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CHANGES IN WAGE NORMS

Wage Setting, Unemployment, and Insider-Outsider Relations

By ASSAR LINDBECK AND DENNIS J. SNOWER*

A good conceptual test of any choice-theoretic analysis of persistent involuntary unemployment in free-market economies is to ask whether it can explain why unemployment cannot be eliminated through underbidding. In particular: (a) Why are involuntarily unemployed workers unwilling or unable to gain jobs by underbidding their employed comrades? (b) Why are laid-off workers unwilling or unable to retain their jobs by underbidding? The lower wage bids may be initiated by the firms, the workers, or both in conjunction; "underbidding" is said to take place when the relevant parties accept such bids.

One obvious explanation could be "social norms," according to which underbidding is not an acceptable form of social behavior: "Thou shalt not steal the job of thy comrades by underbidding them," and "Thou shalt not permit job theft from underbidding" are widely accepted social precepts. These imply that existing wages become "fair wages," independent of current demand and supply pressures in the labor market—much as the so-called "wage norms" operate in studies of George Perry (1980), Arthur Okun (1981), and Daniel Mitchell (1985).

However, for an economist, it is natural to try to explore the rationale for such norms when attempting to answer the two questions above. Nowadays the preponderant answer to these questions is contained in the efficiency-wage theories. This paper suggests a logically independent theory: the "insider-outsider" approach. In the efficiency-wage theories, all labor market power rests with the firms, who make the wage and employment decisions under asymmetric information. It is not in the firm's interest to accept the underbidding of involuntarily unemployed workers, because firms use wages as a screening device for productivity. In this case, the unemployment may be understood in terms of a conflict of interest between the firms and the unemployed workers.

By contrast, the insider-outsider approach places some labor market power into the hands of the employees. The crucial assumption is that it is costly to exchange a firm's current, full-fledged employees (the insiders) for unemployed workers (the outsiders), and that the rent associated with this turnover cost can be tapped by the insiders in the process of wage negotiation. Thus wages may be set so that involuntary unemployment results, but the outsiders are nevertheless unable to improve their position through underbidding, because the insiders make underbidding expensive for the firms to accept and disagreeable for the outsiders to pursue. Accordingly, involuntary unemployment arises out of a conflict of interest between the insiders and the outsiders. (See our 1985b paper.) It should be observed that, unlike the efficiency-wage theories, the insider-outsider approach does not assume a direct effect of wages on productivity.

In what follows, we explore the insider-outsider approach by examining how persistent involuntary unemployment can arise under three separate types of cost from insider-outsider turnover: (*i*) the costs of hiring and firing (see our 1986 paper and Robert Solow, 1985); (*ii*) the costs that arise when insiders are prepared to withdraw cooperation from entrants (and thereby reduce the entrants' productivity) or to damage entrants' personal relations with them (and thereby raise the entrants' disutility of work)

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(see our 1985a paper), and (*iii*) the costs implicit in the adverse effect of labor turnover on work effort (see our 1984a paper). We then take a brief look at the implications of the insider-outsider approach for the theory of labor unions.

I. Hiring and Firing Costs

These are perhaps the most conspicuous turnover costs (for example, the expense of implementing mandatory hiring and firing procedures, engaging in litigation, making severance payments) and they take time to incur. Accordingly, it is a convenient simplification to distinguish among three groups of workers: *insiders* (on whom all the hiring costs have been expended and whose dismissal would trigger the full range of firing costs), *entrants* (who are associated only with hiring costs), and *outsider* (who are unemployed and thus require none of the costs above).

For simplicity, imagine each of these groups to be homogeneous. In particular, suppose that all entrants are associated with the same hiring costs and go through a fixed "initiation period," after which they become associated with the same firing costs.

In accordance with the observation that long-term wage contracts (extending over the entire time which employees spend at their jobs) are usually unenforceable, we make the simplifying assumption that wage contracts (for insiders and entrants) last only for a fixed, limited time span, which we set equal to the initiation period. Thus, once an entrant has gone through this period, he has the same job characteristics and bargaining opportunities as an insider; in fact, he becomes an insider.

