Gradual collective wage bargaining

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**ABSTRACT**

This paper presents an alternative implementation of firm-level collective wage bargaining, where bargaining proceeds as a finite sequence of sessions between a firm and a union of variable size. We investigate the impact of such a 'gradual' union on the wage-employment contract in an economy with concave production. In a static framework, the resulting equilibrium is equivalent to the efficient bargaining outcome. In a dynamic framework with search frictions, we demonstrate that gradual collective wage bargaining coincides with all-or-nothing bargaining when bargaining takes place in fictitious time before production.

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1. Introduction

The general assumption in canonical collective bargaining models is that all employed union members return to the external labor market permanently when negotiations fail.\footnote{For the ongoing relevance of union wage bargaining, especially for European countries, we refer to Booth (2014).} In many real-world labor markets characterized by search frictions, such immediate termination may not be an accurate assumption because it entails, e.g., search costs of finding a new job, search costs of replacing the workforce and opportunity costs of forgone production. Therefore, it is unlikely that neither the union seriously contemplates leaving the firm permanently, nor the firm credibly considers dismissing its entire workforce.\footnote{Bauer and Lingens (2013) provide a rare example of Ronald Reagan’s dismissal of air traffic controllers in 1981, arguably a political rather than an economic act.}

This paper presents an alternative implementation of decentralized collective wage bargaining, replacing the usual 'all-or-nothing' union by our proposed 'gradual' union. Essentially, in a discrete labor setting, the latter implies that the union bargains on behalf of \(N\) workers and if negotiations break down, the marginal worker leaves the firm and the union reblogs on behalf of the remaining \(N - 1\) workers, and so forth. In terms of interpretation, any time before production, the firm may fire an employee, or alternatively, an employee might grow frustrated and exit the firm after which bargaining resumes. Such a collective bargaining environment is particularly relevant in an 'at-will' firm where wage offers are unenforceable and renegotiations are frequent. We refer to Hogan (2001) for a rationalization of the presence of a union in an incomplete contracting environment.

We investigate the impact of a gradual union on the equilibrium wage-employment contract in both a static and dynamic framework of firm-level collective wage bargaining in an economy with concave production. In a static framework, the resulting equilibrium is equivalent to the equilibrium under efficient bargaining (EB), which assumes an all-or-nothing union (McDonald and Solow, 1981). In a dynamic framework where the firm cannot instantaneously replace workers after a breakdown of the wage bargaining, firm-level employment is no longer efficient. We demonstrate that gradual collective wage bargaining coincides with all-or-nothing bargaining when bargaining takes place in fictitious time before production.

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The plan of the article is as follows. In Section 2, we introduce the gradual union in a static SZ framework. Section 3 extends the analysis to a dynamic large-firm search and bargaining environment. Section 4 concludes.

2. Gradual collective wage bargaining without search frictions

In Section 2.1, we present our gradual collective wage bargaining model in a static SZ framework with discrete labor and without externalities arising from job search. In Section 2.2, we derive the equilibrium wage–employment contract and demonstrate its equivalence with the equilibrium wage–employment contract under efficient bargaining.

2.1. Bargaining environment

Consider a fixed-size union of \( N \in \mathbb{N} \) members. A subset of \( N \) union members (the employees) work in the firm. We assume that the union is sufficiently large to cover labor demand (\( N \leq N' \)). We endogeneous the choice of \( N \) later on. We denote \( w(N) \) the employee’s wage in a firm with \( N \) employees. The reservation wage is \( w \). The firm utilizes a single-asset, strictly increasing and strictly concave production function \( F(N) : \mathbb{N} \to \mathbb{R}_+ \). We assume that \( F(j) \geq jw \) for \( j \in \{1, \ldots, N\} \). Furthermore, \( F(0) = 0 \). Denote \( \Delta \) the first-difference operator, e.g. \( \Delta F(N) = F(N) - F(N - 1) \). The firm’s profit function equals \( \Pi(N) = F(N) - Nw(N) \). The neoclassical firm’s profit function is denoted by \( \Pi_{NC}(N) = F(N) - Nw \). Both the firm and workers are risk-neutral.

