

Management Under Differing Labour Market and Employment Systems

Editors

Günter Dlugos, Wolfgang Dorow, Klaus Weiermair
in collaboration with Frank C. Danesy



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Editors

Prof. Dr. Günter Dlugos
Faculty of Economics and Administrative Studies
Department of Business Policy and Business Politics
Freie Universität Berlin, Berlin

Dr. Wolfgang Dorow
European School of Management (E.A.P.)
Paris, Oxford, Berlin, Madrid

Prof. Dr. Klaus Weiermair
Faculty of Economics and Administrative Studies
Department of Economics
York University, Toronto

Frank C. Danesy, M.S.B.A.
Faculty of Economics and Administrative Studies
Department of Business Policy and Business Politics
Freie Universität Berlin, Berlin

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Contributors

Adams, R. J., McMaster University, Hamilton
Aldrich, H., University of North Carolina, Chapel Hill
Blum, R., Universität Augsburg, Augsburg
Böhnisch, W., Universität Linz, Linz
Crispo, J., University of Toronto, Toronto
Danesy, F. C., Freie Universität Berlin, Berlin
Dlugos, G., Freie Universität Berlin, Berlin
Dorow, W., Europäische Wirtschaftshochschule (E. A. P.), Berlin
Endruweit, G., Universität Stuttgart, Stuttgart
England, G. W., University of Oklahoma, Norman
Fürstenberg, F., Rheinische Friedrich-Wilhelm-Universität, Bonn
Gramatzki, H.-E., Freie Universität Berlin, Berlin
Gunderson, M., University of Toronto, Toronto
Haus, B., Politechniki Wroclawskiej, Wrocław
Jaggi, B., The State University of New Jersey – Rutgers, New Brunswick
Jago, A. G., University of Houston, Houston
Kortan, J., Uniwersytetu Lodzkiego, Lodz
Kraft, K., Gesamthochschule Kassel, Kassel
Leibenstein, H., Harvard University, Cambridge
Mannari, H., Kwansai Gakui University, Nishinomiya
Marchington, M., The University of Manchester, Manchester
Marsh, R. M., Brown University, Providence
Martan, L., Politechniki Wroclawskiej, Wrocław
Murata, M., Chuo University, Tokio
Nikolopoulos, A., Hochschule für Wirtschafts- und Handelswissenschaften zu Athen,
Athen
Nutzinger, H. G., Gesamthochschule Kassel, Kassel
Oechsler, W. A., Universität Bamberg, Bamberg
Ondrack, D., University of Toronto, Toronto
Osterloh, M., Universität Erlangen-Nürnberg, Nürnberg
Picot, A., Ludwig-Maximilians-Universität München, München
Putterman, L., Brown University, Providence
Ragan, J. W., University of Houston, Houston
Reber, G., Universität Linz, Linz
Rippe, W., Universität Bamberg, Bamberg
Staber, U., University of New Brunswick, Fredericton
Staehe, W., Freie Universität Berlin, Berlin
Stathopoulos, A. N., Hochschule für Wirtschafts- und Handelswissenschaften zu
Athen, Athen

Strümpel, B., Freie Universität Berlin, Berlin
Takahashi, Y., Chuo University, Tokio
Walter, N., Universität Kiel, Kiel
Weiermair, K., York University, Downsview
Wenger, E., Universität Würzburg, Würzburg
Wheeler, H. N., University of South Carolina, Columbia
Wilson, H. T., York University, Downsview
Zander, E., Freie Universität Berlin, Berlin

The Employment Relation from the Transactions Cost Perspective

Arnold Picot and Ekkehard Wenger

Abstract

The transactions cost perspective rests on the assumption that utility-maximizing individuals seek for efficient solutions of organizational problems by contractual exchange of property rights. Unlike models of perfect markets it takes account of the fact that the operation of a pricing system is not without cost. Consequently, spot market coordination may be inefficient, because its transactions costs exceed those of other modes of contracting. This is especially true for specialized labor inputs, which for various reasons cannot be contracted in infinitesimal quantities on sequential spot markets. Hence, an employment relation emerges, which economizes on transactions costs by mutual agreement on a range of decisions submitted to the employer's authority.

In the absence of legal restraints, employment contracts are usually characterized by the reciprocal right of short-term cancellation, even though in the normal course of events sunk costs incurred during the initial contract period would make it detrimental to both parties to discontinue employment. Common belief that employees are "exploited" under unrestricted freedom of contract resulted in the adoption of various statutory measures, such as legally imposed protection against unfair dismissal, union privileges, or mandatory codetermination. The resulting alternative contract structures are compared with the traditional labor contract in terms of transactions costs.

