

## Efficient Contracts Without Bargaining Over Employment

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Résumé de l'article

Dernièrement, la recherche a favorisé deux modèles de détermination des salaires et de l'emploi pour les industries syndiquées. Ces deux modèles sont, référant aux termes utilisés par Oswald (1985), le modèle monopolistique (MM) et le modèle d'ententes efficaces (MEE). Dans le MM, le syndicat fixe le salaire et l'employeur arrête un niveau d'emploi pouvant maximiser ses profits considérant le nouveau coût de main-d'œuvre, les autres coûts et les revenus. Ainsi, le syndicat décide du niveau de salaire rencontrant ses objectifs propres tout en tenant compte de la demande de travail de l'entreprise. Pour ce qui est du MEE, syndicat et direction s'entendent sur une combinaison de salaire et d'emploi et ce, conformément à leurs courbes d'offre ou de demande.

Le premier modèle tient sa faiblesse de son résultat non-assuré. Il existe, en effet, des combinaisons de salaire et d'emploi plus avantageuses pour les parties que celles émanant du MM. La force de ce dernier, par contre, est de se conformer au courant de pensée traditionnelle selon lequel les syndicats décident des salaires et les employeurs fixent unilatéralement le niveau d'emploi.

Le second modèle, quant à lui, mène à ces ententes, mais n'explique pas comment ni pourquoi on arrive à de tels résultats. Afin d'obtenir une combinaison de salaire et d'emploi efficaces, les entreprises doivent embaucher plus de travailleurs que la quantité maximisant leurs profits. Donc, le syndicat se doit de faire augmenter le niveau d'emploi. La façon la plus directe et la plus simple d'y arriver est de négocier l'emploi, bien qu'il s'agisse le plus souvent d'un droit de gérance.

Cet article démontre que négocier directement le niveau d'emploi n'est pas la seule voie à la sécurité. Il est possible de réaliser cet objectif si l'indemnisation varie en fonction du niveau d'emploi. Les clauses référant à la notion d'ancienneté que renferment la majorité des conventions collectives permettent une telle variation. Plus spécifiquement, des clauses prévoyant l'ancienneté 1) comme critère de mise à pied et de rappel au travail et 2) comme mécanisme de détermination salariale ou d'avantages sociaux suffisent à faire varier le taux compensation avec l'emploi. Ainsi, la plupart des dispositions touchant à l'ancienneté permettent aux deux parties de conclure une entente sûre même si l'employeur décide unilatéralement du niveau d'emploi.

Ceci revêt une grande importance dans le débat actuel sur le mérite relatif des deux modèles quant au comportement des syndicats. Considérant que les avantages acquis par ancienneté permettent d'en arriver à des garanties et qu'une majorité des conventions collectives prévoient de telles dispositions, la distinction entre le MM et le MEE s'avère exagérée et devient une question empirique secondaire. Ayant rappelé les présomptions connues du modèle monopolistique et du modèle d'ententes efficaces, syndicats et employeurs peuvent recourir à des avantages reposant sur l'ancienneté pour arriver à une sécurité contractuelle sans avoir à négocier le plancher d'emploi. Ainsi, les conséquences du niveau de salaire et de celui de l'emploi seraient assurées et absentes de la courbe de demande de l'entreprise bien que cette dernière détermine seule l'emploi.

# ***Efficient Contracts Without Bargaining Over Employment***

**Felice Martinello**

*It is often asserted that unions must bargain over employment if efficient contracts are to be achieved. However, efficient outcomes can be reached and supported if the average rate of compensation paid to labour decreases with employment. The author argues that common fringe benefit and layoff and recall provisions should make the average cost of compensation decline with employment. This implies that most firms and unions can reach and support efficient outcomes even though the union negotiates only wages and fringes, and the employer chooses employment unilaterally. Thus the distinction between monopoly models and efficient bargain models of union-firm interaction is not as relevant an empirical issue as previously believed.*

