The Calmfors-Drifill Hypothesis with Labour Market Frictions and Regulated Goods Markets.

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Abstract

In this paper we present an unemployment model with labour market frictions and monopolistic competition in the goods market. We consider different collective wage-setting systems and compare wages, the unemployment rate and labour market tightness at firm, sector and national (centralized) levels. We find that the Calmfors-Drifill hypothesis is maintained under labour market frictions. In other words, unemployment will be the highest when the bargaining occurs at an industry-wide level. We argue, both analytically and empirically, that regulation in the goods and labour markets plays a crucial role in explaining this result and, then, it may contribute to explaining the historical relationship between wage bargaining institutions and unemployment. Additionally, we show that the Calmfors-Drifill result is conditioned by the tax structure and the progressivity of labour income taxes. This fact might explain the lack of robustness in the findings of many empirical studies on the Calmfors-Drifill hypothesis.

Keywords: Frictional Unemployment, Monopolistic Competition, Wage Setting Systems, Policy Reforms.

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1 Introduction

The Great Recession has been characterized by an unprecedented decline in economic growth and a rise in unemployment rates in OECD countries. This economic downturn has been particularly hard in Europe, particularly in Southern European countries such as, Spain, Portugal, Italy and Greece. All these countries, as is well known, share a common system of collective bargaining: sector-level wage bargaining. This fact led to strong political and economic debate in these countries regarding the reform of employment relations between different social agents (unions, employees and government). Lastly, in order to tackle unemployment and growth problems, the governments have implemented structural reforms, such as in the case of Spain, in order to shift towards a more decentralized bargaining system.

This recommendation is based on the seminal article by Calmfors and Driffill (1988), which pointed out that highly centralized and decentralized bargaining systems perform better than intermediate ones on wage demands. This relationship is known in specialized literature as the inverted-U shape between unemployment and the degree of centralization, or the Calmfors and Driffill’s hypothesis. In an excellent survey, Aidt and Tzanatos (2008) show that evidence supporting the hump hypothesis is weak: fewer than half the studies supported this hypothesis. More specifically, the authors pointed out that “the favour evidence comes from the first generation of studies relied on simple correlations test and that thus failed to control for other determinants of economic performance”.

In order to overcome the discrepancy between theoretical models and the empirical evidence, we develop a general framework that allows us to determine under what conditions the inverted-U shape can be found. It is important to point out that our analytical framework merges five elements that characterize the European labour market. Namely, monopolistic competition in goods markets, employment protection legislation, labour taxation and finally, frictions and collective wage bargaining in the labour market.

There is a growing consensus about the key importance of product market regulation in influencing labour market performance. Blanchard and Giavazzi (2003), for example, or more recently, Fiori et. al (2012) show the effect of deregulation in goods and labour market on the unemployment rate using a simple general equilibrium model where they assume monopolistic competition in the goods market. We therefore use the monopolistic competition set-up because it is the natural framework for analyzing different systems of wage setting.

Labour taxation is also a labour market institution that affects unemployment through its impact on the wage\(^1\). When taxes on labour are introduced, the tax wedge between labour costs paid by an employer (gross wage) and net wage received by an employee ap-

\(^{1}\)Blanchard and Wolfers (2000) analyze the role of a great diversity of shocks and institutions in the rise of unemployment.
pears. It is precisely the net wage received by an employee that is crucial in determining the wage negotiated under a collective bargaining agreement. Related to the previous issues on labour taxation, a relevant component in advanced economies is the progressive tax on income perceived by an employee. It is therefore no surprise that there is a wide-ranging theoretical and empirical literature that has tried to relate progressivity and unemployment. According to this literature, it is well established that progressive taxation has wage-moderating effects, thus stimulating employment in wage bargaining models without frictional cost (see, e.g., Holm and Koskela (1996); Koskela and Vilmunen (1996); Koskela and Schöb (1999). More recently, effects of labour taxation have also been analyzed in the search for a theoretical framework by Pissarides (1988) and Mortensen and Pissarides (2001), among others. Pissarides (1998) shows that under the standard wage bargaining assumption progressive taxation boosts job creation and thereby increases employment.

Models with labour market frictions have proliferated in recent years to explain the unemployment rate. The typical framework in this literature is built on the search and matching models in the Diamond-Mortensen-Pissarides tradition (see, for example, Pissarides (2000) and Mortensen and Pissarides (1994)) where there is individual wage setting. However the wage determination mechanism in Western European countries is, essentially, the collective bargaining. To date, however, little work has been done to incorporate frictions within a collective wage bargaining framework. The major exceptions are Delacroix (2006), Ebell and Haefke (2006), García Sánchez and Vázquez Méndez (2008), Krusell and Rudanko (2012), and more recently, Ranjan (2013) and Bauer and Lingens (2013).

Bearing in mind all the above features, the purpose of this paper is to examine the relation between unemployment and the degree of centralization in wage bargaining in a unified framework that characterizes the most developed economies. More specifically, we construct a labour market model with collective wage settlement and frictions, where the trade unions and employers bargain over wages while firms make decisions about employment (right-to-manage model). Moreover, we assume a progressive income tax on employees and monopolistic competition in the output market. We calculate the amount of employment and labour market tightness when wages are set at the firm, sector and national level and compare them to see under which conditions the hump-shaped hypothesis postulated by Calmfors and Drifflill (1988) holds true.

Our approach is closely related to the following papers: Like Ranjan (2013), we use a Cobb-Douglas production function \( (AL^n) \), but by adding imperfect competition, we can study and compare different levels of collective wage setting: at a firm, sector and national level.

We expand on Ebell and Haefke (2006), assuming a Cobb-Douglas production function (lineal, that is, \( AL \), in their paper) and firm collective and national wage setting, so that
we are able to compare different levels of collective wage setting. Ebell and Haefke, on the other hand, only compare individual and collective wage setting. García Sánchez and Vázquez Méndez (2008) also further developed the Ebell and Haefke paper, with firm collective wage setting. We then improve on García Sanchez and Vázquez Mendez, by assuming a Cobb-Douglas production function and obtaining a result for the national wage setting. Delacroix (2006) presents a model with lineal production functions where some sectors set the wage at the firm level, while others do so at the sector level. We then extend it, assuming a Cobb-Douglas production function and national collective wage setting. Wages, are nevertheless set at the same level across all sectors. We also improve on García and Sorolla (2014) and Spector (2004), by introducing frictions in the labour market.

This paper makes the following contributions: we show that in labour markets with matching frictions and market power, given a certain level of progressivity and tax structure, the employment rate is higher when wages are set at the firm level than when employment is set at the national or sector level. Moreover, when wages are set at the sector level, there is less employment, in other words, the inverted U relationship between unemployment and the degree of centralization in wage setting postulated by Calmfors and Drifill holds true. The intuition is that at the firm level it is not taken into account the effect of the wage on the price of the product, whereas at the sector level it is considered that an increase in the wage leads to a raise the price of the product and, ceteris paribus, a decline in unemployment level. This decrease in unemployment will not affect the income level, and then a higher wage is set. However, at the national level it is considered that the rise of the wage level increases the price but reduces aggregate income increasing unemployment and then there is wage moderation.

These results hold given the same level of progressivity, tax structure and degree of market power. Nevertheless, as we point out later in Table 3, in the OECD countries included in our sample, there is a great disparity between both the labour tax structure and the degree of progressivity set by the different countries and the degree of market power. This empirical evidence help us to explain, using the theoretical results obtained, the lack of robustness in the empirical analysis of the Calmforms-Drifil hypothesis. Evidently, this is not the only explanation, and other ones do exist in the specialized literature, such as the social expenditure internalization argument put forward by Alesina and Perotti (1997), Doménech and García (2008) and García and Sorolla (2014).

The second conclusion is related with the deregulation of labour and product markets in the Southern European countries mentioned at the beginning of this paper\(^2\). We show that at any level of wage setting a decrease in the unemployment benefit reduces unem-

\(^2\)The deregulation on the labor market is a very wide concept that can contain the subsidy of unemployment, the costs of dismissal, the change of the system of negotiation or more concretely a reduction in the bargaining power of workers as show Blanchard and Giavazzi (2003).
ployment. We show also that if wages are set at the sector or national level, the higher the market power degree, the higher the unemployment level. Having this closed relationship between the labour market and the goods market regulation, it seems advisable for reducing unemployment to carried out a deregulation in the goods market.

