LABOR REGULATION AND CORPORATE GOVERNANCE: A COMPARATIVE OVERVIEW

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Abstract

The literature aimed at exploring labor regulation and cross-country comparisons has left partly unexplored two major points: the first concerns potential complementarities or substitutions between patterns of shareholder protection and labour regulation. The second point concerns the role of a comprehensive set of labour rules which contemplates not only employment-unemployment provisions and payoff rights, but also rules and institutional devices which influence employee investments in human capital and have the effect of tying the fortunes of the employee together with those of the firm.

The paper offers a critical overview of some selected studies that have started at considering labour institutions for their influence on the ‘balance’ of power inside the firm, between owners, management, and employees.

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Key Words: Labour Relations, Corporate Governance, Varieties of Capitalism

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1. Introduction

The literature aimed at exploring labor regulation and cross-country comparisons has left partly unexplored two major points: the first concerns potential complementarities or substitutions between patterns of ownership or shareholder protection and labour regulation. The second point is the influence of employees within managerial processes, through the channel of employee representation at firm level. The paper offers a critical overview of some selected studies that have started at filling these gaps by considering labour institutions for their influence on the ‘balance’ of power inside the firm, between owners, management, and employees.

After reviewing contributions which see high worker protection and limited shareholder protection as determinants of poor performances of labor and capital markets, it presents recent theoretical and empirical studies which share an opposite view: This area of research focuses on employee investments in firm-specific human capital and on institutional devices which have the effect of tying the fortunes of the employee together with those of the firm.

The paper is organized as follows. Section 2 examines the literature which gives central importance to financial and labor regulation and sees access to finance as the major condition for firm success.

Section 3 reviews an alternative approach to comparative studies on labor and finance regulation: which focus on strategical interactions and institutional complementarities. Section 4 summarizes new theories and recent evidence originated by the new conception of the firm as nexus of implicit contracts; major novelties of these studies is the abandonment of shareholder primacy and conversely, new concern for high protection of shareholders is accompanied by the parallel use of human resource management practices aimed at obtaining long-term commitment of ‘critical’ employees.

2. Shareholder and labour regulation

Law and finance’ literature, inaugurated by La Porta et al. (1998), assess that the protection and the enforcement of shareholders’ rights are the main preconditions for corporate value. In this area, many contributions by La Porta, Lopez-de-Silanes, Shleifer and Vishny - ‘LLSV’ show that limited protection of shareholders’ interests mainly involves countries with civil law codes and causes concentration of ownership and illiquid capital markets. (see the recent studies by Djankov, La Porta, Lopez-de-Silanes and Shleifer, 2006; 2008).

In the same vein, the enriched law and labor literature emphasizes the fact that soft or strict work
regulations, which arise from the original legal family of each country, influence the proper functioning (in case of common law countries) or the worse functioning (in case of civil law economies) of labor markets as well as financial institutions. This thesis is advocated by Botero et al. (2004), who collected data, as of 1997, for a large sample of 85 countries, on the legal framework in three distinct areas of labor regulation: employment laws; collective relations laws, and various measures which capture social security provisions.

Table 1 lists the main results for finance and labor regulation - collected by Djankov et al. (2006, 2008) and Botero et al. (2004). More specifically, the values for the various measures are grouped by legal families and include two new measures for investor protection. The first is the revised measure of the original index of shareholder rights, originally computed by La Porta et al. (1998) and later revised after criticisms on coding and ambiguities by some authors (Spamann, 2010).

The second value is a new index which takes into account the role of law in addressing various corporate self-dealings undertaken by managers and controlling shareholders (excessive compensation, transfer pricing, self-serving financial transaction, and similarities).

Table 1. Finance-Labor Regulation and Development

<table>
<thead>
<tr>
<th>Common Law countries</th>
<th>Civil Law Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>German Civil Code</td>
</tr>
<tr>
<td>Shareholder protection indexes</td>
<td></td>
</tr>
<tr>
<td>Anti-director rights (a)</td>
<td>4.19</td>
</tr>
<tr>
<td>Anti-self dealing index (aa)</td>
<td>0.66</td>
</tr>
<tr>
<td>Labor regulation Indexes</td>
<td></td>
</tr>
<tr>
<td>Employment Protection (b)</td>
<td>0.2997</td>
</tr>
<tr>
<td>Collective Relations (b)</td>
<td>0.3313</td>
</tr>
<tr>
<td>Social Security (b)</td>
<td>0.4236</td>
</tr>
<tr>
<td>Stock market developments, income per capita and ownership</td>
<td></td>
</tr>
<tr>
<td>Stock market capital. To GDP 1999-2003(c)</td>
<td>85.5%</td>
</tr>
<tr>
<td>Log GNP per capita 1997 (d) ($)</td>
<td>7.8445</td>
</tr>
<tr>
<td>Ownership concentration (e)</td>
<td>44%</td>
</tr>
</tbody>
</table>

(a) The revised index of Djankov et al. (2006), Tab. XIII; (aa) Djankov et al. (2008), Tab. 3; (b)Labor regulation indexes, Botero et al. (2004), Table III; (c) Djankov et al. (2006), Table VI; (d) Botero et al. (2004), Table III, p. 1364; (e) Djankov et al. (2006), Table VI: average percentage of common shares owned by top 3 largest shareholders in 10 largest non-financial, privately-owned domestic firms. (*) significant at 10% level; (**) significant at 5% level; (***) significant at 1% level.

