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Searching for the EU Social Dialogue Model  
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**ABSTRACT**

The European Union and the United States operate different variants of market capitalism. The EU model uses social dialogue institutions to help determine economic outcomes, particularly in the labor market, whereas the US relies more on market forces. The theory of competitive markets provides a powerful framework for analyzing market driven economies and for assessing the conditions under which unfettered markets yield desirable outcomes. But there is no comparable framework for analyzing institution driven economies. This paper argues that models of efficient bargaining/the Coase Theorem offer the best framework for analyzing social dialogue economies and for identifying policies and institutional reforms to improve their functioning.

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“Collective bargaining and social dialogue were designed into the European project from the very beginning.” John Monks, European Trade Unions Congress Secretary, May 2004

The European Union and the United States operate different variants of market capitalism. Both systems base economic transactions on private property and rule of law. Both have open economies with sound monetary and macro-economic policies. Where the EU and US differ is in the role of institutions in affecting outcomes, particularly in the labor market.

The EU relies on collective bargaining between employer associations and trade unions to determine wages and employment and on social dialogue between the “social partners” of labor and capital, often working in concert with government, to choose social and economic policies. The US relies on firms and individual workers to determine employment and wages in competitive markets. The EU has high taxes that provide a strong social safety net for workers. The US has lower taxes and a weak safety net for workers. The differences are sufficiently large to have generated a “war of the models” about how best to organize a market economy (Freeman, 1998).

From the 1960s through the 1970s oil shock and productivity slowdown, the rapid growth and low unemployment of Western European economies led some analysts to generalize that neo-corporatist centralized bargaining wage systems work better than more market based systems (Bruno and Sachs, 1984). In the 1980s Japan’s rapid economic growth and export success directed attention at the virtues of Japanese institutions. During his visit to Harvard in 1986/7 Enzo Tarantelli and I debated whether the Japanese economy was more aligned to the EU institution-affected system than to

more market-driven US.<sup>1</sup> But Japan went into a bad economic decade while US performance improved. From the 1990s through the mid 2000s, the rapid growth and low unemployment in the US shifted sentiment in favor of more market driven variants of capitalist economies.<sup>2</sup>

Regardless of whether more market-driven or institution influenced economies do better in a given period of time, there is generally a wide range of economic outcomes within each group. In the 1990s the US performed well in productivity and employment but Canada, with much the same economic system, had an horrific economic record. From the 1990s through the mid 2000s several smaller EU economies --Ireland, Denmark, Austria, and to some extent the Netherlands -- performed better than Germany and France, among others. Supporters of the EU system often cite the smaller successes as evidence that social dialogue economies can deliver economic efficiency as well as economic security and desirable distributions of income.

When market economies run into trouble, the natural response of economists has traditionally been to seek out imperfections in the market and to suggest ways to eliminate those imperfections. This response builds on the powerful framework that economic theory provides for analyzing real market economies. The model of a perfectly functioning competitive system gives economists and policy-makers a benchmark for measuring real world divergences from the ideal and directs attention at reforms designed to bring the real world closer to the competitive ideal.

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<sup>1</sup> The modest unionization rates, company level unions, use of bonuses related to profits, and limited political role of unions suggested that Japan was closer to the US than to the EU system. But the Shunto offensive, coordination of wage settlements, lifetime employment, lead bank system, industrial concentration, and protection of small firms in the service sector suggested that Japan was closer to the EU than to the US.

<sup>2</sup> For instance, in 2004, 4.9% of the German labor force had been unemployed for over a year,

When EU economies have gotten into trouble, the economists' response is often the same: to identify market imperfections and seek ways to eliminate them. But this seems less appropriate in a social dialogue economy than in a market-dominated economy. Why not seek out imperfections in the social dialogue institutions and search for ways to improve institutional interventions? One reason why economists do not pursue this approach is that we lack a well-specified model of the ideal institution driven economy to benchmark real world divergences from the ideal.

In the world of ideas and in policy discourse the absence of a social dialogue model creates an uneven playing field for assessing the two capitalist models and improving their performances.

*EU social dialogue model, where art thou?*

This paper begins the search for such a model. Section I documents the differences between the EU's social dialogue and collective bargaining system and the US's market driven economy. Section II presents my principal theme: that efficient bargaining models and the Coase theorem offer the best framework for developing the missing social dialogue model. Section III assesses evidence on efficient bargaining from laboratory experiments. Section IV considers the implications from game theory analyses of bargaining for developing an efficient social dialogue system. There is a short conclusion.