On these issues, Blanchard and Giavazzi (2003), suggest that start by product market reforms may facilitate labor market deregulation by reducing the size of the rents shared by firms and workers.

However, this structural reforms have an high opposition by workers and firms due to short-run adjustment cost, including increased unemployment, lower wage and profits. Thus, the existence of short-run costs offers an explanation for the historical aversion of governments to implement structural reforms in product and labour markets in Southern European countries. The analytical expressions we derive for wage bargaining and unemployment deliver a transparent understanding of how labour tax structure and progressivity labour income could affect both endogenous variables. This transition to short-run to long-run can be made less painful by reducing payroll taxes paid by employers and/or raise the income labour progressivity to mitigate the negative short-term impact of labour and product market reforms and facilitate their implementation. This finding is consistent with the view in the political economy literature that reforms packages are politically more viable than individual structural reforms.

The remainder of the paper is organized as follows. In section 2 we summarize the OECD data that we use throughout our theoretical analysis. In section 3, we set out the labour market model and present the analysis of different wage bargaining settings: sector, firm and national level. Lastly, we discuss the results and implications for unemployment. Section 4 outlines the conclusions.

2 Stylized facts for some OECD countries

The Great Recession is characterized by an unprecedented decline of GDP and a sharp increase in the unemployment rate in many countries. However, there are major differences across the OECD countries in labour market outcomes; more specifically, the increase in the unemployment rate between 2007 and 2009 was 9.7% in Spain, 7.2% in Ireland and 4.7% in United States. In the other OECD economies, the increase in unemployment was between 1% and 2.5% (for example, in Italy, Portugal and France) while other countries underwent an increase of less than 1% (for example, Norway and Austria). These differences might be explained by the size of the negative demand shock, the different macroeconomic policy responses (expansionary monetary and fiscal policy), as well as the structure of the labour markets. This paper focuses on this third possible reason for international differences in the labor-market response to the Great Recession: labour-market
institutions and, more precisely, the wage bargaining system. However, our theoretical and empirical analysis goes further, because we add other institutional features, output market power and fiscal parameters that also affect wage bargaining outcomes. We include the degree of competition in the output market, as well as both the labour tax structure and income labour progressivity.

In the theoretical and empirical literature, the notion that wage bargaining institutions play a fundamental role in shaping economic outcomes has received a great deal of attention, at least since the 1980s, when unemployment rose sharply and remained high in most of the major OECD economies\(^3\). Many empirical studies attempt to link cross-country differences in unemployment to the degree of centralization characterizing the bargaining in question (for a survey, see Flanagan (1999)).

One particular influential perspective, first formulated in the seminal paper by Calmfors and Drifill (1988), confirmed that wage bargaining at sector level produces worse results, in terms of employment, than by more decentralized or centralized wage bargaining systems. Wage bargaining systems depend on multiple factors, including trade union density, coverage by collective agreements (union coverage), the centralization and co-ordination of wage bargaining, and a number of labour laws that affect the institutional bargaining framework and socio-economic conditions of the labour market. Thus, it is clear that the wage bargaining system is too complex for just in one or two indicators to capture all the complexities and heterogeneity of this labour institution. Despite potential limitations, we have constructed an index of the wage bargaining system that bears the major number of elements in mind. More specifically, our index is defined as the average of the bargaining level and coordination multiplied by union coverage using only Visser (2013) database on institutional characteristics of trade unions and wage setting\(^4\). The index runs from zero to five\(^5\).

Table 1 provides a classification into three groups of countries, which we have named ANGLO, EUCON and NORDIC, according to their composite index over collective wage bargaining institution.

The first group, ANGLO, includes countries with the lowest score in our composite index. In this case, we assume that this group of countries has a low level of centralization/coordination in the wage bargaining system. In contrast, the NORDIC group of

\(^3\)The OECD Jobs Study (1994) points out the role of labour market rigidities in accounting for the high and persistent unemployment in Europe, and therefore, suggests that greater deregulation is the solution.

\(^4\)This database allows us to construct an index more homogeneous across OECD countries compared to previous work (García and Sorolla(2014)).

\(^5\)Calmfors and Drifill (1988) ranked countries according to similar criteria. More specifically, their ranking is based on the sum of bargaining level and Coordination. The difference between our classification and that elaborated by Calmfors and Drifill (1988), within the same dates, is minimal. However, we include union coverage in our classification due to the importance of extensions to collective contracts in Europe regardless of whether or not they are unionized. For more details, see chapter 3 of the OECD Employment Outlook (2004).
Table 1
Some labour markets institutional indicators in OECD countries.

<table>
<thead>
<tr>
<th></th>
<th>Bargaining level</th>
<th>Coordination</th>
<th>Union Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ANGLO</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>1</td>
<td>1</td>
<td>15.2</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1.09</td>
<td>1</td>
<td>32.3</td>
</tr>
<tr>
<td>Canada</td>
<td>1</td>
<td>1</td>
<td>33.9</td>
</tr>
<tr>
<td>UK</td>
<td>1.18</td>
<td>1</td>
<td>35.9</td>
</tr>
<tr>
<td>Japan</td>
<td>1</td>
<td>4.36</td>
<td>19.3</td>
</tr>
<tr>
<td><strong>EUCON</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>2.18</td>
<td>2.18</td>
<td>60.8</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3</td>
<td>3</td>
<td>44.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.29</td>
<td>2.62</td>
<td>93.08</td>
</tr>
<tr>
<td>France</td>
<td>2</td>
<td>2</td>
<td>92.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>4.45</td>
<td>3.86</td>
<td>42.8</td>
</tr>
<tr>
<td>Greece</td>
<td>4.09</td>
<td>2.27</td>
<td>65</td>
</tr>
<tr>
<td>Germany</td>
<td>3</td>
<td>3.82</td>
<td>69.2</td>
</tr>
<tr>
<td>Spain</td>
<td>3.41</td>
<td>3.09</td>
<td>80.9</td>
</tr>
<tr>
<td>Italy</td>
<td>3</td>
<td>3.27</td>
<td>85</td>
</tr>
<tr>
<td><strong>NORDIC</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Norway</td>
<td>3.36</td>
<td>4.09</td>
<td>72.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3.23</td>
<td>3.68</td>
<td>83.1</td>
</tr>
<tr>
<td>Denmark</td>
<td>3.09</td>
<td>3.95</td>
<td>84.1</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.18</td>
<td>3.86</td>
<td>84.7</td>
</tr>
<tr>
<td>Austria</td>
<td>3</td>
<td>4</td>
<td>98.5</td>
</tr>
<tr>
<td>Finland</td>
<td>4.27</td>
<td>4.27</td>
<td>87.3</td>
</tr>
<tr>
<td>Belgium</td>
<td>4.55</td>
<td>4.68</td>
<td>96</td>
</tr>
</tbody>
</table>

Source: The Bargaining level is an index on the predominant level(s) at which wage bargaining takes place with a range from 1 to 5. Visser (2013) use a five-point scale instead of using a three-point scale used by Calmfors and Driffl (1988). More concretly, 1= Bargaining takes place at the local or company level, 3= the bargaining takes place at the sector or industry level and 5 the bargaining takes place at central level. The number 2 and 4 represent two mixed situations. Source data is the variable Level of Visser (2013). Coordination is an index that measure the bargaining coordination to wage-setting between employers and employees with a range from 1 to 5 based on Kenworthy 2001a and 2001b. The range goes to 1, when the wage bargaining is fragmented, confined largely to individual firms or plants to 5 when the wage setting is realized by centralized bargaining. The variable index is defined as the average of the of bargaining level and coordination multiplying by union coverage. Database Visser (2013). Sample: Average over 1990-2011.

countries constitutes the other extreme, with a high degree of centralization/coordination.

Tables 2 and 3 provide information on different institutional indicators for the period 1990-2013. The countries in these tables are classified according to their wage bargaining system as shown in Table 1. The theoretical study below examines in greater detail the mechanism through which these variables affect the unemployment rate.
Table 2 summarizes the average behaviour of the harmonized unemployment rate (U), the market power degree of goods market (PMR), the employment protection legislation (EPL) and finally, the tax wedges (TW). The last three variables contribute, a greater or lesser degree, to determining the wage bargaining, and thus, the unemployment rate as we will see later in the theoretical model.