In the at-will firm, wage offers are unenforceable. Any time before production starts, the firm may fire an employee, or alternatively, an employee may quit the firm. Employees are irreplaceable. An employee who returns to the external labor market can never re-enter the firm and stays a union member earning the reservation wage.

Union preferences are represented by a utilitarian objective function. The union’s payoff when there are \( N \) employees equals:

\[
Nw(N) + (N' - N)w. \tag{1}
\]

The union’s payoff when there are \( N - 1 \) employees equals:

\[
(N - 1)w(N - 1) + (N' - N + 1)w. \tag{2}
\]

Hence, the gradual union’s net gain from reaching a bargaining agreement equals:

\[
Nw(N) - (N - 1)w(N - 1) - w. \tag{3}
\]

The firm’s net gain from reaching a bargaining agreement equals:

\[
\Pi(N) - \Pi(N - 1). \tag{4}
\]

Following the collective bargaining literature, we assume that conventional generalized Nash bargaining is the appropriate solution concept. The bargaining scope is negotiation over wages alone. The firm chooses the employment level that maximizes profits. The bargainned wage followes from maximizing the Nash product \( \Omega \):

\[
\Omega = [Nw(N) - (N - 1)w(N - 1) - w\phi]\left[\Pi(N) - \Pi(N - 1)\right]^{1-\phi} \tag{5}
\]

where \( \phi \in [0, 1] \) denotes the workers’ bargaining power.

For the sake of expositional clarity, we present an extensive-form bargaining game which unique subgame perfect equilibrium corresponds with the equilibrium wage–employment contract that follows from our static model.
Bargaining proceeds as a finite sequence of pairwise bargaining sessions over wages between the union and the firm. In Fig. 1, each bargaining session is depicted by a box, representing the number of employees on which behalf the union is negotiating with the firm. In the first bargaining session, the union represents \( N \) employees. In each bargaining session, either the union and the firm reach an agreement (A), or negotiations break down (B). Whenever an agreement is reached, the game ends. Whenever a bargaining session ends in a breakdown, one randomly chosen employee exits the game forever, after which bargaining instantaneously starts again between the firm and the union representing the remaining employees. At most \( N \) bargaining sessions can occur before the game terminates in which case all employees have dropped out following failed bargaining sessions.

Within each bargaining session, the union and the firm play a variant of the Rubinstein (1982) alternating-offers game where the firm and the union alternate wage offers. If an offer is accepted, production occurs and the wage is paid. If an offer is rejected by the firm (union), the bargain is either terminated by a specific separation shock that hits at a rate \( \phi_j \) (\( \phi_u \)) or proceeds to the next round, allowing the firm (union) to make a counteroffer. The game continues until the bargaining parties are separated or reach an agreement, which will occur instantaneously in equilibrium. Binmore et al. (1986) show that the generalized Nash bargaining solution emerges for the limit outcome where the time between offer and counteroffer approaches zero.\(^4\)

### 2.2. Equivalence with efficient bargaining

Using the sharing rule that follows from maximizing Eq. (5), it holds that:

\[
\Pi(j) - \Pi(j - 1) = \frac{1 - \phi}{\phi} (jw(j) - (j - 1)w(j - 1) - w)
\]

for all \( j = 1, \ldots, N \).  \( \tag{6} \)

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\(^4\) The bargaining power of the union \( \phi \) equals \( \frac{\phi}{\phi + (1 - \phi)} \).

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### Table 2

Comparison of equilibrium wage-employment contracts.