The descriptive statistics listed in Table 1 (obtained from a database of ample coverage) should prove that law matters: legal systems are the main determinants of both the weak investor protection and greater labor regulation of Continental Europe (German and French Civil law countries). In these economies, the stock market is bound to be underdeveloped, although we observe that no detrimental effects on GDP per capita growth are obtained. However, the latter result only proves that law - and not wealth - matters, as the authors write: “There is no evidence that employment laws or collective relations laws vary with the level of economic development. This result is inconsistent with the implication of the efficiency hypothesis that rich countries should regulate less because they have fewer market failures” (Botero et al. 2004, p. 1364).
A parallel line of reasoning has recently been proposed by the 'insiderness' hypothesis, reviewed below. ‘Insiderness’ is the central aspect which determines outcomes in corporate governance. The idea is that equity orientation opens markets to business competition which damages incumbent positions. *Insider labor*, i.e. workers with protected jobs, and *insider finance*, owners with significant control of corporate assets, share a common interest in preventing competition by new entrants, thus preserving their rents. The theoretical claim of the authors is that a way of categorizing corporate governance systems is concerned with “capturing the extent to which the monitoring, oversight and control of the management of public companies is oriented towards external minority shareholders” (p. 6). The financial data collected by Barker and Rueda are proxies for outsider corporate governance. The index of shareholder protection, originally developed by the LLSV literature, is accompanied by three other measures of orientation towards external minority shareholders: i) stock market capitalization; ii) total values of shares traded on the stock market; iii) international equity issuance (all measures standardized to GDP).

Table 2 presents a selection of a sub-sample of countries examined by the authors.

### Table 2. Financial indicators by country, 1980 and 2004

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>International equity issuance/GDP (%)</td>
<td>0.00232</td>
<td>0.00005</td>
</tr>
<tr>
<td>Equity market capitalization/GDP (%)</td>
<td>0.2674</td>
<td>0.7215</td>
</tr>
<tr>
<td>Value of equity traded/GDP (%)</td>
<td>0.1041</td>
<td>0.2898</td>
</tr>
</tbody>
</table>

Source: Barker and Rueda (2007, Table 1); Shareholder protection index: 6= highest, 0=lowest; (5) 1995; (5) 2002 and 2003.

Data listed in Table 2 show a great cross-country variance since liberal market economies are characterized by stronger minority shareholder orientation. However, as the authors write (p. 10), substantial temporal variance suggests “an overall tendency towards more outsider-oriented corporate governance practices”. In addition, Barker and Rueda (2007) test their hypothesis by econometric estimates over the period 1976-2004. Their results suggest that measures of power of incumbent labor (wage growth, lower increase in hours worked) as well as of incumbent capital (low international trade openness and measures to discourage the entry of other competitors) are the main drivers of limited orientation towards ‘outsider’ finance. Hence, international equity issuance, equity market capitalization, value of equity traded and minority shareholder protection are found to be negatively associated with ‘insiderness’.

The emphasis on product market competition and on interests of insider labor (as stakeholders) is also central in another recent study (Allen, Carletti and Marquez, 2009), focusing on the firm objective function and the importance of stakeholder governance. The authors propose a theoretical model which formalizes corporate strategies into two different scenarios dominated, respectively, by cost or demand uncertainty. In the first, concern for stakeholders induces firms to charge higher prices in order to face cost pressures, thus benefiting stakeholders and softening competition. In this case, the authors demonstrate that shareholder and stakeholder interests end by being aligned. Conversely, when demand uncertainty affects future profitability, concern for stakeholders leads to lower prices relative to the case of shareholder companies, increasing competition. In sum, demand uncertainty leads to a reversal of the insider labor anti-competitive attitude, thus qualifying the hypothesis of Barker and Rueda.

A critical look at the LLSV literature is given by Armour and Deakin (2009), who find that the “crystallization” of a particular legal structure is not the main driver of differences among countries; their other main result is that the close parallelism between weak shareholder protection and strong labor protection, maintained by the law-finance-labor literature, does not hold in a dynamic perspective. As the authors note: "the pattern of change differs depending on the area of law under examination, with creditor rights and labor rights demonstrating much more divergence and heterogeneity than shareholder rights. We interpret this as casting doubt on the plausibility of the mechanisms that have been said to underpin the links posited between legal origins and financial development” (Armour and Deakin, 2009, p. 2).
They also show the importance not of two legal families, but of three ‘parent’ systems: i) the UK, France and Germany; ii) the world’s most developed economy, the US; iii) the largest democracy, India. Also, according to the data they collect for worker protection, here shown in Figure 1, the authors suggest a divide within legal families, between France and Germany (civil law countries), on one hand, and the US, the UK and India (common law economies), on the other.

![Figure 1. Evolution in worker protection in five economies](http://www.cbr.cam.ac.uk/pdf/WP352.pdf)

In addition, cross-country comparison of shareholder, creditor and worker protection reveals that legal rules do evolve but at different paces, and that political changes are good predictors of the most significant changes. For worker regulation, three of the systems - Germany, the US and India - have recorded fewer transformations, whereas the UK and France have undergone more pronounced changes, but in opposite directions.

3. Labour regulation and skill profiles: the ‘varieties of capitalism’ approach

A prominent view to evaluating labor regulation and their interactions with other institutions is offered by the “varieties of capitalism” approach advanced by Hall and Soskice (2001). The authors propose a distinction between coordinated market economies (hereafter: CMEs) and liberal market economies (LMEs).

