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# Regulatory Restraint and Competitiveness – Insights from the New Institutional Business Economics

## Abstract

Firms are major actors in the labour market. Neither macroeconomic or macrosociological reasoning about accumulation regimes nor the ideological presuppositions of 'the' economic analysis of labour law are of great help in tracing the impact of regulation of the labour market and the employment relationship on corporate employment, investment and location decisions. Inspired by the new institutional theory of the firm, we pursue instead empirical examinations of single regulatory practices in order to identify both the costs and the benefits of regulations accruing to firms.

## Microeconomic Approaches to Labour Law

In the western industrialised world, there can be no doubt that a growing number of not only large companies buy globally and change their locations purposefully. Decision makers and observers take different opinions on the decisive motives for these changes – proximity to non-saturated markets, preferential tax treatment, less environmental regulation, for example. There is, however, a certain understanding that direct and indirect labour costs – including wages and fringe benefits, recruitment, training and separation costs and all other costs of organising and utilising a work force – might well harm the competitiveness of firms based in countries with highly regulated labour markets and industrial relations and with a relatively generous welfare system often financed by 'taxes' on labour. In a country like the Netherlands or Germany, would an increased flexibilisation and deregulation of the employment relationship lower the overall user costs of labour for a company? And likewise its profitability or competitiveness, in the short and in the long term? An answer to these questions should be able to inform the debate concerning legal reforms of labour law and industrial relations, even if efficiency considerations are only part of the criteria relevant for legal actions.

My paper is not meant to irritate the organisers of this colloquium who took the initiative in order to fight 'the current dominance of sheer economic approaches'. Instead, I shall follow their invitation and present insights from a particular perspective, namely 'the new institutional business economics' or 'the institutional theory of

the firm'. In this perspective, firms are conceived as acting within a legally and institutionally structured environment. The ubiquity of incomplete and relational contracts between employer and employees, between employees, and between employees and unions gives rise not only to market and bargaining power, but also creates incentive problems endangering lasting co-operation. Among the various strands of literature contributing to an economic understanding of business decisions in an institutionalised world (cf. Sadowski 1996), we stress the economic analysis of labour law and industrial relations.

There are answers to our questions in the literature. Some observers, among them many adherents of the 'law and economics' movement, plead for a far-reaching deregulation of labour-markets and firms to allow for the profit *and* welfare enhancing effects of free, private contracting (cf. Velasco 1973, Epstein 1984). A popular argument pretends that privately efficient institutions do not need to be enforced and that the cost of a lost reputation ensures the (allocationally) efficient breach of explicit or implicit contracts. In clear opposition, sociologists like Streeck (1992: 130) argue that even firms '...fare best if, rather than relying on their private organisational endoskeleton, they build on, submit to, and invest in a common, public institutional exoskeleton to guide their decisions and facilitate their activities'. Illustrating his case against 'economism' he holds that broad and high skills as well as social peace, two redundant capacities necessary for diversified quality production, '... are more likely to be created as a matter of collective institutional obligations rather than individual economic interests' (ibid. 133), and he explicitly includes legally compulsory arrangements. Arguing 'against the deregulatory institutional changes towards the neoclassical minimum' (128) Streeck refers to the German 'virtuous circle' and gives good reasons why the present European institutional rigidities should and could be turned to productive use in forcing management to abandon price-competitive markets and to embark on more demanding, high-value added production.

Given the current dramatic crises of many blue-chip corporations in Germany and Europe, Streeck's and similar contributions may either be judged as already outdated[1] or as plainly wishful thinking. Despite their intriguing coherence, macro narratives of the importance of institutionally rich systems or regimes usually suffer from empirical and economic vagueness: the number of variables considered to be important in each country and the number of countries available for comparison hardly ever match.[2] Scharpf (1988: 61-63) soberly concludes that a combination of idiographic observations and deductive reasoning is the only way out. Adding the business economist's fear of 'ecological fallacies', i.e., the unwarranted inference from aggregates or averages to individual events, and his or her preference for firm

[1] To be fair: Streeck (1992: 145) conceded ' ... that not all institutional rigidities constraining markets and hierarchies are always and necessarily benevolent, and not all social systems of production happen to match the requirements of growing, turbulent and volatile markets for customised, non-price-competitive goods' – but the question here is: which one do? In a paper published only three years later Streeck (1995: 11) himself speaks of '... the success of the 'German model', as long as it lasted,...' and he expresses a certain support for pessimistic predictions about the viability of the German model of capitalism vis-à-vis the deregulatory bias of globalization (ibid.: 28).

