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How Labor Institutions Influence Firms and Labor Markets

Morris M. Kleiner*

During the past year, perceived market failures have resulted in financial and product markets being encouraged to increase their level of government regulation. The labor market, however, continues to be one segment of the economy with the most extensive and deeply ingrained role for institutions and regulations, including employers, unions, and government oversight. How do these institutions influence labor markets, as well as the traditional economic factors of supply and demand?

To understand what happens within firms' labor markets we need to know how organizations set policies and how those policies affect the performance of the organization. The most basic job attribute that firms determine for their employees is compensation—its level and method of pay.¹ When we examine how methods of pay may influence the firm, we find that moving from piece rates to time rates or gain-sharing reduces individual productivity but allows firms to move workers among different tasks without their becoming demoralized.² When the piece rate is changed often, consequently shifting rates of pay and making it more difficult to adjust work effort, employees can become demoralized. Even when the piece rate remains constant, workers can become demoralized if meeting targets for their desired level of pay becomes difficult or out of reach.

Other firm policies, such as employee involvement (EI), can directly influence employee and firm behavior.³

A great many American firms have organized workplace decision-making so as to allow employees to get more involved in their jobs—using policies like self-directed work teams, total quality management, quality circles, profit sharing, and other diverse human resource programs. Using information from employees and from firms, we can ask not only what EI does for firms—the principal question in the literature on the subject—but also what EI does for workers, and can examine EI from the bottom-up perspective of participants rather than managers. We find that EI practices are linked in a hierarchical structure that provides a natural scaling of EI activities and the intensity of the EI effort. Firms take a fairly long time—up to 20 years—to achieve an equilibrium level of employee involvement.⁴ Firms with EI are also more likely to have profit sharing and other forms of shared compensation, as well as other high-performance workplace practices. EI has a weaker influence on output per worker, but a strong and positive influence on overall employee well-being.

In spite of declines in membership, the most important labor market institution influencing both firms and the labor market itself is still the labor union. Unions provide a voice to workers and the mechanisms for raising wages. One additional function of unions is to reallocate resources away from owners of capital to workers without putting the firm out of business.

Nevertheless, firms may oppose unionization, because it might reduce profits and investment. An often neglected area of research on labor market institutions is the direct role for employers in union-organizing campaigns. After examining the determinants and consequences of employer behavior when faced with an organiz-

ing drive, we show that there is a substitution between high wages and benefits, good working conditions, and supervisory practices. There is also some “tough” management opposition to unionism. Our research shows that a high innate propensity for a union victory deters management opposition, while some indicators of a low propensity also reduce opposition. These results are consistent with the notion that firms behave in a profit-maximizing manner in opposing an organizing drive, with the basic proposition that management opposition, reflected in diverse forms of behavior, is a key component in the ongoing decline in private sector unionism in the United States.

The introduction of a union into an establishment initially does not result in generally higher wages relative to when there is no organizing drive, or when the union loses an election or fails to achieve a collectively bargained contract.⁵ Unions initially go for voice-related policies, such as grievance procedures and a seniority system, and then go after wages and benefits. What unions bring to an establishment initially is greater employee voice and due process in terms of job bidding and transparency from management. However, unions generally are associated with fewer policies where pay is at risk, and they reduce wage-related incentives for performance.

Once unions are clearly established and have a long history within a company, how do management and labor interact at the workplace to determine productivity? For example, we consider a large plant in the commercial aerospace industry—where the firm produces large civilian aircraft—and in which strikes, slowdowns, and tough union leaders can influence the productivity of one of the largest plants in the

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United States, by large percentages and by absolute dollar amounts.⁶ Putting together aggressive management leadership with a weak union leader initially may lead to higher productivity, but it also results in the union membership choosing a more militant union leader in response. Consequently, within the plant that we studied, negative productivity outcomes were associated with more strikes, or with collective shirking within the terms of the contract, which occurred when one side of the labor-management team had a more strident leader. However, following the concerted activities such as a strike or slowdown, we found no evidence of long-term effects, with the plant returning to pre-strike levels of productivity within three to six months after the formal settlement of a labor-management dispute.

One of the most controversial questions about the interaction of institutions such as unions is whether they put firms out of business. Much of the conjecture is that unions raise wages above market levels and reduce productivity so that unionized firms are not able to compete with nonunion ones.⁷ However, if there are economic rents attributable to monopolies, or patents in product markets that can be distributed between owners of capital and labor, then higher wages and lower investment in capital may not put firms out of business. Estimates from our models show that at the mean value of the sample, being unionized has no influence on firm solvency. At the highest levels of unionization, though, firm insolvency increases. Additional probing of the issue, using data from the Current Population Survey Displaced Worker Supplement, finds that the probability of unionized workers becoming unemployed because of a mass layoff or plant closing is no higher than for nonunion workers. Although unions reduce profits because of these distributional effects, and labor leaders as well as management may make bad decisions, they are not so foolish as to eliminate the firm's value as an ongoing concern.