## **I The Two Economic Systems**

Exhibit 1 gives a capsule summary of the differences between the EU and US economic systems. The exhibit shows that the EU relies on collective bargaining to set

wages and working conditions to a far greater extent than does the US. In the EU 77 percent of workers<sup>3</sup> were covered by agreements in 2000, many through mandatory extension of contracts to firms outside the bargaining group. In the US bargaining covers only 13 percent of workers, and most collective bargaining contracts are at the firm level. Although EU centralized bargaining allows for “wages drift” (by which firms deviate from the agreement due to their particular circumstances), and although most EU countries have devolved some bargaining to firms or plants, the difference in reliance on institutions in wage-setting with the US remains stark. The 2003 Global Competitiveness Report gave the US the 3<sup>rd</sup> highest rank in terms of having wages set by the company vs by institutions and while the median ranking for EU countries was 68 out of 80 countries in the listing (World Economic Forum, 2003, table 10.19).

The US and EU also differ greatly in the rules that govern “ownership” of jobs. The US has employment at will, which allows firms to lay off or fire workers at their discretion with no legally mandated severance pay. During a strike, the employer can replace strikers and need not re-employ them after the dispute. By contrast, EU employment protection legislation gives some ownership of jobs to workers. The OECD’s index of employment protection legislation, which gives higher scores to countries with greater protection, gave the US a score of 0.7 compared to a score of 2.3 for EU countries in 2003.<sup>4</sup> Strikers in the EU have a right to return to their job after a labor dispute.

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<sup>3</sup>OECD, Employment Outlook 2004, table 3.3, where I have averaged collective bargaining coverage figures for 2000 for 13 EU countries and Norway, excluding the new East European members.

<sup>4</sup> OECD, Employment Outlook 2004, table 2.A2.3, where I averaged the EPL scores for the EU countries and Norway, exclusive of the new entrants.

In the product market the US has fewer regulations governing business activity and makes it easier to form and end businesses than the EU. It takes 64 days to form a business in the EU compared to 7 days in the US. The OECD index of regulations, which codes countries from 0 to 2 in three different areas of regulations, gave the US in 2003 a 1 in product market regulations, 1.1 in administrative regulations, and 1.3 in economic regulations compared to 1.4, 1.5, and 2.0 in these three areas for the EU.<sup>5</sup>

Finally, the US has a more limited welfare state than EU countries. In the US the primary source of economic security is working; unemployment benefits are modest and of limited duration; and income support for single parent families is limited. The US offers health care insurance through employers or private purchase; government provision is limited to the elderly and poor. While state and local governments fund primary and secondary education, a large proportion of higher education is paid by students and their families and by private donations.

By contrast, the welfare state is the EU's primary source of economic security. All EU countries offer high replacement rates for unemployed persons for long periods. All have some form of national health insurance. Many provide housing assistance for workers who lose their job and offer other benefits so that loss of a job does not devastate their living standards. In addition to providing free primary and secondary education, the EU provides low tuition higher education through state support of universities.

To fund the wider role of government in 2004 governments in the EU received 48% of GDP compared to the US government receipts of 32% of GDP<sup>6</sup>.

### **Social dialogue vs market lobbying**

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<sup>5</sup> Djankov, et al, 2000; Conway, et al, table 24

The EU uses social dialogue institutions to bring the voices of business and labor into social and economic policy-making. Most EU countries encourage dialogue at workplaces through mandated works councils. Depending on the country, from 25% to 50% of workers are represented by elected works councils, and almost all workers in middle to large establishments have the option to establish a council at their workplace. The EU social charter requires EU-level councils for larger firms.

By contrast, US labor law discourages firms from setting up systems of dialogue with workers outside of collective bargaining. Section 8a of the US's Labor-Management Relations Act forbids firms from establishing non-union systems of collective representation for fear that companies will create company-dominated organizations to avoid genuine worker organizations. Many firms have employee involvement committees but these committees are legally allowed to deal only with issues that concern the firm such as productivity rather than with worker concerns such as pay, benefits or working conditions.

At the national level, the EU relies on social dialogue committees to ascertain the views of labor and management on diverse issues. The US relies on a very different mechanism for interest groups to contribute to national policy-making – lobbying in which the groups that fund political campaigns meet with legislators to argue for their views.

Exhibit 2 contrasts the EU social dialogue system with the US lobbying system. The upper panel gives the EU's own description of its system, as reported at the 2005 EU social dialogue summit. While the description focuses on dialogue at the EU level, it

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<sup>6</sup> US Bureau of the Census, Statistical Abstract 2006, table 1335.

notes that “ the European social dialogue complements the national practices of social dialogue, which exist in most Member States”. Indeed, it is at the national level where social partnership arrangements are particularly important and where collective bargaining occurs. When an EU government deviates from the consultative model, as the De Villepin government did in France in 2006 when it enacted a new youth labor law without consultation, it risks enraging the groups that were not consulted – in this case, students and unions, whose protests forced the government to withdraw the law.