<table>
<thead>
<tr>
<th>Employment</th>
<th>( N^a = N = N^b &lt; N^c )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage</td>
<td>( w^a = w^b &lt; w^c = w )</td>
</tr>
<tr>
<td>Profits</td>
<td>( \Pi^a = \Pi &lt; \Pi^b &lt; \Pi^c )</td>
</tr>
</tbody>
</table>

Since \( \Pi(j) = F(j) - jw(j) \) and \( \Pi(j - 1) = F(j - 1) - (j - 1)w(j - 1) \), it follows that:

\[
jw(j) - (j - 1)w(j - 1) = \phi F(j) + (1 - \phi)w.
\] \( \tag{7} \)

Summing up Eq. (7) for \( j = 1, \ldots, N \), we obtain:

\[
Nw(N) = \phi \sum_{j=1}^{N} F(j) + (1 - \phi)NW = \phi F(N) + (1 - \phi)NW.
\] \( \tag{8} \)

Using Eq. (8), the firm’s profit equals:

\[
\Pi(N) = (1 - \phi) [F(N) - NW] = (1 - \phi)\Pi^b(N).
\] \( \tag{9} \)

Hence, the profit-maximizing firm chooses the employment level that coincides with the optimal employment level of the NC firm that writes binding contracts with its workers at the reservation wage. It is well known that the optimal level of employment under efficient bargaining with risk-neutral agents also coincides with the latter. As such, we obtain a powerful efficiency argument for gradual collective bargaining.

Table 2 compares the equilibrium wage-employment contract in our setting with those of the NC firm, the EB firm and the SZ firm.\(^5\)

Our equivalence result with EB confirms that in a static SZ environment, collective wage bargaining removes the wage externality by hindering firms from instantaneous renegotiations with its individual workers. As Stole and Zwiebel (1996b, Sec. III.B.) demonstrate, a union has the effect of linearizing the production function since the firm is now dealing with a single entity whose marginal product is identical to its total product. As a result, the bargained wage is no longer a function of employment and thus, the firm has no strategic overhiring incentive anymore. It is important that the efficiency argument for collective bargaining holds irrespective of whether one considers a gradual union (as we do) or an all-or-nothing union (as in Stole and Zwiebel, 1996b).

In the next section we extend the analysis to a dynamic environment with search frictions.

### 3. Gradual collective wage bargaining with search frictions

In Section 3.1, we introduce the dynamic large-firm search and bargaining environment of BL, following the work of Smith (1999) and Cahuc and Wasmer (2001). In Section 3.2, we derive the wage setting curve under gradual collective wage bargaining and show that the equilibrium under gradual collective wage bargaining coincides with the equilibrium under all-or-nothing collective bargaining. In Section 3.3, we discuss the inefficient equilibrium allocation that emerges in our economy.

#### 3.1. Environment

Time proceeds as a infinite sequence of discrete periods, where the length of a time interval is denoted by \( d \). Consider a continuum of workers and a large, countable number of firms \( m \). The population

\(^5\) The rankings in Table 2 assume that \( \phi \in (0, 1) \) in our setting, the EB setting and the SZ setting.
of workers, who each supply one unit of labor inelastically, is fixed and normalized to one. Each firm i opens a continuum of vacancies \( V_i \), which involve flow costs \( c \) per vacancy and employs a continuum of workers \( N_i \). All agents are risk-neutral, infinitely lived and discount future income at rate \( r \). All firms use an identical production technology \( F(N_i) \) with the same properties as in our static model.

The aggregate number of matches between workers and firms is given by \( M(U, V) = e U V^{1 - \gamma} \), where \( \kappa > 0, \gamma \in (0, 1) \). \( V \) is the economy-wide number of vacancies and \( U \) is the pool of unemployed workers. Let labor market tightness be denoted by \( \theta = V/U \), the vacancy filling rate by \( \lambda_m(\theta) = M/V = e \kappa \theta^{-\gamma} \) and the job finding rate by \( p(\theta) = \partial \lambda_m(\theta) \). At the end of each period, an exogenous proportion \( \lambda_i \) of filled jobs are destroyed.

### 3.2. Equilibrium wage–employment contract

The timing of events is as follows. First, wages are bargained. Then, firms choose the number of vacancies, given the bargained wage. As the firm’s problem is stationary, it can be solved recursively.