For the moment, suppose that the insiders are not unionized, so that we can assume the insider wage to be the outcome of an "individualistic" bargaining process between each insider and his firm, whereby the insider takes the wages and employment opportunities of all other workers as given. We require that this bargaining process satisfy two general properties: (*i*) each insider captures some (or all) of the rent inherent in the hiring and firing costs, and (*ii*) the greater this rent, the greater the insider wage.

Then it can be shown that the insider wage will exceed the entrant wage by some positive amount which is not greater than the marginal firing costs. In the same vein, the entrant wage will exceed the outsiders' reservation wage by no more than the marginal hiring costs.

Now consider an economy in which all wages are determined in this way and, at these wages, aggregate labor demand falls short of aggregate labor supply. Is the resulting unemployment "involuntary"?

According to one common definition, involuntary unemployment exists when, at the prevailing wages, workers unsuccessfully seek jobs for which they have the same ability as the current job holders. Yet for our purposes, this definition is too narrow, since insiders, entrants, and outsiders may have different "abilities" to fulfill the available jobs. We can make this idea more precise by dividing the costs of hiring and firing into two categories: (*i*) "indispensable labor costs," without which the act of production could not be performed (for example, screening and search costs in the labor market), and (*ii*) "dispensable labor costs," which are transfers whose abolition would have no intrinsic effect on production (for example, severance payments). Clearly, the indispensable, but not the dispensable, costs should be taken into account in evaluating workers' relative abilities. To deal with unemployment in the presence of ability differences, we provide the following, broader definition of involuntary unemployment: it exists when workers unsuccessfully seek jobs at wages which fall sufficiently below the prevailing wages to compensate the firm for ability differences.

In the context of our economy above, let us measure the ability differences between insiders and outsiders by the differential between their marginal products net of indispensable labor costs. Whenever this ability differential is *less* than the differential between the insider wage and the reservation wage, then the outsiders may be identified as involuntarily unemployed, in the sense that they are arbitrarily exposed to a more restricted opportunity set than the insiders. Moreover, this unemployment will persist whenever the ability differential net of indis-

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pensable *and* dispensable labor costs, is *greater* than the wage differential. For, in that event, the firms have no incentive to replace insiders by outsiders.

II. Cooperation and Harassment

Another potentially important reason why insiders may have a stronger bargaining position than outsiders is that the insiders often have considerable latitude in choosing whether to be cooperative with entrants in the process of production or whether to have, or not to have, good personal relations with them. Thus, insiders are able to affect *both* entrants' productivity via work cooperation *and* their disutility of work via unfriendly attitudes, which we simply call "harassment." Firms generally find it impossible to monitor such "cooperation" and harassment activity perfectly and the wage contracts cannot be made contingent on them. (Output-related wage contracts may not obviate this difficulty, because in many cases firms and/or insiders could find them incentive incompatible, too risky, or too costly to monitor, as shown in our 1985a paper.) Under these circumstances, insiders can protect themselves from underbidding by being prepared to withdraw cooperation from the underbidders or to damage their personal relations with them. In other words, the possibilities of pursuing cooperation and harassment generate economic rent which insiders can exploit in wage determination.

To begin with, let us examine the effects of cooperative activities alone. Suppose that wages are determined by the same individualistic bargaining process as above and that insiders can engage in cooperative activities while entrants cannot. Under these circumstances, entrants receive the reservation wage (and thus are not better off than the outsiders). Moreover, it can be shown that the insider wage, generated by the bargaining process, will exceed the reservation wage by some positive amount which is not greater than the insider-entrant marginal product differential, generated by the disparity between insider-insider cooperation and insider-entrant cooperation.

Assuming for simplicity that cooperative activity has no direct utility cost to the insiders, it is in the insiders' interests to make this disparity as large as possible. They do this by cooperating with one another but refusing to cooperate with entrants.

In an economy which runs along these lines, persistent involuntary unemployment may exist in the following sense. The inherent ability difference between an insider (on the one hand) and an entrant or outsider (on the other) stems exclusively from their different individual abilities to provide cooperation to their colleagues. The corresponding ability-related marginal product differential may be evaluated as the amount by which their marginal products would differ under identical external condition of employment, viz, identical cooperation from their colleagues. Now observe that the bargaining process above may yield an insider wage that exceeds the reservation wage by more than the ability-related marginal product differential, so that the outsiders are involuntarily unemployed. Nevertheless, the firms may have no incentive to replace the insiders. The reason is that the insiders and outsiders do *not* face identical external conditions of employment: the insiders receive cooperation whereas the outsiders (through no fault of their own) do not. Thus, the firms do not find it worthwhile to hire outsiders and consequently the unemployment persists.

