The Politics of Common Knowledge: Ideas and Institutional Change in Wage Bargaining

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Abstract Domestic economic institutions change through processes of conflict and bargaining. Why do the strongest groups in such conflicts ever change their minds about the acceptability of institutional arrangements they once opposed? Drawing on the cases of Ireland in 1986–87 and Italy in 1989–93, this article demonstrates how the process of common knowledge creation between employers and unions changed the course of negotiations over national wage bargaining institutions. Common knowledge creation happens when existing institutions are in crisis. The institutional experimentation that follows such crises, characterized by deep uncertainty, places a premium on persuasive argument. The ideas most likely to serve as the basis for newly common knowledge will have analytical and distributive appeal to both unions and employers, and they must be ratified in public agreements, which I call common knowledge events. Common knowledge events establish new social facts, which can change the payoffs associated with different institutional outcomes. This can lead even powerful actors to accept institutions they had previously opposed.

When the facts change, I change my mind. What do you do, sir?
—John Maynard Keynes

In 1987 Irish employers agreed to the adoption of centralized wage bargaining, an institutional innovation they had previously resisted strenuously.[1] In 1993 Italian employers accepted a nationally coordinated bargaining system that officially allowed firm-level bargaining, which they had previously rejected categorically as an unacceptable institutional arrangement.[2] Irish and Italian employers were the

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1. See Hardiman 1988; and Roche 1994.
2. Trentin 1994.

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strongest actors in these negotiations, and the ones initially most capable of walking away from an agreement. Why did these organized employers agree to fundamental institutional changes they had previously opposed?

Rationalist political scientists emphasize that the changes of mind exhibited by Irish and Italian organized employers must result from a change in their strategic situation, not a change in their underlying material preferences.[3] Constructivist scholars like to highlight such changes of mind as evidence of the ways in which shared understandings—whether about norms[4] or about the social content of identities[5]—mediate the guileful strategic interactions assumed by rationalists. In this article I demonstrate that the establishment of common knowledge facilitates moves to more coordinated institutions, as rationalists have shown;[6] at the same time, it can fundamentally change the character of bargaining by virtue of its intersubjectivity, as constructivists contend.[7] Other scholars have identified common knowledge as a potential point of tangency between these two approaches to politics.[8] The signal contributions of this article are to delineate the process of common knowledge creation and to show, empirically, how common knowledge can change both the institutional preference orderings and bargaining leverage of social actors. The creation of new common knowledge alters socially agreed facts about the character of the economy and the consequent motivations of the bargaining parties. When social facts such as these change, as Keynes observed, so too can opinions about the relative appeal of different sorts of economic institutions.

Over the past twenty years, Ireland and Italy are two of a number of European countries that have used social pacts to attempt to move from disorganized, conflictual bargaining institutions toward the sort of coordinated arrangements characteristic of the "small states in world markets" described by Katzenstein.[9] Unlike in most of these countries, though, the Irish and Italian social pacts actually led to durable moves to more highly coordinated wage bargaining institutions. Social pacts are centralized agreements among governments, unions, and employers' associations that trade off government reforms of fiscal and labor market policy for wage moderation from employers and unions. Such pacts typically emerge from coalitions between weak governments facing economic crisis and battered union federations confronting membership losses, and they have rarely led to long-term

3. For example, Clark 1998. Rationalists stress that a change in preferences over institutional outcomes means a change in "induced preferences over strategies of how to achieve basic ends" (Weingast 2005, 162), rather than any change in fundamental material preferences. The term *institutional preferences* as used throughout this article refers to preferences over institutional outcomes, not to fundamental preferences. See Hall 2005, 131–32 for a critique of this binary distinction.

4. See Finnemore 1996; Finnemore and Sikkink 1998; and Schimmelfennig 2001.

5. See Ruggie 1998; Wendt 1999; and Bially Mattern 2005 for different constructivist approaches to the politics of identity.

6. Chwe 2001.

7. Wendt 1999.

8. Katzenstein, Keohane, and Krasner 1998, 680–82.

9. Katzenstein 1985; on social pacts, see Visser and Hemerijck 1997; and Regini 2000.

institutional changes in domestic economies.[10] In the conclusion I show how the process of common knowledge creation has implications well beyond Ireland and Italy. In countries that confront the challenge of adjusting to international market competition—and most countries today face this challenge—the ability to adopt economic institutions of nonmarket coordination depends to some extent on the ability to establish agreement over the potential gains to such coordination.

The political act of creating common knowledge between rival social groups has much in common with processes of persuasion studied by constructivist scholars of international institutions.[11] The approach to persuasion developed in this article gives primacy to the use of reasoned argument about cause and effect in a context of shared experience.[12] Unions and employers will shift their shared models of the economy—both their causal models of its functioning and their beliefs about the motivations of the other bargaining partner—only when their existing model has shown itself to be flawed, usually through a period of economic crisis or stagnation. They find themselves, therefore, in a period of institutional experimentation, and the uncertainty endemic to such periods influences the sort of ideas that can emerge as the new basis of shared economic understandings between them. The ideas most likely to form the basis of new shared understandings will be those that have analytical and distributive appeal to both parties: they will respond to the failures of the preexisting institutions, but they will also yield potential benefits for unions as for employers. The act of collective interpretation of shared experience is thus firmly anchored in the material preferences of these competing actors, even as it is governed by the cognitive search for solutions to real-world problems.[13]

The emergence of shared ideas in a highly contested area such as wage bargaining must be ratified in public agreements, which I call *common knowledge events*. Sewell proposed the "event" concept to describe "that relatively rare subclass of happenings that significantly transform structures."[14] Common knowledge events transform the structure of wage bargaining by resetting the shared frames of reference of the bargaining parties. Each party is saying that the economy works in a certain way, and each knows that the other knows this. In the cases studied here, unions adopted views of the economy that changed their expected bargaining behavior, moving them closer to the views publicly stated by employers. But, in so doing, their change of view changed the value of institutional outcomes to organized employers. Moreover, the continued uncertainty characteristic of periods of institutional experimentation creates a bargaining context in which the logic of arguing, as Risse[15] calls it, constrains the logic of

10. See Rhodes 1998; and Baccaro and Lim 2007.
11. See Finnemore 1996; Risse 2000; and Schimmelfennig 2001.
12. Hall 1993 and 2005.
13. See Aoki 2001, 239–44; and Hall 2005.
14. Sewell 1996, 262.
15. Risse 2000.

consequentialism. The ability of employers to achieve their most preferred institutional outcome is undermined when that preferred outcome cannot be justified by reference to the newly established common knowledge about how the economy works and the role of unions within it.

I develop these propositions about the process of common knowledge formation in the following two sections before examining them empirically in the episodes of wage-bargaining negotiation in Ireland (1986–87) and Italy (1989–93). In both countries, union and employer bargaining at the beginning of the period was conflictual and decentralized.[16] The major union confederations in each country employed models of the economy that placed the maintenance of the domestic purchasing power of workers as the paramount consideration, while organized employers held very different views. This incompatibility of economic perspectives had subverted previous attempts to introduce coordinated wage bargaining.[17] In the first instance, as I show below, employers succeeded in arriving at a public statement of common knowledge that broke with previous union interpretations and shifted the agreed model of the economy to one that took inflation as the main constraint on international competitiveness. This event, though, led to changes in wage bargaining institutions that employers had previously rejected out of hand. Union acceptance of a new set of common understandings increased the value of negotiated agreement relative to a breakdown of negotiation, thus changing employers' ranking of institutional preferences. In the wake of common knowledge events, they also possessed few persuasive arguments in favor of their most preferred institutional alternatives.

Common Knowledge Creation and Institutional Change

Common knowledge does not mean that you and I each know that a given ball is blue. It means that one knows that the other knows the ball is blue, and that the other knows that the other knows the ball is blue, and so forth.[18] As such, common knowledge is intersubjective, confronting "actors as an objective social fact that cannot be individually wished away."[19] Wendt identifies what is constraining about common knowledge even within the rationalist paradigm: its invulnerability to unilateral change. It is exactly this sort of intersubjectivity—which is to say, one based on methodological individualism and rooted in individual intentionality—that underlies my analysis.

Most constructivists, including Wendt, have a much more expansive conception of the influence of shared ideas on social action. Searle identifies this dis-

16. Baccaro 2003.
17. See Roche 1994; and Locke and Baccaro 1996.
18. Geanakoplos 1992.
19. Wendt 1999, 161.

tinction as separating individual from collective intentionality. Collective intentionality cannot be reduced to individual intentionality, because under it, "I intend only as part of our intending."[20] "So if I am an offensive lineman playing in a football game, I might be blocking the defensive end, but I am blocking only as part of our executing a pass play."[21] Ruggie uses Searle's distinction to show that rationalist theories generally lack any "concept of constitutive rules," merely reducing all struggle to bargaining between actors with preconstituted interests.[22] Ruggie's constructivist alternative focuses attention on the many components of identity that are mutable, showing that the preferences of countries change when those identities change.