Recent research has yielded two leading models of wage and employment determination in unionized industries. Using Oswald's (1985) terminology, the two models are the monopoly model (MM) and the efficient bargains model (EBM). According to the MM the union sets the wage, and the employer chooses the level of employment that maximizes its profits subject to the union wage and other input and output prices. Thus the union sets the wage that maximizes its objective function subject to the employer's demand for labour function. According to the EBM the union and employer choose an efficient combination of wages and employment that lies on their contract curve. Considerable effort has been devoted to determining which of the two models of wage and employment determination is more relevant empirically for unionized industries. This includes the work of Abowd (1989), Brown and Ashenfelter (1986), Card (1986), Eberts and Stone (1986), MaCurdy and

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Pencavel (1986), and Martinello (1989). The results, however, have not been conclusive.

The strengths and weaknesses of the two models are well known (see, for example, Farber 1986, Oswald 1985 or MaCurdy and Pencavel 1986 for excellent analyses of the models). The major weakness of the MM is that its outcome is inefficient. There exist wage and employment combinations that leave both the union and employer better off than the outcome of the MM.<sup>1</sup> The major strength of the MM is that it conforms to the conventional wisdom about how wages and employment are determined in unionized industries: unions negotiate wages, but employers choose the level of employment unilaterally subject to those wages.<sup>2</sup> The wage employment outcomes of the EBM are efficient and this is the major strength of the EBM. The EBM's major weakness is that nobody is sure how the efficient outcomes are reached or supported.

To achieve an efficient wage employment combination, employers must hire more labour than the amount that maximizes profits at that wage. Thus the union must exercise some influence over the level of employment to force the employer to hire more labour than they otherwise would. The simplest and most straightforward way is to negotiate the level of employment directly. In fact, it is often stated that efficient outcomes cannot be supported unless levels of wages *and* employment are negotiated.<sup>3</sup> As noted above, however, unions do not exercise any direct control over employment. Employers generally choose employment unilaterally, albeit subject to the procedural rules for hiring, layoffs, transfers and promotions outlined in the collective agreement. There are exceptions of course. Productivity agreements,

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1 This is true as long as the union is not indifferent to marginal changes in the level of employment. Theoretical models which suggest that the union is indifferent to marginal changes in employment do exist (see, for example, Oswald 1987). However empirical work on union preferences suggests that unions are not indifferent to changes in employment (see, for example, Carruth, Oswald and Findlay 1986, Dertouzos and Pencavel 1981, or Martinello 1989). Further, unions commonly negotiate job security provisions, severance pay provisions, restrictions on contracting out, and technical change provisions in their collective agreements; even in industries that are not facing major decreases in employment. Unions would not place such a high priority on negotiating these types of provisions if they were indifferent to the employment of the marginal worker.

2 The MM actually specifies that the union sets the wage unilaterally, and then the employer chooses employment. The "right to manage" model (Nickell and Andrews 1983) conforms much more closely to actual practice since it specifies that unions and employers negotiate the wage and then employers choose employment unilaterally, subject to the negotiated wage. For the purposes of this paper, however, the difference is not important.

3 For example, Oswald writes "In the efficient bargain model the union must negotiate over employment levels..." (1985:173). Farber writes: "The conclusion is that bargaining over both wages and employment is a necessary but not sufficient condition for an efficient labor contract" (1986:1052).

job security provisions, job restrictions, manning requirements and other work rules do affect employment. However, the influence of these provisions is usually limited and indirect. Moreover, Johnson (1990) and Clark (1990) show that the most common sorts of work rules (restrictions on the capital labour ratio, featherbedding, and restrictions on the intensity of the work effort) are not sufficient to achieve efficient outcomes, except in special cases.