[2] A striking example is Smith's (1991:276) attribution of German export success to one single variable, the codetermination laws.

level data, it seems worthwhile to leave the systemic, general view upon the logic of a 'European accumulation regime' in favour of less aggregated reflections and analyses of specific regulatory practices and their impact on the performance of single firms. While the neo-classical supporters of 'law and economics' may systematically *under*estimate the benefits of regulation, those who praise the richness of an institutional environment neglect the costs and appropriate limits of richness and tend to *over*estimate the benefits of regulation.

We will not dwell here upon the familiar difference between individual and collective rationality (for example, external effects) or upon other theories of integrating single markets into the whole economy, i.e., micro-macro approaches. We will also exclude theories of so-called social market economies. Instead, we direct our empirical analyses towards the aim of tracing corporate reactions to labour regulations.

This departure from organisation theory and business economics leads us to a micro-micro approach. It is in itself of great interest and importance and should finally bring us to less speculative hypotheses about the efficiency results of regulation and regulatory restraint, than do macro narratives. In addition, an approach emphasising the variance between firms, a so-called micro-micro perspective, is a strong desideratum in any theory that places co-ordination failures at the centre of reasoning.[3]

## Business Costs and Benefits of Labour Legislation

We build on the idea that firms – at least temporarily – can have monopsony power and that they can shape their internal organisation. They do not live in a world of *perfect* competition where all differences between competitors are levelled out. It will be the case that firms have built up their market positions by having strategically exploited the opportunities created by their legal environment, for instance, by patent laws, tax exemptions for certain types of labour, or state early retirement provisions. We even envisage the possibility of gaining a competitive edge by self-regulation and commitment investments: Why should the promise of tenure not cause effects similar to an extraordinary warranty promise?

When firms meet on the market place, there may be circumstances where they profit from collective coordination. There are few economic standard arguments put forward in favour of legal restrictions of market behaviour and of the internal functioning of firms beyond the guarantee of freedom of contract and private property – which according to the liberal creed in turn assure prosperity and a civilised society. The history of labour law is a history of the establishment and protection of worker rights. This history is of interest here only insofar as fairness, justice or 'social cohesion' correct market failure and foster the competitiveness of companies – no doubt a rather narrow view.[4]

[3] Cf. for instance the New Keynesian Macroeonomics (Gordon 1990: 1163).

[4] Traditionally, positive consequences of restrictions figure prominently in pedagogical and legal discourses. Today, however, the question of economic *growth promotion* is even raised with regard to environmental regulation (cf. the supporting stance of Porter and Van der Linde, 1995 and the opposing view of Palmer, Oates and Portney, 1995).

One type of argument draws on the *prisoner's dilemma*. If only a third party can enforce the co-operation advantageous to both bargaining parties, there is a role for the state or the law to bring about results that are both in individual and collective interest. More generally, even if the *costs of individual transactions* are not prohibitively high, they may sometimes be lowered by compulsory decisions (cf. the standard case for a compulsory statute of public corporations, namely to overcome investor reluctance in the face of uncertain information rights and liabilities). The more the object of a common interest has the characteristics of a *local public good* and the higher the number of interested parties, the more likely it is that an external, legal intervention can reduce the cost of finding a solution advantageous to the participants of an exchange.

Another type of argument emphasises the long term beneficial effects of restrictions which are manifestly costly in the short term. Such possible investment or *dynamic efficiency* properties of legal interventions, reasonable as they are, may easily serve as a rationalisation of any regulation.