The approach I take in this article is different. I demonstrate that even on the assumption of individual intentionality, the establishment of common knowledge still affects the ordering of favored institutional outcomes and has an independent impact on the bargaining power of actors. When the negotiating parties representing employers and unions jointly accept certain features of the economy as being correct, this common knowledge influences their future options. Because it is out of their individual control, it can result in their adopting institutional outcomes that they once denounced.

In wage bargaining, as in other institutions of the economy, the process of institutional change can usefully be divided into three distinct stages: crisis, experimentation, and consolidation.[23] The problem of common knowledge creation in wage bargaining is that the representatives of unions and employers need to agree on a convergent diagnosis of the economy and some of the features of the solution to that problem. In normal times, these models of the economy are not easily called into question. Common knowledge creation happens only after periods of institutional crisis, once the "the taken-for-grantedness of the old institution [is] called into question" by a wide number of players.[24] Crisis—initiated by declining performance and often by unilateral defection of former players of the game—destabilizes the cognitive basis of existing institutions. This stage leads to second-phase institutional experimentation, which is highly tentative and marked by uncertainty over the distributive outcomes of any new institutional choice. The third stage, institutional consolidation, occurs only after a new institution emerges, and actors are convinced that their new cognitive model convincingly predicts the behavior of others. After consolidation, in other words, actors go back to "taking for granted" the game they are playing.[25]

20. Searle 1995, 26.
21. Ibid., 23.
22. Ruggie 1998, 871.
23. See Aoki 2001; Culpepper 2005, 180–4.
24. Aoki 2001, 241.
25. Ibid., 242–43. A rationalist approach typically emphasizes the coordinative side of institutional "taken for grantedness." Adler's constructivist approach emphasizes instead the importance of legitimacy in the process of how institutions come to be taken for granted. See Adler 2005, 105–9.

The analytical utility of disaggregating the process of institutional change into three stages is to highlight the preeminence of uncertainty during the second stage: that of institutional experimentation. Compelling recent accounts of institutional change emphasize that actors in such cases have material preferences that they pursue through processes of political change.[26] These same accounts show, however, that the process of change is heavily influenced by the uncertainty of the players. How to reconcile these stable material preferences with the pervasive uncertainty characteristic of institutional experimentation is a major challenge for theories of institutional change. The first stage of change, that of institutional crisis, lays bare the fact that existing ways of thinking have a declining ability to predict the outcomes of joint interactions. As Blyth argues, ideas during this phase are often used instrumentally, as weapons to delegitimize existing institutions.[27] Once that stage of upsetting existing institutions has succeeded, though, social actors enter a terrain of more substantial uncertainty, where their material preferences may be stable but their cognitive grasp on the world is not.[28] Although each player has some prior beliefs about what sort of institutions he or she would prefer, these beliefs are less than fully confident. There is a real game of figuring what is going on in the world after the onset of institutional crisis, and it is one in which distributional considerations are prominent but inexact guides to action. Once institutions are consolidated, in the third stage of change, distributive considerations reassert their primacy in short-term negotiation. The players will have agreed on the game they are playing, and they can go back to figuring out the best strategy for getting what they want through those new institutions.

Common knowledge creation, if it happens at all, takes place during the period of institutional experimentation, and the process of persuasion is central to it. During this phase, agreement between the actors emerges from the interplay of their well-defined preferences and their heightened uncertainty about some features of the world they inhabit. This is a point on which rationalists and constructivists remain far apart, analytically. For rationalists such as Weingast, the politics of persuasion is only about Bayesian updating: faced with uncertainty, "events beyond the direct control of the political entrepreneurs advocating the new idea help confirm the entrepreneur's views."[29] It is doubtless correct that evidence in favor of new ideas helps to dislodge previously dominant ideas. Yet constructivists remain skeptical that rationalists can understand by persuasion anything more than informational updating.[30] In their view, evidence is impossible to evaluate without a clear interpretive frame.[31] In short, rationalists see persuasion as an individual process of updating, not a process of establishing shared expectations;

26. See Culpepper 2003; Campbell 2004; and Hall 2005.
27. Blyth 2001.
28. Beckert 1996, 819.
29. Weingast 2005, 163.
30. See Finnemore 1996, 141; Finnemore and Sikkink 1998, 914; and Ruggie 1998, 868–69.
31. Blyth 2002, 38.

constructivists tend to see it as a constitutive activity that fundamentally changes worldviews if it changes any views at all. Between these two extremes there is fruitful but unexplored analytical space for understanding how individuals change their minds when trying to establish new institutions.

During the period of institutional experimentation, I posit that economic actors have some idea of the distributive consequences of any given institutional choice, but the uncertainty characteristic of institutional experimentation creates its own dynamic, such that neither is in complete control of the direction of the conversation. With both actors somewhat uncertain about the consequences of all potential solutions, the course of their argument is unpredictable; the victorious ideas are not simply those instrumentally deployed by the strongest actor. Instead, the uncertainty of experimentation increases the relative importance of Risse's logic of arguing over the logic of consequentialism.[32] The ideas that are likely to form the basis of common knowledge are those that can win the argument. Until new institutions are consolidated—that is, until new rules of the game are established and accepted by all major players, dispersing the cloud of uncertainty that permeates periods of experimentation—all actors are constrained by the analytical strictures of the logic of arguing.

Winning ideas are selected through a process of winnowing. Both actors want to set the new shared understandings in a way that favors them. Winning ideas will have two features: they will respond to the most salient features of an old dilemma, and they will have crossover appeal to both negotiating partners. As Hall argued about Keynesian ideas, "the persuasiveness of economic ideas depends, in part at least, on the way those ideas relate to the economic and political problems of the day. In other words, persuasiveness is an inherently relational concept, determined as much by the shape of current economic and political circumstances as by the shape of the ideas themselves."[33] During processes of institutional experimentation, the ideas most likely to emerge as common knowledge are those that can simultaneously explain the emergence of crisis and offer a way to overcome the previous institutional failure. Moreover, the most persuasive ideas are those that have appeal, politically, to both sides of the conflict. Ideas that do not hold out any promise for a win-win situation are unlikely to convince both actors of the potential value of coordinated action.

I have highlighted that there are clear differences between the approach to ideational emergence taken in this article and those employed by prominent constructivists. It is important to note, too, the significant differences between this approach and other rationalist approaches to this topic. Notably, I do not follow the approach of Garrett and Weingast in conceptualizing ideas as constructed focal points.[34] Schelling made the foundational insight about focal points when he argued that, in

32. Risse 2000.
33. Hall 1989, 369–70.
34. Garrett and Weingast 1993.

the presence of multiple equilibria, the result of bargaining over institutions "may not be so much conspicuously fair or conspicuously in balance with estimated bargaining power as just plain 'conspicuous.' "[35] Garrett and Weingast claim that the principle of mutual recognition laid down by the European Court of Justice was a focal point around which member-states interested in liberalizing trade could converge. Although their argument is innovative, it barely scratches the surface of the ways in which ideas can influence actors' preferences over institutions (again, holding fundamental preferences constant).

A focal point is an institutional solution on which actors interested in coordination, but uncertain how to achieve it, converge. Common knowledge, I will argue, plays a more substantial role in resolving the uncertainty of institutional experimentation. Among competing actors, common knowledge establishes certain assumptions of the world, including their organizational roles in it, as a shared fact. Prior to the establishment of such common knowledge, there is no clear mutual interest in a coordinated solution, because the assumptions of the game being played and the payoffs to different choices are unclear. Focal points are meaningless in the absence of common knowledge of the game being played. Common knowledge events reset shared expectations, creating the potential for gains from coordination that make focal points possible.

Schelling's insight about the importance of conspicuousness in situations of uncertainty remains important. The characteristic of conspicuousness matters for the selection of ideas because of its ability—established post hoc—to crowd out alternatives. What the representatives of employers' associations and unions like to do is bargain about wages, not argue about the world they inhabit. These interest-driven but uncertain actors will therefore gravitate quickly to solutions that allow them to resolve their shared uncertainty and get back to the game of bargaining. Writing about American politics, Kingdon distinguished between how ideas acquire support in the community of policy experts and with politicians: the first process is governed by persuasion, the second by bargaining. What is distinctive about processes of institutional experimentation in the economy is that the social actors play both roles; the "policy experts" are also the same social actors who must agree.[36] Just as in Washington's beltway politics, bandwagons build up behind ideas in the bargaining process. The character of bandwagoning during the phase of institutional experimentation is such that when an idea satisfies the criteria of fit with current problems and appeal to both actors in the negotiation, it can rapidly crowd

35. Schelling 1960, 69.

36. This is the reason that epistemic communities—groups of experts "with an authoritative claim to policy-relevant knowledge" (Haas 1992, 3)—are not central players in processes of common knowledge formation. Ideas emerge as winning ideas not because authoritative experts say they are the right ideas, but because each actor considers the ideas against the evidence available to them and decides on their plausibility as well as their fit with existing interests. Once potential ideas emerge, however, epistemic communities may play the role of honest brokers as social actors debate the implications of alternative arrangements.

out other ideas. Such ideas emerge from the process of discussion: that is, almost literally from nowhere. The winning ideas are not likely to be the long-defended ideas of one or another social actor, as in Blyth's metaphor of ideas as weapons. Once it becomes clear that they meet the two criteria adduced above, they can rapidly become the only plausible alternative conception of the world.