The most striking results to emerge from the data for EU CON countries, compared to the rest of the countries, are as follows: first, and foremost, the EU CON countries on average, have the most regulated goods market (Table 2, PMR average 1.81) and a higher employment protection legislation index (Table 2, EPL average 2.68) compared to Anglo and Nordic countries. Second, as far as the tax wedge is concerned, we find that EU CON countries have a higher level than Anglo countries, but lower than Nordic countries. Moreover, and most significant for our purposes, this group of countries has the higher standard deviation in all variable show in Table 2. This result leads us to think that the Eucon countries could be split in two sub groups according to regulations in labour and product markets. The first sub-group includes the Southern European economies such as Spain, Portugal, Greece and Italy that are clearly highly regulated compared to other countries with the same wage bargaining system. The second sub-group include the rest of countries characterized, in general, by a relatively smaller level of regulation. The empirical evidence show the high positive correlation between both types of regulation across OECD countries (see, e.g., Nicoletti et. al (2001)). Concretely, the correlation between our index of product market regulation (PMR) and employment protection legislation (EPL) is 0.63 in all sample, 0.42 for Anglo, 0.62 for Eucon and finally -0.10 for Nordic countries. The high levels of regulation on both markets as well as the strong correlation between both in Eucon countries have often been blamed for the high unemployment (see, e.g. Blanchard and Giavazzi (2003)).

Regarding the tax wedge, we intend to go one step further, taking into account the composition of the tax wedge and the progressiveness of the income tax. In order to do so, we include the income tax (IT) in the tax wedge, as well as social security contributions paid by workers and employer (WSC and WSE respectively).

Table 3. Columns 1 to 3, display the composition of the tax wedge (TW) and the Column 4 an index of progressivity (PI) based on Holter et. al (2014). As can be seen from Table 3, there are large differences in the composition of the tax wedge across OECD countries over the period 1990-2013. In general, countries with the highest labour tax are also those which tend to have the highest social contributions paid directly by employers.  

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6. We capture the effect of product-market institutions, which has received growing attention in recent literature (e.g Blanchard and Giavazzi, 2003; Fiori et. al. 2012) through an indicator of aggregate product market regulation (PMR). The tax wedge (TW) used here include personal income taxes (IT), as well as employer and employees social security contributions (WSC,WSE).

7. The indicators to product market regulation and employment protection legislation presented in this paper are closely related, with a statistical correlation of 0.62.
### Table 2
Rigidities and institutions.

<table>
<thead>
<tr>
<th></th>
<th>U</th>
<th>PMR</th>
<th>EPL</th>
<th>TW</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ANGLO</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>6.13</td>
<td>1.31</td>
<td>1.00</td>
<td>0.23</td>
</tr>
<tr>
<td>New Zealand</td>
<td>6.48</td>
<td>1.31</td>
<td>1.06</td>
<td>0.27</td>
</tr>
<tr>
<td>Canada</td>
<td>8.16</td>
<td>1.62</td>
<td>1.51</td>
<td>0.28</td>
</tr>
<tr>
<td>UK</td>
<td>6.89</td>
<td>1.18</td>
<td>1.70</td>
<td>0.25</td>
</tr>
<tr>
<td>Japan</td>
<td>3.97</td>
<td>1.58</td>
<td>2.04</td>
<td>0.24</td>
</tr>
</tbody>
</table>
<pre><code>| **average** | **6.32** | **1.4** | **1.46** | **0.25**|
| **std desv** | **1.36** | **0.17** | **0.39** | **0.02**|
</code></pre>
<p>| <strong>EUCON</strong> |      |      |      |     |
| Australia | 6.82 | 1.45 | 1.84 | 0.17|
| Switzerland | 3.78 | 1.88 | 2.18 | 0.22|
| Portugal | 7.43 | 2.13 | 3.92 | 0.23|
| France  | 9.98 | 1.78 | 2.68 | 0.39|
| Ireland | 9.62 | 1.56 | 1.87 | 0.27|
| Greece  | 11.25 | 2.30 | 2.84 | 0.30|
| Germany | 8.12 | 1.68 | 2.95 | 0.36|
| Spain   | 15.99 | 1.81 | 2.72 | 0.30|
| Italy   | 9.21 | 1.73 | 3.14 | 0.40|
| <strong>average</strong> | <strong>9.13</strong> | <strong>1.81</strong> | <strong>2.68</strong> | <strong>0.29</strong>|
| <strong>std desv</strong> | <strong>3.16</strong> | <strong>0.25</strong> | <strong>0.61</strong> | <strong>0.07</strong>|
| <strong>NORDIC</strong> |      |      |      |     |
| Norway  | 4.01 | 1.61 | 2.38 | 0.37|
| Netherlands | 4.42 | 1.30 | 2.90 | 0.35|
| Denmark | 6.05 | 1.43 | 2.46 | 0.40|
| Sewden  | 7.13 | 1.54 | 2.59 | 0.46|
| Austria | 4.68 | 1.57 | 2.71 | 0.38|
| Finland | 9.75 | 1.52 | 2.08 | 0.44|
| Belgium | 8.04 | 1.71 | 2.83 | 0.42|
| <strong>average</strong> | <strong>6.30</strong> | <strong>1.52</strong> | <strong>2.56</strong> | <strong>0.40</strong>|
| <strong>std desv</strong> | <strong>1.97</strong> | <strong>0.12</strong> | <strong>0.26</strong> | <strong>0.03</strong>|</p>

Notes: The harmonized unemployment rate U represents unemployed persons as a percentage of the labor force (the total number of people employed plus the unemployed). The OECD Indicators of Product Market Regulation (PMR) are a comprehensive and internationally-comparable set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. It is increasing in the degree of regulation in the goods markets and has a range from 0 to 4. This series is only available for 1998, 2003, 2008 and 2013 (See Koske et. al. (2015) for more detail). The employment protection legislation (EPL) represents the variable EPRC-v2 from OECD/IDB employment protection database. This synthetic indicator measure the strictness of employment protection – individual and collective dismissals (regular contracts) The Tax Wedge (Tw) is equal to the sum of the income tax (IT), and employees’ and employers’ contributions (WSC and ESC respectively).

As shown below, in a theoretical analysis, more tightly regulated goods and labour markets and higher social contributions paid by employers lead to more unemployment.
Table 3
Tax structure and progressivity

<table>
<thead>
<tr>
<th></th>
<th>IT</th>
<th>WSC</th>
<th>ESC</th>
<th>PI</th>
</tr>
</thead>
<tbody>
<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>0.11</td>
<td>0.05</td>
<td>0.06</td>
<td>0.14</td>
</tr>
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<td>New Zealand</td>
<td>0.27</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
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<td>0.18</td>
<td>0.04</td>
<td>0.06</td>
<td>0.19</td>
</tr>
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<td>0.05</td>
<td>0.07</td>
<td>0.20</td>
</tr>
<tr>
<td>Japan</td>
<td>0.09</td>
<td>0.08</td>
<td>0.09</td>
<td>0.10</td>
</tr>
<tr>
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<td>0.15</td>
<td>0.04</td>
<td>0.05</td>
<td>0.15</td>
</tr>
<tr>
<td>std desv</td>
<td>0.06</td>
<td>0.02</td>
<td>0.03</td>
<td>0.04</td>
</tr>
<tr>
<td><strong>EUCON</strong></td>
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<td></td>
</tr>
<tr>
<td>Australia</td>
<td>0.17</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.11</td>
<td>0.05</td>
<td>0.05</td>
<td>0.13</td>
</tr>
<tr>
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Notes: Personal income tax (IT) is defined as the ratio of revenues from taxes on income, profits and capital gains of individuals to the tax base, which consists of wages and the property and entrepreneurial income of households and the operating surplus of incorporated enterprises. Employees’ and employers’ social contributions tax (WSC) and (ESC) respectively are defined as the ratio of social security contributions paid by employees and by employers to the tax base, which consists of wages. All the effective tax rates have been computed, as suggested in Boscá, García and Taguas (2005), using the methodology proposed by Mendoza et. al (1994). Progressivity Index (PI) measuring the average tax progressivity in OECD countries in the period 2000-07 based on the paper of Holter et. al (2014). This measure take into account income tax for different family types (single, married without children etc.). It is equal to zero for a proportional tax code for all income levels and increases with the raise in the average tax rate as earnings go up. The value of PI range between 0 to 1. Sample: Average level 1990-2013 except PI.