Whether all these types of benefits are real or merely alleged and whether they outweigh the costs of compliance to companies – to repeat: an important, but one-sided perspective, is a matter of empirical analysis of regulatory practices and institutional options. In the main section of my paper I will report results of studies aiming at such empirical examinations of the impact of labour regulations on firm behaviour and performance. All the studies were conducted at the Institute of Labour Law and Industrial Relations in the European Community at the University of Trier, Germany.[5]

The studies selected address the following questions:

1. Is the quest for simplicity of those labour laws that are deemed indispensable really in the interest of companies, as their representatives usually purport?
2. Do procedural regulations do more justice to the particularities of individual firms than substantial norms? How decentralised should effective standard setting be?
3. What are the effects of worker codetermination? Do mandated institutions of worker representation display effects different from voluntary, firm-created ones?
4. Do national vocational education and training institutions create society-wide, general effects, or is there evidence for a strong variance between firms beyond any nationally dominant features? Furthermore, is there firm level evidence of the often praised superiority of the German apprenticeship system, which is strongly rooted in traditional institutions, but relies on voluntary participation, over the legally mandated training obligations of French firms?

### *1. Simple vs. Complex Regulations: The Employment of Disabled Persons*

The complexity of rules, it is true, is not without costs, but is it therefore cheaper to comply with simple laws? The widespread and intentionally impressive use of pay-

[5] A complete list of IAAEG projects and publications is available upon request; they include books on personnel policies of multinational companies and on corporate compensation policies in borderline regional labour markets, i.e., under regime competition.

ment-based cost accounting of regulation is misleading. Schröder (1996) instead develops an opportunity cost calculation and compares the costs of a lack in differentiation with the administrative costs of a complex, sophisticated casuistry. Depending on the variety of situations that companies face, a simple, general rule may prohibit an easy administration and lead to biased competition, if, for instance, young or big enterprises happen to cope better with certain norms than do old or small ones. Such 'under-inclusiveness' of norms rarely gets the attention in the current debates it deserves, partly because such opportunity costs are difficult to measure. The appropriate degree of regulatory detail – the selectivity and accuracy of a rule – must be judged in the face of the variety of the facts of possible cases. Schröder (1996: 65-85) attempts an admittedly crude ranking of alternative means of legal intervention according to their elasticity and their accuracy to capture the specificities of a case on the one hand, the distance they secure between decision makers and decision takers on the other hand: acts, regulations, administrative acts with different degrees of discretion and informal proceedings of administrative agencies and, finally, judge-made law.[6] According to empirical analyses he feels forced to distinguish *at least eighty* different firm situations with regard to the employability of disabled persons – not counting the great variety of impairments: Firms fall in four different size brackets, in two age groups, under five different degrees of health stress, and principally divide into two groups of labour organisation (with patterns of long or short term labour contracts respectively). Schröder then undertakes a comparison of the costs of under-inconclusiveness of the laws to foster the employment of handicapped persons in France and Germany. He concludes that the simpler, more conclusive current German Severely Disabled Persons Act is most likely to result in higher net costs for the majority of enterprises than two more complicated alternatives: the current French Loi n( 87-157 (Loi en faveur de l'emploi des travailleurs handicapés) as well as the former German Disabled Persons Act from 1953 with its subsequent implementing regulation.

### 2. *Procedural Regulation vs. Substantial Prescriptions: Wages and Fringe Benefits*

In many contexts, the decentralisation of negotiations on wages and other working conditions is praised for its capacity to allow for flexible agreements at establishment level, if not workplace level. Such pleas often come with a general preference for procedural regulations over substantial prescriptions, the so-called hardship and opening clauses in industry-wide collective agreements in Germany being a particular example for the firm-specific adaptability and decentralisation of wage-bargaining. Focussing on the distributive consequences of the allocation of rights to the parties bargaining over the firm rent Pull (1996) models the employer's decision to voluntarily offer wages and fringe benefits over and above what they are legally obliged to – as a (sometimes implicit) form of bargaining between employer and employees. She takes the asymmetric NASH-bargaining-solution as a reference point

[6] Aspirations should be modest: As Tullock (1995: 199) states: 'As far as I know, the subject of how much detail we should have in the law has never been seriously discussed before.'

and shows that the production conditions (labour intensity, substitution possibilities, and the degree of firm-specific investments) make a big difference on the outcome, as does the product market position of firms. There are high costs of misunderstanding, if all the variation is suppressed in favour of a 'representative firm'.