The lower panel describes the US lobbying system. It is a market-based system built on the US mode of funding political campaigns through private contributions. Lobbyists buy access to candidates through their contributions and use that access to present their case for/against legislation in private closed-door meetings. The opinion polls summarized in the exhibit show that in the 1990s-2000s the most Americans believed that political lobbyists had too much power and bribed members of Congress regularly, and that as a result most citizens were concerned about the corruption this engendered in Washington.

There is an extensive social science literature on lobbying activities and on the impact of campaign contributions on legislator’s decision, but no comparable analysis of the operation of social dialogue committees.

*EU social dialogue model, where art thou?*

## **II. The Social Dialogue Model and Efficient Bargaining**

The main theme of this paper is that the theory of efficient bargaining and Coase Theorem provide the best framework for answering the “where art thou?” question.

The notion of efficient bargaining has a distinguished pedigree in economics. In

chapter 7 of the Theory of Wages (first edition, 1932), John Hicks argued that collective bargaining should produce agreement rather than impasse in most situations. After all, most strikes lower the joint output of capital and labor and thus make no rational sense. He asserted that “the majority of actual strikes are doubtless the result of faulty negotiation” (Hicks, 146). Efficient bargaining between employers and unions ought to yield the same patterns of outcomes that the efficient market hypothesis predicts for financial markets: randomness. Labor specialists should be no more able to predict strikes from public information than financial specialists can predict financial returns from such information.

In 1946 Wassily Leontief applied the efficient bargaining model to the “guaranteed annual wage” that the US United Automobile Workers negotiated with General Motors. In this contract the Automobile Workers insisted that GM pay for at least a minimal number of hours of work from the existing work force. Leontief interpreted this as bargaining over employment as well as wages and pointed out that through such a strategy the union could shift distribution to labor while maintaining the presumably efficient pre-union wage employment and output.

In 1986 Mancur Olson argued that “all-encompassing” unions – those that represent all workers – should internalize the externalities associated with inefficient bargains and produce more efficient outcomes than unions that represent only some workers in a country. In 1988 Lars Calmfors and John Driffill further developed the notion that centralized or coordinated bargaining yields outcomes comparable to competitive markets while industry level bargaining yields less efficient outcomes.

But the most influential analysis of efficient bargaining lies outside of labor

economics. This is the Coase theorem on property rights and externalities, which has generated a huge literature in law and economics (Coase, 1960). The theorem holds that, absent transactions costs, the clear allocation of property rights/decision-making power suffices to assure efficient outcomes. The reason is that, regardless of who owns what, economic agents should bargain to the most efficient point of production and then divide the maximum output. They ought to leave no money on the table. The prediction that efficiency depends solely on clear property rights suggests that economies with egalitarian rules governing distribution can be as efficient with more unequal income distributions.<sup>7</sup>

### **But real world bargaining is not efficient**

“Using the Coase theorem as the starting point for the analysis of EU economies is more Chicago than Chicago. Bargainers often do not reach efficient solutions.” (Ed Lazear, commenting on the theme of this essay)

The criticism is right. There are many cases of real world bargaining that falls short of efficient agreements. In labor economics, the most widely studied failure of efficient bargaining is in strike behavior. In contrast to Hicks’ prediction that strikes should have no predictable pattern across time or space, strikes are pro-cyclical, occur frequently in some sectors and firms and not in others, are more common in some countries than in others, and occur in narrow time periods. Striking is less common in sectors where the costs to labor and capital are largest but occurs sometimes even when both sides end up as big losers. Game theory, models of asymmetric information, detailed models of negotiations – whatever economists have thrown at the problem –

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<sup>7</sup> Medema and Zerbe (1999, p 838) note that some versions of the Coase theorem add a stronger claim: that the final allocation of resources will itself be invariant to the assignment of property rights. Since the redistributions associated with social dialogue economies are highly likely to affect the allocation of

have failed to put a rational efficient market interpretation onto the strike data.

Labor economists have also examined the prediction that efficient union-management negotiations should alter pay but maintain employment and output. Given that most collective contracts have some form of “management rights” clause that reserves control over hiring to the firm, the claim that the union determines employment seems on the face of it unrealistic. In the few cases where unions have negotiated employment as well as pay, the outcome has often been featherbedding rather than efficient work arrangements (for example, musicians sitting in a studio with recorded music in the early days of radio). Since US unions raise compensation and unionized firms/sectors/workplaces tend to have lower employment growth than their non-union counterparts, most economists reject the notion that collective bargaining produces employment off the demand curve in an efficient way.