How Common Knowledge Events Influence Strategic Interaction

Observing how ideas become shared is much like watching grass grow: nothing seems to be happening in the short term, but one day a former patch of mud is suddenly green. The empirical marker of common knowledge creation is the moment when unions and employers step back and agree, publicly and mutually, that what has emerged from the mud is a lawn. Following the work of Sewell,[37] I call this moment of mutual recognition an event. Common knowledge events reset the shared ideas that both bargaining parties recognize as their cognitive maps of the economy. Once these common understandings are publicly agreed and ratified by competing actors, they crystallize the future terms of debate by clarifying the potential gains from coordination. It is the post hoc constraining nature of these events that sets them apart from the routine agreements signed all the time between employers and unions: what once was up for grabs is now settled, and that changes the character of subsequent bargaining.

What are the empirical consequences of a common knowledge event? A common knowledge event tells each actor what the other actor knows about the way the economy works and the role of the social actors in it. Common knowledge thus creates social facts, and these facts can alter the payoff structures facing bargaining parties. If the economic worldview established through the event is one in which there is a gain to coordination—that is, to a bargained agreement—then the relative appeal of the best alternative to a negotiated agreement declines. Prior to the event, at least one of the partners was not publicly sold on the value of coordinated institutions. When the common knowledge event establishes those benefits with clarity, the partner reluctant to sign a deal based on these principles suddenly realizes there is more to lose by walking away from the bargaining table than by signing an imperfect deal.

In the empirical cases explored below, I show that the ideas eventually accepted by the two bargaining partners as the new reality—their new common knowledge—involved recognition of the goal of international wage competitiveness as central to wage bargaining. In this respect, unions moved further in their views than did employers' associations, which had long clamored for a more internationally oriented process of bargaining. In each case, unions rejected the initial claims of

37. Sewell 1996.

employers over long periods of time. The ideas eventually established as common knowledge were not those originally fashioned by employers. They were narratives that connected the recognition of the actors that they operated in an open economy to a changed perception of the role of organized bargainers in that economy.[38] While organized employers achieved their objective of moving unions to a bargaining model based on an open economy, in doing so they accepted this new formulation as common knowledge.

TABLE 1. *Employers' institutional preferences—pre-common knowledge*

Ireland 1986
Decentralized bargaining > Public coordinated, private decentralized > Centralized bargaining
Italy 1992
Sectorally coordinated bargaining > Decentralized bargaining > Sectoral + Firm-level bargaining

Like most hard-bitten rationalists, the representatives of employers' groups probably believed these agreements were nothing more than public declarations that would not affect their freedom of maneuver in future negotiations with unions. However, the narratives articulated in those agreements included assumptions about the reliability of unions as bargaining partners. This changed the way these employers thought about the value of coordinated outcomes. As depicted in Table 1, prior to the establishment of common knowledge in 1986, centralized bargaining was the least preferred institutional alternative for organized employers in Ireland, who feared wage drift would erode nationally bargained restraint.[39] Employers in Italy preferred to allow no firm-level component to sectorally coordinated bargaining arrangements for the same reason: the threat of firm-bargained wage drift undoing sectorally bargained wage restraint.[40] Before these common knowledge events, continued decentralized bargaining was the most likely outcome in Ireland, where it was the most preferred alternative of employers; and it was also a plausible outcome in Italy, where unions were dead-set against the employers' most preferred option of sectorally coordinated bargaining without firm-level supplementary bargaining.

Common knowledge events in the two countries established a shared set of ideas as true. One of those ideas was that unions were committed to wage restraint in pursuit of competitiveness, and both sides knew that both sides knew this. By tying unions to a bargaining norm based on international competitiveness, the common knowledge event increased the appeal to employers of a set of bargain-

38. See Hall (2005, 135–37), for a discussion of how narratives link past experiences to present institutional preferences.
39. Roche 1994.
40. Pérez 2000.

ing institutions—their least favored alternative in the pre-common knowledge ordering—relative to the alternatives (as illustrated in the revised institutional ranking in Table 2). Before the common knowledge event, they would have walked away rather than accept their worst alternative. After the event, the acceptance by unions of international wage competitiveness as the orienting idea of bargaining changed employers' preference orderings; enough employers were enticed by the possible prospects of coordinated negotiations over wage restraint that a failure to agree to some new institutions of coordinated bargaining had become more costly. The establishment of social facts through common knowledge changed their strategic situation.

TABLE 2. *Employers' institutional preferences—post-common knowledge*

Ireland 1987
Decentralized bargaining > Centralized bargaining > Public coordinated, private decentralized
Italy 1993
Sectorally coordinated bargaining > Sectoral + Firm-level bargaining > Decentralized bargaining

Recall that the common knowledge event does not establish new institutions; it merely establishes shared understandings with clarity. Thus, the actors are still in a period of institutional experimentation, which means that the logic of arguing still has weight in their negotiations over new institutional rules. This creates a second mechanism through which common knowledge events influence institutional negotiations. Actors are constrained, logically, by the fact that they share the same view of the economy. Their disagreements, like those of social scientists, become subject to empirical resolution rather than mired in ideological dispute. Unless negotiating in bad faith, institutional solutions they might not have favored previously become not only palatable—there becomes no plausible alternative to them. In the case of the institutional orderings of employers in the wake of the common knowledge event, employers lacked any plausible argument as to why their first-best arrangement should be preferred, if indeed unions agreed about the principle of wage restraint. Employers preferred their second-best option to no negotiated agreement, and their reasons for opposition—distrust of the bargaining behavior of unions—no longer made sense according to the shared view established in the common knowledge event.

Even if one accepts the logic of argument up to this point, there is a potential objection to my claim that by signing up to new institutions, employers were in some sense constraining themselves. Wage restraint is an empirically observable phenomenon, so why could employers not conditionally agree to their second-best option but reverse their decision if it turned out later that unions really did not exercise wage restraint? In the long run, surely, this is exactly what employers would do: absent wage restraint, they would withdraw from the new bargaining institutions. But this sort of objection ignores the periodization of institutional change discussed in the previous section. Having reconsolidated institutions—that is, having returned to a world in which the basic shared expectations and rules of the game are taken for granted—neither employer nor union leaders will rush to return to the uncertainty of institutional experimentation. Although wage bargainers are constantly arguing, they are not constantly arguing about the institutions of wage bargaining. They would rather argue about wages and working conditions. One of the robust findings from the common pool resource dilemmas studied by Ostrom is that individuals would rather use punishment within an existing set of coordinating institutions than eliminate the transgressor from further potential cooperative possibilities or destroy the institutions.[41] Social actors do not change institutions frequently, because institutions serve an important coordinative function, and coordinative institutions work best when they are taken for granted. Accepting a new set of wage bargaining institutions usually means accepting them for a period of years before revisiting their fundamental rules of operation. They are not discarded casually.

The next two sections consider these propositions in light of the empirical experiences of Ireland and Italy. The first part of each section explains the process by which ideas for common knowledge about the economy emerged in each country and identifies the common knowledge event. The precondition for the common knowledge that emerged in each case was the ability to solve cognitive puzzles created by the failures of old institutions. Yet winning ideas had not only to satisfy this condition, but also to provide crossover appeal to both parties. The second part of each section then shows how the common knowledge event led employers to agree to coordinated bargaining outcomes they had previously opposed, both by changing their expectations about the future bargaining behavior of unions while also rendering them unable to defend their first-best preferences with compelling arguments.