Pull and Sadowski (1996) use this approach to examine how the bargaining power and the fall-back positions of the bargaining parties are influenced by legal entitlements, all else being equal. While, in Germany, employees' fall-back positions are given by well-specified compulsory minimum standards, their bargaining power is influenced by procedural rights of codetermination. These procedural entitlements leave much more leeway, often intentionally. With regard to the dual system of German collective bargaining Pull and Sadowski challenge the widely held view that industry bargaining keeps conflictual distributive bargaining out of firms. They provide firm-level evidence and explain with recourse to micropolitics and organisation theory why usually the higher echelons of management are the favourite recipients of 'social' fringe benefits. They draw two conclusions on the relative importance of procedural and substantial regulations in industrial relations:

- Compulsory minimum standards do not only influence the amount of fringe benefits and wage premia offered by *marginal* establishments, but – representing fall-back positions – exert an influence on the compensation policies of *every* establishment, including intramarginal firms. This impact of minimum standards on wages and fringe benefits is generally underestimated.
- While procedural rights are often praised for their efficient adaptability to firm-specific circumstances, their usefulness as a tool to raise workers' bargaining power depends on important non-legal resources. The impact of procedural entitlements is therefore generally overestimated in the debate on the appropriate framing of industrial relations.

Contradicting naive deregulatory hopes, both contributions underline the insight that simplicity and flexibility may not only jeopardise regulatory objectives but – what is more important in our context – hit companies in unintended ways and to different degrees – thus missing the proclaimed goal of enhancing a fair competition between companies.

### *3. Voluntary vs. Mandated Regulation*

#### WORKER PARTICIPATION

Surprisingly little is known empirically about the efficiency properties of the German works constitution. The available studies on the relationship between aggregate firm performance (productivity, profits, investments, etc.) and the existence of works councils are inconclusive, not the least due to major methodological deficiencies. In an attempt to overcome these data and measurement problems Frick (1996) singled out the field of personnel turnover to study the impact of dismissal protection and worker powers given by the German Works Constitution Act. He compared the turnover and efficiency consequences of the relatively strong insider position of Ger-

man workers with the outcome of the rather different labour law and industrial relations system in Britain and Australia – again using data collected on the low aggregation level of firms or establishments.

Frick (1996) draws on modern theories of the labour contract and the employment relationship (co-specialised investments, information asymmetry, post-contractual opportunism) and shares Aoki's (1984) notion of organisational efficiency. This stakeholder view takes the *combined* utility of shareholders and incumbent employees as performance measure. Led by Hirschman's exit-voice scheme Frick assembles strong evidence to prove that works councils significantly reduce the number of dismissals, thereby securing workers' quasi-rents. Simultaneously they reduce the number of employees voluntarily leaving the firm, thereby reducing the turnover costs to firms by increasing workers' readiness to accept deferred compensation schemes. The non-mandated systems of worker representation in Australian and British firms exert no comparable influence on the dismissal decisions of management, their impact on resignations is much weaker. Frick attributes these differentials to the inherently lower credibility of legally non-mandated systems of worker representation. His findings rule out the idea of employer reputation as a powerful disciplining device in the labour market and show clear limits to self-regulation.[7]

It is worth noting that the robustness of the influence of mandated systems of worker representation implies general, nation-specific effects. *In retrospect*, these observations certainly lend themselves to more aggregate modes of reasoning.

### VOCATIONAL EDUCATION

My last example of our micro-microeconomic analyses of the impact of labour law and the institutional environment of firms refers to corporate training strategies. The classic comparison of skill formation and utilisation in French and German firms, 'l'analyse societale', that originated at the LEST, Aix-en-Provence, took great pains to demonstrate an eminent 'societal effect' on company organisation and policy (Maurice, Sellier and Silvestre 1986).