By the same token, laid-off workers may be unable to retain their jobs by offering to work for lower wages. Specifically, suppose that there is a business downturn and that firms respond by laying off a number of employees. It can then be shown that it is in the best interest of the remaining employees to withdraw cooperation from the laid-off workers and thereby prevent underbidding.

Harassment activities can achieve a similar purpose. We observe that employees are free to decide how friendly or unfriendly they should be to fellow workers—activities whereby they can affect each other's disutility of work, but which firms usually cannot obtain complete, verifiable, and objective information about. Insiders can keep unemployed and laid-off workers from underbidding by creating the credible expectation that underbidders will be harassed. As a result, outsiders have a higher reservation wage than the insiders.

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If the outsiders were able to avoid harassment, they would be willing and able to do the insiders' work for less than the insiders' wage. Yet they do not have this option. Their choice set, even allowing for their abilities, is less favorable than that of the insiders. Thus the unemployment may be regarded as involuntary, in much the same way as a person involuntarily relinquishes his wallet when a mugger asks him to "choose" between his wealth, and his health.

III. Effort and Labor Turnover

A third significant reason why firms might not comprehensively replace their high-wage insiders with low-wage outsiders is that the implied labor turnover would have an adverse effect on the morale of all their employees and consequently work effort and productivity would fall. As in some versions of the efficiency wage theories, we assume that firms have incomplete information on work effort and thus wages cannot be made dependent on it. Insiders know this and raise their wage above the level at which outsiders would be willing to work, but firms do not replace them since the associated productivity loss would dominate the reduction in labor cost.

To drive this point home in a simple way, suppose that future productivity is stochastically related to current work effort (due to lags in production or monitoring). Thus, firms cannot use current wages to reward workers for their current effort; at best, they can reward the stochastic output response to past effort. They can also use the turnover rate to stimulate effort by specifying a cut-off productivity, below which an employee is dismissed.

Let the firm's remuneration package consist of (a) a wage (which may be time rate and/or piece rate), and (b) the cut-off productivity. The firm can raise the labor turnover rate by raising its cut-off productivity. This reduces the expected future reward which each employee receives for current effort. It can be shown that the effort response depends on a substitution effect and an income effect (see our 1984a paper). By the former, effort falls: the employee works less hard since he is more likely to be fired and thus less likely to be compensated for his effort. The income effect raises effort: the employee works harder in order to avoid the possibility of being fired.

In this context, turnover has an adverse effect on effort if the substitution effect dominates the income effect. Whenever this is the case and insiders capture some of the economic rent associated with the turnover cost, then there may be involuntary unemployment in the following sense: Insiders and outsiders have the same abilities and differ only in terms of their competitive positions. If the outsiders could gain employment without affecting employees' effort incentives, they could perform the same job as the insiders—and do it for less than the insider wage. But since that option is closed to them, they may be considered involuntarily unemployed.

IV. Union Activity

Thus far our explanation of involuntary unemployment has not only avoided the presumption of government regulations, but also has made no reference to the activity of labor unions. However, the insider-outsider approach does suggest how unions may accentuate involuntary unemployment. It also provides several rationales for union activity and indicates how each can contribute to involuntary unemployment.

Assuming that unions are more responsive to the interests of their employed members than to the unemployed ones, there are many ways in which a union can help raise the wages of its insiders without reducing their chances of continued employment: (a) it may amplify the costs of hiring and firing (for example, severance pay, hiring and firing procedures); (b) it could increase the effectiveness and variety of cooperation and harassment activities; (c) it can augment insiders' bargaining power and thereby enable them to capture a greater share of the available rent from their jobs; (d) it can provide insiders with new rent-seeking tools: threats of strike and work-to-rule are the most prominent examples. (See our 1986, 1984b papers.) In this manner, the insider-

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outsider approach offers an explanation how unions get their clout, and why employers choose to negotiate with unions rather than turn to nonunionized workers.

In short, the insider-outsider contributions described above may be seen as an attempt to rationalize simultaneously the existence of wage norms, involuntary unemployment, and the economic role of labor unions.

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