In a similar vein, studies of productivity among sectors and firms find that competitive pressures can induce producers to raise productivity so greatly that they almost certainly had previously unexploited opportunities to increase efficiency – what Leibenstein (1966) called X-efficiency. Galdon-Sanchez and Schmitz (2002) have documented a particularly striking example of this in the recovery of US and Canadian iron ore producers from the collapse of steel production in their home markets in the 1980s. The iron ore producers raised their productivity massively compared to otherwise comparable iron ore producers operating in markets that had little or no increase in competitive pressures. The intensified competitive pressure led the firms to reform work and staffing rules that they could readily have done before they faced great competitive

pressures.

### **Empirical studies of the Coase Theorem**

Law and economics analyses of the Coase theorem in diverse other settings also give a mixed picture of its real world applicability. Steven Medema and Richard Zerba (1999) reviewed studies of the effect on agricultural production of the property right to control animal trespassing on farmlands. Two studies found efficient outcomes but both attributed the outcomes to social pressures/norms to keep animals off farm lands rather than to efficient bargaining between farmers and ranchers. The third study rejected the efficiency outcome. In 1989 John Donohue examined the 1980s Illinois employment experiment, which paid bonuses to workers or to firms to encourage the unemployed to find employment quickly from the perspective of the theorem. One variant of the experiment paid the bonuses to unemployed workers who found a new job quickly. Another variant paid the bonuses to the firms for hiring unemployed workers quickly. The Coase Theorem predicts that the property right to the bonus ought not affect the employment outcome. But the payments to workers led to greater employment and bonus receipt than did the payments to firms. Whether the Coase theorem failed because transactions costs were higher than the experiment envisaged as some critics of Donohue's work argued (see Medema and Zerba, 869-871), or because of some other form of non-optimizing behavior, the important conclusion is that in this real world example, the allocation of property rights affected efficiency.

Studies of divorce laws, where the state changes the law from requiring both sides to agree to a divorce (so that the side most eager for the divorce would pay more to the other side to accept it) to allowing one side to insist upon the divorce, have also found the

Coase Theorem wanting. Peters (1992) reported that changes in divorce laws from mutual to unilateral divorce had effects consistent with the theorem: a change in the division of family assets but no change in the frequency of divorce. But ensuing work, summarized in Allen (2006), has found that rates of divorce rise when the law moves from mutual divorce to unilateral divorce, contrary to efficient bargaining. Wolfers' (2006) analysis offers further evidence and analysis of the problems with the Coase Theorem in this setting.

The most widely studied Coase theorem prediction relevant to EU labor problems relates to employment protection laws (EPL). The Coase theorem predicts that EPL will not affect aggregate outcomes but will alter the distribution of income. Many policy analysts dismiss the prediction and argue that weaker EPL laws would reduce unemployment, but empirical analyses find no such consistent effect. The OECD (2004) review of studies of EPL concluded that "the numerous empirical studies of this issue lead to conflicting results, and (notes further that) moreover their robustness has been questioned." Baker et al's (2005) analysis showing that empirical results vary greatly with modest variation in the models, countries, time period, and measures used to assess the impact of EPL is more consistent with EPL having no effect on the volume of employment or unemployment than with the belief that it has effects.

This does not mean the EPL does not impact labor market outcomes. Stronger EPL regulations are associated with lower flows of labor from employment into unemployment, which benefits older workers, and with lower flows from unemployment to employment, which generally harms younger workers and other new entrants to the job market (OECD, 2004). What is important is that the effects are on the distribution of

employment rather or more than on the volume of employment or unemployment, consistent with the Coase theorem.

Still, the EPL studies aside, the bulk of empirical work in labor and in law and economics indicates that the efficient bargaining model does not fit reality well. Does this make Coase theorem style thinking irrelevant for assessing social dialogue economic systems?

I think not. Empirical analyses of market driven economies show that real markets often fall short of 100% efficiency, but the competitive model still provides a valuable framework for analysing market performance. In finance the efficient market hypothesis is a useful first approximation and benchmark, even though researchers have uncovered numerous empirical regularities that reject the model. By analogy, the efficient bargaining/Coase theorem model can still be a valuable ideal for illuminating social dialogue systems even though the world does not evince efficient bargaining as a general rule.

### **III. Laboratory experiments and behavioral economics**

Another way to judge the relevance of efficient bargaining models to real situations is through laboratory experiments. The bulk of experiments in which efficient production requires cooperation among people – the prisoner’s dilemma<sup>8</sup>; public goods games<sup>9</sup>– shows that people attain efficient or near efficient solutions in many cases even without formal side agreements. For example, tit for tat behavior tends to dominate

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<sup>8</sup> The prisoner’s dilemma is the most widely studied cooperation game. Efficient production requires that the two participants choose to cooperate even though there is an incentive to defect. See Wikipedia

<sup>9</sup> In public goods games subjects invest money in a public pot whose value increases, often with higher returns the greater the amount invested, and keep the money they did not invest in the pot plus an even share of the money in the pot. See Wikipedia

prisoner's dilemma games, producing efficient outcomes. And while participants in public goods games rarely contribute 100% to the pot, they almost never contribute the 0% that theory predicts. If people approach efficient solutions without side agreements, perhaps a modicum of bargaining would bring them even closer.