Analysing primary data on production and personnel policies of more than eighty – partly well matched – firms in Britain, Germany, France, and Luxembourg, Backes-Gellner (1995), however, convincingly demonstrates that there are indeed strong *firm level effects*. (Nearly) all firms following similar production strategies (mass production or flexible specialisation in manufacturing, comprehensive versus specialised services in banking) and, in manufacturing, acting under similar product market pressure finally arrive at the same factual skill blend, *independently* of the nationally different systems of vocational education and training.

These systems, it is true, determine the initial training situation, the process of upgrading, and presumably the costs of firm training in ways that vary according to firm characteristics, and also show differences between national averages.

[7] The organisational efficiency of the legal regulation of worker rights in vocational training in Germany is demonstrated in Sadowski, Frick and Backes-Gellner, 1995.

In Germany, companies rely heavily on initial vocational education. The apprenticeship system, though highly regulated, rests on voluntary participation. On average, industries and companies regularly rely on the external labour market to hire skilled personell or to offer apprentices trained in excess to their demand. The willingness to train has been weakening in recent years.[8] In France, most of the vocational skills are obtained through further vocational training and through learning by doing as part of systematic job rotation schemes – a system well supported by the legally compulsory obligation of French companies to spend at least 1.5% of the annual wage bill for training purposes. For manufacturing companies, comparisons of machine stoppages may serve as one indicator of the relative success of the national alternatives. Taking this yardstick and assuming similar machinery, German and French plants fare equally well. Although the regulatory policies towards vocational training are very different in both countries, they appear to be functionally equivalent. Despite popular belief the tighter French legal regulation compensates for the assumed lack of tradition in dual initial vocational education (Backes-Gellner 1996: Tab. 49).

Assessing these studies on labour institutions of presumably great importance for the competitiveness of companies, sometimes country or societal effects may be so strong that in the end a societal analysis is warranted. Often, however, the variation of the regulatory impact on companies within one country is wide, while firms in similar market contexts behave similarly despite different national institutional environments. In this case the idea of a representative national firm must be dismissed in favour of micro-micro-analyses. The more that global competition or supranational regulation level out national institutional differences, the more a business economics perspective seems to be appropriate right from the beginning.

## Institutional Business Economics and Supranational Social Policy Making

The new institutional business economics offers a partial but nevertheless fruitful approach to an assessment of the impact that the legal shaping of personnel policies, industrial relations, and labour markets has on the performance and competitiveness of firms. Stressing the private calculus reflects the importance, if not preponderance of company decisions in western economies nowadays, be they national, trans- or multinational in ownership or management. With the internationalisation of production and financing, it is even more important for single nation states to take into account corporate interests and corporate room for manoeuvring, no matter whether their policy-making is economically or socially motivated. Our analyses focus on *private net benefits* of regulation, the benefits often being neglected in the rhetoric of management as well as in the common libertarian analysis of law and economics, whereas macrosociologists are prone to play down private costs. We start with the refutable hypothesis that the idea of the representative firm is ill-suited to the reality

[8] Legal attempts to mitigate the incentive problems of the voluntary provision of general training by firms are dealt with by Sadowski (1981).

of competition, and we therefore allow for firm-level differentials (micro-micro-analyses). The empirical, international comparison of the firm-level impact of single regulatory practices is typically the touchstone for our economic hypotheses, and here we need the helping hand of labour lawyers to get to know and to understand the prevailing rules.

Management and politicians exposed to regime competition should profit from thorough international comparisons, because otherwise they might be misled by stereotypes and rash conclusions. Since the mobility of capital – and in a certain sense of labour, too – does no longer stop at the frontiers of nation states, any supranational effort to regulate labour markets is exposed to the same logic of private actors. It is therefore of general interest to know when public labour regulation does not merely impose costs on actors, but fosters market functioning and organisational competitiveness. This knowledge should be appreciated especially when the protection of workers and their representatives is the foremost preoccupation.

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