1. The Transactions Cost Perspective as a Ramification of Neoclassical Economics

The transactions cost perspective rests on the assumption that utility-maximizing individuals seek for efficient solutions of organizational problems by contractual exchange of property rights. Under certain assumptions it can be shown that perfect and complete markets provide an efficient solution to such problems. This is the basic proposition of neoclassical economic theory which is usually referring to an analytical framework expounded by K. J. Arrow (1964) and G. Debreu (1959). Within an Arrow-Debreu-world, trade of contingent claims completely specified for every state of nature will lead to a Pareto-efficient allocation of resources, including an optimal distribution of risk.

Of course, the viability of such a solution to organizational problems depends on the assumption that the operation of a pricing system is without cost. If this assumption is abandoned, trade of contingent claims may be inferior to other modes of contracting. Costs of observing an agent's behavior, costs of unambiguously specifying the state of nature, and costs of drawing and enforcing contracts must be taken into account. As a consequence of such "transactions costs" organizational problems will emerge which cannot exist within the framework of an Arrow-Debreu-world; their explanation and optimal solution require a ramification of conventional neoclassical analysis by adopting a transactions cost perspective: alternative solutions to organizational problems are to be compared in terms of transactions costs. This is the basic proposition underlying two seminal papers of R. H. Coase (1937, 1960).

It has to be stressed that transactions costs are not necessarily costs that materialize in net cash outlays; all kinds of disadvantages associated with different modes of contracting, e.g. time consumption or enforcement efforts, have to be taken into account. To be sure, such non-financial costs have to be converted into a financial cost equivalent, if an evaluation of different forms of economic organization is to be performed in monetary terms; consequently, a correct and all-inclusive calculation of relevant transactions costs often meets with evaluation problems which can not be solved without relying on rough and ready guesses. Anyway, it would be foolish to ignore non-financial transactions costs because of computational problems or to disregard the existence of trade-offs between financial and non-financial burdens (Picot 1982: 271). Moreover, computational problems are not specific to non-financial burdens; under uncertainty, even the amount of future cash flows cannot exactly be calculated in advance. Every decision is based on more or less informed guesses; the rule that it is better to be vaguely right than precisely wrong applies to the transactions cost perspective as well as everywhere.

Another problem with the transactions cost perspective is equally pervasive. Speaking of costs, it does not make sense to evaluate "all" costs; what matters are only "relevant" costs that are affected by the decision in question. Hence, transactions costs need not be taken into account if they are "sunk" costs of former decisions. Costs of drawing a statutory law already in effect are irrelevant for activities of single business firms operating in an established legal environment; likewise costs of an existing organizational form of an enterprise are sunk costs with respect to subordinate agreements with single employees. Thus, transactions costs have always to be related to specific decisions or decision levels, with due regard to the consequences for subordinate decisions, if decisions on a higher level are taken. Hence, an evaluation of the costs of establishing a legal framework has to anticipate the transactions costs incurred by business firms engaging in contractual exchange within the framework in question (Michaelis and Picot 1987: 87-88).

After all, the transactions cost perspective is a starting point for a unified economic theory of organization, including both the micro- and the macro-level. To be sure, its explanatory power is neither unlimited nor equally distributed among different organizational problems; especially basic institutional changes, such as the French Revolution or the abolition of serfdom and slavery, cannot satisfactorily be explained from the

transactions cost perspective, at least not by now. But there is neither an economic nor a non-economic approach that offers a superior, much less a satisfying, explanation for such “macrosociological” phenomena without recourse to ad-hoc arguments (Domar and Machina 1984, Schüller 1985: 263, Stigler, 1984). If elimination of a theory requires a superior one, a transactions cost perspective may be helpful even in the analysis of basic institutional change, as long as no one in the social sciences can present a positive theory of the state that offers a satisfying explanation for phenomena of the kind mentioned above. Much less is there any reason to exempt the political system and its decisions from economic analysis – neither from a positive nor from a normative point of view.

This may seem far-fetched when it comes to an analysis of the employment relation; but it has to be borne in mind that the employment relation is one of the main targets of government regulation. Not only in most industrialized states but also in ancient and medieval societies the free exchange of private property rights in labour has been subject to severe restrictions imposed by authoritarian rulers, peer groups with legal privileges, or governments supported by majority voting. High enforcement costs and high violation rates notwithstanding, many of these restrictions have survived over decades or even centuries, and their final abolition was frequently accompanied by heavy shocks or breakdown of the political system. The interplay of special-interest coalitions, which lies at the heart of labor market regulation, has been analyzed elsewhere (Olson 1982); hence, the remaining parts of the paper do not deal with the evolution of institutional restraints governing the employment relation but concentrate upon how employers and employees adapt individually to a given legal framework. Individually optimal adaptation, of course, should not be mistaken for compliance, as is evident from a prospering shadow economy in heavily regulated environments; nevertheless, the shadow economy differs from the respective parts of a free labor market, because there is no recourse to the courts if a breach of contract occurs.