In a coordinated market economy (CME) such as Germany, employee involvement may fit well with concentrated share-ownership: employee representatives participate in decision-making with block-holders and cooperate with them in monitoring managers. At the same time, moderate wage differentials across firms and industries reduce the propensity of employees to change jobs, and are consistent with cross-shareholdings and investments of employees in firm and industry-specific skills.

A different variety of capitalism is represented by Liberal Market Economies (LME) as the Anglo-Saxon systems, characterized by dispersed ownership, individual investors have little incentive for active governance. Such features are parallel to market relations and arm’s-length exchanges of labor services: the distinctive features of labor relationships are wage patterns linked to labor market conditions, decentralized company-level bargaining, and, lastly, no restrictions on labor adjustment.

A distinctive feature of liberal market and coordinate economies concerns the varieties of production regimes and their different skill profiles. Estevez-Abe et al. (2001) show that diverse types of worker protection prevailing in various types of capitalism are associated with different types of skills: i) firm-specific skills, acquired through on-the-job training, are valuable to the employer who carried out the training but not to other employers; ii) industry-specific skills, acquired through apprenticeship and vocational schools, may be valuable to other employers in specific sectors, especially when certified, iii) general skills, more transferable, have a value independent of the type of firm or industry. The authors show that, on one hand, Coordinated Market Economies (CMEs) provide institutional support for forms of industry-specific training (adopted in environments of collaborative research and development between firms) or promote support for the acquisition of firm-specific competences.

The high unemployment protection of Denmark is a good case in point for the first kind of skill equilibrium. As Estevez-Abe et al. (2001, p.152) argue: “A high replacement ratio also eliminates the downward pressure on specific skilled wages, as unemployed skilled workers do not have to take job...
offers at discounted wages”. In addition, “A longer benefit duration permits the unemployed industry-specific skill holders enough time to find another job that matches their skills, especially if they are permitted to turn down jobs that are outside their core competences”.

A different case is that of the high employment protection (accompanied by a low degree of unemployment protection) which characterizes Japan, a typical example of firm-specific skill equilibrium. In Japanese companies, loyalties in labor relations and high length of job tenure are forms of insurance for workers to acquire those company-specific skills which the enterprise needs.

Conversely, Liberal Market Economies (LMEs) provide economic agents with greater opportunities to acquire general skills, adaptable to multi-purpose technologies. In LMEs, such as the US, individuals without employment and unemployment protection are encouraged to develop general, rather than specific, skills, as the corporate strategies in LMEs tend to require.

Table 3 lists some country data for employment and unemployment protection indexes and skill profiles. The first indicator, developed by Estevez-Abe et al. (2001), is a composite measure obtained as the average of three different indicators: the OECD relative stringency of legislation on individual hiring and firing rules; the OECD restrictiveness of collective dismissal rules; and company-based protection computed by the authors by taking into account firm-level protection (such as the presence of employees in company bodies with manpower decisions). Unemployment protection is the unemployment replacement rate, the share of a worker’s previous wage which is replaced by unemployment benefits. Table 3 gives some support to the thesis that “employment protection increases the propensity of workers to invest in firm-specific skills, whereas unemployment protection facilitates investment in industry-specific skills. The absence of both gives people strong incentives to invest in general skills”. (Estevez-Abe et al., 2001)

<table>
<thead>
<tr>
<th>Country</th>
<th>Median Length of Tenure (a)</th>
<th>Vocational Training Share (b)</th>
<th>Vocational Training System (c)</th>
<th>Empl. Protection (d)</th>
<th>Company Based Protection</th>
<th>Unempl. Protection (e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>4.4, 31</td>
<td>Mixed</td>
<td>0.53</td>
<td>2</td>
<td>0.91</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>10.7, 34</td>
<td>Dual apprenticeship</td>
<td>0.86</td>
<td>3</td>
<td>0.77</td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>4.2, 3</td>
<td>Weak</td>
<td>0.14</td>
<td>1</td>
<td>0.10</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>8.3, 16</td>
<td>Company based</td>
<td>0.76</td>
<td>3</td>
<td>0.33</td>
<td></td>
</tr>
</tbody>
</table>

Source (a) The median length of enterprise tenure in years, 1995 (OECD Employment Outlook, 1997);

(b) Share of age cohort in either secondary or post-secondary vocational training (UNESCO, 1999);

(c) Character of vocational training system according to whether most training occurs at company level (as in Japan), through a dual apprenticeship system (as in Germany), or through some mixture of the latter two;

(d) weighted average of restrictiveness of individual hiring and firing rules, and of rules on collective dismissals (OECD);

(e) measure based on

i) the presence of employee-elected bodies with a significant role in company manpower decisions;

ii) the existence of strong external unions with some monitoring and sanctioning capacity; and

iii) the systematic use of employee sharing practices between parent companies and subsidiaries or across companies.

(f) based on unemployment replacement rates, generosity of benefits, definition of “suitable” job (OECD).

For details, see Estevez-Abe, Iversen and Soskice (2001, Tables 4.1, 4.2, 4.3).

