<table>
<thead>
<tr>
<th><strong>Title</strong></th>
<th>Social consensus, income policies and unemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Authors(s)</strong></td>
<td>Durkan, Joe; Harmon, Colm</td>
</tr>
<tr>
<td><strong>Publication date</strong></td>
<td>1996-03</td>
</tr>
<tr>
<td><strong>Series</strong></td>
<td>UCD Centre for Economic Research Working Paper Series; WP96/11</td>
</tr>
<tr>
<td><strong>Publisher</strong></td>
<td>University College Dublin. School of Economics</td>
</tr>
<tr>
<td><strong>Item record/more information</strong></td>
<td><a href="http://hdl.handle.net/10197/1784">http://hdl.handle.net/10197/1784</a></td>
</tr>
<tr>
<td><strong>Notes</strong></td>
<td>The original photocopying quality of this item renders some text unreadable. A hard copy is available in UCD Library at GEN 330.08 IR/UNI</td>
</tr>
</tbody>
</table>

Downloaded 2019-08-02T11:01:31Z

The UCD community has made this article openly available. Please share how this access benefits you. Your story matters! (@ucd_oa)

Some rights reserved. For more information, please see the item record link above.
Social Consensus, Income Policies and Unemployment

by

Joe Durkan
University College Dublin
and
Colm Harmon
Maynooth University,

WP96/11
March 1996
Social Consensus, Incomes Policies and Unemployment.

J. Durkan (UCD) and Colm Harmon (Maynooth)

Introduction

This paper has two objectives. The first is to test in a more rigorous manner the conclusion contained in a previous paper (Durkan 1992) that centralised bargaining in the Irish context accelerated the rate of wage inflation. The second is to examine the related question of the degree of insider power operating in the labour market in Ireland (Harmon 1992).

Centralised Bargaining and Wage Inflation

The argument in Durkan (1992) was very simple, though it had several strands. It was based on a historical analysis of the emergence and development of centralised bargaining in Ireland.

The emergence of centralised bargaining in Ireland was a result of a concern with industrial relations following the maintenance men's dispute of 1969. Centralised bargaining, in the form of National Agreements, began as a means of ensuring that the information asymmetry that lay behind that dispute would not recur so that employers and trade unions could agree on rates of pay at levels which ensured the absence of industrial disputes. An institutional framework which set pay to prevent industrial disputes was likely to find the threat of industrial unrest was a factor pushing up wage inflation.

The actual development of the wage process under centralised bargaining also created an environment under which wage inflation was likely to accelerate, for two reasons.
First, the whole process of wage negotiation was compromised by
the role of Government. Government sought to influence the
outcome of National Agreements by official statements, and by
generally exhorting the 'Social Partners' to agree wage increases
that would provide full employment, but simultaneously were
concerned with the political implications of a return to a free
for all with the possibility of other economy-wide disputes.
Thus it was no surprise to find the Government guidelines were
exceeded to a very marked degree in formal announced National
Agreements, while simultaneously Government welcomed the
agreement.

Second, the form that centralised bargaining took during the
period 1970-1981 also contributed to an acceleration of wage
inflation. At the central level employers and trade unions
negotiated increases in basic rates of pay. These negotiations
involved setting pay norms which satisfied both sides, and an
examination of the basic terms of the pay agreements of the
period suggest that the increases in pay reflected expected
productivity and inflation as a minimum, with the added factor
in relation to the industrial relations side referred to above.
However the agreements permitted further increases in basic rates
of pay negotiated at local level, under a variety of reasons.
The actual increases in pay were much greater than the
increases warranted under the basic terms of the centralised
agreement, but could not be faulted as they fell within the local
bargaining clauses. Thus what appeared to be a centralised
bargaining framework was in effect a two tiered system. It is
this two tiered system that makes it difficult to see the period
1970-1981 as falling within the model of a centralised bargaining
framework. One conclusion of the 1992 paper was that the two
tiered nature of wage settling was unlikely to result in full
employment.

One further point emerged from the historical analysis, and was
an observation on the extent to which the electoral cycle was a
factor in the wage negotiation process, adding to wage inflation.

The type of analysis contained in the 1992 paper is suggestive
but not definitive. It contains arguments in favour of the
hypothesis that centralised bargaining, as practised in Ireland,
accelerated wage inflation, but could not prove it, nor indicate
the extent of excess wage inflation. The paper built upon the
analysis contained in Bacon, Durkan and O'Leary (1982), which,
while it contained many of the elements needed to obtain the same
result, was still looking to incomes policies as the means to
bringing the economy back to full employment. As part of this,
Bacon et al. contained a detailed analysis of incomes policies
across a range of countries, the objective being to determine the
conditions under which incomes policies were effective. The core
of the incomes policy part of Bacon et al. was a comparison
across 10 countries of the institutional framework within which
incomes were determined, where the variables under consideration
were as follows:

(i) the focus of negotiation - centralised or otherwise
(ii) the extent of participation - bilateral/tripartite
(iii) permanent or temporary
(iv) a common framework of analysis among participants
(v) political climate - favourable or unfavourable
(vi) compliance - voluntary or mandatory
(vii) union orientation - solidaristic/economistic

