisations) and whose benefits represent a socially desirable solution in terms of higher employment and lower inflation. As such the benefits may meet government macroeconomic goals and enhance collective welfare. The crucial aspect is that workers' incentives to bear the costs are represented, for instance, by unemployment benefits, training programs and other types of guarantees supplied by the government. Thus, from this perspective the sharing of objectives mainly concerns workers/unions and government. This can partly explain the interest of a strand of the literature in modelling co-operation between *the union and the government* on inflation and unemployment (Gylfason, Lindbeck, 1994; Acocella, Ciccarone, 1997; Burda, 1997). More recently Acocella and Di Bartolomeo (2001) have modelled a co-operative regime by considering an objective function given by the linear combination of the objective function of a monopoly union and the government. Both are assumed to take care of price stability and employment, whereas the union is also interested in real wage.

From this perspective, in the paper it is believed crucial to shift the focus of attention from the organisational features on to the agents' motivational aspects and to consider the bargaining sides as endowed with social preferences embodying such sharing of objectives. Social preferences, in fact, refer to an agent who "not

only cares about the material resources allocated to her but also cares about the material resources allocated to relevant reference agents" (Fehr, Fischbacher, 2002: C2). Generally, in the literature the type of social preferences considered are the ones believed to best represent reciprocal fairness or conditional cooperative attitude such as inequity aversion, envious preferences and pure altruism/unconditional cooperative attitude (Fehr, Fischbacher, *idem*). In this frame of analysis, it seems appropriate to introduce a type of social preferences characterising agents' positive concern for collective welfare, meant as *positively* valuing not only the single agent's own objective but also the ones of the other members of the reference group. This motivation can be underpinned by the values or rules shared by the social setting in which the agents are embedded; these rules can help raise the awareness of social interests and of collective goals (Alkire, Deneulin, 2000). In this specific context, the rules underlying collective preference may be based, for instance, on the awareness that in a long-run perspective high inflation rate may negatively affect investment and growth (Leigh-Pemberton, 1992), which may be detrimental for employment (Marsden, 1995). This type of argument leads to the more general consideration that such preferences can be shaped by the knowledge shared by labour market parties that as Marsden (*idem*) argues, the tight connection between their own interests is such that conflicts may inflict heavy costs on both sides.

An example of collective-welfare-oriented preferences can be traced back to the Swedish case in the post war period until the mid seventies, when both the employers and union representatives kept their freedom from government intervention by guaranteeing wage moderation in order to preserve the economy competitiveness, and employment. Thus the government delegated the responsibility for income policy to labour market parties in exchange for macroeconomic balance (Nilsson, 1993).

The type of collective-goal-oriented preferences considered in this paper is taken as one of the ways of introducing a co-operation-and-consensus-based behaviour deriving from the sharing of common goals. In major details, our main concern is to analyse the effects of social preferences on the bargaining outcomes in terms of wage and employment by considering firms and union as the

relevant groupings in the bargaining process. It is important to specify that social preferences are characterised by the internalisation of the opponents' welfare in each agent's objective function according to some degree of other-regarding concern (ORC). In the following sections the model will be explained in details (§2), in §3 the main implications of considering the other regarding behaviour with respect to the selfish one will be shown. It will be also analysed in §4 whether the presence of social preferences can lead to some welfare improvement. Finally conclusions will be drawn.

2. The model

We consider bargaining in the classical framework in which the monopoly union (monopoly seller of labour to the firm) controls wages and the firm controls employment. We shape the agents' objective functions in such a way as to include what we have previously called other-regarding concern (ORC). In order to model this type of ORC preferences, we consider each agent's objective function as a linear combination of her own welfare and the other's. This means that individual welfare is affected to a certain extent, depending on the parameter of the linear combination, also by the opponent's welfare. As will become clear later, the objective functions embodying ORC concerns, can be taken as a more general form of the standard ones depending on the value of the parameters of the linear combination.