For the German case, one can note that the combination of industry- and firm-specific skills renders the country’s companies vulnerable to two different problems: the hold-up between employers and their workers for firm-specific skills, and ‘poaching’ of trained workers from other enterprises for industry-specific skills. The employee channel of representation at company level and industry-level bargaining are addressed toward solving these problems and ensure that employees invest in company- and industry-specific skills. Conversely, the US, is “an archetypical case of a country with a weak company and vocational training system, but a very advanced higher education system. Indeed, a college education in this country is widely considered the only effective insurance against an otherwise highly volatile and uncertain labor market.”(Estevez-Abe et al. 2001, p. 172)

A related topic concerns the industrial fields of specialization, clearly distinct between one country and another. Germany mainly specializes in sectors characterized by incremental innovation, as data from the European Patent Office suggest (Hall and Soskice, 2001), whereas the USA shows the
prevalence of sectors of radical innovation. But the introduction of the sectoral dimension and innovation patterns has direct implications for labor protection requirements, as shown by Bassanini and Ernst (2002). As is known, two different regimes of innovation may be distinguished. In the first, called Schumpeter Mark I (characterizing sectors such as precision instruments, standardized software and household appliances), innovation is radical, investment projects are short-lived, capital depreciation is rapid, and knowledge and competences are general. In this type of regime, featuring creative destruction, firms rely on the external labor market, requiring low hiring and firing costs and fast worker turnover. As Ernst and Bassanini (2002, p. 15) clarify, “in these industries, newly hired personnel brings in new ideas and allows substituting for older organizational routines, while the use of a standardized knowledge base allows newly hired staff to quickly learn specific applications”.

The opposite is true for the other, routinized regime (electronic components, aircraft and spacecraft), also known as Schumpeter Mark II, in which technological change is by creative accumulation. In this case, investments are long-term oriented and human capital and skills are firm-specific. Firms rely on the internal labor market, since “the best available competences for this type of innovations can be often found inside the firm itself” (p.15).

These considerations have immediate implications for market regulation. By considering the logarithm of patent per capita and the indicator of stringency of product regulation and employment protection, Bassanini and Ernst (2002) obtain an unequivocal sign for the first indicator for 26 OECD countries, suggesting that enhancing competition in the product market contributes to improving the innovation performance of a country. However, the effects for employment protection are ambiguous. By distinguishing countries by regimes of coordination, the above authors find negative and significant correlations only in countries with low or intermediate levels of co-ordination of the wage bargain; conversely, in other economies, characterized by high coordination, no significant relationships are obtained.

Table 4. Innovation and regulation: Patents per million inhabitants and product/market regulation

<table>
<thead>
<tr>
<th></th>
<th>Product market regulation</th>
<th>Employment Protection</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Countries with high levels of coordination</td>
<td>Countries with low and intermediate levels of coordination</td>
</tr>
<tr>
<td>Patents per million of inhabitants</td>
<td>Corr. coefficient 0.23 t-statistic 3.27</td>
<td>Corr. coefficient -0.23 t-statistic -0.68</td>
</tr>
<tr>
<td></td>
<td>Corr. coefficient -0.48 t-statistic -2.06</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bassanini and Ernst (2002).

These results may reflect differing sectoral specialization. As observed by Bassanini and Ernst (2002, pp. 15-16), countries with uncoordinated industrial relations have a comparative technological advantage in industries characterized by an entrepreneurial technological regime, in turn associated with a flexible labor market; countries characterized by industries with a population of large and well-established firms make more use of the firm’s internal labor market and need high and stringent employment protection.

To sum up, the importance of institutional complementarities is confirmed by a whole set of information. In Germany, many labor institutions which secure “long employment tenures, industry-based wages, and protective works councils” are feasible, because firms have access to finance, independently of downward fluctuations in profitability; they are also well integrated in a corporate governance system characterized by limited recourse to poaching of skilled workers, inter-firm collaboration, technology transfer, and cross-shareholdings. (Hall and Soskice, 2001, p. 27)

Table 5 offers some comparative features which support the thesis of institutional complementarities.
Table 5. Complementarities in corporate governance institutions Coordinated Market Economies (CME) and Liberal Market Economies (LME)

<table>
<thead>
<tr>
<th>Industrial relations</th>
<th>CME</th>
<th>LME</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bargaining level (a)</strong></td>
<td>Germany Sectoral 10.7</td>
<td>Japan Sectoral 8.3</td>
</tr>
<tr>
<td><strong>Job Tenure (b)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Corporate Governance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ownership concentration (c)</td>
<td>41.5</td>
<td>33.1</td>
</tr>
<tr>
<td>Cross-shareholdings (d)</td>
<td>42</td>
<td>22</td>
</tr>
<tr>
<td>Employee participation in monitoring function (e)</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Compensation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CEO Compensation (f)</td>
<td>47.1</td>
<td>44.2</td>
</tr>
<tr>
<td>CEO earnings to manual worker earnings (f)</td>
<td>10.2</td>
<td>7.8</td>
</tr>
<tr>
<td>Earning dispersion (g)</td>
<td>2.87</td>
<td>2.99</td>
</tr>
</tbody>
</table>

Sources: (a) OECD (2004); (b) OECD 1997; (c) average percentage of common stocks owned by five top largest shareholders, Prowse (1995); (d) Prowse (1995); (e) Employees appoint some board members, OECD (2003, pp. 47-50); (f) Towers Perrin (2005), US=100, 2003; (g) manufacturing; 90-10 percentile ratios for gross earnings of full-time employees, Towers Perrin (2005).