The experiments on the Coase theorem by Elizabeth Hoffman and Matthew Spitzer highlight the strength and weakness of the theorem. Their experiments assigned a number to each of two participants, one of which could be cashed in for real money. A coin toss gave the property right/power to determine which number gets cashed in to one of participants. Without bargaining the person who won the toss would presumably select their number for that is the most that they can get. They should do this even if the second party has a larger number, producing a socially inefficient outcome from the perspective of the pair. But bargaining ought to yield the efficient outcomes. The person with the power to determine which number cashes in ought to pick the highest number subject to a side arrangement in which they obtain more money than they could earn from cashing in their own number (arguably, the entire reward less some minimal payment to the second party, who would otherwise get nothing).

Hoffman and Spitzer found that over 90% of the sets of bargainers brought the higher number to the experimenter for an efficient allocation. But the bargainers distributed the rewards in a manner inconsistent with rational bargaining. They tended to divide the money equally even though that meant that the party with the property right accepted less than he/she would have gained by selecting their own number! When Hoffman and Spitzer altered the allocation of the property right from a coin flip to the winner of a contest and educated the winner about choosing in their own interests, the

majority of pairs chose the joint maximum but only 60% bargained for more than they would have gotten by selecting their own number.

In sum, these experiments yielded efficient outcomes, but they also found that participants got to the efficient outcome through decision processes far from the self-interested economic rationality that underlie the Coase Theorem.

Stewart Schwab's (1988) experiment used a more complicated bargaining design that failed to produce efficient solutions. In Schwab's experiment students were divided into union and management teams that bargained over 3 items: wages, vacation days -- which benefited workers more than they cost management up to 15 days but which after 15 days cost management more than their worth to workers, and a contract clause that allowed the firm to move work from the union plant to a non-union plant. In half of the experiments, the work clause produced more value to the management team than to the union team. In the other half, keeping the clause out of the contract meant more to the union. A fully efficient bargain required that the parties agree to 15 days of vacation and adopt the transfer clause in the first variant and reject the clause in the second variant. The wage (\$1 benefit to workers = \$1 cost of the firm) gave the parties an easily transferable way to redistribute output from the optimal solution. But Schwab found that "neither item was bargained to a fully efficient result" (p 251). The contracts produced an average of 11 days of vacation pay and the optimal solution for the transfer clause in 2/3rds of the cases. The bargaining left money on the table.

Surprisingly, even though bargainers did not reach optimal efficiency, the experiment validated the prediction of the Coase theorem that changes in property rights do not affect allocation. In one variant of the experiment the firm had the initial property

right to transfer the work. In another variant the union had the initial right to forbid the transfer. The two property rights regimes produced contracts with similar outcomes (approximately 2/3rds efficient) while giving a greater share of the joint output to the party with the property right.

Thus, like the “real world” assessments, laboratory experiments give a mixed picture of Coase theorem/efficient bargaining. Bargaining pairs sometimes reach efficiency and sometimes not. Distributive outcomes are sometimes consistent with the model and sometimes not. These findings raise what is arguably the critical stumbling block for the theme of this essay: whether actual behavior diverges so much from rational optimizing as to invalidate the use of efficient bargaining/Coase Theorem models as benchmarks for analyzing EU social dialogue economies.

### **behavioral economics and efficient bargaining**

A large growing body of evidence from psychology and behavioral economics shows that people make decisions in ways that deviate substantially from the rational optimization that economists have historically assumed. Some of these forms of non-rational optimizing behavior make attainment of efficient outcomes more likely – notably the tendencies for cooperation and for fair distribution of outcomes – but others call into question the entire notion of efficient bargaining to a social optimum.

As an example of the latter, consider the evidence that possession of a good raises a person’s valuation of it – “the endowment effect” on preferences. The endowment effects experiments show that random assignment of items to people (such as coffee mugs of a given color) raises their valuation of the item and thus leads them to ask for more money to give up the item than they would be willing to pay for it had it not

been in their possession (Kahneman, Knetsch, and Thaler (1990)). When willingness to accept payment diverges from willingness to pay for the same item the volume of trade will be below what the Coase theorem would predict for reasons beyond transactions costs. Two economies with different initial distributions of property rights would have different social optimum.