The next section explains the dominant mode of labor contracting under a regime of free exchange in terms of transactions costs; the subsequent and last section of the paper deals with the consequences of modern labor law.

2. The Employment Relation in Free Labor Markets

From the beginning, transactions cost analysis found its most important application field in the employment relation (Coase 1937, Williamson et al. 1975). It is here where the deviation of empirical contract structures from contingent claim trading is most striking; not even sequential spot markets, which under certain circumstances serve as a perfect substitute for contingent claims, bear any close resemblance to substantial parts of the labor market. Consequently, contracts are not devised as an exchange of completely specified goods or services; instead, the parties to the contract agree *ex ante*, i.e. when the contract is drawn, upon the distribution of decision rights to be exercised *ex post* (Wenger 1984). This can easily be interpreted in terms of transactions costs. As

it is prohibitively costly to anticipate all contingencies and the optimal actions of the coalition members when they enter into the employment relation, the implementation of the contract in concrete instances will be determined by decisions which will be taken according to the decision rights agreed upon initially. This later implementation necessarily carries distributive risks or even the danger of open distributional struggle, but has to be accepted as a flexible tool for coping with unanticipated changes in environmental conditions.

Labor contracts in a free market setting are usually characterized by the reciprocal right of short-term cancellation and the clear-cut authority of the employer. The employer's authority would be of no account, if the signing of labor contracts did not presuppose sunk costs and, therefore, require a longer pay-off period. Otherwise, labor services would be contracted in infinitesimal quantities on sequential spot markets involving no need for the employer's discretionary authority. But because sunk costs arise at the beginning of the employment relation, it is mutually advantageous for both contracting parties not to discontinue employment in the normal course of events. Nevertheless, the parties insist on the right of short-term termination which reflects the transactions cost of anticipating exactly those conditions under which a future continuation of the labor contract will be disadvantageous for either one of the parties.

The unilateral right to terminate the contract suggests that the employee is always able to secure at least the distributional position offered by the next best alternative. Without sunk costs, this would be sufficient to protect the worker's interests, because he would not have been better off without accepting the contract. With sunk costs to be borne by the workers, however, a mutually advantageous labor contract has to offer a wage differential over the next best post-contractual employment alternative. This quasi-rent¹ is the financial source for the amortization of their proportionate sunk cost components. Here, the right to terminate the contract is an inadequate protection for the employee, and there is no economic justification for the employer's bargaining power to appropriate the employee's surplus over the next best alternative by extorting wage concessions or by excessive use of discretionary power. Under unrestricted entrepreneurial power to redistribute cooperative rents at the expense of incumbent employees, the latter could not be induced to take over sunk costs. This may lead to the consequence that rents from team production, which could be created under a superior contractual arrangement, must be foregone. If this is true, *both* employer *and* employee have a vital interest in the protection of the latter's quasi-rents.

If employees have protective rights, however, there is no guarantee that these rights cannot be exercised in order to expropriate the employer. Protection against dismissal, for example, may reduce work incentives, because the employer can not fire a worker "at will"², but is dependent on a complicated legal procedure which increases transactions costs of discriminating against low performers. The ensuing moral hazard problems are a strong argument in favor of short-term termination rights. Hence, control of behavior and performance in free labor markets is predominantly based on "exit", when it comes to the well-known distinction between "exit" and "voice" coined by Hirschman (1970).

To be sure, an important school of management literature believes that moral hazard problems of free labor contracts may be solved more efficiently by trust relations and common values of industrial clans with long-term stability, in which employees' "psychological success and emotional well-being" should be assured (Ouchi and Price 1978). This is the basic message of "Theory Z" (Ouchi 1981). It has to be noted, however, that mutual trust is not a viable organizational device, if a breach of trust is individually rational. Hence, it is extremely difficult to establish a viable long-term trust relation without short-term termination rights. As game theory tells us, problems of the prisoner dilemma type can be solved in repeated game-situations, if the value of the first round is sufficiently low in relation to the net present value of all future repetitions (Taylor 1976). Consequently, bargaining within employment relations, where both parties have an interest in preserving their respective quasi-rents, may lead to efficient results only if either side is entitled to short-term exit, a provision that reduces the value of the first round, thereby destroying either side's incentives to cheat (Wenger 1984).