Institutional Change in Ireland

The dramatic change in Irish industrial relations institutions is now widely known, though how unlikely it seemed at the time has been lost in the glare of discussion of the startling rise of the Celtic Tiger.[42] The Program for National Recovery (PNR), signed in October 1987, moved Ireland to highly centralized bargaining institutions, shortly after British Prime Minister Margaret Thatcher had moved in the opposite direction in the neighboring United Kingdom. Both observers[43] and participants[44] have noted that the framework for this unlikely institutional change was hammered out in negotiations in the National Economic and Social Council

41. See Ostrom 1990 and 2005, 266–67.
42. See Hardiman 2002; and Ornston 2004.
43. Hardiman 2002.
44. O'Donnell 1998.

(NESC), whose final report, "A Strategy for Development, 1986–90," was published in November 1986. As summarized by Hardiman: "In this forum, employer and union leaders developed a shared analysis of the nature of the country's economic problems and the priorities that needed to be addressed. [The Strategy for Development] accepted that moderation in pay increases would be essential to improve [international] competitiveness and, thus, generate the necessary economic improvement, though it did not explicitly advocate an incomes policy."[45] How did this common knowledge emerge from the conflictual history of Irish industrial relations? How did the adoption of common knowledge influence the surprising choice to move to centralized wage bargaining institutions in 1987?

Institutional Experimentation and the NESC Paper

By the middle of the 1980s, employers and unions in Ireland both perceived existing institutions of industrial relations as broken: employers because they were not delivering the pay restraint they had hoped for, unions because the existing institutions marginalized them. Ireland had previously experimented with centralized bargaining institutions in the late 1970s, which had collapsed when private-sector employers repudiated them in 1981. Irish employers had withdrawn from centralized bargaining institutions because they disagreed with union leaders about the causes of high unemployment: employers attributed unemployment to excessive wage agreements, unions to deficient demand stimulus.[46] Given these divergent perspectives, Irish employers had judged decentralized bargaining a better way to achieve wage restraint. Yet decentralized bargaining had been only partially successful in this goal between 1981 and 1986. While wage growth and strikes declined during this time, wage gains in Ireland had continued to outpace inflation.[47] During the first half of the 1980s, Ireland moved from being a high-inflation to a low-inflation economy (20 percent in 1981 to 4 percent in 1986). Organized employers in this disinflationary environment were interested in resetting the wage expectations of workers across the economy, most colorfully illustrated in their set of advertisements showing Ireland as a runner that had slimmed down since 1981 but faced competition from international partners whose inflation was even lower.[48]

Union leaders publicly dismissed this view, claiming that the only plausible source of job creation was increased government spending, especially in capital investment and construction.[49] Union leaders specifically derided the view of employers that the private sector was the source of economic and job growth: "Experience showed that waiting for the private sector to take advantage of the

45. Hardiman 2002, 8.
46. Roche 1994, 170.
47. Ibid., 178.
48. *Irish Times*, 4 July 1986, 11, 18. The peak federation of Irish Trade Unions explicitly rejected the suggested trade-off of the FUE campaign; see *Irish Times*, 26 July 1986, 1.
49. *Irish Times*, 30 January 1986, 11.

improved economic environment and to create jobs would not work, certainly in the short term, [the ICTU said]. Improved public finances . . . had to be used to fund employment creation."[50] While decentralized bargaining had been disappointing for employers, it had been a disaster for Irish unions. Union leaders faced an organizational imperative to demonstrate their continued relevance to members in a context of decentralized bargaining, which had widened pay differentials and threatened internal solidarity.[51] The political landscape of high unemployment and the defeat of neighboring British unions by the Thatcher government also put pressure on union leaders to compromise.[52] The strategy pursued by the union movement included a call for a return to centralized bargaining, announced in the summer of 1986. Organized employers rejected this renewed overture.[53]

The employer vision—a strategy of economic recovery based on international competitiveness through wage restraint—had no appeal to union leaders. The union strategy based on high public-sector employment growth in a period of national indebtedness had no appeal to employers. Yet throughout 1986, these leaders were negotiating together with other interest groups through the National Economic and Social Council (NESC), an advisory body that had previously produced only short-term reports on economic and social policy. The chair of the NESC, Pádraig Ó hUiginn, pushed the social partners to abandon past NESC practice and instead to produce a medium-term report with a "comprehensive analysis of the challenges" facing the Irish economy.[54] Developing such an analysis required employers and unions to enunciate a shared view of the economy. The view they adopted in the report took as the heart of its analysis the fact that Ireland was a small, open economy whose employment prospects depended on the competitiveness of its tradeable sectors:

> What is crucial for the attainment of sustained economic growth in an economy such as Ireland's is the capacity of the internationally trading sectors to produce goods and services and to sell them competitively on export markets. . . . In the short-term this can be achieved by securing the maximum degree of cost-competitiveness and in the medium-term by defending competitive advantage while at the same time expanding the productive capacity of the economy.[55]

Moreover, the report committed union leaders and employers to a diagnosis that broke with the Irish unions' previously stated view of the sources of economic

50. *Irish Times*, 19 March 1986, 1.
51. Roche 1994, 178.
52. See Hardiman 1988, 221–25; and MacSharry 2000, 128–29.
53. See Roche 1994; and *Irish Times*, 3 May 1986, 7.
54. Ó hUiginn's stated concern was to develop a plan that dealt with high levels of government debt. There is little evidence available from negotiating participants, but it would appear that Ó hUiginn had no well-established views about the appropriate solution to conflicts between unions and employers. See MacSharry 2000, 124.
55. NESC 1986, 148.

growth: "those sectors of the economy which exclusively or predominantly serve the domestic market . . . cannot be regarded as independent sources of sustained economic growth. . . . Secondly, domestic demand cannot be regarded as an independent source of sustainable growth."[56] The NESC report represented the first public disavowal by union leaders of their previously stated position that deficient demand was the cause of low growth and unemployment.[57]

Yet the NESC report was not an outright union capitulation to the position of employers—that competitiveness depended on the private sector. Instead, the report publicly committed both sides to an economic interpretation that linked the sources of GNP growth to the traded sector. The NESC report thus enshrined what one might call a "small states in world markets" view of the economy.[58] Such a view clearly fit with the perceived economic needs of employers: that of inducing wage moderation and controlling the ratio of public debt to output. Yet it did so through a framework that also linked Ireland to those small states in which unions played a prominent role in economic governance: Austria, Sweden, and Norway. In a widely covered speech given at the end of 1986, union leader Bill Attley specifically praised the consensual industrial relations of these countries as models for the future of Ireland.[59]

For readers unfamiliar with the history of Ireland, it is worth pausing here to underline how unlikely it was that the Irish social partners in 1986 chose Austria, Sweden, and Norway as the cases to which they would compare themselves. Such a choice undermines two potential alternative explanations—one European, one materialist—for the content of the common view adopted through the NESC report. The claim that membership in the European Community (EC) was the driving force behind the Irish outcome is unsupported by any evidence. These comparison countries did not belong to the EC at the time, and the intellectual action in the Community in 1986 was in the movement toward a single market, not toward the building of centralized bargaining. There is no plausible causal chain linking Irish membership in Europe, which had been constant since 1973, to the rather sudden emergence of the "small state" common knowledge in Ireland in 1986. Certainly the material crisis profoundly influenced the negotiations, but it is implausible to claim that this country with high debt, high unemployment, and net emigration was "forced" by the crisis to compare itself to prosperous Sweden. If the crisis had "forced" the social partners to latch onto the most obvious available alterna-

56. Ibid., 147.
57. Roche 1994, 170.
58. Katzenstein 1985.
59. Hardiman 1988, 234. Peter Cassells, Assistant General Secretary of the peak association of Irish trade unions, summarized the changed union perspective after the return to centralized bargaining in 1987: "We took the view that the most acceptable models on which to base a Programme for National Recovery should be successful European countries such as Austria, Denmark, Finland, Norway, and Sweden. These countries have rejected the confrontationist approach of the New Right and have lower levels of unemployment than the United States or the United Kingdom"; *Irish Times*, 17 October 1987, 16.

tive model, that would surely have been its largest trading partner and neighbor, the United Kingdom.

Only through the lens of the theory of idea winnowing developed here is the Irish choice of the "small states" view easily comprehensible. Given the durably high level of unemployment, Irish employers were in a stronger position than unions, and so it was predictable that in the common knowledge event unions would move further toward the position of employers than vice versa. That shared position, though, was distinct from the one advocated by employers, which held no attraction to unions. Despite their labor market strength, employers were unable to impose that view unilaterally. The "small states" framing, engineered through the negotiations of the NESC, was the only one that linked a diagnosis of the current crisis with an ideational program that could draw support from both employers (who wanted to be internationally competitive and cut the deficit) and unions (who wanted to bolster their organizational role and cut unemployment).

The NESC report was nothing more than a statement of common views, and it was a statement without the formal power to bind anyone. The document, moreover, made no commitment to a particular set of wage bargaining institutions. As a common knowledge event, though, the publicly shared understandings it ratified would become pivotal to future negotiations over wage bargaining arrangements.