The motivation functions are V_f for the firm and V_u for the union and are expressed as follows:

$V_f = (1-b_f)\,? \ + b_f\,U$
   (1)
$V_U = (1-b_u)U + b_u\,?$
   (2)
where $? = p(y(n))y(n) - wn$
                         with $y = f(n)$, $f'>0$, $f''<0$, $p'<0$,
                         $U = [wn + (m-n)s]$
                         m = union membership
                         s = alternative wage or unemployment subsidy
                         $1/2 > b_f ? 0$, $1/2 > b_u ? 0$

$?$ and U are respectively the standard profit function for a monopolistic firm and the standard utility function for the union. The degrees of the union's and the firm's ORC, b_u and b_f, indicate that either agent weighs the self-seeking payoff and the other's payoff in her motivation function. They sum up to one, which underlines that an increase in the weight of the opponent's payoff implies a reduction in the weight of one's own payoff. Accordingly the presence of ORC implies some reduction in the importance of self-seeking interests. Moreover, the restrictions on the parameters imply that each agent ever considers her own payoff more than the other one's.

In the model it is assumed complete and perfect information and the timing of the strategic interaction is the following: 1) the union makes wage demand; 2) the firms observes and chooses employment; 3) the final payoffs will be $V_f\,{}^*(w^*(bu,bf),n^*(bu,bf))$; $V_U{}^*(w^*(bu,bf),n^*(bu,bf))$.

2.1 Solving backward: the firm's reaction function

In stage (2), the firm maximises the objective function for any arbitrary wage demand set by the union and her reaction function is:

$$py'(n_{ORC}*(w)) \; ? \; \cfrac{1}{1? \cfrac{1}{?_{y,p}}} ? \begin{Bmatrix} 1? 2bf \\ \dfrac{1? bf}{1? bf} w ? \dfrac{bf}{1? bf} s \end{Bmatrix} \tag{3}$$

The firm's reaction function shows that as the firm internalises the union's objective according to her degree of ORC, cares not only about her profit but also about workers. This implies that
a) labour demand rises when the alternative wage decreases.
b) labour demand rises when firm's ORC rises as one can see from the derivative with respect to bf:

$$\frac{?py'(n_{ORC}*(w))}{?bf} \; ? \; 0$$

Thus, the greater b$_f$, the greater labour demand as the firm, taking into account union welfare, when setting employment is more willing to increase employment to let union welfare grow as well.
In absence of ORC, for b$_f$=0, (3) becomes the standard solution for the monopolistic firm:

$$py'(n_M *(w)) \; ? \; \cfrac{w}{1? \cfrac{1}{?_{y,p}}} \tag{3bis}$$

The above equation corresponds to the standard solution for a monopolist firm. Moreover, The firm's reaction function with relativism concerns is above the selfish one if the following inequality holds:

$$py'(n_M *(w)) \begin{Bmatrix} 1 ? \dfrac{1}{?_{y,p}} \end{Bmatrix} ? \; s \tag{4}$$

According to (4), the marginal benefit from behaving as a selfish monopolist has to be greater than the marginal benefit from unemployment. This implies that the relativist labour demand is above the individualist one when employment is lower than the level corresponding to the alternative wage, s.

As one can see from (5) below, the elasticity of labour demand is a function of the elasticity of the labour demand in the standard monopolist case, and a function of the firm's ORC.

$$?_{n,\,w_{ORC}} \quad ? \quad \left[?1 \; ? \; \frac{bfs}{(1 \; ? \; bf)\,MR(n)} ? \right] ?_{n,\,w_M} \tag{5}$$

In (5), *MR(n)* stands for the marginal revenue in the standard case (without ORC).

2.2 The union maximisation problem and the equilibrium solutions

The union chooses the wage maximising the objective function subject to the firm labour demand and from the first order conditions one obtains the equilibrium union wage demand. The existence of an intersection point between the latter and the firm's reaction functions allows individuating the equilibrium wage (see the Appendix for further details), which is:

$$w^{*}{}_{ORC} ? \; s \frac{(1 ? 2bf)(1 ? bu ? bf)?_{n,\,w_M} ? bf(1 ? 2bu)(1 ? bf)}{(1 ? 2bf)(1 ? bf ? bu)?_{n,\,w_M} ? (1 ? bf)(1 ? 2bu)} \tag{6}$$