Other deterrents against cheating certainly do exist, as is shown by Theory Z with its close resemblance to "medieval views that bound men tightly to social institutions" (Sullivan 1983; 140). Wages rising with seniority, which render the worker's exit option void, enable Japanese firms to exert heavy pressure on individual employees, thereby reducing incentives to shirk; but it is very doubtful that this is a pareto-efficient solution, as long as the industrial clan in its Japanese version is associated with high levels of dissatisfaction, stress, mental illness, and even suicide rates,³ as well as an "unfair cleavage between regular and subcontract workers" (Koshiro 1983: 83). Moreover, regular workers with life-time commitment and end-loaded wage profiles are underpaid for approximately two decades in exchange for uncertain seniority wages beyond the age of forty. The pretended "trust relation" with their employer firm offers no protection against non-systematic risks in a competitive environment. When the so-called "Japanese employment system" had to pass its first major test, i.e. the oil shock of the mid-seventies, "big firms [. . .] introduced quite an unusual practice [. . .] (and) singled out middle-aged employees with long-term service [. . .] and forced (!) them to take up voluntary (!) resignation" (Tsuda 1982: 208–209). How firms handled the "trust relation" with their workers may be illustrated by quoting the president of a leading textile firm, who explained the reason for the dismissal of long-term employees as follows: "When a ship is about to be wrecked, heavier cargoes should be thrown off first to sea" (quotation from Tsuda 1982: 206).

After all, there is no evidence that clans with medieval attributes embody an efficient solution to organizational problems of employment relationships within a competitive dynamic environment. Under mutual termination rights there are better opportunities to pursue individual preferences and to reduce both shirking and excessive use of discretionary power. Recent developments in Japan seem to conform with this hypothesis: social customs associated with clan organization are eroding, whereas the exit option is gaining significance even in the primary segment of the labor market, where stable long-term relationships have long been governed by the rules of the "Japanese employment system" (Wirtschaftswoche 1986, 1987).

Nevertheless, the predominance of termination rights as a cost-minimizing device leading to efficient contract structures in a free labor market does not imply optimality of an unrestricted hire and fire policy; whenever workers receive quasi-rents in exchange for their burden of sunk costs, the optimal degree of worker protection is different from zero. Hence, even in free labor markets some protective devices may evolve; even if transactions costs of legal claims may be prohibitive, social customs induce rational employers to avoid arbitrary dismissals, because they do not want to jeopardize their reputation. It has to be borne in mind, however, that it is not at all clear to what degree social customs protecting incumbent workers and supporting the "internalization of labor markets" (Elbaum 1983) would have evolved in truly free markets without union privileges⁴; hence the traditional structure of labor contracts, which for the most part has not explicitly been imposed by law, cannot easily be interpreted as a free market solution, because the mere presence of union privileges may suffice to change the evolution of other labor market institutions. There is every reason to believe that workers' shares of sunk costs and, hence, the need to protect their quasi-rents are rather small in non-unionized settings and increase markedly with union power, because employers are forced to shift the burden of specialized investments at least in part to the workers, if unionization and strike activities cannot be prevented (Monissen and Wenger 1987). Consequently, what can be observed in unionized, but otherwise unregulated markets as traditional contract structure amounts to an overstatement of workers' protective needs in non-unionized settings. Nevertheless, some of the features of the traditional labor contract may even survive a complete abrogation of union privileges.

Under the traditional labour contract workers' quasi-rents are partly protected by restricting the discretionary authority of the employer with respect to content and powers of decision. More important, the contracted wage level is agreed upon for a minimum contract duration with the further implicit or explicit stipulation that the wages are fixed from below, possibly in nominal terms but usually relative to a general trend of wages as stipulated by a union contract. Wage reductions for an individual employee are regarded as a breach of the implicit agreement, unless his performance is much lower than expected or his old job becomes redundant; even then, however, they are very likely to be avoided because of a strong tendency in favor of a dismissal. With zero transactions cost, this would often be an inefficient solution; but if bad performance is costly to detect and verify, finely tuned wage reductions may be inferior to an "all or nothing" solution, because the latter has at least two favorable consequences: on the one hand, the worker faces a small probability of a high penalty, a provision which allows to reduce costly control activities; on the other hand, the employer is prevented from redistribution by unjustified wage cuts.

To prevent unjustified redistribution is also necessary with respect to general wage cuts affecting the whole work-force of a firm. Such wage cuts may be desirable, when a firm faces extraordinarily poor business conditions. In such settings continued employment may conflict with the economic interest of the employer, unless the work-force is ready to give up a part of their quasi-rents. With sufficient wage cuts, however, Pareto-

efficient employment relations may be preserved. But if wage cuts must be made dependent upon credible signs of the employer's financial difficulties, it may happen that with asymmetric information and high transactions costs of removing informational asymmetries, wage reductions can not be realized without dismissal of a part of the work-force. The destruction of specific capital could become an inevitable consequence (Hart 1983). Thus, an excess sensitivity of dismissals to business fluctuations may at least partly be explained by transactions costs (Hall and Lazear 1984).