Employers and the Establishment of New Bargaining Institutions

After the NESC agreement in 1986, Irish trade union leaders made repeated public statements that they were willing to make a multiyear commitment to wage moderation as part of a national tripartite agreement covering social and economic policy reforms. As late as June 1987—eight months after the release of the NESC report—Irish employers reiterated their opposition to institutions of centralized bargaining.[60] Unions had no organizational capacity to force the hand of employers, and no exogenous shock suddenly weakened them. How then did the common knowledge event of the NESC report affect the calculus of employers, such that they eventually agreed to establish centralized bargaining in Ireland?

The shift of the position of Irish employers is attributable to two mechanisms. First, their institutional preference ordering was reshuffled by virtue of the adoption of the "small states in world markets" perspective of the NESC report. Prior to the report, centralized bargaining was the worst possible outcome for organized employers, because they had expected it would create substantial wage drift.[61] The NESC report though, had made centralized bargaining more attractive—since unions had publicly bought into the importance of coordinated wage restraint for international competition—while simultaneously making a public pay round from which

60. Hardiman 1988, 236–37.
61. MacSharry 2000, 126–27.

employers were excluded much less attractive. Why? Before the common knowledge event, employers would most likely have allowed public coordination while retaining decentralized bargaining for the private sector. However, in the NESC report they had acknowledged that the traded sector was the motor for the economy. If they had chosen exclusion from the pay negotiations, unions representing the private sector would clearly have taken the public-sector agreement as a floor from which they would bid up their own prices: since they were the productive motor of the economy—as agreed by employers in the NESC report—they could demand more than the public sector.[62] The common knowledge event had reversed the previously existing second-best and third-best outcomes for employers. It was better to be included in a bargaining round with the public sector than to be excluded and to be forced to bargain upward from the floor it established.[63]

In this way, the NESC report changed the evaluation of institutional outcomes from an employer perspective. It also undermined employers' credibility in arguing for decentralized bargaining in light of the new cooperative approach to policymaking that the NESC report had introduced. This point was publicly recognized by critics of the return to centralized bargaining within the Irish business community, after the signing of the PNR. The cooperative policymaking among the government, employers, and unions in the wake of the NESC report had made it increasingly implausible for organized employers to withdraw from a cooperative institutional solution: the leadership of organized employers "reached the stage where, if the present government sought their support in achieving something they considered important, they would have no real option but to grant it."[64] Or as the same business publication later asserted in its editorial condemning the agreement: "[I]t is little or no surprise that the employers' organisation, the Federated Union of Employers, was far from enthusiastic and in reality remained very much an unhappy onlooker in the whole proceedings."[65] The common knowledge event of 1986 had established as a shared fact that Ireland was a small open economy; given that socially recognized fact, organized employers had difficulty producing a reasoned argument that could convince other players why the country should stick to decentralized bargaining institutions.

Eighteen months prior to this institutional change, the agreement of employers was unforeseeable. In the absence of the agreed set of interpretations reached in the NESC report, it is unlikely that organized employers would have accepted centralized bargaining institutions in October 1987, as observed by leading schol-

62. Hardiman 1988, 237.

63. Union leader Peter Cassells, writing in the *Irish Times* after the agreement, made very clear that the PNR was a compromise, not a change of fundamental material preferences: "Employers are concerned about their profits, farmers with their own self-interest and trade unions with the interests of workers and their families, the unemployed and those on social welfare"; *Irish Times*, 17 October 1987, 16.

64. *Business and Finance*, 8 October 1987, 12.

65. *Business and Finance*, 15 October 1987, 1.

ars of the Irish political economy.[66] "It would be misleading to suggest that a return to centralized negotiation linking pay with other policy objectives was in any sense inevitable. . . .[T]he possibility of negotiating a new centralized pay agreement had emerged from discussions publicly conducted in the mid-1980s over how best to plan for medium-term economic recovery."[67] Without the event of the NESC report, the Fianna Fail government would most likely have negotiated a public-sector pay deal with the unions, while private-sector employers would have opted for their own decentralized firm-level negotiations. Having accepted the "small states in world markets" view of the Irish economy in the NESC report made centralized bargaining more appealing to employers than publicly coordinated bargaining from which they would be excluded. This commitment also weakened their ability in negotiations to convince others of the value of decentralized bargaining institutions. In a way their leaders had not anticipated, the NESC report made it difficult for organized employers to oppose the move to centralized bargaining.

Institutional Change in Italy

The central institution of Italian wage setting during the 1980s was the *scala mobile*—the wage escalator—which automatically increased wages in response to increases in inflation. Employers detested the *scala mobile* because it imposed wage increases that rendered them internationally uncompetitive; unions claimed that any other arrangement would undermine the purchasing power of workers, whose wages would not keep up with inflation.[68] With the Italian entry into the narrow bands of the European Monetary System (EMS) in 1990, companies lost the capacity to use devaluation to compensate for high wage increases. In 1989, even before the loss of the devaluation option, the peak association of Italian employers (Confindustria) had publicly signaled its intention to abandon the *scala mobile*. This triggered a period of institutional experimentation that culminated in the common knowledge event that marked the permanent end of the *scala mobile* in July 1992. However, the possible replacements for the system of the *scala mobile* were unclear; the adoption of the EMS and the power resources of the actors are indeterminate in predicting how the actors would choose among various potential bargaining regimes. The agreement on new institutions, reached in July, 1993, established national wage bargaining that included the possibility of firm-level bargaining. Employers had rejected this proposal as late as the summer of 1992. This section examines how employers and unions arrived at the shared understandings ratified in the July 1992 social pact, and then how those shared understandings influenced organized employers during negotiations over the institutional change of 1993.

66. See Roche 1994; O'Donnell 1998; and Hardiman 2002.
67. Hardiman 1988, 217.
68. Mania and Orioli 1993, 13–35.

Institutional Experimentation and the Rise of "Forecast Inflation"

Italian unions and employers sought different guarantees from any new institution that would replace the *scala mobile*: employers wanted to restrain inflation, while union leaders wanted to preserve the real incomes of their members. Given the new constraints imposed by the loss of exchange rate flexibility, each partner recognized that inflation was detrimental to international competitiveness, but they held different views about the sources of inflation. This difference came down to a set of beliefs about automatism and the sources of inflation in the Italian economy. From the perspective of employers, moving to coordinated institutions required a new norm of bargaining that would break the automatic link between past inflation and future pay demands from unions. Confindustria therefore sought to replace the *scala mobile* with national sectoral bargaining and to eliminate firm-level bargaining.[69] Unions, led by the Confederazione Generale Italiano del Lavoro (CGIL, the largest union), were skeptical that a nationally negotiated wage norm could correctly anticipate the future rate of inflation.[70] They expected wage drift to erode any national agreement, and they wanted to be sure any bargaining arrangements would compensate their members for losses incurred in sticking to a national rate.[71] If automatism of the sort embodied by the *scala mobile* was to be abandoned, unions wanted to use firm-level bargaining to compensate for shortcomings of a national deal.

Given this divergence of views, how did employers and unions come to a jointly agreed convention for bargaining? The large cognitive movement between 1989 and the agreement of 1992 was the emergence of the government's official inflation forecast, which had never previously been considered credible, as the new basis of bargaining. Starting from virtually nowhere, this coordinating idea became so prominent that it had crowded out any other alternative by early 1992. After denouncing the *scala mobile* in 1989, the paramount concern of employers was to end automatic adjustment; what would replace it was unclear to all parties. The idea of basing negotiations on the government's inflation forecast did not emerge fully formed from the heads of employers, as a weapon to bludgeon the unions into submission.[72] Instead, it was an idea that picked up steam only after being the centerpiece of a government proposal in mid-1991—championed by a former moderate union leader, Franco Marini—which steadily gained traction as the wage part-

69. While Italian employers in the internationally traded sectors had initially pushed for the decentralization of wage bargaining during the 1980s, they had discovered that the internationally sheltered sectors dictated the rate of inflation in such a system (see Pérez 2000, 451). They therefore preferred nationally coordinated sectoral bargaining, led by the traded sectors, to decentralized bargaining.

70. The government, as both an employer and a setter of the prices of goods such as electricity, was perceived by both partners as a potential source of inflation outside their control.