These characteristics thus reinforce the higher mean unemployment rate of this group,
regardless of the degree of centralization of the system, and suggest that EUCON countries, and particularly the Southern Europe have the institutional characteristics to generate a higher unemployment rate than other countries.

Finally, we conclude this empirical analysis by testing the hump hypothesis and its robustness. As mentioned above, Calmfors and Drifill (1988) found a hump-shaped relationship between an index of coordination and the unemployment rate. We examine this issue taking into account our relative index of collective bargaining. Figure 1 plots a scatter diagram of the unemployment rate against our relative index. In the period under study, there is weak evidence in support of the hump hypothesis. Additionally, given this scatter plot, we can now draw the line that best fits the data using an ordinary least squares regression of unemployment on the squared relative index and the relative index. The regression results confirm the minimal relationship between these two variables. More specifically, the equation estimated yields \( u = 5.75 + 1.84 \text{ (Index)} - 0.17 \text{ (Index)}^2 \) with a standard error of (s.e 1.83) and (s.e 0.43) respectively and \( R^2 = 0.064 \). However, if we omit Spain in our regression we obtain a more weak relationship \( u = 6.23 + 0.81 \text{ (Index)} - 0.13 \text{ (Index)}^2 \) with \( R^2 = 0.029 \).

Figure 1. Scatter plot of the unemployment rate and relative index of collective bargaining with the regression line.

From the graph above we can see that there is a weak hump-shaped pattern between bargaining structure and the index of collective bargaining for the time period and country under study. This result is not entirely surprising in light of existing literature testing the hump hypothesis\(^8\). Furthermore, in the academic literature, a large body of research supports the view that lower product market and labour market regulation reduces the unemployment rate. Accordingly, we explore with more detail the relationship between the variable product market rigidity (PMR) and employment protection legislation (EPL).

\(^8\)See Aidt and Tzanatos (2008), for an excellent survey of these issues.
with our relative index in the next two figures.
Figure 2. Scatter plot of product market regulation and index of collective bargaining with the regression line.

Figure 2 is a scatter plot (with the best fitting regression line). The estimated expression is $\hat{PMR} = 1.35 + 0.31 \text{ (Index)} - 0.06 \text{ (Index)}^2$ with (s.e 0.16) and (s.e 0.03) respectively and ($R^2 = 0.18$).

Figure 3 Scatter plot of employment protection legislation and index of collective bargaining with the regression line.

Figure 3 is a scatter plot (with the best fitting regression line). The estimated expression is $\hat{EPL} = 1.15 + 1.12 \text{ (Index)} - 0.19 \text{ (Index)}^2$ with (s.e 0.32) and (s.e 0.07) respectively and ($R^2 = 0.52$).

From the graph and estimated expression above we can see that there are a clear hump-shaped pattern between bargaining structure and the degree of rigidity in the goods market and the employment protection legislation. These results indicates the strong interdependence between the labour wage bargaining setting and product and labour market
regulation as a key factor to consider when implementing policy reforms in Eucon countries. Given this strong interdependence one should expect a clear inverse U curve in Figure 1 and then, what is the explanation for the lack of robustness of the hump-shaped hypothesis predicted by Calmfors and Drifill (1988) in our sample period?

We provide a possible answer based on a third factor: labour tax structure and the progressivity of labour tax income, which also affects unemployment and exhibits, or not, an inverted-U shaped relationship in regard to bargaining structure. This third factor can reinforce or moderate the hump-shaped hypothesis. Furthermore, within a group of countries that belong to a certain wage bargaining system, for example the EUCON countries, we can explain the different unemployment rate performance through this heterogeneity of fiscal variables.

The purpose of the next theoretical section is to illustrate the relationship between unemployment rate and the wage bargaining system and some other factors: market power and taxation that, simultaneously, determine the unemployment rate under the different wage bargaining systems.

3 The Labour Market

In this section, we present a model of the labour market with matching frictions, where we compute the equilibria under different levels of centralization in wage bargaining: firm, sector and centralized, and then compare them. We assume, as is typical in the Pissarides matching model, that each worker has one unit of labour to devote to market activities at every instant of time. Thus, in this framework each worker can be employed or unemployed.

3.1 Equilibrium of Flows in the Labour Market

The labour market is characterized by a standard search and matching Mortensen-Pissarides framework. The change in employment is determined by unemployment inflows and outflows. In its steady state (flow equilibrium) the number of matches or inflows in the labor
market, denoted by $X$, is equal to the number of outflows, which is equal to the existing amount of employment $L$ multiplied by an exogenous destruction rate $\lambda$. This means:

$$X = \lambda L$$

that is:

$$\frac{X}{U} = \lambda L$$

The matching function is $X = m(V, U)$ where $V$ are vacancies, $U$ the amount of unemployment and then $U = (N - L)$ where $N$ is the total size of the workforce. We assume that $m$ has constant returns to scale and $m_V > 0$ and $m_U > 0$. As usual, we define the degree of the labour market tightness as $\theta \equiv \frac{V}{U}$ and we calculate both the rate at which vacant jobs become filled as $\frac{X}{U} = m(1, \frac{1}{U}) \equiv q(\theta)$ and the rate with which an unemployed worker finds a job $\frac{X}{U} = \frac{V}{U} \frac{X}{V} = \theta q(\theta)$ where $q' < 0$ and $\frac{d(\theta q(\theta))}{d\theta} > 0$.

Substituting $\frac{X}{U} = \theta q(\theta)$ and $U = (N - L)$ into the equilibrium labour market flows equation (2) we obtain:

$$\theta q(\theta)(N - L) = \lambda L$$

rewriting this expression we obtain an equation that determines the employment level in terms of the degree of the labour market tightness:

$$L = \left[ \frac{\theta q(\theta)}{\lambda + \theta q(\theta)} \right] N = \left[ \frac{1}{1 + \frac{\lambda}{\theta q(\theta)}} \right] N$$

where $\frac{dL}{d\theta} > 0$, meaning that if the number of vacancies per unemployed person (labour market tightness) increases, more employment is needed in order to have equilibrium of flows ($\frac{X}{U} = \lambda$). Roughly speaking, if we have more matches, more workers must be out and in order to have more workers out, we need more employment.

### 3.2 Wage Setting at the Sector Level

#### 3.2.1 Employment at the sector level with frictions and monopolistic competition.

We formalize the interaction between the representative union and the representative firm as a three-stage game, where wage settlement is bargained by the union and the firm. First the firm opens vacancies, then the wage is negotiated, and finally the firm chooses the amount of employment. This is the right-to-manage model where wages are set by considering the employment function\(^{11}\).

\(^{11}\)In models with frictions and individual wage setting, employment and wages are usually set at the same time, calculating the Nash equilibrium or employment is set before having the Stole and Zwiebel
3.2.2 The goods market.

The economy is characterized by monopolistic competition in the goods market. We assume $J \in [0, 1]$ sectors with one firm per sector that produces a different good, $Y_j$:

$$Y_j = F(L_j).$$

(5)

The aggregate demand function facing firm $J$ is

$$Y_j = \left( \frac{P_j}{P} \right)^{-\sigma} I,$$

(6)

where $\sigma > 1$ is the constant elasticity of demand of product $J$ with respect to its price, $I$ denotes the total real income, $P_j(t)$ is the price of product $j$, $P(t)$ is a price index with the usual properties and $Y_j(t)$ is the corresponding quantity demanded of the good produced by firm $j$.