The terms of the traditional labor contract, therefore, do not exclude the possibility that the quasi-rents of employees will be annihilated by ex-post involuntary dismissals.

3. The Employment Relation under Modern Labor Law

The weak protection of workers' quasi-rents induced governments all over the world to restrain freedom of contract by law. Especially in Western Europe mandatory codetermination and legal restraints of the employer's right to dismiss are pervasive. One of the popular arguments is based on alleged distortions of the entrepreneurial decision calculus which is supposed to yield inefficient results, because the net present value of decisions affecting the work-force "does not include" the discounted stream of quasi-rents destroyed by dismissals of employees. As has been explained above, however, it is not a capitalistic management which is responsible for inefficient dismissals, but the transactions costs of ex-post bargaining for wage reductions. It has to be noted that free negotiation in the absence of transactions costs implies that the employment contract will be terminated only if both parties concerned explicitly consent. Unilateral termination will not occur as long as the other party is prepared to make sufficient concessions in order to avert the necessity to realize less advantageous alternatives outside the firm. Under these circumstances all decisions to terminate employment will be Pareto-efficient and never occur against the will of the dismissed party. Only if renegotiation of the contract is characterized by high transactions costs or legally imposed restraints, labor-saving investment decisions may, on balance, have a negative effect. Hence, we can draw an important conclusion: in the absence of transactions costs rights of employees do not change the efficiency of decisions in ex-post situations; what may be affected is the efficiency of risk allocation in ex-ante situations, because protective rights bear upon the distribution of gains or losses in different ex-post situations⁵. For these reasons it is obvious, that codetermination or protection against dismissal cannot have socially desirable consequences, unless they allow economizing on transactions costs or improve the allocation of risk.

As far as transactions costs are concerned, it is not at all clear why codetermination or dismissal protection should solve problems that cannot be solved in a free market setting. Transactions costs, that prevent a perfect protection of employees' quasi-rents in free labor markets, cannot be assumed away only because protective rights are imposed; the major problems of a protection of quasi-rents remain unchanged, at least

in principle. Costs of continuously assessing employment alternatives outside the firm have to be borne in *any* institutional setting, if a destruction of quasi-rents were to be excluded; the same is true for the interest of employees to understate their surplus over the next best alternative in order to improve their bargaining position within the firm (Monissen and Wenger 1987). Obviously, if employees were to continuously reveal their true estimates to the employer, he would always know how much concessions he could extort from the employees, and labor's share would be always endangered. Just as much is there reason for the employer to conceal his own share of quasi-rents. Of course, the willingness of either side to reveal its true estimate will rapidly increase, if the other party announces a termination decision; but with or without codetermination, the resulting flow of information will come too late, if the decision has already required a longer planning period. As far as, for example, labor-saving investments are concerned, costly precommitments often prevent a reconsideration of the investment decision, even if a lower wage rate is part of a revised decision calculus.

Even if all these problems of asymmetric information were reduced⁶ under an extensive codetermination scheme including long-term corporate planning, as some authors indeed do believe but cannot prove (e.g. Schneider 1983), such an improvement would have to be traded off against the increased costs of ex-post settlements associated with a suspension of termination rights. Whereas termination rights set predictable limits to the possible extent of distributional conflict, there are no such limits, if the parties are bound together by an obligation to bargain until a solution is accepted unanimously. Suspension of termination rights, therefore, results in permanent haggling. As a consequence, complicated arbitration procedures⁷ and increased litigation with high costs of conflict resolution can be observed⁸. In such an environment there are strong incentives to redirect the decision-making authority of labor's representatives by granting pecuniary or non-pecuniary allotments at the cost of represented employees⁹.

But even more important are consequences which are not visible at the firm level but dispersed among customers and suppliers. By "protecting" the quasi-rents of the employees in one specific firm, the quasi-rents in related firms are completely ignored. If the costs of specific human capital are generally protected by blocking labor-saving investments, it is in the first instance to the disadvantage of the related investment industry, if the latter is characterized by a high degree of specific human and non-human capital. As specificity seems to be very likely in investment industries, the protection of quasi-rents in customer firms would destroy quasi-rents in these industries. The argument in favor of protecting quasi-rents by codetermination rights automatically raises a dilemma. Should everybody's quasi-rents be protected by granting decision rights, or can an economically justified criterion be presented in order to discriminate against quasi-rents of minor social importance which do not substantiate decision rights?