The conclusion of the analysis was that successful incomes
policies required both a degree of permanence in the institutions
of incomes policies and a common framework of analysis. During
This type of analysis is also suggestive only. Subsequently, in the work of Calmfors and Driffl (1988), and Layard, Nickell and Jackman (1991), more theoretical approaches provided a better basis for the earlier and indeed later conclusions. Calmfors and Driffl concluded that "both heavy centralisation and far-reaching decentralisation are conducive to wage restraint, whereas intermediate degrees of centralisation are harmful." It is of some interest to note that Calmfors and Driffl differ from Bacon et al. in the meaning attached to centralisation, in particular with regard to the Austrian experience. The two-tier system in operation in Ireland falls outside the pure centralised model, and into the intermediate category, and thus would not produce optimum results in terms of the performance of the economy, within the Calmfors and Driffl model.

Layard et al. provide an important insight in relation to a centralised union structure (even where there is no centralised bargaining framework). The centralised union will select "a real wage consistent with full employment" and it will do this because it values, not only the continuation in employment of its members, but also a reduction in unemployment, since unemployment imposes costs on its members. This is essentially the idea captured by the notion of a common framework of analysis, but is much less demanding.

Table 1. The Wage Equation - Dependent Variable: % change in average earnings

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>3.969</td>
</tr>
<tr>
<td>CPI</td>
<td>0.657</td>
</tr>
<tr>
<td>PA70</td>
<td>5.792</td>
</tr>
<tr>
<td>PA72</td>
<td>9.582</td>
</tr>
<tr>
<td>PA74</td>
<td>4.158</td>
</tr>
<tr>
<td>PA75</td>
<td>15.361</td>
</tr>
<tr>
<td>PA76</td>
<td>-0.278</td>
</tr>
<tr>
<td>PA77</td>
<td>4.993</td>
</tr>
<tr>
<td>PA78</td>
<td>5.663</td>
</tr>
<tr>
<td>PA79</td>
<td>2.442</td>
</tr>
<tr>
<td>PA80</td>
<td>0.020</td>
</tr>
<tr>
<td>PNX</td>
<td>-1.892</td>
</tr>
<tr>
<td>PESF</td>
<td>-0.546</td>
</tr>
</tbody>
</table>
Increases of almost 6, 10 and 15 per cent occurred above those that would have occurred in the absence of the negotiated agreements.

A more general conclusion is that where Government pursued a more active policy on incomes, as in 1976 with the Interim Agreement, later with the two National Understandings, and finally with the PNR and PESP, this acceleration of wage inflation did not occur. However, this should not be overstated, since, as indicated above, Government had some part to play in the size of the tax wedge. A more complete model is needed to capture this.

There was one further hypothesis implicit in the 1992 paper, viz. that excess wage inflation increased over time, as the trade union movement learned to turn the concerns of Government into income increases, and as the two tier system was developed. If this hypothesis had any merit, then one would expect the impact of the agreements, as measured by the size of the coefficients on the dummy variables, to increase over time. This is clearly not the case.

A surprising feature of the equation is the size of the coefficient on the CPI. We would have expected a value close to unity.

Finally, this section of the paper only looks at the extent to which wage inflation is accelerated in a situation where there is no pressure for lower wage inflation from the labour market. The second part of the paper looks at this, but we have not yet properly integrated the two insights as yet.

Centralised Bargaining and Outsiders

There is an alternative way to think about the form of centralised bargaining framework that developed in Ireland, viz. as a device to maintain the power of insiders, and to exclude from employment, and from exerting any pressure on the labour
market, those who are currently unemployed or entering the labour market. Thus, rather than examining the effect on earnings of centralised bargaining what we are interested in is the effect on unemployment. To make this operational it is necessary to formulate a testable hypothesis, which incorporates the insight that the insider-outsider theory provides.

The starting point is a dynamic labour demand equation, based on the formulation of Blanchard and Summers (1986) and Alogoskoufis and Manning (1988), and the interpretation by Groenewold and Taylor (1992).

\[ l_t = \sigma l_{t-1} - (1-\sigma)\theta (w-p)_t + e_t \]

where all the variables are in logs, \( l_t \) is employment as determined by employers, \( (w-p) \) is the real wage and \( e \) is a random shock. The parameters \( \sigma \) and \( \theta \) are non-negative and are respectively, the short run adjustment coefficient and the long run real wage elasticity of the demand for labour. The nominal wage is set before the event captured by \( e \) occurs, and is agreed by insiders so that actual employment equals the size of the insider group. The insider group is itself a weighted average of the expected effective labour force and last period's employment, as per the following

\[ (1-\alpha)n^*_{t-1} + \alpha l_{t-1} \]

where \( n^* \) is the expected effective labour force (i.e., the expectation formed in period \( t-1 \) of the labour force less those who are classified as unemployed). If \( \alpha = 1 \) then insiders consist entirely of incumbent workers, whereas if \( \alpha = 0 \) insiders will consist of the expected labour force, but there will still be some unemployment due to those who are regarded as unemployed. In this formulation insiders are willing to consider new entrants to the labour force as constituting part of the insider group, but are exclude those unemployed. In some sense \( \alpha \) is a measure of the extent of insider power. The wage rate sought by the insider group will ensure that the group is fully employed.