3.2.3 Firm’s problem

The firm in sector $j$ chooses $L_j$ and $V_j$ in order to maximize the sum of expected discounted profits taking the nominal wage and $\theta(t)$ as given

$$\Pi_j = \int_0^\infty e^{-\rho t}[P_j(t)F(L_j(t))] - (1 + \tau_J)W_j(t)L_j(t) - cP(t)V_j(t)]dt$$

subject to

$$\dot{L}_j(t) = X_j(t) - \lambda L_j(t) = q(\theta(t))V_j(t) - \lambda L_j(t)$$

(8)

and

$$Y_j(t) = \left( \frac{P_j(t)}{P(t)} \right)^{-\sigma} I(t),$$

(9)

where $c$ is the constant flow cost per vacancy, $V_j(t)$ is the number of vacancies posted by the firm, $W_j(t)$ is the before-tax wage and $\tau_J$ denotes the payroll tax rate paid by employers. Taking (6) into account, we rewrite the firm objective as

$$\Pi_j = \int_t^\infty e^{-\rho t}[P(t)I(t)^{\frac{1}{2}}F(L_j(t))]^{1 - \frac{1}{2}} - (1 + \tau_J)W_j(t)L_j(t) - c(t)P(t)V_j(t)]dt$$

subject to

$$\dot{L}_j(t) = X_j(t) - \lambda L_j(t) = q(\theta(t))V_j(t) - \lambda L_j(t)$$

solution. As noted by Cahuc and Wasmer (2001) both solutions coincide when the production is linear.
The first order condition (see Ebell and Haefke (2006) or García Sánchez and Vázquez Méndez (2008)) gives the amount of employment (the employment equation) at the sector level in terms of the exogenous variables $W_j$, $\tau^f$, $P$ and $I$, that is\textsuperscript{12}:

$$F(L_j)^{-\frac{1}{\sigma}} F_L(L_j) = \frac{m}{PL^\frac{1}{\sigma}} \left[ (1 + \tau^f)W_j + \frac{(\rho + \lambda)cP}{q(\theta)} \right]$$

where $m \equiv \frac{1}{1 - \frac{\mu}{\sigma}}$ is the market power degree.

For calculation purposes, we assume a Cobb-Douglas production function: $F(L_j) = AL_j^\alpha$, whereby the amount of employment (12) is:

$$\alpha A^{\frac{\alpha - 1}{\sigma}} (L_j)^{-(1-\alpha + \frac{\mu}{\sigma})} = \frac{m}{PL^\frac{1}{\sigma}} \left[ (1 + \tau^f)W_j + \frac{(\rho + \lambda)cP}{q(\theta)} \right]$$

we also assume that the cost of hiring is proportional to nominal wage, thus $cP = \gamma W_j$, where $\gamma$ is a positive constant having

$$\alpha A^{\frac{\alpha - 1}{\sigma}} (L_j)^{-(1-\alpha + \frac{\mu}{\sigma})} = \frac{m}{PL^\frac{1}{\sigma}} \left[ (1 + \tau^f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] W_j$$

Solving the above expression for $L$, we obtain an explicit employment equation that depends on nominal wages $W_j$ and labour market tightness $\theta$, where amount of employment is given by:

$$L_j = \left[ \frac{m}{PL^\frac{1}{\sigma}} \left[ (1 + \tau^f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] W_j \right]^{-\frac{1}{(1 - \frac{\mu}{\sigma})}}$$

and one can compute the elasticity of labour demand with respect to the wage, $\epsilon_L$, that is $-\frac{1}{(1 - \frac{\mu}{\sigma})}$. The solution of this program takes implicitly into account that, for a given wage $W_j$, the firm sets the price $P_j$ using the aggregate demand function. This implies that the effect of $W_j$ on $P_j$ is considered by the firm when deciding employment. In other words, the employment level depends on $\frac{W_j}{P_j}$ but it is set by the firm considering that an increase in $W_j$ increases $P_j$.

### 3.3 Union wage setting at the sector level

In order to write the union’s objective function and set the wages at the sector level, we first need to define the worker asset values. The value of being employed in firm $j$, $E_j$, is given in flow terms by the following value function\textsuperscript{13}

\textsuperscript{12}One may be tempted to call $L_j$ the labour demand of the firm, but note that this is not the case because $L_j$ is really the number of units of labour really hired by the firm. In fact labour demand $L_d^j$ is given by $L_d^j = L_j + V_j$.

\textsuperscript{13}To determine the net wage for a worker in this context, we assume the equivalence between the optimal consumption and the labour income, see for example, Blanchard and Galí (2010) and Langot (2014).
\[
\rho E_j = (1 - \tau^w)W_j - a + \lambda (U_j - E_j) \tag{16}
\]

where \(\rho\) is the discount rate and \(U_j\) denotes the asset value of an unemployment worker. Furthermore, \(a\) and \(\tau^w\) are tax parameters such that the income tax paid by an employed worker per period is \(T = a + \tau^wW(t)\). This tax includes income tax plus the social security contribution paid by employees. When \(\tau^w > 0\) and \(a = 0\) the tax schedule is purely proportional. With \(a < 0\), the tax schedule is progressive and with \(a > 0\) is regressive in the sense that average tax rate increases or decreases with income. The after tax income is then given by \((1 - \tau^w)W_j - a\).

The asset value equation of an unemployed worker \(U_j\) is

\[
\rho U_j = B + \theta q(\theta) (E_j - U_j) \tag{17}
\]

where \(B\) is the value of unemployment benefit that is not taxed. If the total number of union members in sector \(j\) is \(N\) and \(L_j\) of them become employed, then the expected welfare of a union member is given by\(^{14}\)

\[
\left(\frac{L_j}{N}E_j + \frac{N - L_j}{N}U_j\right) \tag{18}
\]

We suppose that the fallback position of the union is \(U_j\) when the firm rejects the union’s wage offer. Thus, following Ranjan (2013), the aggregate surplus or union’s objective in flow terms is:

\[
V = \left(\frac{L_j}{N}E_j + \frac{N - L_j}{N}U_j\right) - U_j = (E_j - U_j)L_j
\]

and using (16) and (17) we obtain\(^{15}\):

\[
V = \left(\frac{L_j}{N}E_j + \frac{N - L_j}{N}U_j\right) - U_j = (E_j - U_j)L_j = \frac{[(1 - \tau^w)W_j - a - B] L_j}{\rho + \lambda + \theta q(\theta)} \tag{19}
\]

On the other hand, the firm’s objective function is given by

\[
\Psi = \Pi_j - \Pi_j = P(t)I(t)^{\frac{1}{\gamma}}F(L_j(t))^{1 - \frac{1}{\gamma}} - (1 + \tau^f)W_j(t)L_j(t) \tag{20}
\]

because the outside option or the fall-back position of the firm is \(\hat{\Pi}_j = -c(t)P(t)V_j(t)\), namely the sunk cost of open vacancies.

We now determine the wage at sector level bargained between the union and the monopolistic firm. To do so, we apply the Nash bargaining solution for setting the wage

\(^{14}\)We assume that the \(N\) workers are equally distributed between sectors which, in the unit interval, means \(N_j = N\).

\(^{15}\)If the union cares only about insiders, one only substitutes the asset value equation of an employed worker in \((E_j - U_j)L_j\) as, for example, in Ebell and Haefcke (2006).
and use the "right-to-manage" approach according to which employment is unilaterally
determined by the firm. In our framework, as already discussed before, first the bargaining
parties agree on a wage rate using the profit-maximizing level of employment and then
firms decide employment. As is usual in such models, the relative bargaining power of
the union is given by a number $0 \leq \beta \leq 1$ while the firms are endowed with bargaining
power $16 (1 - \beta)$. Applying this bargaining solution the negotiating parties decide on $W$ in
order to maximize subject to the employment equation given by (15). Note that setting
the wage at the sector level implies using the employment equation derived when the firm
takes into account the aggregate demand function. This can be interpreted as saying that
there is only one firm per sector and so the wage is set for the firm and then for the sector.

The Nash bargaining maximand is

$$\Omega = V^\beta \Psi^{1-\beta} \quad (21)$$

and the first-order condition with respect to nominal wage yield:

$$\Omega_w = 0 \Leftrightarrow \beta \frac{V_w}{V} + (1 - \beta) \frac{\Psi_w}{\Psi} \quad (22)$$

where variables with subscripts refer to partial derivatives (e.g., $V_w = \frac{\partial V}{\partial W}$).