In absence of ORC, the equilibrium wage is the following:

$$w_M^{*} ? \; \frac{s\,?_{n,\,w_M}}{1 ? \; ?_{n,\,w_M}} \tag{6bis}$$

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The ORC equilibrium employment level is shown below:

$$py'(n_{ORC}*(w_{ORC}*)) \ ? \ \cfrac{s}{1 \ ? \ \cfrac{1}{?_{y,p}}} \cfrac{(1 \ ? \ bu \ ? \ bf \,)?_{n,w_M}}{(1 \ ? \ bu \ ? \ bf \,)??_{n,w_M} \ ? \ (1 \ ? \ bf \,)(1 \ ? \ 2bu)} \quad (7)$$

whereas without ORC, the equilibrium employment level becomes:

$$py'(n_M*(w_M*)) \ ? \ \cfrac{s}{1 \ ? \ \cfrac{1}{?_{y,p}}} \ ?\cfrac{?_{n,w_M}}{1 \ ? \ ?_{n,w_M}}? \quad (8)$$

Given the above results from the strategic interaction between the firm and the union, $(w_{ORC}*, \ n_{ORC}*(w_{ORC}*))$, the comparative statics analysis gives the following results (see the Appendix for details):

$$\frac{?w_{ORC}*\,?bu,bf\,?}{?bf} \ ? \ 0; \qquad \frac{?n_{ORC}*(bu,bf)}{?bf} \ ? \ 0$$

$$\frac{?w_{ORC}*\,?bu,bf\,?}{?bu} \ ? \ 0; \qquad \frac{?n_{ORC}*(bu,bf)}{?bu} \ ? \ 0$$

The first couple of derivatives shows that the union (the leader) when setting the wage, knows that the firm weighs more the importance given to workers and decides to exploit the firm's higher ORC by choosing a higher wage. This means that as the union internalises the firm's objective, raises wage until the weighed marginal benefit for employed is equal to the weighed marginal cost for unemployed (lower employment) and to the marginal cost for the firm (lower profit).

The second couple of derivatives shows that the union when setting the wage, weighs more the firm's profit and sets a lower wage with a corresponding higher employment.

3. How do the equilibrium employment and wage from other-regarding preferences (w_{ORC}*, n_{ORC}*) behave in comparison with the ones from selfish preferences (w_M*, n_M*)?

In this section, the equilibrium solutions respectively corresponding to the standard case and to the ORC preferences will be compared. The ORC employment level is always greater than the selfish one (i.e. py'(n_{ORC}*(w_{ORC}*))<py'(n_M*(w_M*))) whereas they are equal when *bu=0* for any *bf* (< ½). As to wage, the inequality below corresponding to w_{ORC}>w_M has to hold:

$$\left[\frac{bu}{1 - bf - bf} \right] - 2\left[\frac{1}{1 - 2bu} \right] > \left[1 - \frac{1}{\varepsilon_{n,\,w_M}} \right] \tag{9}$$

It yields a clear-cut result in two cases: the ORC degrees are the same (first case below); one agent is selfish and the other has some other- regarding concern (third case). When the ORC degrees are different but both positive, it is crucial the elasticity value and we focus our attention on the situation where this inequality surely holds. For any value of the monopolist labour demand elasticity, the above inequality holds if the whole expression on the left-hand side is ?0 (second case).

Given the previous consideration, three cases will be considered in the subsequent part.

First case: the agents have the same degree of other regarding concern (bu=bf)

When the parameters are equal, it is always the case that the employment level with ORC is greater: $n_{ORC}^*(w^*) > n_M^*(w^*)$. As to the equilibrium wage, $w_{ORC}^* ? w_M^*$, if the following holds:

$$\frac{b}{1\,?\,b} \; ? \; ? \; \frac{1}{?n,\,w_M} \tag{10}$$

and $w_{ORC}^* ? w_M^*$ in the opposite case.

The left hand side of (10) can be taken as the relative degree of ORC, and the right hand side as an indicator of agents' market considerations driven by labour demand elasticity, which affects the union bargaining power and the mark-up on non labour income. If for both the degrees of concern with the other welfare prevails over economic considerations, the ORC equilibrium wage is greater than the selfish one. With a low value of labour demand elasticity and an effective union bargaining power, it is necessary a higher ORC degree to achieve wage moderation with respect to the situation characterised by a high elasticity. In the latter case the constraint of market conditions, characterised, for instance, by a high product demand elasticity, limits the possibility of transferring a wage increase on price and weakens the union power. Thus, one needs a lower value of *b* to obtain wage restraint.