In what follows, we do not explicitly consider the vacancy choice of the firm but refer to BL for the derivation of the job creation curve, which we here repeat for further reference:

\[
\frac{\partial F(N_i)}{\partial N_i} - \frac{\partial w(N_i)}{\partial N_i} = w(N_i) + (r + \lambda_s) \frac{c}{\lambda_m(\theta)}. \tag{10}
\]

We now turn to the derivation of the wage-setting curve for our gradual collective wage bargaining setting.

#### 3.2.1. Wage determination

We assume that we are in a steady state in which the firm always returns to the target employment level \( N_i^* \) in the next period, irrespective of what happens in the current period. This implies that the size of the union is constant at \( N_i^* \).

The utility of an employed worker in a firm with employment \( N_i \) is:

\[
W^e (N_i) = w(N_i) \delta + \frac{1}{1 + r \delta} \left[ (1 - \lambda_s \delta) W^e (N_i^*) + \lambda_s \delta W^b \right]. \tag{11}
\]

where \( W^b \) denotes the outside option of the worker.

The utility of an employed worker in a firm with employment \( N_i - \varepsilon \) is:

\[
W^e (N_i - \varepsilon) = w(N_i - \varepsilon) \delta + \frac{1}{1 + r \delta} \left[ (1 - \lambda_s \delta) W^e (N_i - \varepsilon) + \lambda_s \delta W^b \right]. \tag{12}
\]

Next, we specify the union objective. With \( N_i \) workers, the payoff of the union is:

\[
\Psi (N_i) = N_i W^e (N_i) + (N_i^* - N_i) W^b. \tag{13}
\]

If \( \varepsilon \) workers leave the firm, the payoff of the union is:

\[
\Psi (N_i - \varepsilon) = (N_i - \varepsilon) W^e (N_i - \varepsilon) + (N_i^* - N_i + \varepsilon) W^b. \tag{14}
\]

Thus:

\[
\Psi (N_i) - \Psi (N_i - \varepsilon) = N_i \left[ W^e (N_i) - W^e (N_i - \varepsilon) \right] + \varepsilon \left[ W^e (N_i - \varepsilon) - W^b \right]
\]

\[
= N_i \left[ w(N_i) - w(N_i - \varepsilon) \right] \delta + \varepsilon \left[ w(N_i - \varepsilon) - \frac{r}{1 + r \delta} W^b \right] \delta
\]

\[
+ \varepsilon \frac{1}{1 + r \delta} (1 - \lambda_s \delta) \left[ W^e (N_i^*) - W^b \right]. \tag{15}
\]

Turning to the firm side, the payoff (profit) of the firm with \( N_i \) workers is:

\[
\Pi (N_i) = \left[ F(N_i) - w(N_i) N_i - c V_i \right] \delta + \frac{1}{1 + r \delta} \Pi (N_i^*). \tag{16}
\]

Since the difference equation for firm-level employment equals:

\[
N_i = N_i + \lambda_m(\theta) \delta V_i - \lambda_s \delta N_i, \tag{17}
\]

it holds that:

\[
V_i = \frac{N_i - (1 - \lambda_s \delta) N_i}{\lambda_m(\theta) \delta}. \tag{18}
\]

Substituting Eq. (18) in Eq. (16) yields:

\[
\Pi (N_i) = \left[ F(N_i) - w(N_i) N_i - \left[ N_i - (1 - \lambda_s \delta) N_i \right] \frac{c}{\lambda_m(\theta) \delta} \right] \delta
\]

\[
+ \frac{1}{1 + r \delta} \Pi (N_i^*). \tag{19}
\]

If \( \varepsilon \) workers leave the firm, the payoff of the firm is:

\[
\Pi (N_i - \varepsilon) = \left[ F(N_i - \varepsilon) - w(N_i - \varepsilon) (N_i - \varepsilon) \right]
\]

\[
- \left[ N_i^* - (1 - \lambda_s \delta) (N_i - \varepsilon) \right] \frac{c}{\lambda_m(\theta) \delta} \delta + \frac{1}{1 + r \delta} \Pi (N_i^*). \tag{20}
\]