The solution for the wage equation is standard and corresponds to

$$W_j = \left[ \beta \frac{m}{\alpha} + (1 - \beta) \right] \frac{(B + a)}{(1 - \tau^w)} \quad (23)$$

The bargained nominal wage depends on the model parameters in a very intuitive way.
First the higher the workers “bargaining strength”, $\beta$, the higher is the nominal wage.
Second, more generous benefits, $B$, greater is the increase in the negotiated wage. Third,
when $a$ decreases, the negotiated wage decreases, this means, in particular, that with
progressive tax rate ($a < 0$), the wage set is lower than the one set with a regressive tax
rate ($a > 0$) and, finally the wage increases with market power $m$. We assume that the
government sets $b = \frac{B}{P}$ and $\bar{a} = \frac{a}{P}$, in which case the wage equation is

$$W_j = \left[ \beta \frac{m}{\alpha} + (1 - \beta) \right] \frac{P(b + \bar{a})}{(1 - \tau^w)} \quad (24)$$

Lastly, we are able to compute the amount of employment, at the sector level, by
substituting (24) in (15) yields

$$L_j = \frac{m \left[ (1 + \tau^f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] \left[ \beta \frac{m}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau^w)}}{I^2 \alpha A^{\frac{\alpha-1}{\pi}}} \quad (25)$$

$16$ In the theoretical literature the value of this parameter, $\beta$, is narrowly related to the regulation on
the labor market. See for example Blanchard and Giavazzi (2003).
3.4 Short-run general equilibrium at the sector level

With symmetric equilibrium in the output market $L_j = L$ for all j. Furthermore at general equilibrium income is equal to production, i.e. $I = AL^\alpha$. Thus, we can substitute $I$ in (25), obtaining an explicit relationship between the amount of employment when wages are set at the sector level and labour market tightness $\theta$ equal to

$$\frac{\theta q(\theta)}{\lambda + \theta q(\theta)}$$

and substituting (27) in (26), we get the equilibrium labour market tightness:

$$\alpha A \left[ \frac{\lambda + \theta q(\theta)}{\theta q(\theta)} \right] \frac{1}{N} \left( \frac{1}{1 - \alpha} \right) = m \left[ (1 + \tau^f) + \frac{(p + \lambda)\gamma}{q(\theta)} \left[ \frac{\beta m}{\alpha} + (1 - \beta) \right] \right] \frac{(b + \bar{a})}{(1 - \tau^w)}$$

We call this equilibrium with wage setting at the sector level $(\theta_S, L_s)$. It is then easy to prove (see appendix) that an equilibrium exists and is unique and $\frac{\partial \theta_S}{\partial m} < 0$, $\frac{\partial \theta_S}{\partial \beta} < 0$, $\frac{\partial \theta_S}{\partial 0} < 0$ and $\frac{\partial L_S}{\partial m} < 0$, $\frac{\partial L_S}{\partial \beta} < 0$, $\frac{\partial L_S}{\partial 0} < 0$ and $\frac{\partial L_S}{\partial \beta} < 0$.

It should be underlined that the level of employment obtained using a Cobb-Douglas production function is more general than the one obtained with the linear production function $(AL)$ used in Ebell and Haefke (2006) and García Sánchez and Vázquez Méndez (2008). Their results represent the special case $\alpha = 1$.

3.5 Short-run general equilibrium at the firm level

We now show that the equilibrium at the firm level is the equilibrium at the sector level (28) for the case $m = 1$. If unions set the wage at the firm level, then they take into account the firm’s employment equation which, if we assume infinite firms per sector $J$ in the interval $[0, 1]$, implies that firms take the price $P_j$ as given and then the firm $i$ in sector $j$ chooses $L_{ij}$ and $V_{ij}$ in order to maximize

$$\int_0^{\infty} e^{-\mu t} P_j(t) F(L_{ij}(t)) - (1 + \tau^f)W_{ij}(t)L_{ij}(t) - \alpha P(t)V_{ij}(t)dt$$

(29)
subject to

\[ \dot{L}_{ij}(t) = X_{ij}(t) - \lambda L_{ij}(t) = q(\theta(t))V_{ij}(t) - \lambda L_{ij}(t) \]  

and then the first order condition (see Cahuc and Zylberberg (2004) or Ranjan (2013)) gives the employment for firm \( ij \) as:

\[ F_L(L_{ij}) = \frac{1}{P_j} \left[ (1 + \tau')W_{ij} + \frac{(\rho + \lambda)cP}{q(\theta)} \right] \]  

assuming that \( Y_{ij} = A(L_{ij})^\alpha \) and \( cP = \gamma W_{ij} \), the employment equation is:

\[ \alpha A(L_{ij})^{\alpha-1} = \frac{1}{P_j} \left[ (1 + \tau') + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] W_{ij} \]  

and solving for \( L_{ij} \) we get

\[ L_{ij} = \left[ \frac{\frac{1}{P_j} \left[ (1 + \tau') + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] W_{ij}}{\alpha A} \right]^{-\frac{1}{\alpha-1}} \]  

where \( \epsilon_L = -\frac{1}{1-\alpha} \). Note that in this case the firm does not take into account the effect of the wage \( W_{ij} \) on the price of the product \( P_j \) when deciding employment. In other words the employment level, as is usual, depends on \( \frac{W_{ij}}{P_j} \) but it is set by the firm considering that an increase in \( W_{ij} \) does not affect \( P_j \). This implies that an increase in the wage decreases more the employment level due to the higher labour demand elasticity \( \frac{1}{1-\alpha} > \frac{1}{1-\frac{1}{\epsilon}} \).

The union’s fallback option is the life income of an unemployed worker \( U_{ij} \) and then the payoff to the union net of its outside option is the surplus, \( V \), given by

\[ V = \left( \frac{L_{ij}^U}{L_{ij}} E_{ij} + \frac{\dot{L}_{ij} - L_{ij}}{L_{ij}} U_{ij} \right) - U_{ij} = (E_{ij} - U_{ij})L_{ij} = \frac{[(1 - \tau^w)W_{ij} - a - B]L_{ij}}{\rho + \lambda + \theta q(\theta)} \]  

The payoff net of the outside options for the firm, is expressed as

\[ \Psi = \rho(\Pi_{ij} - \tilde{\Pi}_{ij}) = P_j(L_{ij})^\alpha - (1 + \tau')W_{ij}L_{ij} \]  

where \( \tilde{\Pi}_{ij} \) is the firm’s fallback option, as explained earlier. The generalized Nash bargaining objective can then be written as:

\[ \max_{W_{ij}} \Omega = V^\beta * \Psi^{1-\beta} \]  

where \( \beta \) and \( 1 - \beta \) represent the bargaining power of the union and the firm, respectively. The wage at the firm level is computed maximizing the previous expression subject to (33) and the optimal wage is
\[ W_{ij} = \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{P(b + a)}{(1 - \tau^w)} \]  
(37)

and we then compute the amount of employment of firm \( ij \) substituting (37) in (33) that gives

\[ L_{ij} = \left[ \frac{P}{P_j} \left[ (1 + \frac{\rho + \lambda}{\theta(q)} \gamma + \left( \frac{\beta}{\alpha} + (1 - \beta) \right) \frac{(b + a)}{(1 - \tau^w)} \right] \right] \frac{1}{1 - \alpha} \]  
(38)

Since all firms are identical they all choose the same wage and thus in equilibrium

\[ L_{ij} = L_j = L, \quad P = P_j \]  

and the amount of employment is given by:

\[ L = \left[ \frac{(1 + \tau^f) + \left( \frac{\rho + \lambda}{\theta(q)} \gamma + \left( \frac{\beta}{\alpha} + (1 - \beta) \right) \frac{(b + a)}{(1 - \tau^w)} \right] \right] \frac{1}{1 - \alpha} \]  
(39)

namely the Ranjan solution (2013) when \( \tau^w = \tau^f = \tilde{\alpha} = 0 \). Finally, we combine (27) and (39) to obtain an expression for the equilibrium labour market tightness at the firm level:

\[ \alpha A \left[ \frac{\lambda + \theta q(\theta)}{\theta(q)} \frac{1}{N} \right]^{1 - \alpha} = \frac{(1 + \tau^f) + \left( \frac{\rho + \lambda}{\theta(q)} \gamma + \left( \frac{\beta}{\alpha} + (1 - \beta) \right) \frac{(b + a)}{(1 - \tau^w)} \right] \frac{1}{1 - \alpha} \]  
(40)

in other words, the equilibrium tightness obtained when wages are set at the sector level with \( m = 1 \). We call this equilibrium \( (\theta_F, L_F) \). It then follows that labour market tightness and employment when wages are set at the sector level are lower than labour market tightness and employment when wages are set at the firm level. In other words, \( \theta_F < \theta_S \) and \( L_F < L_S \).  