Thus one model is consistent with the observed method of wage and employment determination in unionized industries, but it predicts inefficient outcomes. The other model predicts efficient outcomes but it requires some union control over employment that is not observed. This paper shows that bargaining over employment is not necessary for the achievement of efficient contracts. Efficient outcomes can be reached and supported if the average rate of compensation varies with employment. The seniority clauses found in most collective agreements cause the rate of compensation to vary with employment. Specifically, (1) layoffs and recalls done according to seniority, and (2) benefit seniority provisions, where senior workers receive larger compensation or fringe benefits (eg. longer vacations), are sufficient to cause the average rate of compensation to vary with employment. Thus common seniority provisions allow unions and employers to reach efficient outcomes even though employers choose employment unilaterally.

While these results are found elsewhere, they are presented in models that are quite different from the standard textbook models of unions, and from the models specified for empirical work on unions.<sup>4</sup> This paper shows the results within a more conventional model of unions. My intention is to make these results more easily accessible to other researchers. A modest generalization of these symmetric information results is also provided since fairly general union preferences are specified, and an arbitrary number of workers is allowed.

However, my main intention is to point out an apparently unrecognized implication of the above mentioned results for the current debate over the relative merits of the MM and EBM models of unions. Since the seniority provisions allow unions and firms to support efficient outcomes without bargaining over employment, and since most collective agreements contain these seniority provisions, the distinction between the monopoly models and efficient bargain models is overstated and not an important empirical issue. Given the usual

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4 The results can be found in Hall and Lilien (1979), Kuhn and Robert (1989) and implicitly in Kuhn (1988). Hall and Lilien's (1979) work, for example, is specified in total compensation-employment space rather than the usual wage employment space. Perhaps that is why their result for efficient contracts (given no uncertainty) has had so little impact on the debate over the MM versus the EBM.

assumptions of the MM and EBM, unions and firms can use these seniority provisions to reach efficient outcomes without any bargaining over employment. Thus, wage and employment outcomes will be efficient and off of the firm's conventional labour demand curve even though firms choose employment unilaterally.

A clear implication of this analysis is that the seniority provisions are endogenous. The seniority clauses are negotiated by the bargainers to exploit all possible gains from trade.

### THE MODEL: EQUAL COMPENSATION PAID TO ALL WORKERS

Consider the North American norm of one union and one firm (or establishment) negotiating a collective agreement that covers the workers of only that firm. For simplicity, let the firm hire only one occupation, let the workers be homogeneous with respect to their productivity, and assume that there is no uncertainty or asymmetric information. The collective agreement covers every worker in the firm whether they are union members or not (also the North American norm), every worker works the same number of hours, and every worker receives the same wage. Assume that there are no fringe benefits or other benefit seniority provisions. Thus the average compensation per worker ( $v$ ) is constant for all levels of employment and equal to the wage ( $w$ ). Layoffs and recalls may be done according to seniority, but it makes no difference to the firm since all workers are equally productive and paid the same amount.

The employer's goal is to maximize profits. Given conventional assumptions about the technology and the output market, the marginal revenue product of labour is a decreasing function of employment (so that the demand for labour is downward sloping) and the isoprofit curves look like curves  $p_1$ ,  $p_2$ , and  $p_3$  in Figure 1. The isoprofit curves show the combinations of average compensation per worker ( $v$ ) and employment ( $N$ ) that yield the same level of profit to the employer. Lower isoprofit curves correspond to higher profit levels. All isoprofit curves reach a maximum where they intersect the demand for labour curve ( $d$ ), because, for any constant average rate of compensation, the demand curve shows the level of employment that maximizes profits and puts the firm on the lowest isoprofit curve. For example, if the wage is  $w_1$  then average compensation per worker is constant for all levels of employment and equal to  $w_1$ . Figure 1 shows that, given  $w_1$ , the firm maximizes profits by hiring  $N_1$  workers.  $N_1$  puts the firm on the lowest possible isoprofit curve subject to the constant average compensation per worker. Note that the

same level of profit obtains if (for some reason)  $N_2$  workers are hired at a wage of  $w_2$ .