Second case: The agents have a different degree of other-regarding concern (bu? bf)

As well as in the previous case, the employment level with ORC is greater, $n_{ORC}^*(w^*) > n_M^*(w^*)$ and $w_{ORC}^* < w_M^*$ if the following occurs:

$$\frac{bu}{bf} \; ? \; 2(1\,?\,bf) \tag{11}$$

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As one can notice in (11), when there is a different degree of ORC, market driven considerations do not enter the choice of the union when setting the wage. In this context, for wage restraint the ratio of the union's ORC to the firm's one has to be greater than 1. Thus, if the union cares more about the other than the firm does there will be always wage moderation with respect to the case with selfish behaviour, for any value of the elasticity. Accordingly the size of *bu* with respect to *bf* is crucial for wage moderation.

Third case: The responsibility for wage moderation and higher employment
An interesting case to analyse concerns which of the two bargaining sides it is better take on the responsibility for wage moderation and higher employment. In this respect, it is useful to consider the limit of the left hand side of (9) for *bf*? 0 e ? *bu*? ?0,1/2?, which is equal to + ? . This implies that when there is a union with some positive ORC facing a firm rather scarcely interested in the opponent welfare, the outcome will be wage moderation. along with higher employment. One obtains an equal result when the limit of the left hand side of (9) is taken for *bu*? 1/2 and ? *bf*? ?0,1/2? , which is equal to + ? . Thus, in these two cases it possible to achieve wage moderation and higher employment with:
- a highly concerned union facing a firm with a lower ORC;
- a union with some positive ORC interacting with a firm which tends to behave selfishly.
On the contrary, inequality (9) holds and $w_{ORC} > w_M$ when *bu=0* and ? *bf*? ?0,1/2? as the left hand side of (9) is equal to -2. Moreover, as specified above, the employment is such that $n_{ORC}^* = n_M^*$.
The same as to wage ($w_{ORC} > w_M$) occurs if *bf* ? 1/2 and ? *bu*? ?0,1/2?. According to the latter two cases, there is not any wage moderation in the two following situations when:
- a purely selfish union deals with a firm with some positive ORC; also the union fully exploits the monopoly power and the degree of firm's ORC, by setting a higher wage with a corresponding unemployment level not reduced.
- the union is characterised by some ORC though lower than the concern of the firm which tends to be fully interested in the

union's welfare. In addition, the employment level will be higher than in the purely selfish case.
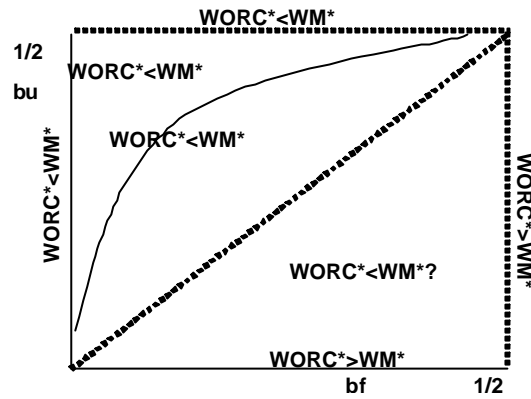

Fig. 1

The figure above depicts an entire set of *bu*-and-*bf* values entailing wage moderation, related to inequality (9). This set is located in the area above and along the curve, which represents the combinations of *bu* and *bf* annulling the left hand side expression in (9):

$$\left[\frac{bu}{1-bf}bf - 2 \right]\frac{1}{1-2bu} = 0$$

This equality guarantees that $w_{ORC} < w_M$ and below the curve the equilibrium relativist wage may be either higher or lower than the selfish one, depending on the labour demand elasticity. Along the diagonal (first case with *bu*=*bf*) in order to have wage moderation, the condition described above has to be satisfied.

Following the previous results it is possible to argue that wage moderation is easier to achieve when the union ORC is higher than the firm's. Moreover, when both agents have some positive ORC, this guarantees that employment is *always* higher than the level with selfish preferences. In the case of bargaining involving a selfish and an ORC type, when the union is selfish, there is not any wage moderation and employment is the same as in the standard model. In the opposite situation with a firm tending to act selfishly, one obtains wage moderation and higher employment.

3.1 Social preferences and the targets of wage moderation and of unemployment

Following the results analysed in the previous section, the subsequent step is to firstly identify what the role of social preferences can be in order to achieve wage/price moderation and the reduction in unemployment according to the importance given by the bargaining sides to either target or both. Secondly it is also interesting to single out the agent who may take on the responsibility for the outcome in terms of wage and unemployment.

