



# Worker participation under the threat of dismissal: a challenge for innovative companies?

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In the last ten years, dismissal regulation has been the focus of increased policy concern in the EU, mainly due to its alleged influence on a number of national economic aggregates (such as employment levels and economic growth). Several European countries experienced an increased frequency of reforms addressing the dismissal regulation for permanent contracts, in particular countries with relatively stringent legislations before the crisis, notably Spain, Italy and France.

While the idea, openly declared, behind this deregulation wave is that employment and economic growth can be stimulated by reducing hiring and firing costs, a more thoughtful analysis of the data shows that weaker dismissal constraints may hamper the effectiveness of worker participation mechanisms (such as consultation and co-determination devices), through which a direct voice in management is given to employees in order to encourage their effort and the development of firm-specific human capital, crucial to the repositioning of firms in the most innovative and dynamic market segments and to take the high road of the long-term competitiveness.

Let me start by taking a step back, to trace the general logic that underlies the labour market reforms introduced in Southern European countries (like Italy) in recent years.

The interaction between employee and employer, in standard economic models, is analysed by assuming that the two contracting parties bargain within a principal-agent scheme, where the worker has an informational advantage compared with the employer. The worker, in fact, cannot be perfectly monitored and his effort cannot be fully ascertained, and this allows the employees to exert sub-optimal effort in the workplace. Moreover, the risk of an “unfair” behaviour (shirking) of the worker should tend to be larger if the latter is protected by a stringent discharge legislation reducing the risk of dismissal. The economic literature has produced a number of contractual solutions that alleviate the risk of shirking (starting from the theory of the efficiency wage of Shapiro and Stiglitz ([AER, 1984](#))). The proposed conclusions are many. However, it is widely shared the view that to link workers’ remuneration to company’s results, under certain assumptions, encourages the productive effort of the workers. This conclusion is consistent with the policy choices made in several EU countries.

One of the limitations of this approach, however, is the assumption that the employer, unlike the worker, never adopts opportunistic behaviours, for example in the form of downward revisions of workers’ earnings or other pejorative changes of the labour contract imposed to the employees by threatening dismissal (such problem is commonly referred to as “hold-up” of the employer, see Acharya et al. (RFS, 2013) and ([JLE, 2013](#))). If this assumption was true, it would be theoretically sustainable the idea that the worker does not need a particular legal protection. Unfortunately, unfair

actions by the employer cannot be excluded (and this, in fact, explains why protective discharge regulations were adopted in many labour law frameworks for decades). Since the risk of such employer's misconduct exists, the substantial elimination of restrictions on the possibility of dismissal is likely to deeply affect the firm internal relations, with significant effects on the effectiveness of participatory mechanisms.

While, on the one hand, larger bargaining opportunities at a firm level allow the employees to participate actively in the business decision-making processes and to share the returns of successful investments, on the other hand, weaker dismissal constraints are likely to reduce the effectiveness of the worker's contribution in the decision-making, because employees remain exposed to the threat of dismissal. Only in the presence of significant protection against unfair dismissal, the employee, not fearing reprisals, can actively contribute (even in a conflicting way, if necessary) to investment decisions and to the definition of the company's research strategies. The dismissal deregulation wave experienced by many EU countries in the last decade, therefore, may tend to sterilize the voice of the worker in the company. The problem is not only for trade unions (which will see their power reduced), but also, and especially, for knowledge-intensive companies, where the firm-specific human capital (i.e. effort and skills) plays a key role in R&D programs and innovative projects.

In a recent work [1], I have empirically analysed the relationship between the evolution of labour market regulations and the innovation performance of companies in the major world economies. The econometric analysis suggests that an improvement of employee participation mechanisms in company decision-making has a significant effect on the innovation output of manufacturing firms only where the dismissals legislation is sufficiently stringent. This effect, moreover, is greater the more the human capital is important in the production, that is, at the technological frontier, where the role of the worker is actually crucial. Where dismissal constraints are milder, participation mechanisms have a weaker effect. I interpret this result by arguing that stronger profit rights of workers encourage their innovative effort only if coupled with an appropriate regulation of the control rights of employers.

Nevertheless, this correlation may be explained in another way. For example, some influential economists speculate that more restrictive dismissal regulations make labour inputs relatively more costly than capital inputs and therefore stimulate the adoption of capital-intensive technologies in production (see for example the recent paper by Alesina et al. ([NBER, 2015](#))); if these capital-intensive technologies are also more innovative, then it could emerge a positive correlation between worker friendly laws and firms' innovation output, due to the phenomenon of capital-deepening and not to the innovative efforts of workers. Appropriate econometric tests, however, allow me to confirm the robustness of my interpretation of the empirical evidence with respect to this and to other alternative explanations.

In conclusion, the analysis outlined here suggests paying attention to what economists call "institutional complementarities". In particular, to achieve the goal of activating incentive mechanisms that encourage the productivity of the worker, it is necessary to coordinate participatory mechanisms with legal protection against unjust dismissal. This may be obtained by coupling representation devices with stronger dismissal laws or by bringing firing decisions under the scope of worker participation institutions (as in the German *Mitbestimmung*, which in fact makes external discharge constraints less crucial). Without this coordination, the cooperative mechanisms that should foster the emergence of virtuous relationships within companies and the development of human capital, useful for innovation and technological upgrading in the long term, are likely to be undermined. Only a careful analysis of the data will tell us whether and to what extent the recent policy measures (weakening discharge constraints) adopted in some EU countries will produce the negative effects of the type discussed here.

[1] Belloc, F. (2016) Employee Representation Legislations and Innovation: Evidence from Manufacturing Sectors. Working Paper, University of Chieti-Pescara (Italy)

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