Figure 1  
Firm Isoprofit Curves

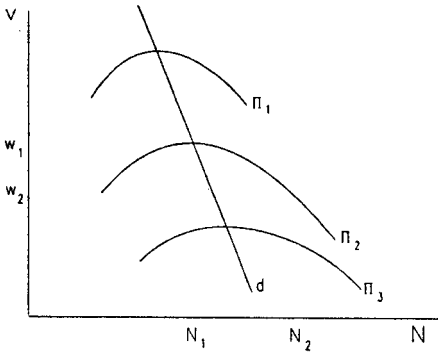
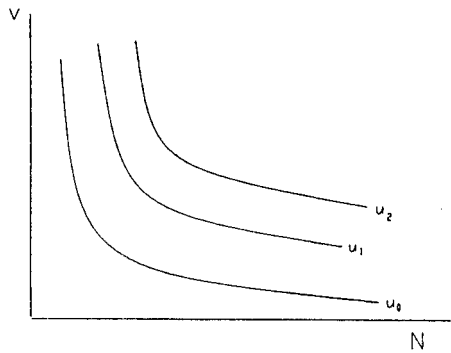


Figure 2  
Union Indifference Curves



Assume that the union's preferences over average compensation per worker ( $v$ ) and employment ( $N$ ) can be described by indifference curves that look like those shown in Figure 2. The indifference curves imply that for a constant  $v$  the union prefers more employment to less, and that for a constant  $N$  the union prefers higher average compensation per worker to lower average compensation per worker. Thus, combinations of  $v$  and  $N$  on higher indifference curves are preferred to those on lower indifference curves. The indifference curves also imply that the union is willing to trade average compensation for employment and vice versa, and that the rate of trade varies along an indifference curve.<sup>5</sup>

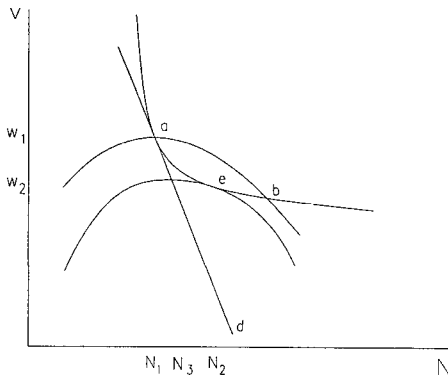
Figure 3 puts the union indifference curves and firm isoprofit curves together. According to the monopoly model the union chooses a wage like wage  $w_1$  (in Figure 3) since it puts the union on the highest possible indifference curve given the demand for labour.<sup>6</sup> The firm then chooses

5 The convex indifference curves shown in Figure 2 occur if and only if the union objective function that corresponds to the indifference curves is quasiconcave. Martinello (1989) estimates that union preferences are quasiconcave in an empirical investigation of the preferences of one union.

6 It makes no difference if we consider a right to manage type model where the union and firm negotiate a wage that is below  $w_1$ . All of the analysis follows in exactly the same way.

the level of employment unilaterally, in order to maximize its profits subject to the union wage.  $w_1$  is average compensation per worker for all levels of employment so the firm chooses  $N_1$  employment to maximize profits. The outcome  $w_1, N_1$  (point a) is inefficient because there exists average compensation employment outcomes (like point e) that are preferred by both the union and the firm. Indeed, all of the average compensation employment outcomes inside the lens delimited by points a and b are preferred to point a. Efficient outcomes realize all possible mutual gains and they occur at the tangencies of union indifference curves and firm isoprofit curves. Any efficient outcome (like point e) is unattainable if the firm chooses employment unilaterally subject to the wage set or negotiated by the union. For example, if the union sets wage  $w_2$  in order to attain the preferred point e, the firm would not employ  $N_2$  workers. It would employ  $N_3$  workers, since  $N_3$  yields the highest possible profits given  $w_2$ . Thus an inefficient outcome ( $w_2, N_3$ ) endures.