A second example of behavioral findings that challenge any efficient bargaining analysis is the evidence that individuals choose “default” options in savings behavior for long periods even when other options dominate the default (Beshears et al, 2006). Since the transaction cost of shifting to a higher return option are nominally modest, the implication is that there are large internal transactions costs that deter rational choice. If a person does not efficiently bargain with themselves to make the sensible decision, it seems unrealistic that they can bargain efficiently with others, per any efficient bargaining model.

Without gainsaying the importance of these and related findings from behavioral economics on how people really make decisions, I reject the strong claim that this evidence by itself invalidates the use of efficient bargaining/Coase Theorem models as ideals for social dialogue systems.

One reason why the findings do not invalidate the efficient bargaining ideal is that markets can be efficient even when bargainers make decisions in ways that diverge greatly from economic rationality. Markets based on “zero intelligence agents” – computer code that chooses randomly among options – give efficient or near efficient outcomes when the agents face budget constraints and/or operate under exit and entry conditions (Gode and Sunder). The agents that make bad decisions lose their position in

the market over time while those who randomly drew good decisions increase their share of the market. In a bargaining situation, the pair of bargainers that reach efficient outcomes, even by chance, will expand their market presence, leading to an evolution toward efficient outcomes.

Another reason is that people may make more rational decisions when they represent others in collective bargaining or social dialogue settings than when they act on their own behalf. For instance, I would expect that pension fund managers who may follow some low return default in their own savings behavior would search carefully for the best returns for the fund as part of their job. Similarly, someone who might take a high risk in a personal investment would choose lower risk options when representing widows and pensioners. Indeed, while society does not care how someone invests their own funds, it places “fiduciary responsibility” on those investing on behalf of others, which means that they ought to be able to give rational explanations for their decisions. If my expectations are correct, some behavioral anomalies in private decision-making will not generalize to settings where decisions are part of someone’s social role.

Finally, collective bargaining and social dialogue usually involve group decision-making, which can also produce decisions that differ from what people make on their own. Studies of group judgment show that under some circumstances groups make better use of information than individuals. This is the “wisdom of crowds” that improves estimates of parameters and that reduces variation in those estimates (Surowiecki, 2004). But other studies show that group decision-making can lead to erroneous decisions, which members of the group hold with high confidence (Sunstein).

Sunstein gives a telling example of erroneous group decision-making in an

experimental setting. Participants are asked to estimate whether the experimenter is using a Red urn, which has 60% red balls, or a Black urn, which has 60% black balls. The experimenter selects balls from the chosen urn and gives one ball to each person. If each person independently guesses the urn from which the experimenter selected the balls, they would guess the urn whose color they had drawn; and the group would choose the urn with the color of the majority of the balls. Thus, if 3 of 5 persons draw black balls, the group would choose the black urn. But if individuals vote seriatim on the urn (and do not give the color of the ball they drew), the group can go astray. If the first two people drew red and guessed red, and the others drew black, the group might unanimously choose the red urn. The third person might be swayed by the two preceding guesses and guess red as well even though she drew black. The fourth, who also drew black, might also guess red, on the grounds that 3 of 4 draws were red. The fifth would presumably make the same choice. This “information cascade” leads the group to choose red without dissent.

Reviewing the literature on group judgments, Sunstein concludes that “group polarization can be heightened, diminished, and possibly even eliminated with seemingly small alterations in institutional arrangements” (p 45). This suggests that whether groups behave in a more economically rational way than individuals may depend critically on the arrangement and framing of group interactions.

#### **IV Game Theory and Institutional Design**

The argument that analyses of efficient bargaining/Coase theorem offer the most promising road toward the missing EU social dialogue model directs attention not only at empirical analyses of actual bargaining situations but also at theoretical investigations of

bargaining situations by rational (or other) decision-makers and of institutional designs that can produce efficient outcomes. Game theory provides a rich set of models on conditions for efficient bargaining and the Coase theorem. The associated implementation theory (Jackson, 2001) examines ways to design institutions so that the parties reach or approximate efficient equilibrium. Although researchers in these areas have not directed their investigations toward EU social dialogue systems, the work offers potentially useful insight toward the “holy grail” social dialogue model.

What does the game theory/implementation theory say about bargaining and social dialogue activities?