3.6 Short run general equilibrium at the national level

At the national level the union knows when setting the wage that all firms are going to set the same price because they are identical and then \( P_i = P_j \), that is \( I = Y_j = AL_j^a \), and that employment is going to be the same and \( L_j = L \). This means to consider in the employment equation given by (13), namely,

\[ \alpha A^{-\frac{1}{\tau^w}} (L_j)^{-\left(1 - \alpha + \frac{2}{\tau^w}\right)} = \frac{m}{P \tau^w} \left[ (1 + \tau^r) + \left( \frac{\rho + \lambda}{\theta(q)} \gamma \right) \right] W_j \]  
(41)

\footnote{One might ask why we assume that when wages are set at the sector level, we assume only a monopolistic firm in sector \( j \) while when wages are set at the firm level, we assume infinite firms in the interval \([0, 1]\) in sector \( j \). The answer is that usually one assumes that at the sector level, the wage is negotiated using a coalition of all firms within the sector (see García Sánchez and Sánchez Méndez (2008) and García and Sorolla (2014)) and then the labour demand of the total coalition of firms coincides with the one of the monopolistic firm when firms are distributed in the interval \([0, 1]\).}
that $I = Y_j = AL^\alpha$, $L_j = L$. Hence, by symmetry, at the national level, the union is going to set the same wage for all sectors $W_j = W$, in which case the employment equation becomes:

$$L = \left[ \frac{m}{\alpha A} \left[ (1 + \tau) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] W \right]^{-\frac{1}{\alpha}}$$

(42)

being then $\varepsilon = \frac{1}{\alpha}$. In this case an increase in the wage $W$ increases $P$ but reduces also aggregate income $I$ implying a higher level of unemployment.

Now the payoff net of outside options for the firm is

$$\Psi = \rho(\Pi - \bar{\Pi}) = PF(L) - (1 + \tau_f)WL$$

and, the payoff for the union, net of its outside option $V$, yields

$$V = \left( \frac{L}{L} E + \frac{L - L}{L} U \right) - U = (E_j - U_j) L = \frac{((1 - \tau_w)W - a - B)L}{\rho + \lambda + \theta q(\theta)}$$

(44)

In order to obtain the wage, we once again maximize the generalized Nash bargaining objective

$$\max_W \Omega = V^{\beta} \Psi^{1-\beta}$$

(45)

subject to (42) and the optimal wage is

$$W = \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{(B + a)}{(1 - \tau_w)}$$

(46)

assuming again $B = P\beta$ and $a = \bar{a}P$, we compute total employment substituting (46) in (42) obtaining

$$L = \left[ \frac{m}{\alpha A} \left[ (1 + \tau) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau_w)} \right]^{-\frac{1}{\alpha}}$$

(47)

Finally, we combine (27) and (47) to obtain an expression for the equilibrium labour market tightness at the national level:

$$\alpha A \left[ \frac{1}{\theta q(\theta)} \right] \frac{1}{N} \left( 1 - \alpha \right) = m \left[ (1 + \tau) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau_w)}$$

(48)

namely, the equilibrium at the sector level but with $\frac{\beta}{\alpha} + (1 - \beta)$ instead of $\frac{\beta m}{\alpha} + (1 - \beta)$. We call this equilibrium $(\theta_N, L_N)$.
It then follows that for the same parameters of the model $\theta_F > \theta_N > \theta_S$ and, then, $L_F > L_N > L_S$. The reason is that $m \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] > m \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] > \left[ \frac{\beta}{\alpha} + (1 - \beta) \right]$. This means a "conditional" (to have the same parameters) inverted-U shaped relationship between employment and the level of wage bargaining when there is monopolistic competition in the output market ($m > 1$). The intuition behind our results is as follows. As argued above, at the firm level, it is considered that an increase in the wage does not affect the price of the product whereas at the sector level the increase in the wage rise the price of the product, this outcomes implies a lower decrease of employment and produces higher wage demands. On the other hand, at the national level an increase in the wage rise the price of the product but also decreases aggregate income, implying a higher decrease of employment which reduces the wage. Moreover, it is easy to see that this inverted-U shape increases when market power $m$ rise.

However, this conditional inverted-U shaped relationship may not appear as clearly in the data, as we saw in Figure 1, above. The model provides one possible explanation: a different tax structure and different degrees of labour tax progressivity. It is then possible to explain the discrepancy between the Calforms and Driffl hypothesis and the mixed empirical evidence due to the diversity of fiscal parameters between countries. Additionally, this discrepancy may also occur if the union internalizes some degree of social government expenditure as shown by Alesina and Perotti (1997), Domenech and Garcia (2008) and Garcia and Sorolla (2014). In this case, the social expenditure internalization may provide another justification for the lack of robustness of the Calmfors-Driffl hypothesis.

4 Conclusions

In this paper we present a labour market model with matching frictions, different levels of collective wage setting: firm, sector and national and monopolistic competition in the goods market. We obtain an inverted-U shaped relationship between unemployment and the level of wage bargaining system. These findings complement those obtained by Calmfors and Driffl (1988) in a set up with matching frictions and regulated goods markets. Moreover, our theoretical analysis goes one step further, showing that this inverted-U shaped relationship is obtained conditional on the same fiscal policy, in particular, labour tax structure and the level of tax progressivity and the same market power degree. One implication of our findings is that the heterogeneity found in the tax structure and the progressivity on labour income can explain the mixed empirical evidence concerning the lack of robustness of the Calmfors-Driffl hypothesis.

We hope that our results will help establish a complementary perspective of the relationship between wage bargaining system with labour market frictions and unemployment. We point out that rather than focusing on the wage bargaining system alone, future re-
search should explore the relationship between product and labour market regulation and the labour tax structure in greater detail in order to assess how political economy reforms can help to reduce unemployment in countries characterized by wage bargaining at a sector level. For example, a wide range of studies illustrate the beneficial effects of product and labour market deregulation in terms of employment and growth in the long-run. However, in the short run there are a painful transition with lower wages and possible higher unemployment. This transition can be made less painful by using fiscal policy, in particular by reducing payroll taxes paid by employers to boost the employment creation and/or raise the income labour progressivity to compensate the lower wage during the transition. This mixed between structural reforms and fiscal policy may be a good strategy to combat the high unemployment rate in Southern economies.

5 References


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Appendix A

A.1 The Negotiated Wage at Sector Level.

This appendix develops the expressions for the terms \( \frac{\psi_w}{\psi} \) and \( \psi_w \) in the first-order condition (22) that determines the Nash bargaining solution. We start by looking at the profit response of the firm to a change in the wage rate \( \psi_w \).

The (net) profit function \( \psi \) is

\[ \psi = P(t)I(t)^{\frac{1}{2}}F(L_j(t))^{1-\frac{1}{2}} - (1 + \tau')W_j(t)L_j(t) \]  

(49)

Therefore, the expression for the marginal value of the wage \( \psi_w \) is

\[ \psi_w = P(t)I(t)^{\frac{1}{2}}(1 - \frac{1}{\sigma})F(L_j(t))^{\frac{1}{2}} \frac{\partial F(L_j(t))}{\partial L_j} - (1 + \tau')\left[ L_j(t) \frac{1}{W} \right] \]

notice that we assume \( L(w) \).

If we take into account the Cobb-Douglas function production \( F(L_j) = AL_j^\alpha \) and multiply all by \( \frac{WL}{W} \), we can rewrite the above expression as

\[ \psi_w = P I^{\frac{1}{2}}(1 - \frac{1}{\sigma}) \alpha \epsilon_L A^{(1-\frac{1}{2})}L_j^{-\frac{\alpha}{2}} \frac{1}{W} - (1 + \tau')L_j \left[ 1 + \epsilon_L \right] \]  

(50)

Notice that since the environment is stationary, we omit the use of time subscripts.