In terms of outcomes, both group of economies, CMEs and LMEs, are capable of assuring similar results, at least when distributional aspects are excluded from the comparison, as confirmed by the econometric estimates of Hall and Gingerich (2004). This implies a confutation of the LLSV thesis: if one restricts analysis to developed countries, as Hall and Soskice do, Coordinated Market Economies, which are also civil law countries, do not deliver inferior results to Liberal Market Economies, as national indicators confirm, although high differentials are recorded within each group - as seen, for instance, in the unemployment rates of US and Ireland. In any case, Hall and Soskice do not argue that one group is superior to another, but that the two types of economies are characterized by different production regimes and different ‘capacities for innovation’. It is not by chance that Botero et al. (2004) are careful to not use differences in GDP growth as outcomes of different regulatory frameworks, but solely as an exogenous control variable.

One of ingredient of success of the Deutsch variety of capitalism may be attributed to codetermination and the device of a two-tier board. The micro econometric evidence, even if little quantitative literature has been devoted to scrutinize the main effects of co-determination, is well represented by the study of Fauvera and Fuest (2006). The authors, who integrate the study carried out by Gorton and Schmid (2004) study, consider a sample “of all publicly traded (AG) German corporations as of 2003, including firms with varying degrees of labor representation (from zero to more than one-half) and firms for which labor representation is both optional and mandatory” (p. 677). What Fauvera and Fuest find, using their sample, is that prudent levels of employee representation on corporate boards can increase firm efficiency and market value.

Similar findings are obtained by Vitols (2004), who shows that in Germany the increasing importance of institutional investors is accompanied by the parallel use of long-term commitment of ‘core’ employees. “An augmented stakeholder system is emerging through the inclusion of institutional investors in the old stakeholder coalition of interests. On the level of practice, it is argued that negotiated shareholder value is being adopted in Germany. This German variant of shareholder value is distinct from Anglo-American practice because major changes implementing shareholder value must be negotiated within the augmented stakeholder coalition.” (Vitols, 2004, p. 357)

A recent episode in the car industry offers fruitful insights: the German case of Volkswagen:

“Volkswagen became the latest German carmaker to safeguard jobs at factories in its home market, agreeing a deal that will rule out job cuts until 2014 for 100,000 staff. …It comes after Daimler struck a deal to guarantee jobs for 10 years at its biggest German factory, an agreement remarkable for its duration in the face of the acute slump in the car industry. VW’s deal with IG Metall follows an agreement last year between company and union for an increase in salaries of more than 4 per cent, when the company also secured agreement to introduce a small element of performance-related pay. VW is also sticking to its target of trying to raise productivity by 10 per cent a year.”


However, it must be admitted that in the last few years, recent trends have been observed in terms of convergence towards a market oriented system even
there is also supportive evidence that some fundamental differences are still significant.

For instance, in Germany there have been significant shrinkages in the coverage of collective bargaining and the expansion of various non-standard employment relations. In this country, larger numbers of workers are outside the pool of core workers and as noticed by Thelen (2009, p.483), “the problems currently plaguing the German training system have less to do with the quality of training them than they do with the quantity of training slots available to youth.”

The importance of other prominent changes in labour regulation is the focus of the next section.

4. New developments and recent evidence

Various additional points have been raised in the last few years. Some interesting issues, focused on labor and internal governance are briefly reviewed below.

4.1 Internal governance and ‘critical employees’

Insider labor may also play crucial role in the internal operation of a firm, as argued by Acharya, Myers and Rajan (2009). The authors start their analysis by critically evaluating the system of checks and balances that monitor the decisions of corporate managers. They observe that CEOs are often self-interested (as already shown by Shleifer and Vishny, 1997); the market for corporate control plays an insufficient role, as disciplinary devices and shareholders exert poor control over institutional mechanisms like boards (see also Monks, 2008).

However, they argue “that there are important stakeholders in the firm, such as critical employees, who care about its future even if the CEO has short horizons and is self-interested and shareholders are dispersed and powerless. These stakeholders, because of their power to withdraw their contributions to the firm, can force a self-interested myopic CEO to act in a more public-spirited and far-sighted way (Acharya, Myers and Rajan, 2009, p. 1). This process can be called ‘internal governance’.

Three points qualify this new mechanism of governance. First, there is a bottom-up influence exercised by those employees who have no formal control, but who may affect the firm’s rents. Second, there are also non-financial investors, such as employees, who make firm-specific investments, as already shown by Blair (1999). Third, the presence of different parties as different claimers and with different time-horizons introduces the need “to pay attention to others’ residual claims in order to elicit co-operation “(Acharya, Myers and Rajan, 2009, p. 1).

Internal governance has a natural premise in the new concept of firms advanced by others, including Rajan and Zingales (1998, 2000), in which the availability of financing has given investments in intangible assets such as human capital more importance. In the new firm, which qualifies as a nexus of explicit and implicit-relational contracts, i.e., informal agreements sustained by the value of future relationships (Baker, Gibbons and Murphy, 2002), top executives develop closer contacts with lower-level but talented employees; middle managers are eliminated, and “the firm bifurcates into top management who are owners/partners ... and worker/managers who cannot be trusted till they have served time in the firm” (Rajan and Wulf, 2003, p. 32).

In terms of internal organization, a trend towards delayering seems to emerge. Two specific dimensions of the firm’s hierarchy must be considered: breadth (number of positions reporting to the CEO) and depth (number of positions between the CEO and the divisional manager). An examination of both dimensions, like that performed by Rajan and Wulf (2003) for the 1990s in over 300 large U.S. industrial firms, reveals organizational changes toward a new flattening firm. For instance, in terms of breadth, “the number of managers reporting to the Chief Executive Officer (CEO) has increased steadily over time, from an average (median) of 4.4 (4) in 1986 to 7.2 (7) in 1999”. In terms of depth, “the number of positions between the CEO and the lowest managers with profit responsibility (division heads), has decreased steadily by more than 25% over the period” (Rajan and Wulf, 2003, pp. 1-2).