71. Mania and Orioli 1993.

72. Blyth 2001 and 2002.

ners sought a shared framework that would respond to the failures of the *scala mobile*.[73]

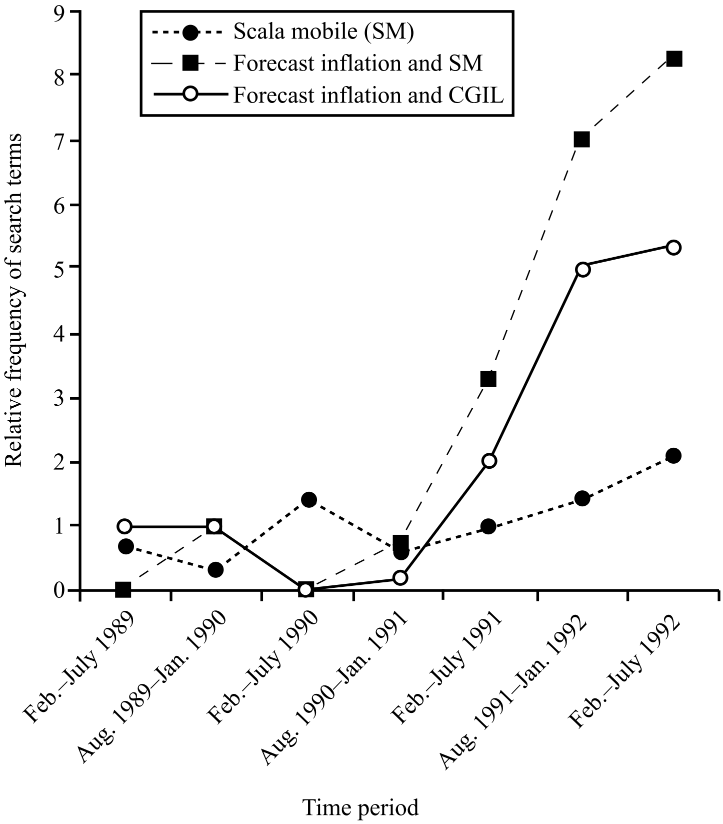
To track the evolution of the expressed views of the wage-bargaining partners, I undertook an extensive search of the leading Italian newspapers between 1989 and 1993.[74] The two figures that follow demonstrate the steep rise of references to the government's inflation forecast in discussions of future wage bargaining arrangements. Each graph shows the evolution of newspaper articles using the specified terms for six-month intervals from 1989 to the conclusion of the agreement on 30 July 1992 abolishing the *scala mobile*. Figure 1 uses data from 1,638 articles from ANSA, the official Italian press agency, while Figure 2 uses data from 808 articles in *La Repubblica*. The two graphs tell the same story, but both are shown to demonstrate that the rise of forecast inflation was not a peculiarity of one single news source.[75] The vertical axis of the two graphs shows the relative frequency of references to the *scala mobile*; to the *scala mobile* in combination with forecast inflation; and to forecast inflation in combination with the CGIL. Thus, the dotted line shows that the number of references to the *scala mobile* was relatively stable throughout the period of institutional experimentation, with a slight jump during the final six months leading to the agreement of 1992.

As both graphs show, however, the number of references linking the discussion of the *scala mobile* to the government's inflation forecast increased dramatically in 1991, once Marini had suggested it as a possible baseline for bargaining. Between February and July 1990, there were no articles in either ANSA or in *Repubblica* that used the term "forecast inflation" together with "*scala mobile*"; between February and July 1992, there were thirty-three such articles in ANSA and twenty-eight such articles in *Repubblica*. Articles using the terms CGIL and forecast inflation show the same steep acceleration during this time. Such joint references do not prove that the CGIL liked the idea of forecast inflation. Indeed, the union's leadership opposed it for a long time, as discussed below. But they were forced to talk about it because of their leadership's inability to propose an alternative bargaining norm that could be persuasive to employers. How did "forecast inflation" become the only game in town?

73. The *scala mobile* and forecast inflation are not merely two different standards for bargaining over inflation. The *scala mobile* was not about bargaining at all—it automatically adjusted inflation into future bargaining rounds. The debate was thus over whether to have automatic adjustment in some modified form and what norm to use as the basis of inflationary expectations for future bargaining rounds.

74. The search involved more than 1,600 articles from the official Italian news agency, ANSA, and more than 800 articles from *La Repubblica*, as well as a smaller number of articles from *Il Corriere della Sera*, *L'Unità*, *La Stampa*, *Il Manifesto* (the paper closest to the CGIL union leadership), and *Il Sole 24 Ore* (the paper owned by Confindustria). ANSA, *Repubblica*, and *Corriere*, which were electronically searchable, were the sources used most heavily to track changes in opinion over time.

75. *Repubblica* is considered a voice of the center-left, while ANSA is considered a voice of the center-right. The correlation between the frequency of citations in the two independent sources was .97 for the search term "scala mobile"; .99 for the joint search terms "scala mobile" and "inflazione programmata" (forecast inflation); and .85 for the joint search terms "CGIL" and "inflazione programmata."



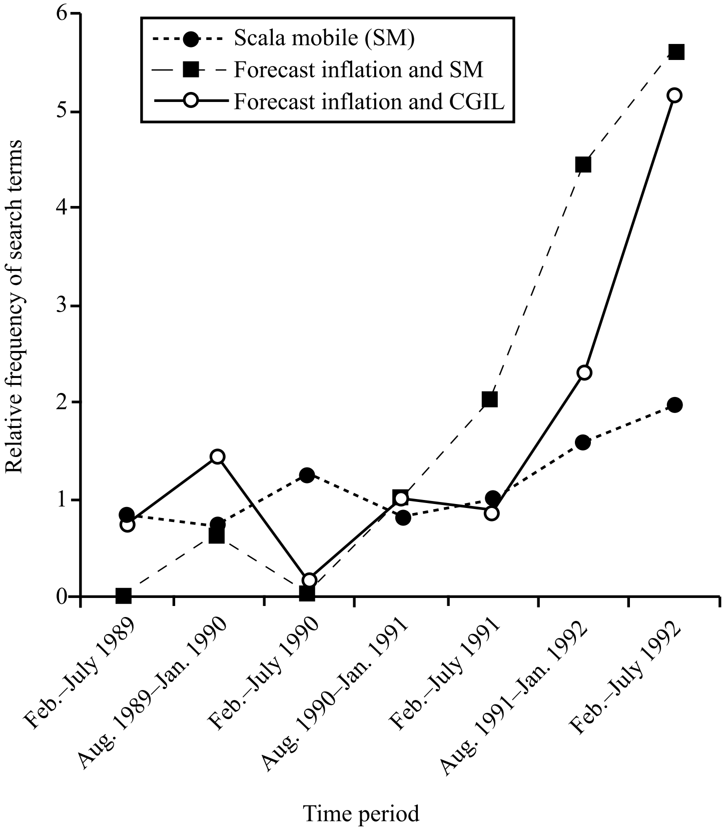
Notes: Figures 1 and 2 show six-month periods from the beginning of 1989 to the signing of the agreement in July 1992 that eliminated the *scala mobile*. Italian labor relations tend to have concentrated bursts of negotiation at two times during the year: June–July and December. The six-month periodization in these two figures therefore groups June and July together. The figures measure growth in press citations of the following terms: "scala mobile"; "scala mobile" and "inflazione programmata" (forecast inflation); and "CGIL" and "inflazione programmata." The vertical axis (relative frequency) shows the proportion of citations of a search term in the given time period compared with the median number of citations of that search term over the entire time period. In ANSA, 1,638 articles mentioned one of the search terms.

FIGURE 1. *Growth of forecast inflation references (ANSA)*

Prior to summer 1991, the government's inflation forecast had simply not been credible as a baseline for negotiation.[76] In July Labor Minister Marini included

76. *Repubblica*, 26 May 1991, 8.

the government's inflation in his proposals for institutional reform.[77] In September 1991 the leader of the CGIL flatly rejected the inflation forecasts of the government as noncredible.[78] By the end of November 1991, though, the three union leaders held a joint press conference making the "updating" (raising) of the government's inflation forecast a central plank of their public appeal.[79] By this point, clearly, union leaders were anticipating that this government figure would play a central role in whatever institutional solution was adopted; why else would they appeal to raise an inflation forecast in a joint press conference?



Notes: See note to Figure 1. In *Repubblica*, 808 articles over this time mentioned at least one of the search terms.

FIGURE 2. *The growth of forecast inflation references (Repubblica)*

77. *Repubblica*, 10 July 1991, 39.
78. *Repubblica*, 20 September 1991, 5.
79. ANSA, 11 November 1991.

The union leaders had resisted the emergence of forecast inflation as a bargaining baseline, if there were to be no post hoc adjustments, because it often underpredicted real inflation. As such, it was a point that employers would be more likely to favor as the starting point for negotiations. The CGIL leadership, though, was unable to devise an alternative norm for bargaining that did not rely on automatic adjustment, and it was clear that any system based on automatic adjustment would not overcome the primary difficulty of the old wage-setting system: inability to maintain inflation rates at the levels of the European competitor countries such as France and Germany.[80] The government's forecast, once proposed as a serious baseline for discussion (by a former union leader no less), responded to the perceived problem without manifestly favoring one side or the other. The rise of forecast inflation as a potential norm thus posed a challenge to the CGIL leadership: if automatism had to be abandoned, what was wrong with using the government's forecast as the bargaining baseline? Given that the phase of institutional experimentation requires actors to propose institutional solutions that can persuade other actors, the CGIL could not simply argue that it thought the norm was not good enough for workers.

