



# Should civil servants be restricted in wage bargaining? A mixed-duopoly approach<sup>☆</sup>

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## ABSTRACT

Should civil servants (employees in the public sector) be allowed to bargain collectively? To answer this question, we construct a model of unionized mixed duopoly and examine the regulatory framework of public institutions, especially focusing on a wage regulation imposed on the public firm. The wage regulation turns out to yield critical welfare implications as it gives rise to two opposing strategic effects: the wage regulation intensifies downstream-market competition while it loosens upstream-market competition. The overall welfare effect is ambiguous, depending crucially on the degree of product differentiation between the firms. We also show that, in contrast to the popular belief, granting the right to bargain collectively to civil servants would not necessarily help them because they tend to demand excessively high wages when they are allowed to bargain collectively. Finally, we briefly discuss a new perspective on the role of profit motives in public institutions when the wages are determined endogenously.

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## 1. Introduction

Mixed markets, where state-owned public firms compete against private firms, are fairly common in developed, developing, and former communist transitional economies. In many countries, public firms exist and compete with private firms in a range of industries such as the airline, rail, telecommunications, natural gas, electricity, steel, and home-delivery industries, as well as services such as banking, home loans, health care, life insurance, hospitals, broadcasting, and education.<sup>1</sup> In fact, even those typically considered as national monopolies in a narrowly defined sense can be regarded as competing in mixed markets with product differentiation, because there are often other firms or industries which produce substitutable goods and services.<sup>2</sup> Accordingly, the study of mixed markets has become increasingly popular in recent years.<sup>3</sup>

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<sup>1</sup> Among developed countries, mixed markets are more prevalent in Europe, Canada, and Japan. Although they are less significant in the United States, there are examples of mixed oligopolies such as the packaging and overnight-delivery industries.

<sup>2</sup> For instance, De Fraja (1993) points out that although a national rail system is usually considered as a national monopoly, it does have some oligopolistic interaction with private coach companies.

<sup>3</sup> Merrill and Schneider (1966) and Harris and Wiens (1980) are the pioneering works in this field. See also Bös (1986, 1991), De Fraja and Delbono (1990), and Nett (1993) for excellent surveys.

In standard mixed-market models, public firms are typically assumed to maximize social welfare while private firms are to maximize profit.<sup>4</sup> Under this setup, it is often supposed that the role of public firms is to maximize social welfare by correcting inefficiencies arising from market failures. There is no convincing reason to believe, however, that employees in the public sector (to whom we refer somewhat loosely and inclusively as civil servants throughout the paper, mostly for expositional purposes) share the same goals; it rather seems more natural to assume that they aim at maximizing their own utility just like employees in the private sector.<sup>5</sup> If the goals of civil servants are not to maximize social welfare, their behavior may need to be regulated in some ways. What becomes crucial along this line is how wages in the public sector should be regulated because the wage level virtually determines the firm's productive efficiency, ultimately leading to serious welfare implications.<sup>6</sup> If wages in the public sector are set in an inappropriate way, any subsequent effort to increase efficiency might totally be wiped out. It is this aspect of public firms that we focus on in this paper.

In reality, the way civil servants are regulated is surprisingly diverse across countries. In many countries today, civil service salaries are determined largely through collective bargaining between the union and the government, although there are often some job- and title-specific restrictions. In contrast, there are still some countries such as Germany (for the case of *Beamte*), Japan and the US where civil servants are regulated and restricted in some senses. When civil servants are restricted in their right to bargain collectively, their salaries are more or less tied to the average wages in the respective industries (the 'equal pay for equal work' principle) or those in the private sector as a whole. In Japan, for instance, civil servants are typically not allowed to bargain collectively, and their wages are instead determined based on the advice of the National Personnel Authority, called *Jinji-In-Kankoku*, with its particular emphasis on the equalization between the private and public sectors.<sup>7</sup>