In the new firm, incentives must promote specialization of human capital but also avert competition from talented and key employees who can exit from the firm. For instance, Rajan and Zingales (2000, p. 28) offer some examples which show the importance of human capital and encourage the search for new foundations for corporate finance, such as that of the advertising agency Saatchi and Saatchi:

"In 1994, .S. fund managers, who controlled 30 per cent of the shares, opposed the award of a generous option package to Maurice Saatchi, the charismatic chairman of Saatchi and Saatchi... The opposition of the fund managers led to the departure of Maurice Saatchi, and was quickly followed by the resignation of several key senior executives. These executives, together with the Saatchi brothers, started a rival agency (M&C Saatchi), which in a short period of time captured some of the most important accounts of the original Saatchi & Saatchi, including British Airways, Mars, Dixons, and Gallagher. Interestingly, one of the executives who left, wrote in his resignation letter: ‘I am not leaving the company. The company has left me’."
Figure 2. The Flattening Firm - Organizational Span in a sample of 300 large US companies

Source: Rajan and Wulf (2003, Tab.2, p.41; Tab. 4, p. 43)

The process of empowerment thus needs a higher proportion of the value of incentive - long-term pay to the value of salary and bonus, as shown in Figure 3, which demonstrates that, as the number of the positions reporting to the CEO increases, the importance of long-term rewards also increases.

In sum, the modern corporation profile, which emerges from the American scenario depicted in the studies mentioned above, shows an intrinsic need for lengthening its governance devices: short-run fixed rewards are partially substituted by long-run incentive payments; top executives develop closer contacts with ‘critical’ employees, as signaled by recent trends in breadth and depth changes in the firm.

The serious drawbacks have been represented by the malfunctioning of the Anglo-Saxon incentive system, which has left too much space to entrenchment and managerial misconduct (Bebchuk and Fried, 2003) and income inequalities (Freeman, 2007). The view of “Executive Compensation as an Agency Problem” (Bebchuk and Fried, 2003), has had an influential role in explaining how CEOs payments have been set by rent seeking executives, rather than by competitive forces.

In any case, other different failures have characterized European economies, as we will see below.
4.2 Changes in labour regulation in European economies

Important changes in labor regulation (and deregulation) have characterized the European economies and influenced their performance in terms of innovation and productivity.

One main channel which secures flexibility is numerical flexibility, represented by the use of temporary and part-time contracts. It is known that the most important rules for the protection of labor contracts are measured by the OECD Employment Protection Legislation index (EPL), which covers two different areas: regular jobs or temporary works. In the first area, job protection is represented by firing restrictions. In this case, negative effects are expected, since opportunistic behavior is encouraged under lower threat of dismissal (Boeri and Jimeno, 2005). In the second area, we find deregulation of employment contracts, which allows firms to use fixed-term contracts or temporary work agencies. Usually, in the case of rigid regulations for permanent employees, fixed-term contracts play the role of ‘buffer stock’; their importance is thus conditioned by several crucial factors such as the role of firing and hiring costs, elasticity of substitution between permanent and temporary workers, and relative wages of permanent and fixed-term employees.

Other arguments show that there is a trade-off: employment protection raises the costs at separation, but also encourages specific investments and efficiency. In this vein, Belot, Boone and van Ours (2007), using a theoretical model and empirical estimates for 17 OECD countries, highlight the existence of an inverse U-shaped relationship between employment protection and economic growth. They show that the exact optimal level of employment protection depends on other labor market features, such as the bargaining power of workers and other wage rigidities (e.g., minimum wages). They found that, when effort and investments in human capital are non-contractible, employment protection solves hold-up problems. Protection of this kind encourages employees to invest in firm-specific human capital and this beneficial effect is stronger in those sectors in which firm specialization in competences is more important.

Note that temporary contracts may have important effects. On one hand, under the assumption that temporary workers intend to obtain permanent positions, these arrangements may be screen devices to select new employees, and are thus “potential ‘stepping stones’ to generally preferable permanent jobs” (Engellandt and Riphahn, 2005, p. 282). On the other hand, fixed-term contracts reduce the training motivation for workers and firms and discourage investments in firm-specific human capital.

The European scenario is an ideal case to test these competing hypotheses, since reforms in temporary contracts have characterized various countries and have been more important than changes in rules for regular contracts. Indeed, three main components are included in the OECD indicator for EPL strictness: protection of regular workers against individual dismissals, requirements for collective dismissals, and regulation of temporary employment (OECD, 1994, p.65). The changes recorded by the OECD, shown in Figure 4, show that the greatest relaxation in the strictness of rules has been recorded for temporary contracts.

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**Figure 3. Number of Positions reporting to the CEO**

- Long-term incentives
- CEO

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**Figure 4. Changes in labour regulation in European economies**

- Long-term incentives
- CEO

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We also examine the strictness of rules on temporary work agencies and fixed-term contracts, computed by Brandt et al. (2007) for a subset of European economies, and by considering time-varying cross-country data (Figure 5):

**Figure 5.** Development of employment protection legislation of temporary contracts - 1995-2008

Source: OECD. The figure shows evolution of indicator computed by authors; scale is 0-6 and falling values mean less restriction on temporary contracts.
Figure 5 shows that there has been considerable diversity in the dynamic patterns of the stringency of temporary contracts, and Italy has made the most significant change toward deregulation. Additional evidence shows that changes in formal rules have been accompanied by changes in de facto practices, as Italian companies have recorded drastic increases in employment flexibility.