Protecting all quasi-rents over and above scarcity values by decision rights will finally endanger an economic system based on decentralized decision-making. Within a net of interrelated economic activities the result would be tantamount to the situation where everyone decides on everything. The transactions costs of such an arrangement are

certainly higher than the occasional destruction of quasi-rents by labor saving investment projects. For this reason, it has to be gratefully accepted that the legal systems in the western world have very wisely refrained from protecting the market value of positions endangered by the competitive forces of open markets (Buchanan and Faith 1982). If this basic principle of economic organization were abandoned by substituting pervasive codetermination for contractual termination rights, the transactions costs of economic change and progress in general would tend to become prohibitive.

There remains the question of whether the suspension of termination rights in labor contracts can be justified by a criterion that discriminates in favor of employees' quasi-rents, whereas other quasi-rents of minor social importance should be exposed to termination rights. But even if one ignores the "narrow" economic efficiency calculus of optimal allocation and concentrates entirely on income shares, codetermination rights protecting employees in particular seem at variance with distributive justice. If one relied, for example, on the popular criterion of ranking the degree of direct material disadvantage, one should draw attention to the fact that the annihilation of firm-specific human capital with the ensuing income losses is very often less important than the general economic consequences of a fall in local real estate values or the collapse or decline of smaller local business firms. This suggests that in the case of a shut-down of a major factory the terms of agreement should not be negotiated with workers' representatives but with the authorities of the country or community affected. Efficiency considerations, however, are not fully reflected in such arrangements, if they are imposed on firms ex-post; optimal contracting and allocation require negotiations *before* a major firm settles down. Consequently, it does not seem to be economically desirable to rely on codetermination rights imposed by a central government but to enforce competition among municipal or regional authorities designing optimal investment incentives for immigrating firms. In the United States competition between states seems to prevent what centralized legislation in German labor law has achieved on behalf of pretended interests of workers. Of course, such competition is emphatically deplored by advocates of labor market regulation (Harrison 1984: 403), but there is no economic argument why governments should not be forced to compete for citizens and taxpayers, as are business firms trying to attract workers or consumers. In fact, emigration, as a termination right of last resort, is an indispensable weapon for business firms and individuals to defend themselves against failures of the political system.

If a suspension of termination rights seems to be highly questionable from a transactions cost perspective, there may still be considerations of risk allocation speaking in favor of worker protection. Though the related problems are beyond the subject of this paper, some concluding remarks on the efficiency of risk allocation may be helpful.

It has to be borne in mind that there is no reason to expect that codetermination rights will only be exercised to maintain the status quo¹⁰. It is indeed very likely that potential increases in the company's market value that depend on decisions which are subject to codetermination will be appropriated by the workers, at least in part. The ultimate consequence will be that any change in business policy not initially anticipated has to be paid for by sufficiently large concessions to the workers. This will be reflected in a

reduction of initial wages, which will, of course, grow over time as long as market conditions prove favorable. A wage level once attained tends to be protected, unless the firm goes bankrupt, and, consequently, the overall probability of wage cuts may be reduced in comparison with a system without protective rights. But this is not an improvement of risk allocation; to consider a wage reduction as a risk is tantamount to a nonsense concept of risk. An anticipated reduction in the wages of older workers, which would be the only adequate consequence of a sure drop in performance, is no risk at all¹¹. Protection of older workers against wage cuts, which is a widely accepted goal of union policy today¹², produces just those quasi-rents, which compensate workers for a specialized investment in form of wages below productivity during the first half of the work-life. Consequently, in labor markets, where no gifts are provided, protective rights for older workers increase the risk defined in an economically correct sense, i.e. risk in terms of the present value of life-time income. The worker who happens to join a company experiencing unanticipated favorable results will enjoy steadily increasing wage levels. In contrast, a worker starting his employment career with a firm which goes bankrupt after some time will lose a substantial part of the expected value of his life-time income. Thus, the lowering of the misspecified "risk" of wage reductions in consequence of protective codetermination rights has to be traded off for a sizeable increase in the risk of human capital as related to a worker's life-cycle. The intensified exposure to firm-specific (non-systematic) risk brought about by codetermination rights is certainly not in the interest of a representative worker entering the labor market. Payment of wages according to the life-cycle of worker performance would considerably reduce quasi-rents of employees, and the unavoidable transactions costs of their protection would not have as detrimental consequences as today and in the years to come.

Appendix: Discussion

During the discussion at the conference, a vast range of problems lying beyond the scope of the paper was touched. As a consequence, it proved impossible to integrate more than a few contributions of the discussants into the final version of the written text. As a substitute, we comment separately on some selected points.