If there is a pressing need for controlling inflation and labour demand elasticity constrains the possibility of the firms transferring wage increase on prices, there is little scope for role of social preferences as market conditions may suffice for wage restraint.

When wage and price restraint along with employment represent primary targets, it would be preferable to have both bargaining sides *equally* concerned with collective welfare to the extent depending on market conditions. In details, in presence of an elastic labour demand, it can be argued that the goals can be met in the case of the bargaining agents being equally *moderately* interested in the opponent's welfare. On the contrary, in the case of market conditions strengthening the union bargaining power, social preferences would require each side take into account the opponent's welfare in a *significant way* and to the same extent. In

the latter case the union would not fully exploit the bargaining power and would not raise the wage as much as in the selfish case.

If the main objective is only unemployment, this is possible with the union and the firm taking into account moderately and to the same degree the opponent's welfare. This leads to an employment level higher than in the standard case whereas the outcome in terms of wage will depend on the value of labour demand elasticity.

If for some reasons we will not dwell upon in this paper, it is necessary to choose the agent who has to take on the responsibility for both wage moderation and a higher employment, it is more effective the role played by the union. This clearly depends on this type of setting with the union behaving as the leader and controlling wages.

4. A comparison with the efficient bargaining solution

A further development of this analysis is to verify whether in this type of strategic interaction with the monopoly union behaving as leader and controlling wages and the firm setting the employment level, the presence of some positive ORC degree in both bargaining sides allows for collective welfare improvement. Thus, it is interesting to compare the ORC results from the model above with the ones from efficient bargaining. The efficient bargaining solution is derived from our model setting *bu* and *bf* equal to zero and by maximising the union objective function ((2) above) subject to the constraint of a given level of firm's profit ((1) above). As the marginal utility of income is constant, the contract curve is vertical and the result is:

$$py'(n_{EB})\left(1 - \frac{1}{\varepsilon_{y,p}}\right) = s \qquad (12)$$

According to (12), n_{EB} is the optimal employment level for any value of wage. It can be compared with (7), the ORC equilibrium employment level, which can be rearranged as follows:

$$py'(n_{ORC}) \left[1 - \frac{1}{?_{y,p}} \right] ? s \frac{?1? bu? bf? ?_{n,WM}}{(1? bu? bf)?_{n,WM} ? (1? bf)(1? 2bu)} \qquad (7bis)$$

The ORC marginal revenue is always greater than the one in the case of efficient bargaining as in (7bis) it can be shown that the ratio on the right hand side of s is always greater than one for $? bf < 1/2$ and $? bu < 1/2$, and for $? < -1$ (see the Appendix). This implies that for any wage above s (given (4) above), $n_{ORC}{}^* < n_{EB}{}^*$. Interestingly, efficient bargaining with ORC gives the same result as in (11). The relevant aspect of this result is that when the strategic interaction between the firm and the union does not allow for the union leadership, the presence of objective functions with ORC does not play any role in the efficient bargaining.

Moreover, in presence of ORC, the solutions coincide with the efficient bargaining one (i.e. in (7bis) the ratio at the right hand side of s is always equal to one if either $bf = 1$ or $bu = 1/2$. Which is never the case as the social preferences would be such that either the firm values only the union welfare or the union equally weighs her own welfare and the firm's.

Following these considerations it is not mistaken to argue that when the bargaining sides are interested in both targets of wage restraint and higher employment, the presence of social preferences may induce some welfare improvement. This occurs if agents' behaviour based on the ORC motivation, encompasses any couple of bu and bf allowing for wage moderation and higher employment with respect to the selfish case (examined in the previous section), though the level of employment is lower than the efficient bargaining solution.

Concluding Remarks

Along with the organisational form of industrial relations, a crucial role can also be played by the motivational aspects underlying agents' behaviour and their decision-making process. The type of motivation taken into account in the paper is related to social preferences and regards the extent to which the agents involved in the bargaining process internalise some concern with collective welfare (by taking into account the opponent' welfare). In our view, such preferences allow modelling the sharing of objectives, which, following Pohjola, is believed to be one of the main characteristics of neocorporatist systems as it can foster consensus and cooperation on overall macroeconomic goals. The internalisation of ORC in the objective functions of the bargaining sides has disclosed the possibility of achieving a better macroeconomic performance in terms of wage moderation and employment, starting from the motivational assumption based on the awareness of the importance of collective goals, and considering the interaction of such social preferences with market conditions.

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