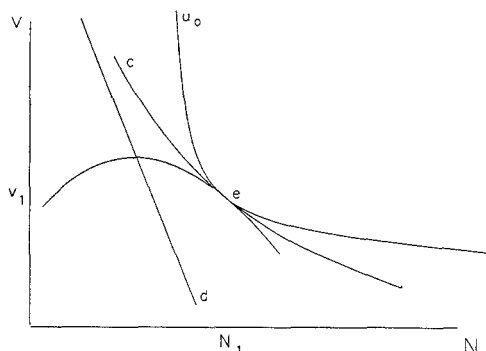
Figure 3  
Equal Compensation for all Workers



To reach an efficient outcome the level of employment must lie to the right of the demand for labour.<sup>7</sup> This cannot occur in the monopoly model because the firm chooses employment unilaterally subject to the wage. The firm always chooses the level of employment given by the demand for labour to maximize its profits. An efficient outcome can be achieved if the union negotiates both the wage and the level of employment.

7 See footnote 1.

Figure 4  
Supporting Efficient Outcomes



An efficient outcome like point  $e$  can be achieved by explicitly negotiating a wage equal to  $w_2$  and a level of employment equal to  $N_2$ . However, one does not observe unions negotiating levels of employment. Oswald (1987) and Oswald and Turnbull (1985) provide proof. Oswald mailed questionnaires to the sixty largest unions in the U.S. and Britain and he writes: "the survey suggests that trade unions do not normally negotiate over the total number of jobs. ... the employer seems to be seen, by both sides, as having the right to set employment unilaterally" (1987:9). Oswald (1987) goes on to write that there are exceptions. Oswald and Turnbull study British labour contracts and conclude: "unions do not bargain routinely about the level of total employment in their firm ... Except in special cases it is the employer who has the unilateral right to fix the total number of jobs" (1985:82).

For Canada, Swan (1982, p. 272) writes that "the involvement of unions in the hiring process has been, with a few minor and one major exception, negligible." Swan (1982) explains that the major exception is the operation of hiring halls by some construction unions. However even in that case, the union does not and cannot affect how many workers are hired by the employer. It only affects how those hires are allocated across union members. For the U.S., Kochan (1980: 357) writes that

security against permanent job loss is one benefit that unions and employers have not been able to underwrite to any large degree through private collective bargaining. ... The majority of unions have not been able to achieve protection against permanent job displacement through collective bargaining.

Management control over the number of hires and layoffs is usually specified explicitly in the management rights clauses found in most collective agreements. However even when there is no management rights clause, or the clause fails to explicitly grant management the right to



determine the level of employment, management may retain the legal right to determine employment unilaterally. This comes from the residual rights (or reserved rights) doctrine, which states that all rights not explicitly allocated in the collective agreement are retained by management.<sup>8</sup>

Thus, given the constant wage and no bargaining over employment, efficient outcomes to the right of the demand for labour are not attainable.

### EFFICIENT OUTCOMES WITHOUT BARGAINING OVER EMPLOYMENT

Now consider the case where the union negotiates two types of payments for the workers: a straight time wage ( $w$ ), and a fringe benefit payment ( $z$ ). Let  $z$  be independent of the worker's hours so that  $z$  is a quasi-fixed labour cost. The main components of  $z$  are time paid but not worked (i.e. vacation pay) and life, disability, and medical insurance premiums.<sup>9</sup> Assume that the union and firm negotiate seniority provisions to ensure that layoffs and rehires are done according to seniority.<sup>10</sup> Junior workers are laid off first and rehired last. Further, assume that the union and firm negotiate benefit seniority provisions so that total compensation rises with seniority. With only one occupation, let the union negotiate an hourly wage that is the same for all workers. However let the costs of payments for time paid but not worked and life

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8 To be fair, however, this doctrine is not accepted by all labour arbitrators. It appears to receive more support in Canada than in the U.S., but there is a divergence of opinion in both countries (see, for example, Kochan 1980:377-381, and Swan 1982:270-272).