Because of its potential impact on national welfare, the regulatory framework of civil servants has naturally been a topic of heated debate. Although different countries have their own regulations and it is certainly difficult to draw a clear line,<sup>8</sup> a recent trend is clearly shifting towards granting civil servants the right to organize and bargain collectively, mostly from the viewpoint of protecting workers' rights. For instance, a report by the Committee on Freedom of Association, one of the six Governing Body committees of International Labour Organization (ILO), points out that the current Japanese system is not consistent with international labor standards, and urges the Japanese government to engage in full consultations with the trade unions with the view to amend the current legislation that denies civil servants the right to bargain collectively (Cases 2177 and 2183, November 2002). The Committee has also issued a recommendation against the US state of North Carolina, which as well as in some other US states, strictly prohibits any collective bargaining in the public sector, that the government should promote a framework allowing collective bargaining in the public sector (Case 2460, March 2007). The stance taken by ILO reflects an emerging global consensus that the right to bargain collectively (and even strike) constitutes an important part of workers' rights that should be respected even for civil servants.

Despite this recent trend, however, welfare consequences of allowing civil servants to bargain collectively are not necessarily straightforward, especially in a mixed market. This paper thus examines the regulatory framework of public institutions with a particular focus on the wage regulation imposed on their employees. To this end, we consider two distinct regulatory regimes in a mixed duopoly. In the first, civil servants are allowed to form a union to represent themselves and, more importantly, to bargain collectively just as workers in the private sector.<sup>9</sup> In the second, civil servants are prohibited to bargain collectively, and their wages are tightly regulated by some wage-setting rule (unilateral regulation), which more or less abides by the 'equal pay for equal work' principle. We compare these two regimes and explore welfare implications of the wage regulation imposed on civil servants.

The analysis reveals that the way civil service salaries are determined indeed leads to substantial welfare consequences. As is normally the case in this type of setup, the welfare effect of the wage regulation hinges critically on its impact on the equilibrium wages (or the prices of intermediate goods): roughly speaking, the wage regulation is welfare-enhancing if it lowers the wages.

<sup>4</sup> See, for instance, De Fraja and Delbono (1989), Cremer et al. (1991), Fjell and Pal (1996), Anderson et al. (1997), Pal (1998), Pal and White (1998), and Matsushima and Matsumura (2003).

<sup>5</sup> Of course, one can argue that mission-oriented public institutions tend to attract more 'motivated agents.' For instance, Besley and Ghatak (2005) emphasize the importance of motivation and preference matching in a mission-oriented, rather than profit-oriented, sector. Still, there is no convincing reason to believe that even the goals of those 'motivated agents' coincide precisely with the goals of public institutions.

<sup>6</sup> The productive efficiency of public and/or private firms in mixed markets is examined by many researchers in other contexts. See Nett (1994), Nishimori and Ogawa (2002), Corneo and Rob (2003), Ma (2004), and Matsumura and Matsushima (2004) for theoretical discussions on this issue. Using the data on Japanese parcel companies, Mizutani and Uranishi (2003) empirically examine the efficiency of public firms. Megginson and Netter (2001) provide an excellent survey.

<sup>7</sup> Although the advice formally covers only national government employees, it typically sets the baseline and hence has strong impacts on salaries for local government employees.

<sup>8</sup> For instance, in Britain, civil service salaries are based on the recommendations of independent review bodies rather than on collective bargaining. The review bodies, however, receive detailed evidence from trade unions and employees, and their recommendations are usually adopted by the government. There is also a country like France where the legal status of collective bargaining is somewhat uncertain. In France, although unions are recognized as capable of conducting negotiations, these negotiations are not compulsory, and the government is free to disregard any agreement that may have been reached. See Bordogna (2003) for more detail.

<sup>9</sup> Canada is one of those countries which provides several examples of mixed unionized oligopoly: unionism in the public sector is very active, as represented most notably by Canadian Union of Public Employees (CUPE), while at the same time, public firms play a very large role in the Canadian economy. One prime example of this case is Canada Post which competes with private enterprises such as FedEx. Employees at Canada Post are represented by the Canadian Union of Postal Workers (CUPW) — one of the most active trade unions known for a series of high profile strikes.

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