Furthermore, we also make use of the following relationship between the revenues and costs given by the expression (14) on the labour demand.

\[ A^{(1-\frac{1}{2})}(L_j)^{\frac{\alpha}{2}} P I^{\frac{1}{2}} = \frac{m}{\alpha} \left[ (1 + \tau') + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] W_j L_j \]  

(51)

Substituting (51) in (50) gives

\[ \psi_w = \frac{(\rho + \lambda)\gamma}{q(\theta)} \epsilon_L L_j - (1 + \tau')L_j \]  

(52)

Finally, substituting the expression (51) in the profits (49) yields, after some further manipulations,

\[ \psi = \frac{(\rho + \lambda)\gamma}{q(\theta)} \epsilon_L W_j L_j - \frac{1}{(1 + \epsilon_L)}(1 + \tau')W_j L_j \]

from which it follows that

\[ \frac{\psi_w}{\psi} = \frac{1 + \epsilon_L}{W} \]  

(53)

where \( \epsilon_L = -\frac{1}{(1-\frac{1}{\sigma})} \).

With respect to the trade union’s utility, we find that
\[ V = \frac{(1 - \tau^w)W_jL_j - L_j(B + a)}{\rho + \lambda + \theta q(\theta)} \] (54)

using (54), we can derive \( V_w \)

\[ V_w = \frac{[(1 - \tau^w)][L_j + \partial L_j \partial W_j] - \partial L_j \partial W_j (B + a)}{\rho + \lambda + \theta q(\theta)} \]

Thus, it follows that

\[ \frac{V_w}{V} = \frac{[(1 - \tau^w)][L_j + \partial L_j \partial W_j] - \partial L_j \partial W_j (B + a)}{(1 - \tau^w)W_jL_j - L_j(B + a)} \] (55)

The first-order condition with respect to nominal wage is given by

\[ \Omega_w = 0 \iff \beta \frac{V_w}{V} + (1 - \beta) \frac{\Psi_w}{\Psi} \] (56)

Next, substituting (53) and (55) in (56) and rearranging yields the expression for the wage negotiated at sector level (23).

It is important to highlight that with a similar procedure as described above we can obtain the wage negotiated at firm and national level.

A.2 The Employment Level at Firm, Sector and National.

To be able to perform this demonstration, we need an explicit matching function. For example, the matching function, \( X = m(V,U) = U^{1-\xi} \vee^\xi \), \( 0 \leq \xi \leq 1 \), describes the number of labour contracts, \( X \), that are concluded given the number of job seekers and vacancies (Pissarides, 2000). From the matching function, the job-finding rate of the worker can be derived as \( \frac{X}{U} = \left( \frac{V}{U} \right)^\xi \). Taking into account the definition of labour market tightness as the relative number of traders in the market \( \theta = \frac{V}{U} \), we express the probability that a vacancy will be filled or job-finding rate as equal to \( \frac{X}{V} = \theta^\xi \). We also define the rate at which vacant jobs become filled as \( \frac{X}{V} \equiv q(\theta) = \frac{1}{\theta^{1-\xi}} \). Thus, the term \( \theta q(\theta) = \frac{\theta}{\theta^{1-\xi}} = \theta^\xi \), namely the job-finding rate.

We go on to compare the labour market tightness at the firm, sector and national level. These expressions are given by:

\[ \alpha A \left[ \frac{\lambda + \theta q(\theta)}{\theta q(\theta)} \right] \frac{1}{N} = \left[ (1 + \tau^f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] \frac{\beta}{\alpha} \left[ \beta (1 - \beta) \right] \frac{(b + \tilde{a})}{(1 - \tau^w)} \] (57)

\[ \alpha A \left[ \frac{\lambda + \theta q(\theta)}{\theta q(\theta)} \right] \frac{1}{N} = \left[ (1 + \tau^f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \right] m \frac{\beta m}{\alpha} \left[ \beta (1 - \beta) \right] \frac{(b + \tilde{a})}{(1 - \tau^w)} \] (58)
national level

$$\alpha A \left( \frac{\lambda + \theta q(\theta)}{\theta q(\theta)} \right) \frac{1}{N} \left( 1 - \alpha \right) = \left( 1 + \tau f \right) + \frac{(\rho + \lambda)\gamma}{q(\theta)} m \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau^w)} \quad (59)$$

We can clearly see that the left-hand side for all three expressions are identical. The first part of the analysis concentrates on analyzing this common term $$\alpha A \left( \frac{\lambda + \theta q(\theta)}{\theta q(\theta)} \right) \frac{1}{N} \left( 1 - \alpha \right)$$, which for notational convenience, we will denote as $$\eta$$. This allows us to express the left hand side as a function only of tightness and the same model parameters.

$$\eta = \alpha A \left( \frac{\lambda}{\theta q(\theta)} + 1 \right) \frac{1}{N} \left( 1 - \alpha \right) = \alpha A \left( \frac{\lambda}{\theta^2} + 1 \right) \frac{1}{N} \left( 1 - \alpha \right) \quad (60)$$

By differentiating (60) with respect to $$\theta$$, we clearly obtain a decreasing relationship. Thus, the left hand side of equations (57), (58) and (59) is a decreasing function of $$\theta$$ for a wide range of reasonable parameters and have the same shape as that appearing in Figure 1.

There is a similar structure for the right-hand side of equations (57), (58) and (59). On the one hand, there is a common term in all equations that, for simplicity, let us define as $$\varphi \equiv (1 + \tau f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \frac{(b + \bar{a})}{(1 - \tau^w)}$$. This terms is clearly an increasing function of $$\theta$$ when considering that $$q(\theta) = \frac{1}{\theta^\gamma}$$. On the other hand, there are specifics term for each wage bargaining system that depend on product market regulations. We therefore also introduce the following definition:
\[
C_f \equiv \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \\
C_s \equiv m \left[ \frac{\beta m}{\alpha} + (1 - \beta) \right] \\
C_n \equiv m \left[ \frac{\beta}{\alpha} + (1 - \beta) \right]
\] (61)

It is important to note that we obtain a model directly comparable to the Calforms-Drifill model.

Therefore, with all of the abovementioned features we find that when parameter \( m \) has a value higher than one \( C_s > C_n > C_f \). This finding is more relevant given that the term \( \varphi \) is common between all wages bargained given the same labour tax structure and income progressivity. This result is best illustrated in the Figure 2 where the right hand side of equations (57), (58) and (59) are plotted as positively sloped curves with respect to \( \theta \).

We then graphically show in Figure 3 the right-hand side and left hand side of equations (57), (58) and (59) to find the labour market tightness in equilibrium when the wage is bargained at the firm, sector and national level.
Finally, in a steady state, $\theta$ determines the unemployment (or employment) based on the condition that the measure of laid-off workers in a period must be equal to the measure of unemployed workers gaining employment given by the expression $(27)\theta^c$.

\[
L = \left[ \frac{\theta q(\theta)}{\lambda + \theta q(\theta)} \right] N
\]  

or similarly

\[
L = \left[ \frac{1}{\frac{\lambda}{\theta^c} + 1} \right] N
\]  

Hence, we find that when $\theta$ has a higher value, the employment level rises and, consequently, the unemployment rate decreases.

Next, we consider the more general scenario by taking into account the fiscal variables. The right-hand side of equations (57), (58) and (59) are respectively

\[
\begin{align*}
\varphi * C_f & \equiv (1 + \tau f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau w)} \\
\varphi * C_s & \equiv (1 + \tau f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \left[ \frac{\beta m}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau w)} \\
\varphi * C_n & \equiv (1 + \tau f) + \frac{(\rho + \lambda)\gamma}{q(\theta)} \left[ \frac{\beta}{\alpha} + (1 - \beta) \right] \frac{(b + \bar{a})}{(1 - \tau w)}
\end{align*}
\]  

If we take into account the heterogeneity of the fiscal parameter shown in Table 3, it is easy to demonstrate the disparity in unemployment rate in the OECD countries outside the wage bargaining system. We can conclude, for example, that it is possible to find specific countries with a higher unemployment rate with wage bargaining at the firm level than at the sector level, depending on the fiscal parameter.