Thus:

\[
\Pi (N_i) - \Pi (N_i - \varepsilon) = \left[ F(N_i) - F(N_i - \varepsilon) - N_i \left[ w(N_i) - w(N_i - \varepsilon) \right] \right]
\]

\[
- \varepsilon \left[ w(N_i - \varepsilon) - \frac{1}{1 + r \delta} W^b \right] \delta. \tag{21}
\]

The surplus sharing rule following Nash bargaining in our gradual union setting implies:

\[
\phi \left[ \Pi (N_i) - \Pi (N_i - \varepsilon) \right] = (1 - \phi) \left[ \Psi (N_i) - \Psi (N_i - \varepsilon) \right]. \tag{22}
\]

Substituting Eqs. (15) and (21) in Eq. (22), dividing both sides by \( \varepsilon \) and taking the limit as \( \varepsilon \to 0 \) yields:

\[
\phi \left[ \frac{\partial F(N_i)}{\partial N_i} - \frac{N_i \partial w(N_i)}{\partial N_i} - w(N_i) + \frac{(1 - \lambda_s \delta) c}{\lambda_m(\theta) \delta} \right] \delta
\]

\[
= (1 - \phi) \left[ \left( N_i \frac{\partial w(N_i)}{\partial N_i} + w(N_i) - \frac{r}{1 + r \delta} W^b \right) \delta
\]

\[
+ \frac{r}{1 + r \delta} (1 - \lambda_s \delta) \left( W^e (N_i^*) - W^b \right) \right]. \tag{23}
\]
Notice that on both sides, the wage schedule \( w(N_i) \) enters only via the derivative of the total wage bill. Isolating this derivative on the left-hand side yields:

\[
N_i \frac{\partial w(N_i)}{\partial N_i} + w(N_i) = \phi \left[ \frac{\partial F(N_i)}{\partial N_i} + \frac{(1 - \lambda_i \sigma)}{\bar{\sigma}} \frac{c}{\lambda_m(\theta)} \right] + (1 - \phi) \frac{1}{\bar{\sigma}} \left[ \frac{r b}{1 + r b} W^b - \frac{1}{1 + r b} (1 - \lambda_i \sigma) \left( W^r(N_i) - W^b \right) \right].
\] (24)

Integrating Eq. (24) and dividing both sides by \( N_i \) yields the wage-setting curve in our gradual collective wage bargaining setting:

\[
w(N_i) = \phi \frac{F(N_i)}{N_i} + \left[ \frac{(1 - \lambda_i \sigma)}{\bar{\sigma}} \frac{c}{\lambda_m(\theta)} + (1 - \phi) \frac{r b}{1 + r b} \right] W^b - (1 - \phi) \frac{1}{\bar{\sigma}} \left[ (1 + r b) w(N_i) - r W^b \right].
\] (25)

### 3.2.2. Equivalence with wage setting under all-or-nothing collective wage bargaining

In order to show the equivalence with wage setting under all-or-nothing collective wage bargaining of BL, we derive the steady-state stationary equilibrium where firm-level and aggregate employment

\[
((1 + r b) w(N_i) - W^b) = \hat{\beta} \left( \frac{F(N_i)}{N_i} + \left[ \frac{(1 - \lambda_i \sigma)}{\bar{\sigma}} \frac{c}{\lambda_m(\theta)} + (1 - \phi) \frac{r b}{1 + r b} \right] W^b \right).
\] (30)

Note that in the absence of search frictions (\( c = 0 \)), employment is efficient as the marginal production value of a worker equals the worker’s outside option, as long as the environment implies \( \delta \to 0 \). This observation confirms our static equivalence result of gradual collective wage bargaining and efficient bargaining of McDonald and Solow (1981) (see Section 2.2).

### 3.3. Inefficient equilibrium allocation

We discuss the inefficient equilibrium allocation that arises in our search and collective wage bargaining economy in the case of an exogenous number of firms. Given the equivalent wage setting under all-or-nothing or gradual collective bargaining, this allocation coincides with the equilibrium allocation of BL who derive that firm-level employment and labor market tightness are inefficiently low. We highlight the role of the curvature of the production function and the union’s bargaining power in affecting the firm’s optimal employment decision.