Although unions are the dominant labor market institution in the manufacturing sector, other government-run institutions have formed in the service sector that can, in some ways, serve as substitutes for some of the voice and monopoly functions of unions. For example, occupational licensing by the government has evolved as a partial substitute for unionization in the service sector.⁸ Generally, licensing and other forms of regulation of occupations are driven by the occupational associations who lobby government for regulation. Occupational regulation in the United States generally takes three forms. The least restrictive form is registration, in which individuals file their names, addresses, and qualifications with a government agency before working in their occupation. The registration process may include posting a bond or filing a fee. In contrast, certification permits any person to perform the relevant tasks, but the government—or sometimes a private, nonprofit agency—administers an examination and certifies those who have achieved the level of skill and knowledge for certification. For example, travel agents and automobile mechanics are generally certified but not licensed. The toughest form of regulation is licensure; this form of regulation is often referred to as “the right to practice.” Under licensure laws, working in an occupation for compensation without first meeting government standards is illegal. In 2003 the Council of State Governments estimated that more than 800 occupations were licensed in at least one state, and more than 1,100 occupations were licensed, certified, or registered.

Using a specially developed survey of the U.S. population that is consistent with the Current Population Survey, we find that 35 percent of the respondents answered that they were either licensed or certified. Approximately 6 percent stated that individuals who did not have a license could do the work, which is the definition of government certification. Therefore, 29 percent are fully licensed. Another 3 percent stated in the survey

that all who worked would eventually be required to be certified or licensed, bringing the total that are or eventually must be licensed or certified by government to 38 percent. In contrast, union members are about 12 percent of the U.S. workforce. Having a license is associated with approximately 14 percent higher hourly earnings, depending on the detail of the specifications, and this result is similar to the union wage premium. The measure of dispersion of wages among licensed jobs is about the same as, or only slightly smaller than, that among unregulated ones. In contrast, unionization reduces the variance in wages.

Unlike unions, which can engage in concerted activities such as strikes or work slowdowns, licensed workers do not sign collective agreements with their employers. Nor do they engage in strikes against employers to raise wages. Occupational licensing can affect pay and employment through increasing quality by imposing initial education, testing, continuing training requirements, internship requirements, or fees. Further, licensing can use the police powers of the state to monitor and prevent the potential work effort of unlicensed workers. Competition by unlicensed individuals is virtually eliminated through the use of the state's enforcement process. Finally, the regulatory board through its administrative procedures of establishing large entry barriers and moral suasion can reduce the number of openings in schools that prepare individuals for licensed positions.

Overall, what role do more intense labor market institutions, such as labor law restrictions on management and unionization, have on national economic performance? Using a measure of national performance for OECD nations, such as foreign investment between nations and over time, we show that labor market institutions have an economic effect.⁹ Firms are more likely to seek investment opportunities in nations that allow for more managerial or business flexibility in dealing with the workforce that may then entice foreign

investment. Nevertheless, the results do not necessarily suggest that a nation or state would be better off trading social equity through fewer restrictive industrial relations institutions for higher levels of foreign investment. Seeking to analyze and examine the balance of the proper level and intensity of labor market institutions is likely to continue to be a central task of both labor economists and policymakers.

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⁵ R. B. Freeman and M. M. Kleiner, "Impact of New Unionization on Wages and Working Conditions: A Longitudinal Study of Establishments," NBER Working Paper No. 2563, May 1990, and *Journal of Labor Economics*, 7 (3), pt. 2 (1990), pp. S-8–25.

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⁷ R. B. Freeman and M. M. Kleiner, "Do Unions Make Firms Insolvent?" NBER Working Paper No. 4797, July 1994, and as "Do Unions Make Enterprises Insolvent?" *Industrial and Labor Relations Review*, 52 (4) (July 1999), pp. 507–24.

⁸ M. M. Kleiner and A. B. Krueger, "The Prevalence and Effects of Occupational Licensing," NBER Working Paper No. 14308, September 2008, and "Analyzing the Extent and Influence of Occupational Licensing on the Labor Market," NBER Working Paper No. 14979, May 2009.

⁹ M. M. Kleiner and H. Ham, "Do Industrial Relations Institutions Impact Economic Outcomes? International and U.S. State-Level Evidence," NBER Working Paper No. 8729, January 2002, and as "Do Industrial Relations Institutions Influence Foreign Direct Investment? Evidence from OECD Nations," *Industrial Relations*, 46 (2) (April 2007), pp. 305–28.

Dynamic Measures of Inflation

Ricardo Reis*

While the definition of inflation is widely agreed upon — "a continuing rise in the general price level" according to Merriam-Webster — turning it into a concrete measure is much more difficult. One key obstacle is figuring out how to combine all of the price changes in the economy into a single number,

and this price-index problem has occupied many economists for centuries.¹

Roughly three approaches have been taken. One is rooted in statistics, seeing price indexes as estimators of an underlying concept, and focusing on probability models of price dynamics and how to deal with sampling uncertainty, consistency, efficiency, and so on. Another approach uses both mathematics and logic, proposing axioms that price indexes should satisfy, and from them deriving the formulas necessary to com-

pute the indexes. A third approach uses models of economic choice, whether of producer or consumer behavior, and derives price indexes as dual measures of changes in welfare.

Across all approaches, most of the work so far has been static. While the price indexes are used to compare two dates, the theory underlying them gives little or no role to time. More recently, a dynamic approach has surfaced, in an attempt to measure inflation and to answer three separate questions.²

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