What it could, and did argue, was that predicting inflation was simply too complex a task for the government to perform.[81] Entering tripartite negotiations in June, the CGIL leadership continued to cast fundamental doubt on the credibility of the government's forecast rate of inflation as a basis of negotiation, asserting that actual inflation in 1992 appeared to be considerably higher than that forecast by the government.[82] This may or may not have been simple prenegotiation posturing. However, it laid the ground for a decisive point in negotiations, given the state of institutional experimentation: a factually resolvable argument. In the absence of a new wage agreement, Italian wages in the first half of 1992 had been determined without the *scala mobile*. Thus, if the 1992 wages were to be equal to or higher than forecast inflation—the emerging norm pushed by the government for the wage bargainers—this would have provided strong evidence for the claim that sectoral bargaining, without any sort of automatic adjustment, was sufficient to maintain the purchasing power of workers. This was a claim that the president of Confindustria, Luigi Abete, began pursuing publicly in early June: "the gross median salary in the manufacturing sector in 1992 has risen by more than 5 percent without the *scala mobile*. Forecast inflation is 4.5 percent. It is not therefore true that the manufacturing worker loses out with respect to forecast inflation if he does not have the *scala mobile*."[83] This factual disagreement became a turning point in the final negotiations, when Abete repeated his claims about the growth of wages without the *scala mobile*, while union leaders argued that they had different fig-

80. *Repubblica*, 26 May 1991.
81. ANSA, 28 February 1992.
82. *Repubblica*, 5 June 1992, 47.
83. *Corriere della Sera*, 2 June 1992.

ures, saying "it depends how you calculate it. Let's ask for a third body to decide on the figures: the Bank of Italy."[84]

What was crucial to this exchange is that unions were unwilling to sign the accord before a technical group (central bank economists), accepted by both sides, came up with an evaluation of the facts that was jointly accepted.[85] In their analysis, the bank's economists confirmed Confindustria's claims that gross compensation would exceed the forecast rate of inflation in 1992, even without the *scala mobile*.[86] This joint analysis of the problem was the turning point of the negotiations and the basis for the prime minister's final proposal.[87] Prime Minister Giuliano Amato's draft enshrined the objective of protecting the purchasing power of real salaries in the accord that abolished the *scala mobile*, and the 1992 social pact was signed by all parties on 31 July.[88] Once the parties agreed to submit the technical question to an honest broker, it became implausible for union leaders to negotiate in good faith to a different outcome.

Clearly, the leadership of the CGIL preferred some sort of coordinated bargaining outcome to no agreement at all.[89] Their potential gain from coordination lay not only in the fear that a failure to agree would topple the government, but also in the hope of using coordinated bargaining to increase their competitive advantage over their more radical shopfloor competitors, the COBAS.[90] Yet, over the course of negotiations with employers, they had proven unable to articulate a credible alternative norm of bargaining other than that of forecast inflation. While CGIL leaders were not happy with the accord of 1992, their self-criticisms after the fact are illuminating: "A union that falls into a trap should ask itself why we fell in. And the error was not committed in the last three days [before signing] but in the last ten years lost in defending at all costs the *scala mobile* without being capable of proposing alternatives."[91]

The common knowledge event of 1992 reset the shared expectations of wage bargainers around the norm of forecast inflation. The emergence of that norm was the product of an environment in which the winning idea would have to persuade

84. *Corriere della Sera*, 29 July 1992, 17.

85. The bank's economists could be said to function here as an epistemic community, a point drawn to my attention by the editors. The high technical standards and impartiality ascribed to the economists of the Bank of Italy was indeed the source of their authority in regulating this dispute (on the development of this community, see Quaglia 2005). The bank's intervention, though, was important for illustrating the dominance of the logic of arguing over the logic of consequentialism in this process. The bank did not propose the standard of forecast inflation—a moderate union leader had done that, one year earlier. Yet the inability of the CGIL to enunciate an alternative bargaining norm meant that its only oppositional strategy was to take up factual argumentation about forecast inflation: did it correctly predict inflation?

86. *Corriere della Sera*, 30 July 1992, 19.

87. Cipolletta 2002.

88. Mania and Orioli 1993, 166.

89. *Unità*, 6 August 1992, 3.

90. See Pérez 2000, 452; and Rhodes 1998.

91. *Manifesto*, 6 August 1992, 3.

all participants of its viability, and forecast inflation was the only norm that proved able to meet that requirement. The CGIL leadership failed to generate alternative proposals that could persuade other players, and so left space for the experimental role of bargaining based on forecast inflation to become the only game in town.

Employers and the Establishment of New Bargaining Institutions

The 1992 agreement was by almost any measure a victory for Confindustria, which finally succeeded in burying the *scala mobile*. The agreement shifted the terms of wage bargaining discourse from a norm of automatic adjustment to one of bargaining between employers and unions on the basis of the forecast inflation rate. It thus established the expectations of employers about the framework within which unions would pose their future wage bargaining demands. The 1992 agreement abolished the old institution only; it did not establish new wage-bargaining institutions. Postagreement, therefore, Italian employers and unions remained in a situation of institutional experimentation, where the logic of arguing continued to have important influence on outcomes. What blocked a shift to new institutions was the contentious issue of firm-level bargaining. Unions, which had been challenged throughout the 1980s by independent "grassroots committees" (COBAS) and autonomous union groups, wanted an agreement that both reinforced their plant-level structures and allowed for firm-level bargaining on top of the sectoral agreement, to allow for productivity-tied increases.[92]

Confindustria initially opposed the institutionalization of supplementary firm-level bargaining for two reasons. First, Italian employers viewed a single national (sectoral) agreement as the best way to control labor costs.[93] Establishing two different levels of negotiation would have created the possibility of firm-level wage drift. Employers had refused to budge from their opposition to firm-level bargaining in the 1992 agreement for exactly this reason. Second, small firms were ill-equipped for firm-level bargaining, and they wanted to ensure that any agreement that applied to large firms did not force them into bargaining with unions and thus spur unionization of their workforces. Any agreement on firm-level bargaining required that organized employers accept the proposition that a contractual role for firm-level bargaining would not undo the cost-containment of national agreements nor impose firm-level bargaining on small companies.

Prior to the 1992 agreement, allowing firm-level bargaining on top of sectoral bargaining had been the worst possible outcome for employers. The public commitment of unions to the norm of bargaining based on forecast inflation changed the attractiveness of this arrangement, making it preferable to decentralized bargaining, which employers had previously found incapable of delivering wage

92. Locke and Baccaro 1996, 297–300.
93. Pérez 2000, 451.

restraint.[94] The same public knowledge that made this arrangement acceptable, if not ideal—some members of Confindustria still preferred no firm-level bargaining—gave the representatives of organized employers no argumentative leg on which to stand in pursuing their first-best option. The potential gains of a bargained agreement were such that they could no longer threaten to walk away easily, and in arguments with national union leaders they were unable to adduce good reasons why firm-level bargaining should not be adopted, given the agreed bargaining norm.[95]

The 1992 agreement had established common expectations among only the national unions and Confindustria. The agreement did not apply to unaffiliated labor militants like the COBAS. Thus, in the 1993 institutional agreement that consolidated the new institutions of wage bargaining, Confindustria insisted that the competent local bargaining units have appointed representation from those unions that had signed the national agreement, thus linking firm-level bargaining to groups that had signaled their agreement with the new pay norm.[96] This provision makes sense only in the light of the common understandings about the bargaining partners established in 1992. The representatives of organized employers would enter such an institutional arrangement—their second-best outcome—only if they could be sure that the firm-level bargainers understood the new norms in the same way as the national bargainers.

This institutional feature highlights the way the common expectations created by 1992 were the only possible cognitive basis on which Italian employers would have agreed to allow firm-level bargaining on top of the sectorally negotiated bargain. Without the agreement on firm-level bargaining, the national unions would never have agreed to the terms of the compromise of 1993. This arrangement would have retained a functionally decentralized system, in which firm-level bargains varied widely. The 1993 institutional change became possible only when employers and unions established common knowledge about the functioning of bargaining without the *scala mobile*.

Conclusion

This article has demonstrated how common knowledge formation influences the process of domestic institutional change through the cases of Irish and Italian wage bargaining. Common knowledge events transform the character of subsequent bargaining by changing shared models of the economy and thereby the shared understandings of the motivations of the bargaining partners. In these cases, the major

94. Author's interview with Innocenzo Cipolletta, Director General of Confindustria from 1990 to 2000, Milan, Italy, 18 July 2003.
95. Cipolletta 2002.
96. See Locke and Baccaro 1996, 299; and Cipolletta 2002.

change in views of the economy took place among unions: union leaders accepted a view of wage bargaining as disciplined by the constraints of international competition. The fact that union leaders altered their stated views of the functioning of the economy changed the institutional preference ordering of employers, as summarized in Table 3. In neither case, though, was the eventual outcome the one most preferred by employers. Their arguments for their preferred outcomes were premised on a view of union negotiating behavior—unwillingness to restrain wages—that was inconsistent with the newly established common knowledge, and thus difficult to sustain in negotiations. As a result, they eventually accepted second-best outcomes they had previously rejected.