1. Economic imperialism was one of the main subjects of the discussion. According to a major fraction of the participants, political solutions based on democratic values, such as mandatory codetermination, should not be judged from a "narrow" economic viewpoint. The "narrow" economic viewpoint, however, respects individual preferences which can be easily overridden by "political solutions". The quality of "political solutions" varies considerably, as the example of the Soviet Union, perhaps the most important "political solution", shows. To be sure, western democracies leave more room for the pursuit of individual preferences; but even here, there is every reason to distrust political solutions of problems that can be solved in the marketplace. The detrimental effects of special interest coalitions capturing the political system of west-

ern democracies has well been documented by Olson (1982); as to West Germany in particular, cases like “Flick” or “Neue Heimat” or the all-embracing involvement of political parties in tax fraud activities raise serious doubts as to whether the agents within the political system are trustworthy representatives of the voters. Political solutions based on “democratic values”, therefore, do not necessarily work in the interest of voters and are often nothing more than a failure of the political system of representative democracy. Mandatory codetermination, for example, was never a primary goal of workers but was heavily promoted by union officials and their allies in the political parties, who could expect institutional support for their organization as well as additional influence and income sources from regulated labor markets. It is important to note that under direct democracy, where voters decide on political issues themselves, political agents cannot as easily indulge in their preferences for regulation; hence it is not surprising that in Switzerland, a stronghold of direct democracy, the people voted against mandatory codetermination by a margin of more than 2:1. Direct democracy within the political system apparently works against “democratization” of the economy (Brauchlin 1981: 90, 101). It supports the “narrow” economic viewpoint against democratic folklore.¹³

2. The debate on economic imperialism resulted in a general critique of the “commercialization” of social relations. Some discussants feared that worker motivation and trust would be destroyed if the employment relation were “commercialized”; another discussant was very displeased with Chicago economists interpreting marriage as a long-term contract or comparing protective services of the state with those of the Mafia. Trust, love, democracy, and social peace were stressed as basic principles instead of the profane economic concept of exchange.

Alas, we do not live in the best of all worlds. Not even the Roman Catholic Church does rely on trust, but rotates the clergy among parishes in order to prevent the development of trusting relations detrimental to the employer (Faith et al. 1984). Love is neither a necessary nor a sufficient ingredient of marriage which for good reasons is organized as a contract with termination rights. Even where love exists, it is not free of considerations of exchange and genetically determined self-interest (Becker 1981, McKenzie and Tullock 1984): a wealthy good-looking prince will rarely fall in love with a blind, ugly scar-faced amputee unable to bear children. Moreover, many societies do not accept that a couple marries, simply because they love each other.

As to democracy and social peace, there is no reason for moral arrogance with respect to different political systems. It would be foolish to expect that the democratic welfare state with territorial sovereignty will finally turn out as the last step in the evolution of protective agencies. Whatever will happen in the future – we should not forget that many achievements of former societies, as admirable as they may seem even today, were dependent upon activities nowadays regarded as criminal.¹⁴

But most important, social peace cannot be preserved by a political system that is economically not viable. One has to bear in mind, that the whole complex of codetermination and union wage policy amounts to a considerable redistribution in favor of the older generation, which aggravates the intergenerational problems inherent in the Ger-

man social security system. Thus, the conservation of union privileges, codetermination, and many other institutional devices of modern labor law do not promote social peace, as many people still believe, but increase the risks of its breakdown when coming generations try to get rid of the burden placed on them by the older generation.

3. In defense of codetermination, a representative of Volkswagenwerk AG reported harmonious cooperation between management and the workers' council in an atmosphere of "mutual trust and information" supported by first-class trips around the world that enable workers' representatives to get acquainted with foreign production techniques on a "parity basis". First of all, this is not a viable defense of mandatory codetermination, because in a free market setting no company is prevented from creating a workers' council and letting its members fly first class around the world. Second and more important, the reported harmony seems to be more of a part of business ideology than of reality. A leading German business magazine reports a long series of plots even within the firm's management and cites as "the most influential clique members of the workers' council and union leaders", who were involved in the overthrow of two chief executive officers in the 1970s (*Manager-Magazin* 1986: 45). Even if one does not believe in everything that can be found in the press, the unusually high turnover of chief executive officers is not a sign of "mutual trust and information". Moreover, the rhetoric of mutual trust was not what the financial markets acquiesced in when it turned out that the firm had lost nearly half a billion DM in a huge currency fraud due to entirely insufficient internal controls (*Der Spiegel* v. 8. 6. 1987: 27-42). But third, and most important, there are data indicating that the firm may have been captured by a coalition of incumbent workers at the expense of stockholders, consumers, and the workforce outside the firm. Within the last fifteen years the firm omitted four times its dividend and in spite of the sustained economic recovery of the mid-1980s domestic employment at the end of 1986 remained below its peak level of 133970 reached in July 1971, even though the firm operates within an environment characterized by high unemployment rates *and* pays above-average wages to incumbents. These are the typical attributes of a monopoly of organized labor, and the outcomes bear resemblance to the economic effects of Yugoslav firms (data from the respective annual reports).