When workers cannot be replaced instantaneously, the firm has an incentive to hire strategically, which can be seen from differentiating Eq. (29):

\[
\frac{\partial w(N_i)}{\partial N_i} = \hat{\beta} \left( \frac{\partial F(N_i)}{\partial N_i} - \frac{F(N_i)}{N_i} \right) \leq 0.
\] (31)

This wage externality allows the firm to lower the wage by hiring additional workers. In isolation, overemployment would result. However, not only the incentive for overhiring emerges but bargained wages also increase. This countervailing wage rise effect arises for two reasons. First, workers’ ability to hold up production increases firms’ costs of rejecting a wage offer. Second, overhiring increases workers’ job finding probability and thereby decreases the workers’ costs of rejecting a wage offer.

BL demonstrate that the countervailing wage rise effect dominates the strategic vacancy posting effect by comparing the policy function, which implicitly relates firm-level employment \( N_i \) to labor market tightness \( \theta \), in their all-or-nothing collective bargaining setting to the policy function of a planner. In a symmetric stationary equilibrium where firm-level and aggregate employment are constant, these policy functions take the following form (see Eqs. (23) and (22) in BL):

\[
\frac{\partial F(N_i)}{\partial N_i} = \frac{r + \lambda_i + \gamma(\theta)}{1 - \gamma} \frac{c}{\lambda_m(\theta)} + \frac{a_1}{r + \gamma(\theta)} \left( \frac{\partial w(N_i)}{\partial N_i} \right) N_i
\] (32) \[
\frac{\partial F(N_i)}{\partial N_i} = \frac{r + \lambda_i + \gamma(\theta)}{1 - \gamma} \frac{c}{\lambda_m(\theta)}
\] (33)

with \( a_1 = \frac{\rho(\theta)}{r + \gamma(\theta)} \). In Eq. (32), the Hosios condition is imposed to ensure that the crowding externality of firms’ vacancy choice is internalized.

An increase in the curvature of the production function \( \frac{\partial F(N_i)}{\partial N_i} \) or a larger bargaining power of the union \( \hat{\beta} \) increases \( \frac{\partial w(N_i)}{\partial N_i} \) in Eq. (31). Hence, inefficiently low equilibrium firm-level employment negatively depends on both the curvature and the union bargaining power parameters (see Eq. (32)).
4. Conclusion

To acknowledge the prevalence of collective bargaining in contemporary labor markets characterized by search frictions, this paper presents an alternative implementation of firm-level collective wage bargaining. In a sequence of bargaining sessions, the gradual union bargains on behalf of its workers and if negotiations break down, a marginal employee leaves the firm and the union rebargains on behalf of the remaining workers. We investigate the impact of gradual collective bargaining on the equilibrium wage-employment contract in an economy with concave production.

In the static framework of Stole and Zwiebel (1996a,b), the resulting equilibrium is equivalent to the static efficient bargaining outcome of McDonald and Solow (1981). The driving force behind this equivalence result is that collective wage bargaining removes the wage externality by preventing firms from renegotiating instantaneously with its individual workers. A union has the effect of linearizing the production function. The bargained wage is no longer a function of employment and the firm has no strategic overhiring incentive anymore. The efficiency argument for collective bargaining holds irrespective of whether one considers a gradual union or an all-or-nothing union.

In the dynamic framework with search frictions of Bauer and Lingens (2013), we demonstrate that wage setting under gradual collective bargaining and all-or-nothing collective bargaining again coincide when bargaining takes place in fictitious time before production starts. In case the firm cannot immediately replace its workforce and abstracting from firm entry, it has been shown that the wage rise effect typical of unionized bargaining dominates the strategic overhiring effect. We conclude that the resulting inefficient equilibrium allocation in a search and collective wage bargaining economy is not driven by the particular implementation of firm-level all-or-nothing collective bargaining.

References