9 *Employee Compensation in Canada* (1980) reports that in 1978 time paid but not worked accounted for almost 60% of negotiated fringe benefits in union firms. Life and health plans accounted for another 11%. Payroll taxes (eg. social security and unemployment insurance) can also be quasi-fixed costs since they have upper limits on the total contribution. However I abstract from them since they are not paid to the worker. Money purchase pension contributions are usually calculated as a percentage of earnings, so they can be folded into the wage. Defined benefit pension contributions may be quasi fixed depending on how they are calculated.

10 Seniority provisions ensuring that layoffs are done according to seniority are standard in most North American collective agreements. For the U.S. Freeman and Medoff (1984) report that 78% of all union contracts (89% in manufacturing) stipulate that seniority be the most important factor in permanent layoffs. Freeman and Medoff (1984) also report the results of a survey of managers in private, non-agricultural, non-construction firms regarding their actual layoff practices. 84% of the firms never lay off a senior worker in place of a junior worker. Another 14% lay off a senior worker in place of a junior worker only if the junior worker is believed to be worth significantly more on net. In Canada, Craig (1990) reports that in 1985, 80% of all contracts in large firms make seniority a criterion for layoffs while 75% use it for recalls.

and medical insurance increase with seniority.<sup>11,12</sup> Thus the quasi-fixed fringe benefit costs rise with seniority. Senior workers receive larger fringe benefit payments than junior workers and, therefore, higher total compensation.

Since senior workers are laid off last and recalled first, the average per worker cost of compensation falls as employment increases. For example, if employment increases the new junior workers are paid smaller fringes than the incumbent senior workers and the average cost per worker must fall. If employment decreases the low fringe workers are laid off while the high fringe senior workers remain. This causes the average cost per worker to increase. The differences in fringe benefits yield an average cost per worker curve (or compensation schedule) like curve *c* in Figure 4. Contrast *c* with the horizontal, constant average cost per worker schedules shown in Figures 1 and 3, where all workers receive the same wage and there are no fringes.

The firm still chooses employment unilaterally to maximize profits subject to the average compensation schedule. Thus the firm still chooses the level of employment that puts them on the lowest possible isoprofit curve subject to being on the average compensation schedule. Given schedule *c*, the firm chooses employment  $N_1$  to maximize profits. At  $N_1$  average compensation per worker is  $v_1$ , but the firm hires more labour than the amount shown by the demand for labour curve. The falling average cost of employing labour induces the firm to hire more labour than it would with a constant average cost of compensation. The firm hires more workers to take advantage of the falling labour costs. Thus an efficient outcome to the right of the demand for labour can be achieved by the appropriate choice of an average compensation schedule even though the firm chooses employment unilaterally. Figure 4 shows the efficient outcome *e* achieved by the compensation schedule *c*.

The details of the mathematics supporting the graphical analysis presented here are available from the author. In this more rigorous analysis, I also show that the results continue to hold when hours are variable and when the union cares about the inequality of compensation across senior and junior workers.

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11 Freeman and Medoff (1984) show that the value of vacation pay and life and medical insurance rises, as a percentage of wages, with the age of the worker. Since wages also rise with age, the dollar value of these fringes rises with the age of the worker.

12 It is clear that while vacation pay is explicitly linked to seniority and not age, the cost of life and health insurance depends on the age of the workers and not seniority. Thus the cost of the insurance premiums may not necessarily rise with seniority. This problem is solved if we assume (not unreasonably) that age and seniority are sufficiently correlated.

## CONCLUSION

To sum up, job restrictions or bargaining over employment are not necessary to reach efficient outcomes. Efficient wage, fringe and employment outcomes can be achieved and supported by compensation schedules where the average rate of compensation declines with employment. Although this result has been presented elsewhere, it has had little impact on the debates over whether contracts in unionized industries are efficient, and whether the MM or the EBM is the appropriate model (from an empirical point of view) of wage and employment determination in a unionized setting.