These changes were recorded in a period which witnessed the re-emergence of a divide between Europe and the US. In the words of Trichet (2007):

"Faster output growth and slower labour input growth have jointly contributed to increase measured labour productivity growth in the US. These recent developments are in stark contrast to the rest of the post-WWII experience. First, they represent a break in the process of European catching-up and a resumed widening of the productivity gap with the US. Second, the broad tendencies across the Atlantic are no longer aligned, so we cannot explain them with the occurrence of a worldwide adverse shock, such as oil in the 1970s. The roots of the European productivity slowdown must be found within Europe."

One of the hypotheses suggested by Trichet “is that the aggregate euro area picture is misleading, because important differences exist across countries”. Among these differences, the main divide, as in the EU-US comparison, is attributable to Total Factor Productivity. Indeed, in the intra-European context, the main disparity in labor productivity growth between individual European economies is to be found not in differences in the intensity of the production factors, but in the multifactor productivity component, the residual measure which captures not only unmeasured inputs but also effects due to organizational and institutional changes.


<table>
<thead>
<tr>
<th>Country</th>
<th>Labor Productivity growth</th>
<th>TFP growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>1.63</td>
<td>0.89</td>
</tr>
<tr>
<td>Belgium</td>
<td>1.12</td>
<td>-0.19</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.63</td>
<td>-0.28</td>
</tr>
<tr>
<td>Finland</td>
<td>2.31</td>
<td>1.56</td>
</tr>
<tr>
<td>France</td>
<td>1.63</td>
<td>0.61</td>
</tr>
<tr>
<td>Germany</td>
<td>1.74</td>
<td>0.68</td>
</tr>
<tr>
<td>Ireland</td>
<td>3.62</td>
<td>0.63</td>
</tr>
<tr>
<td>Italy</td>
<td>0.42</td>
<td>-0.29</td>
</tr>
<tr>
<td>Neth.</td>
<td>1.53</td>
<td>0.58</td>
</tr>
<tr>
<td>Spain</td>
<td>0.54</td>
<td>-0.68</td>
</tr>
<tr>
<td>Sweden</td>
<td>2.38</td>
<td>0.79</td>
</tr>
<tr>
<td>UK</td>
<td>1.89</td>
<td>0.42</td>
</tr>
<tr>
<td>EU13</td>
<td>1.62</td>
<td>0.39</td>
</tr>
</tbody>
</table>

Source: EU-KLEMS

One explanation is that reforms ‘at the margin’, which enlarge recourse to fixed-term contracts, allow firms to exploit hiring flexibility in favorable business conditions, but not to obtain downward flexibility in adverse conditions; possible employment gains due to the reforms are offset by productivity losses due to decreasing marginal returns (Boeri and Garibaldi, 2007).

An examination of recent studies which test the role of labor protection shows fluctuating results. Some contributions, through econometric estimates and samples of ample coverage, have found that union density, unemployment benefits and product market regulation generally contribute toward increasing joblessness, but that high degrees of employment protection may exert opposite and beneficial effects, since higher job security increases effort and reduces wage bonuses; they also found substitutive effects of product and labor market regulation, since an increase in product market competition, increasing labor turnover, lowers job security (Amable et al, 2007). Others separate the role of temporary contract legislations and document the (negative) influence of lower temporary contract regulation on productivity growth (Dew-Becker and Gordon, 2008; Damiani and Pompei, 2009). By country-sectoral comparisons, they found that shorter-term jobs and lower employment tenures may discourage investments in skills and have negative effects on multifactor productivity growth; conversely, forms of employee involvement in corporate governance, such as co-determination, mitigate these perverse effects on efficiency patterns.

Other authors have found negative effects only for protection of regular jobs but not for temporary ones (see Bassanini, Nunziata and Venn, 2009). A brief array of the selected empirical contributions which test the comparative performances of corporate governance and labor institutions is given in Table 7.
Table 7. Comparative capitalism and labor protection: some selected econometric studies

<table>
<thead>
<tr>
<th>Study</th>
<th>Sample</th>
<th>Institutional indicator(s)</th>
<th>Dependent variables</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Botero et al. (2004)</td>
<td>85 countries</td>
<td>(i) Employment laws, (ii) collective relations laws, (iii) social security laws</td>
<td>Unempl. rate, labor force participation, size of unofficial economy</td>
<td>More severe labor regulation is associated with lower labor force participation and higher unemployment, especially of the young.</td>
</tr>
<tr>
<td>Barker and Rueda (2007)</td>
<td>18 OECD countries 1976-2004</td>
<td>Insider labor power: I) employment protection; ii) wage growth in manufacturing; iii) hours worked in manufacturing</td>
<td>International equity issuance, equity market capitalization, value of equity traded, shareholder protection</td>
<td>Higher levels of employment protection for insider labor, limited liberalization of capital markets and low degree of minority shareholder protection promote a more block-holder dominated system of corporate governance.</td>
</tr>
<tr>
<td>Hall and Gingerich (2004)</td>
<td>20 OECD countries 1971–1984 and 1985–1997</td>
<td>Indices for labor relations and corporate governance</td>
<td>Economic growth</td>
<td>Institutional complementarities are confirmed; labor market deregulation is influential only in nations where financial markets are similarly fluid.</td>
</tr>
<tr>
<td>Amable, Demmou, Gatti (2007)</td>
<td>18 OECD countries 1980-2004</td>
<td>OECD indicator for labor-product market regulation (EPL and PMR) and finance (credit to economy and financial assets to GDP)</td>
<td>Unemployment, joblessness and inactivity</td>
<td>Positive effect of EPL on employment performance; substitutability relationship across product and labor market regulation policies</td>
</tr>
<tr>
<td>Damiani and Pompei (2010)</td>
<td>16 European countries 1995-2005.</td>
<td>(i) Employment laws, (ii) collective relations laws (Botero et al. 2004 source)</td>
<td>Total Productivity (TFP) growth</td>
<td>Low protection of fixed-term contracts has negative effects on TFP; collective relations measures (including co-determination) have positive effects</td>
</tr>
</tbody>
</table>

