



# Unions as commitment devices

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## Abstract

Under incompleteness of contracts, we consider one role of unions is to function as commitment devices. When wage and dismissal rates contingent on the states are not specified in labor contracts, firms cannot promise ex ante to maintain employment. Thus, firms must offer a high wage to encourage workers in accumulating skills. However, if unions resist firms' dismissal policies, unions can play a significant role as commitment devices for job security. As a result, since firms can decrease wage and increase employment level, we can expect the profit of the unionized firms to be higher than that of non-union firms. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Organizing unions and collective bargaining have been established and spread as a universal right of workers all over the world during the 20th century, and is described explicitly in labor law. This implies that workers can organize unions even if firms are against their existence. Indeed, there have been many conflicts between unions and firms resulting in damage to both the firms and the workers due to the insistence of opinions and hard fought battles. Empirical studies, for example Freeman and Medoff (1984), Brunello (1992), and Becker and Olson (1992), show that the existence of unions reduces firms' profits. This means that firms would not want strong unions, so they prevent union activities and discourage employees from managing and organizing unions. Union membership rates are declining in many developed countries.

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Unions are typically viewed in a negative light when they exercise their strong bargaining power and lead to an inefficient allocation of labor. In the real world, an important purpose of unions is to raise wage, and thus unions have chosen aggressive actions like strike activities and lockouts to realize this purpose. However, other goals should also be considered by unions. In this paper we conclude that unions should exercise their strong bargaining power to maintain high job security rather than raising wage payment.

According to the 'Exit and Voice' approach of Hirschman (1970), unions play a positive and significant role as the voice system for constructing good industrial relations. Unions can collect employees' claims and demands, and report them to firm managers. Firms then put the unions' reports to practical use increasing productivity and profit. The voice system of unions is thus valuable for firms. However, unions are not the only means of instituting the voice system. Firm managers can also institute adequate systems of communication and decision making between managers and workers without the constraints imposed by collective bargaining.

Focusing on unions' bargaining power, we provide a substantial new role for unions as commitment devices under contractual incompleteness. In the real world, contracts are apt to be incomplete due to huge transaction costs and few contracts are specific on matters of job duration and employment stability. Under contractual incompleteness, firms cannot promise high job security to workers in a recession. Firms always optimize employment level ex post. However, if unions exercise their power in relation to job security, firms can promise to keep employment levels high as a result of the unions' role as a commitment device.

In this paper, a simple labor contract specifying a basic wage level is considered. Usually, payment is explicitly specified in labor contracts, i.e. wage offers are verifiable. Unless it is verifiable, many workers may not get paid since a firm would not be punished in court for non-payment because of the unverifiability of the wage. Hence, as the labor law states, basic wage should be described explicitly in labor contracts. However, workers still face uncertainty in job security under the free dismissal principle supported by labor law since a firm can dismiss employees with some restrictions determined by the labor law.

Actually, few employment contracts beyond 1 year are formally made in the US, while making employment contracts in writing is indispensable in the court system from the viewpoint of the stature of frauds. In Japan, labor law prohibits workers and firms from making long-term contracts beyond 1 year. Furthermore, dismissal rates of employees contingent on the states cannot be specified ex ante in labor contracts due to the huge transaction costs. Under contractual incompleteness, a firm cannot ex ante promise to keep employment high nor promise not to maximize its ex post profit. In other words, opportunism cannot be constrained; a firm always maximizes the ex post profit. Employees then take this into account when making contracts with the firm. When workers are required to learn skills, the firm must compensate the training cost of workers by paying a wage higher than that in the spot labor market. Since the firm optimizes its employment level ex post and does not maintain excess employment after observing the realized state, workers are unwilling to make contracts with the firm unless a sufficiently high wage is offered.

If the union's resistance activities to the firm yield sufficient severance pay as dismissal compensation, then a low basic wage can cover workers' training cost, and the unionized firm will have a lower payment and higher job security than a non-union firm. Therefore, the unionized firm can use the union as a commitment device for job security, and increase the ex

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