The result becomes more important to the debates once one recognizes that the layoff and benefit seniority provisions considered here are found in most collective agreements and that they should cause the average rate of compensation to decrease with employment. Thus unions and firms can reach efficient outcomes even though the firm chooses employment and hours unilaterally. This, in turn, means that the distinction and choice between the monopoly and efficient bargain models are much less important empirical issues than they previously appeared.

For empirical researchers this implies that the major reason for specifying the MM over the EBM (namely that employers appear to choose employment unilaterally) is no longer valid. Researchers can concentrate on models that yield efficient outcomes (given the usual assumptions of the models) since a mechanism by which those outcomes can be supported has been identified. At the same time the arguments of this paper call out for empirical research on the shape and characteristics of compensation schedules to validate the role that they play in supporting efficient outcomes.

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## ***La convention collective sans négociation du niveau d'emploi***

Dernièrement, la recherche a favorisé deux modèles de détermination des salaires et de l'emploi pour les industries syndiquées. Ces deux modèles sont, référant aux termes utilisés par Oswald (1985), le modèle monopolistique (MM) et le modèle d'ententes efficaces (MEE). Dans le MM, le syndicat fixe le salaire et l'employeur arrête un niveau d'emploi pouvant maximiser ses profits considérant le nouveau coût de main-d'œuvre, les autres coûts et les revenus. Ainsi, le syndicat décide du niveau de salaire rencontrant ses objectifs propres tout en tenant compte de la demande de travail de l'entreprise. Pour ce qui est du MEE, syndicat et direction s'entendent sur une combinaison de salaire et d'emploi et ce, conformément à leurs courbes d'offre ou de demande.

Le premier modèle tient sa faiblesse de son résultat non-assuré. Il existe, en effet, des combinaisons de salaire et d'emploi plus avantageuses pour les parties que celles émanant du MM. La force de ce dernier, par contre, est de se conformer au courant de pensée traditionnelle selon lequel les syndicats décident des salaires et les employeurs fixent unilatéralement le niveau d'emploi. Le second modèle, quant à lui, mène à ces ententes, mais n'explique pas comment ni pourquoi on arrive à de tels résultats.

Afin d'obtenir une combinaison de salaire et d'emploi efficaces, les entreprises doivent embaucher plus de travailleurs que la quantité maximisant leurs profits. Donc, le syndicat se doit de faire augmenter le niveau d'emploi. La façon la plus directe et la plus simple d'y arriver est de négocier l'emploi, bien qu'il s'agisse le plus souvent d'un droit de gérance.

Cet article démontre que négocier directement le niveau d'emploi n'est pas la seule voie à la sécurité. Il est possible de réaliser cet objectif si l'indemnisation varie en fonction du niveau d'emploi. Les clauses référant à la notion d'ancienneté que renferment la majorité des conventions collectives permettent une telle variation. Plus spécifiquement, des clauses prévoyant l'ancienneté 1) comme critère de mise à pied et de rappel au travail et 2) comme mécanisme de détermination salariale ou d'avantages sociaux suffisent à faire varier le taux compensation avec l'emploi. Ainsi, la plupart des dispositions touchant à l'ancienneté permettent aux deux parties de conclure une entente sûre même si l'employeur décide unilatéralement du niveau d'emploi.

Ceci revêt une grande importance dans le débat actuel sur le mérite relatif des deux modèles quant au comportement des syndicats. Considérant que les avantages acquis par ancienneté permettent d'en arriver à des garanties et qu'une majorité des conventions collectives prévoient de telles dispositions, la distinction entre le MM et le MEE s'avère exagérée et devient une question empirique secondaire. Ayant rappelé les présomptions connues du modèle monopolistique et du modèle d'ententes efficaces, syndicats et employeurs peuvent recourir à des avantages reposant sur l'ancienneté pour arriver à une sécurité contractuelle sans avoir à négocier le plancher d'emploi. Ainsi, les conséquences du niveau de salaire et de celui de l'emploi seraient assurées et absentes de la courbe de demande de l'entreprise bien que cette dernière détermine seule l'emploi.