Constructivist analysis recognizes better than most rationalist work that the outcomes of social change are not entirely foreordained by the structure and power resources of interest groups.[97] The contribution of this article has been to show that the act of jointly interpreting the world can comfortably be accommodated within a framework based on methodological individualism and within which actors never totally lose sight of their basic material preferences. This approach thus differs from the one taken by Blyth.[98] Blyth's work on institutional change in Sweden and the United States forcefully underlines the importance of Knightian uncertainty to processes of institutional change; that is, of an uncertainty that goes well beyond risk. Blyth is right that actors are in a state of institutional experimentation because they lack agreed ideas for making sense of the world. But their uncertainty is not total; they have some idea of the distributive implications of alternative institutions.

This uncertainty magnifies the importance of arguments that are not only self-interested but also capable of persuading other parties. The shared frameworks that emerge during such periods—such as that of the governmental inflation forecast in Italy as a basis for nonautomatic wage bargaining—would have been difficult to predict a priori. Neither governments nor social partners are likely to be able to impose such ideas. The very process of arguing about them winnows the field of plausible candidates. As Italian unions discovered, once a candidate emerges from the field of competing ideas, the acceleration of a plausible coordinating idea becomes difficult to stop. As the experiences of Irish and Italian employers also show, even powerful actors are weakened in bargaining situations when they are unable to adduce compelling arguments on behalf of their most preferred institutional arrangement.

Many readers will have considered European integration as a more parsimonious explanation for these outcomes. That is incorrect. There is no doubt that the entry of Italy into the narrow bands of the EMS influenced the timing of the insti-

97. As Herrera notes, this is not an issue that divides rationalism from constructivism as much as one that divides essentialism (which admits no art of interpretation in defining material preferences) from constructivism (Herrera 2005, 77–85).
98. Blyth 2001, 2002.

TABLE 3. *Common knowledge events, employer preferences, and institutional outcomes*

	Event	*Common knowledge*	*Pre-event institutional preference*	*Postevent institutional preference*	*Outcome*
Ireland	NESC report November 1986	Ireland as small open economy	Decentralized > Public coordinated, private decentralized > Centralized	Decentralized > Centralized > Public coordinated, private decentralized	Centralized bargaining
Italy	Social Pact July 1992	Competitiveness based on norm of forecast inflation	Sectorally coordinated bargaining > Decentralized bargaining > Sectoral + Firm bargaining	Sectorally coordinated > Sectoral + Firm bargaining > Decentralized bargaining	Sectorally coordinated + Firm-level bargaining

tutional crisis in Italy. However, the dissatisfaction of Italian employers with the existing system of domestic wage bargaining had roots that ran much deeper than EMS commitments.[99] The wage bargaining institution that Italy finally adopted—sectoral coordination with firm-level productivity bargaining—was one of many alternative solutions that could have been consistent with the loss of currency devaluation as a policy tool in Italy. One was sectoral bargaining without firm-level bargaining; another was decentralized bargaining. Which solutions were ultimately acceptable to both employer and union representatives depended on how they thought the economy functioned and what they thought of each other as bargaining partners. Without explaining these perceptions—and it is difficult to explain them without the common knowledge events described here—one could not explain why one particular institution was chosen over others.

The Irish case even more manifestly rejects an interpretation based on European constraints. There is no convincing argument for why membership in the European Community precipitated the institutional crisis there or dictated the institution that emerged from the bargaining of the partners. In fact, most of the small states in world markets that were central to the discussion of change in Ireland were not members of the EC in 1986. The Irish decision to join in the Economic and Monetary Union (EMU) initiative in the 1990s may have stabilized the wage bargaining institutions first established in 1987,[100] but it obviously cannot explain their genesis, since the domestic institutions came years before the Maastricht criteria. I have shown through careful tracing of the expressed interests of the players and the interpretations of other scholars familiar with these cases that the institutional solutions reached were in no way foregone products of European commitments. Not only could the institutions of wage bargaining have developed in a different form than they did—they very probably would have, in the absence of the common knowledge events described.

The Irish and Italian cases are particular instances of a more general question: How do social actors bargain and puzzle their way to new institutions during periods of economic change? Ireland and Italy succeeded in adopting more coordinated institutions of wage bargaining; that is, they changed their model of capitalism, but not by following neoliberal institutional prescriptions. Authors writing from differing theoretical perspectives agree that institutions of nonmarket coordination often provide robust alternatives to market regulation in the areas of corporate governance and finance, education and training, and intercompany research and development, in addition to the area of industrial relations.[101] Ireland and Italy, like many countries in the globalized economy, faced economic crises—characterized by fiscal imbalances, high unemployment, and problems of competitiveness for export sectors—that had roots in both domestic institutions

99. Pérez 2000.
100. Hardiman 2002, 7.
101. See Hall and Soskice 2001; Amable 2003; and Yamamura and Streeck 2003.

and changing international market conditions. These crises were real and apparent to major actors in both countries—not, as some constructivist scholars have argued, conditions that were recognizable as a "crisis" only once a new economic framework had been adopted.[102] The solution of decentralized bargaining was certainly a possible outcome to these crises. Employers in both countries had, however, experimented with decentralized bargaining and were not uniformly persuaded it could deliver the wage restraint they sought. As in other countries that face changing conditions of international competition, employers and unions disagreed with each other's prescriptions but recognized their past institutions were no longer delivering the outcomes they wanted.

The adoption of decentralized bargaining does not require the emergence of common knowledge. It merely requires that an actor favoring liberalization possess the political or market power to impose such regulation on any opponents to it, as Margaret Thatcher and her conservative government did in the United Kingdom. Coordinated bargaining, however, requires that unions and employers perceive potential gains to coordination. Organized employers, for example, will see no gain in coordination if it does not hold out the prospect of a better settlement (wage restraint combined with reduced strike activity) than they might achieve under an alternative institutional arrangement. The agreement between union and employer representatives established that the shared game between these actors was taking place in an open economy, where failure to restrain wages would damage competitiveness and employment, thereby creating the possibility of a game in which a coordinated solution was preferred by both parties. The small open economy framing was no focal point on which these actors stumbled to achieve their already established interest in coordination; it created the intersubjective understandings that solidified their interest in coordination.

In showing that common knowledge can be created in the presence of past histories of conflictual industrial relations, this article departs decisively from more deterministic elements of the varieties of capitalism literature. Hall and Soskice argue that the difficulty of creating common knowledge between bargaining partners with divergent views is a large barrier to any institutional change that increases the level of coordination in wage bargaining institutions, as happened in Ireland and Italy.[103] For Hall and Soskice, therefore, countries that lack the right history will fail when they try to adopt the institutions of nonmarket coordination. The evidence in this article, contrariwise, suggests that the development of common knowledge is indeed possible, even in countries that lack a history of coordinated institutions. In both Ireland and Italy, countries famed for contentious industrial relations and weak corporatism,[104] employers' associations and unions moved from having incommensurable views of the economy to a convergent set of views under

102. See Blyth 2002 and Widmaier 2003.
103. Hall and Soskice 2001, 63.
104. Baccaro 2003.

which coordinated bargaining was seen to have virtues by both partners. The epilogue to this story is one of long periods of stability under the new, more coordinated institutions.

The prominence of the "small states in world markets" reference point in the Irish case also invites a reassessment of the historical emphasis in Katzenstein's classic account of adjustment strategies in European small states. For Katzenstein, the institutions of corporatist coordination grew up in conscious reaction to the bitter social conflict of the interwar period.[105] The institutions of compromise developed out of a shared belief of unions and employers in small countries that their vulnerability to international markets did not permit them the luxury of unregulated social conflict. The challenges and crises faced by Irish wage bargainers were far less violent and momentous than those of Europe in the 1930s. Yet employers and unions in Ireland could see in the small state framing of their joint situation clear analytical and distributive appeal. Employers adopted it as the basis for a strategy of export promotion based on wage restraint. Unions embraced it as a potential solution to problems of unemployment that also placed them—the unions—as central figures in the management of the political economy. Faced with a choice between modeling themselves on the mighty union movement of Sweden or the battered unions of the United Kingdom, the appeal of the former choice to Irish union leaders is obvious. The broader implication is that cooperative institutions do not require a particular history. And if the defining characteristics of small states is high vulnerability to international economic shocks, there may in this era be many countries in which social actors are capable of constructing a joint understanding that they are small states in world markets.

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105. Katzenstein 1985, 136–90.

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