The above allows us to derive the following equation for the unemployment rate:

\[ u_t = \beta + (1-\alpha)u'(t) + au_{t-1} + v_t \]

where \( u'(t) \) is the natural rate of unemployment, which is modelled as a quadratic trend, and \( v_t \) is a composite error term. This is the general form we want to estimate. However we also want to examine the effects of centralised bargaining. Table 2 presents the results, where we have included dummy variables for the agreements. (Note that a separate dummy is used for 1964, excluded from the earlier analysis). The time period is as before.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Equation 1</th>
<th>Equation 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>3.062 *</td>
<td>2.871 *</td>
</tr>
<tr>
<td></td>
<td>(2.36)</td>
<td>(2.53)</td>
</tr>
<tr>
<td>( u_t )</td>
<td>0.737 *</td>
<td>0.754 *</td>
</tr>
<tr>
<td></td>
<td>(6.34)</td>
<td>(7.47)</td>
</tr>
<tr>
<td>( t )</td>
<td>-0.27 *</td>
<td>-0.026 *</td>
</tr>
<tr>
<td></td>
<td>(-2.87)</td>
<td>(-3.19)</td>
</tr>
<tr>
<td>( t^2t )</td>
<td>0.001 *</td>
<td>0.001 *</td>
</tr>
<tr>
<td></td>
<td>(3.25)</td>
<td>(3.39)</td>
</tr>
<tr>
<td>NWR54</td>
<td>-0.050</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-0.71)</td>
<td></td>
</tr>
<tr>
<td>NWA70</td>
<td>0.61</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.64)</td>
<td></td>
</tr>
<tr>
<td>NWA72</td>
<td>0.31</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.33)</td>
<td></td>
</tr>
<tr>
<td>NWA74</td>
<td>-0.108</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-1.07)</td>
<td></td>
</tr>
</tbody>
</table>
The 1964 National Wage Recommendation exerted no pressure in either direction on unemployment. The National Wage Agreements were similarly ineffective – with the exception of the 1975 agreement, whose effect is statistically significant, and which added to unemployment. Thereafter, the first National Understanding was associated with a reduction in unemployment, but of course it must be remembered that this Understanding incorporated some direct employment creation, and the impetus of the full employment measures begun in 1978 were still in operation. The second Understanding, to the extent that the coefficients can be interpreted, added to unemployment. The most interesting feature of the results is the role played by the PNR and the PESP. Both were associated with a reduction in the unemployment rate.

There are several important results to be noted. First, the value of \( a \) is significantly less than 1. Some 25 - 30 per cent of those unemployed retain a voice in the labour market. Employment is not wholly made up of insiders, unemployed people exert some pressure also. We are not entirely happy with the unemployment rate, as we feel it would be better to distinguish between short and long term, and what we may be getting here is a strong effect from short-term unemployment, and very little from long-term unemployment.

Second, the quadratic time trend, which is a proxy for the natural rate of unemployment, are statistically significant, but play a small effect in the model.

Third, the income policy variables provide a useful indicator of the success of centralised bargaining in reducing unemployment.

Conclusion
This paper has attempted to test the impact of the form of centralised bargaining that developed in Ireland on wage inflation and unemployment. The approach was very simple, involving the estimation of two equations, one ad hoc, the other with a better basis. The results are surprising in that they indicate that the early agreements added very significantly to wage inflation, but not much to unemployment, and the later agreements reduced wage inflation and unemployment. The surprise relates, not to the direction of the wage unemployment relationship, but to the difference between early and later agreements. There is definitely some evidence that unemployment was exerting downward pressure on wage rates, and that this was operationalised via the system of centralised bargaining. However, this pressure did not produce full employment, so that the paper is also saying that there are degrees of insider power i.e. \( a \) varies between 0 and 1, rather than \( a = 0 \) or 1. What we have not done is linked the two sides of the paper together through a mechanism that shows how wage bargaining impacts on wage inflation for a given level of unemployment and insider power, and how this in turn affects unemployment.
References

Centre for Economic Research Papers

Working Papers represent preliminary reports on research in progress and should not be cited without permission from the authors. Policy Papers represent preliminary reports on policy-oriented research carried out by members or associates of the Department of Economics, University College Dublin. The following is a comprehensive list of the last year's working and policy papers issued by the Centre. A complete list of other publications of the Centre is available on request.

Working Papers 1994

WP94/2: Rodney Thom: "A (Weak) Exogeneity Test of the German Leadership Hypothesis" March 1994
WP94/4: David Madden: "How does Unemployment Affect Marginal Direct and Indirect Tax Reform?" April 1994
WP94/7: Cormac Ó Gráda: "Anthropometric History What's in it for Ireland?" June 1994.
WP94/10: Cormac Ó Gráda and Brendan Walsh: "Recent Trends in Fertility and Population in Ireland, North and South" July 1994
WP94/14: Frank Barry: "Exchange Rate Policy when the Labour Market Exhibits Hysteresis" September 1994