First, the analyses show that the institutional structure of a bargaining game matters critically as to whether it yields a socially efficient outcome. Using different modelling structures Anderlini and Felli (2001) and Dixit and Olson (2000) find that even modest transactions costs for participating in a bargaining or dialogue system can readily lead to inefficient equilibrium.<sup>10</sup> Since there are always some transactions costs in any negotiation, the implication is that the Coase theorem is non-robust to these costs. In a similar vein Jackson (2001) stresses that particular mechanisms for implementing decision-making can have huge effects on strategic behavior and social outcomes. These analyses also highlight a tension between bargaining systems that allow participants to reach undesirable equilibrium (giving them an incentive to avoid those decisions) and systems in which renegotiation allow participants to escape disaster but which reduce the

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<sup>10</sup>Anderlini and Felli use an alternating offer model of negotiation where the bargainers pay a transactions fee at each stage and show that strategic “hold up” conditions can produce situations where the parties never come to a profitable agreement. Dixit and Olson model a public goods game in which free rider considerations induce many people to opt out of the bargaining process, which leads to failure to produce the good.

disincentive to make poor decisions in the first place.

From one perspective, the dependence of results on institutional detail is disappointing, since it suggests that small differences in design can have large effects on the success or failure of social dialogue systems. But this is not a surprising result given the dependence of outcomes on the specifics of game structures broadly (Kreps, 1990). Optimistically, it suggests that experimentation or tinkering with a system has the potential for improving outcomes. It also suggests that EU policies that require bargaining or dialogue may help achieve efficient outcomes.

Second, studies that examine the characteristics of bargainers and bargaining situations show that homogeneous groups, with similar endowments and abilities, operating under stable power relations, are more likely to reach efficient bargains than others (Rajan and Zingales (2000)). Inequality reduces the chance for attaining efficiency because it increases the incentive for the poor or less productive to use their resources for rent-seeking rather than to contribute to social output. Stable relations increase the chance of reaching efficient bargains because parties can be secure that gains from an efficient contract accruing to the other side will not change their relative power in the future. For example, if 80% of an expected gain from an efficiency enhancing economic reform goes to business and business can use this gain to campaign for laws that may restrict union power in the future, unions may refuse to go along with the reform, even though it raises the income of business and workers <sup>11</sup>

These considerations suggest that EU countries, particularly the smaller ones, are

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<sup>11</sup> Taking a different approach, Hirshleifer (1995) stresses the importance of the technology of conflict in leading parties to allocate different fractions of their resources to fighting over distribution as opposed to producing more output, and shows that under some technologies some resources will always be spent on

reasonably well-suited to reaching socially efficient outcomes through bargaining.

Income inequality is modest compared to the US. Populations are relatively homogenous. And society, including the business community, accepts the legitimacy of labor organizations. The development of EU wide institutions has, moreover, given an additional layer of security to the social partners.

Third, analyses show that the ability of participants to make side payments can affect outcomes substantially. Commitment to make compensating transfers raises the chances of attaining the efficient outcome. In situations where one of the parties loses from an agreement, the ability of the winner to commit to the transfer is necessary for the agreement. But transfers themselves can be inefficient, reducing the value of the bargain, for instance by reducing the incentive of workers and firms in declining industries to shift to more productive activities (Dixit and Londregan, 1995). This appears to be agricultural policy in both the US and EU.

Surprisingly, however, the side contracting or transfers that lie at the heart of efficient bargaining do not always improve efficiency, even in a world of complete information and zero transactions cost. Jackson and Wilkie (2005) show that parties can use side contracts to manipulate the payoff from bargaining so as to redistribute incomes to themselves at the cost of efficiency. They suggest that side payments work better when only one player makes them (for instance where someone pays another party to reduce pollution) than in situations where many participants make side payments (say in encouraging public goods production). They also show that side payments are more likely to support efficient strategies when three or more players are involved in decision-

making. The implication is that tripartite bargaining – capital, labor, and government, may be particularly fruitful, at least in some circumstances. The 1987 Irish social pact in which unions accepted small wage increases, so that firms had incentives to expand production, while the government compensated workers with tax reductions may be a case in point. The Pact and succeeding Irish agreements contributed to Ireland's recovery from economic basket-case in the 1980s to Celtic wonder-economy in the 1990s-2000s.

Fourth, information is an important determinant of the likelihood of attaining efficient outcomes. Complete information with each party knowing the other's situation is no guarantee of efficiency, but its absence – private information in which parties know only their own benefits/costs – increases the chance of inefficient results. Bargaining over an indivisible item – say greater authority for the firm to set working hours that will raise output -- can result in inefficiencies when each agent privately knows their valuation but is uncertain about the valuation the other party places on it (Myerson and Satterthwaite). In this case there is an incentive to use private information strategically to gain a larger share of income, which can lead to an agreement that fails to maximize joint surplus or to no agreement at all. McKelvey and Page (2002) show that the outcome in such circumstances will be tilted toward the party who initially has the property rights rather than being independent of the initial property rights, per the Coase Theorem.

The bottom line of the game theory/implementation theory analyses of bargaining is that the way society – government or social partners – design a social dialogue or bargaining system is likely to affect economic outcomes.