Notes

- 1 This measure of asset specificity can be traced back to Marshall (1920: 520, 626).
- 2 For a recent defense of the contract "at will", which in the United States is still the predominant form of labor contracting in the non-unionized sector, see Epstein (1984).
- 3 According to a recent study of Cooper (1984), Japan shows by far the highest mental ill health scores among the highly developed countries included in the study (other highly developed countries were Sweden, Germany, the United States, and Great Britain). The executive job dissatisfaction score in Japan was 34% as compared with 22% in the U.S. and 18% in Germany. Suicide rates among middle-aged male Japanese employees have risen by approximately 130% between 1975 and 1984 (*Wirtschaftswoche* 1986: 49).

- 4 There is strong evidence that unionization would be insignificant if legally imposed union privileges were abolished. See Monissen and Wenger (1987), Reynolds (1984). What may survive in a system of free markets are employer-dominated “company unions” which differ markedly from unions in the traditional sense. Employer-dominated “unions” serve as an agency of personnel marketing on behalf of the firm and are not designed to antagonistic interest representation on behalf of employees as is traditionally understood of unions in industrialized countries of the West.
- 5 This implies that contingent claim trading is ruled out by restrictions of freedom of contract or prohibitive transactions costs. Of course, in an Arrow-Debreu-world where ex-post decision rights can be dispensed with, free trading of contingent claims always leads to an efficient risk distribution.
- 6 For an important decision problem where rather the opposite is true, see Monissen and Wenger (1987), section IV, figure 1.
- 7 Arbitration in labor conflicts is quite expensive, especially if arbitrators are not subject to external control. In Germany, for example, mandatory arbitration in codetermination affairs is a welcome source of income for members of the legal profession. Judges of labor courts may appoint themselves mutually as chairmen of arbitration commissions. The resulting discretionary power forces employers to tolerate high arbitration fees. For a day’s work as chairman of an arbitration commission a judge frequently receives more than his monthly earnings as a civil servant (Schlochauer 1983).
- 8 In Germany, the number of lawsuits filed with labor courts has risen dramatically during the last two decades (Kotzorek 1985: 312).
- 9 The relevant practices are mostly illegal and therefore kept secret, but sometimes emerge in the courts. Recently, a court invalidated an election of the members of a workers’ council because a large automobile manufacturer had financed and otherwise supported the election campaign of “friendly” candidates (Arbeitsgericht Berlin v. 8. 8. 1984, 18 BV 5/84, employer’s appeal denied by the Federal Labor Court, 4. 12. 1986, 6 ABR 48/85, Der Betrieb v. 23. 1. 1987: 232). The election had to be repeated and a group of radical left-wing candidates supported by no less than 43% of the voters won a substantial minority of the seats in the workers’ council. Since then, the firm is haunted by continued labor unrest and permanent struggle between two factions of the work force (Frankfurter Allgemeine Zeitung v. 15. 9. 1987: 14). This indicates that it is essential for firms to maintain “harmonious” relations with the members of the workers’ council. It is interesting to note that in the United States and Great Britain, where unions have far-reaching privileges on the firm level and on the shop floor, corruption among union officials has long been well-documented (see e.g. Taft 1964: 207–211, 685–705). There is no reason to expect that codetermination rights created in Germany during the 1970s will finally lead to different findings.
- 10 This is especially true since some courts have acknowledged the right of the workers’ council to interfere with entrepreneurial decisions through injunction (Eich 1983).
- 11 Evidences for declining productivity beyond the age of forty are pervasive. See, e.g., Dalton and Thompson (1971), who show that a drop in performance among middle-aged employees is not confined to blue-collar workers, as many people may believe.
- 12 This is not to say that the pervasive social custom to overpay older workers can not have other roots than unionization. Unions, however, for various reasons, inevitably bring about wage profiles favoring senior workers usually protected by explicit stipulations in the union contract. As a substitute or supplement, they promote changes in statutory law on behalf of incumbents. For a more elaborate treatment of this point, see Monissen and Wenger 1987, Section 6.
- 13 Of course, voluntary participation schemes can be and often are efficient (Michaelis and Picot 1987); but this does not speak in favor of legally imposed codetermination schemes, as many people may believe. Voluntary participation which can be terminated at a short notice or even at will must not be confounded with mandatory codetermination under suspended termination rights.
- 14 For a detached analysis of organized violence by protective agencies see Lane 1979.

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