As mentioned above, various labor market regulations offer remedies for hold-up by employers, as regards provision for insurance, job-seeking and training incentives, and many studies on macro-economic frameworks have analyzed the impact of these policies on employment and unemployment rates, or on unemployment inflows and outflows, as reviewed by OECD (2007), but have reserved less space to evaluation of corporate success. However, some recent contributions have addressed this issue, although empirical evidence calls for further examination of the conditions which support employment tenure, investment in skills, and organizational improvements which outperform short-term oriented arrangements.

6. Conclusions

Two main lines of research have been considered. The first, oriented to a shareholder perspective, sees access to finance as the major condition for firm success and considers high labor regulation, as well as lower shareholder protection, as serious obstacles to this access. The second - more fragmentary - view calls attention to the importance of institutional complementarities by showing that systems of labor regulation exert their function in strategic interactions with other institutions. In this perspective, Liberal Market Economies provide economic agents with greater opportunities to acquire general skills, adoptable to multi-purpose technologies, whereas Coordinated Market Economies offer institutional support for forms of industry-specific training, adopted in environments of collaborative research and development between firms. These results may reflect differing sectoral specialization. Indeed, the industrial structure of stakeholder economies, such as Germany and Japan is significantly different from that of shareholder countries -the US and UK. In the first group, manufacturing industries are much more important, whereas in the second group services are predominant. One future line of research is to ascertain, as noticed by Allen, Carletti and Marquez (2009, p.29), “whether the different industry and corporate governance structures across countries can be attributed to the fact that cost uncertainty is relatively more important than demand uncertainty in manufacturing compared to services”
Other concerns for sectoral specialization are important. Countries with uncoordinated industrial relations have a comparative technological advantage in industries characterized by an entrepreneurial technological regime, typified by general skills and patterns of radical innovation; this regime, in turn, is associated with a flexible labor market, but also by the internal governance exerted by ‘critical employees’. Countries characterized by industries with a population of large and well-established firms make more use of the firm’s internal labor market and need high and stringent employment protection. In these economies, work councils, cooperating with management in more shareholder-value oriented firms, are mainly adopted in economies with firm- and industry-specific skills and cumulative innovation. We have also seen that Germany is an ideal case to verify “whether employee representatives - while seeking to govern the firm in a manner that protects their own interests—indirectly protect the interests of minority shareholders and thereby increase firm value.” (Fauver and Fuerst, 2006, p. 674).

In sum, a central and common concern is the importance of labor relations. In the US, transferable-general managerial ability leads to more external hires, and increases in equilibrium top executive wages. In economies like Germany, with cumulative innovation systems and firm or industry-specific skills, codetermination devices and job guarantees typify a different successful road.

What reveal unsuccessful are experiences of those countries, Italy is a case in point, simply characterized by significant changes toward increases in employment flexibility, without innovation in human resource management practices and stimulus to training and upgrading of skills, with detrimental effects on productivity growth.

References


30. OECD, Employment Outlook, Paris, various years.


Notes

1. The employment laws index is the average of four different measures: i) alternative employment contracts; ii) cost of increasing hours worked; iii) cost of firing workers; iv) dismissal procedures. The collective relations laws index is an average based on two indicators: i) labor union power; ii) collective disputes. The Social Security laws index considers three different measures: 1) old age, disability and death benefits; 2) sickness and health benefits; 3) unemployment benefits.

2. Djankov et al. (2008) consider five indicators of stock market development: i) the average ratio of stock market capitalization to GDP; ii) the (median) premium paid for control in corporate control transactions; iii) the average number of domestic publicly traded firms; IV) the average value of initial public offerings; a proxy for ownership concentration.

3. The authors consider a duopoly two-period model, in which decisions adopted in the first period influence the survival of the firm and hence the second period results. They show that, in the case of cost uncertainty, the survival probability increases by the fact that higher prices are charged (to offset higher costs); in this case, the shareholder and stakeholder approaches are equivalent. This is not true in the case of demand uncertainty, when competition is intensified and incentives firms to reduce their prices; however, these incentives are lower in stakeholder firms.

4. Rajan and Wulf use “a detailed database of job descriptions of top managers, reporting relationships, and compensation structures in over 300 large U.S. firms tracked over a period of up to 14 years” (Rajan and Wulf (2003, p. 1).

5. The authors, reviewing a large body of literature, observe that: “The evidence supporting the standard view that labour deregulation yields a positive impact on employment is, however, seemingly not conclusive-” (p. 5).