## **V. Conclusion**

This paper has argued that efficient bargaining/Coase Theorem models offer the

best starting point for analyzing EU social dialogue economies. Since the evidence shows that these models fit the economic world at best loosely, they are most sensibly viewed as benchmarks comparable to the perfectly functioning competitive model used to benchmark market-driven economies. If the representative agent hypothesis is correct, participants in social dialogue systems may be less prone to anomalous decision-making than laboratory experiments find for individuals acting on their own behalf. On the other hand, if deviations from rational self-interest favor cooperative behavior, as experimental studies indicate, social dialogue systems where decision-makers diverge from economic rationality may reach efficiency more readily than game theoretic models suggest.

Overall, this review of laboratory and theoretic analyses relevant to understanding social dialogue economies suggests the virtue of a research programme that examines design factors that lead parties to efficient solutions, not only on the assumption of rational strategic behavior but also on potentially more realistic assumptions about how people make decisions. In any case, whatever the true social dialogue theory turns out to be, it should help level the playing field in the “war of the models” between the EU and US economies and it should direct attention at ways to improve the efficacy of social dialogue institutions. Given Enzo Tarantelli’s commitment to social dialogue as a way for Italy to resolve its economic problems in the 1980s, I would guess that were he with us today, he would look favorably upon these areas of research and be contributing to them.

*EU social dialogue model, where art thou?*

### Exhibit 1: The EU and US Economic Systems

	US : Invisible Hand	EU : Social Partners
<b>ECONOMY</b>		
<b>Labor Market:</b> Wages	Market/employer driven	Collective bargaining with extension
employment	employment at will – employers own job	employment protection legislation – workers own job
company level formal dialogue	Illegal under Section 8a of the Labor Management Relations Act unless union involved; employee involvement committees	European Works Councils (EC 94/45/EC); different country council legislation
<b>Product Market</b>	less regulated, with ease of entry and exit, bankruptcy laws favorable to debtors	greater regulation of business, harder entry and exit
<b>GOVERNMENT</b>		
<b>safety nets</b>	limited, short duration of unemployment benefits	high replacement for unemployment with long duration, so long spells
<b>health</b>	health care through employer/private purchase	national health care
<b>higher education</b>	universities dependent on private support, tuition, business linked	publically funded, free universities

Source: Author's analysis

## **Exhibit 2: EU Social Dialogue from workplace to national policy**

### **European Social Dialogue** (Social Dialogue Summit, Brussels, Sept 2005)

European social dialogue is the discussions between employee and employer representative organisations (the social partners). These can take the form of consultations, negotiations and joint actions undertaken by the social partner organisations.

At European level, social dialogue takes two main forms - bipartite dialogue between the European employers and trade union organisations, and tripartite dialogue involving interaction between the social partners and the public authorities.

These are the essential means by which the social partners help define European social standards, and play a vital role in the governance of the Union. European-level social dialogue has received strong institutional recognition in the EC Treaty and in the conclusions to a number of key European Council meetings, notably those of Laeken and Barcelona. Combining the values of responsibility, solidarity and participation, the European social dialogue complements the national practices of social dialogue, which exist in most Member States.

### **US Lobbying**

As of mid 2005, the US had nearly 35,000 registered lobbyists for Congress alone. Lobbyists in the US target the Senate, the House of Representatives, and state legislatures. They may also represent their clients' or organizations' interests in dealings with federal, state, or local executive branch agencies or the courts. Lobbyists sometimes also write legislation. Since 1998, 43 percent of the 198 members of Congress who left government to join private life have registered to lobby. Former lawmakers are hired as lobbyists because of their relationships with their former colleagues as well as other contacts. In 2006, 273 former members of Congress or heads of federal agency were lobbyists.

Attitudes of Americans toward lobbying:

75% believe political lobbyists have too much power, 1994-2001 (Harris)

81% believe it is common for lobbyists to bribe members of Congress, 2006 (Pew)

91% concerned about corruption in Washington, 2006 (Fox)

Source: EU dialogue, Europa, European Commission, <http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/05/344&format=HTML&aged=0&language=EN&guiLanguage=en>; Knowlton, Brian "Lobbyists' scandal has a K street home" International Herald Tribune, January 11, 2006, [www.ihf.com](http://www.ihf.com)

US <http://en.wikipedia.org/wiki/Lobbyist>; under lobbying. Harris Poll #23, May 16, 2001, table 2, [www.harrisinteractive.com/harris\\_poll/printerfriend/index.asp?PID=233](http://www.harrisinteractive.com/harris_poll/printerfriend/index.asp?PID=233), [www.citizen.org/print](http://www.citizen.org/print) article.fm?ID=14945 for Pew and Fox polls.

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