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Legal competition, political process and irreversible investment decisions

Bruno Deffains [a,b,*], Dominique Demougin [c]

[a] University Paris 10 Nanterre and CNRS, EconomiX, Bâtiment Max Weber, 200 Avenue de la République, 92001 Nanterre Cedex, France
[b] European Business School, Wiesbaden, Germany
[c] European Business School, Department of Law, Economics and Governance, 65201 Wiesbaden, Germany

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ABSTRACT

We compare the effects of competition for the design of labor laws in an environment characterized by irreversible investments in human and physical capital. We compare autarky with two-country cases, assuming that capital is mobile and labor immobile. We distinguish two cases. In the first, the political system is free from capture, while in the second, we examine the case where labor captures the institutional design problem. We find that in the former case legal competition reduces welfare while in the latter it improves the overall outcome.
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1. Introduction

The last decade has been characterized by great efforts in the analysis of legal institutions to explain the economic performance of nations. For instance, La Porta, Lopez-de-Silanes, Shleifer and Vishny (hereafter LLSV) have produced empirical papers analyzing the importance of legal origin (LLSV, 1998) and its implication on corporate governance (LaPorta, 2000, 2002) to justify international differences in financial development. These papers show that the Anglo-Saxon, French, German or Scandinavian legal origin to which a country belongs, the contents of laws and the quality of law enforcement influence not only the degree of investors' protection, but also the performance of capital markets. Their empirical studies depict a situation in which common law countries provide stronger protection for investors compared to civil law countries. This feature may help explain why common law countries have more developed financial markets, more concentrated ownership and higher equity returns than civil law countries. Levine (2004) extends the analysis to the banking system, noting that countries with more stringent enforcement of contracts and closer creditor protection are also those with more developed banking systems and higher economic growth rates. Rajan and Zingales (1998) employ a cross-country statistical approach and show a positive correlation between the legal tradition and the growth of firms dependent on external financing. One might derive that these studies converge with Posner's hypothesis that common law evolves towards efficiency. Implicitly, these results also contribute to the idea that civil law might be less efficient.[1]

Beside academics, there is also wide consensus among politicians and members of international organizations concerning the determinant role of legal institutions for the wealth of nations. For example, the Doing Business Report (World Bank, 2006) states that "although the importance of macro-economic policies cannot be denied, there is an ever-widening consensus today

* Corresponding author. University Paris 10 Nanterre and CNRS, EconomiX, Bâtiment Max Weber, 200 Avenue de la République, 92001 Nanterre Cedex, France. Tel.: +33 1 40 97 77 86.
E-mail address: bdeffains@u-paris10.fr (B. Deffains).

[1] Posner uses the Kaldor–Hicks criterium for efficiency, so he also focuses on economic growth.

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concerning the determining role of the quality of the laws and rules governing business and that of the institutions responsible for applying them". Altogether, nations receive signals that may influence their decisions to change their legal setup.[2]

These developments raise an important question. Should countries with weaker economic performances copy the legal system of nations with better results? The paper aims to demonstrate that the answer is not obvious. In that respect, it is not the first one to point out some weaknesses in the LLSV approach. In particular, empirical methods have frequently been criticized (Roe, 2002; Arrunada and Andonova, 2006). However, the theoretical channels from legal rules to economic outcomes received less attention.

As comparisons between legal institutions are put forward, this prompts the search for a theory of legal competition. In order to focus on this question, we develop a simple model in which neither the allocation of factors has an influence (countries are identical) nor economic integration (there is no specialization), so that only the legal setup of countries plays a determinant role. To capture the importance of this setup, we consider an environment characterized by irreversible decisions in terms of physical and human capital investments. In such an environment, the legal structure affects the efficiency of the firm and by aggregation that of the entire economy. In the case of a closed economy, we identify the optimal legal framework that maximizes welfare by taking into account the organizational costs of firms.

In the alternative case of an open economy, we study the effects of competition between legal orders. The European Union is a good example of the relevance of the topic. Capital is highly mobile between the different member states, and countries within the EU have quite different institutional settings. At the same time, there are efforts to increasingly harmonize institutions across the member states. In some fields this is done via central collective decision. In other fields, member states are supposed to converge in their policies and institutions through the open method of coordination. The latter method implies decentralized institutional and policy decisions at the national level.

In that respect, our analysis relates to the broader debate of systems competition. The conclusions of that literature are contrasted. Some authors, in the tradition of Hayek and Schumpeter, advocate competition as a mean to induce efficiency (e.g. Mahoney, 2001; Ogus, 2003). Others disagree claiming that systems competition would lead to a "race to the bottom". For example, in the case of taxation, Mintz and Tulkens (1986) and Wildasin (1988) find that the Nash equilibrium in jurisdictional competition is generally non-optimal. Edwards and Keen (1996) show that, in a tax competition framework, welfare can be higher if Leviathan governments cooperate. Similar results are shown by Romano (2005) in the case of competition concerning corporate charters, by Fluck and Mayer (2005) for corporate governance, and Marceau and Mongrain (2004) for criminal law. Sinn (2003) summarizes the main arguments against systems competition arguing that it amounts to a reintroduction of the market by the back door. Applying the heuristic to the institutional design, the argument would be that in a well-functioning democracy the legal framework should have been structured to counter market failures. In such a setup, introducing legal competition would reintroduce the failures at the higher level of government decision.

Our model analyzes the effects of economic integration on the (de)-regulation of labor markets in a Tiebout type model (see, Tiebout, 1956). It considers an economy where a good is produced by a firm using capital and labor supplied by a worker. Productivity can be increased by irreversible investments in physical capital and/or in human capital. Specifically, before the firm and the worker meet, they must decide how much to invest. The capital market is perfectly competitive whereas the labor market is not. Specifically, the wage is determined by Nash bargaining, where α represents the worker's share in the surplus. The worker's bargaining power α becomes the main variable of interest (Blanchard and Giavazzi, 2003). It is meant to capture the extent of labor market rigidities (unionization, laws and regulations) and α is determined by the government at a pre-stage prior to production. Variations in α affect the respective investment decisions. With respect to the choice of α, we distinguish between a benevolent welfare-maximizing government and a government that represents the worker's interests only. For each case, we consider in turn a situation under autarchy (a single country with no trade) and a situation of economic integration, represented by two countries among which capital is mobile.

As far as the results are concerned, our paper concurs with Sinn provided that the political process is welfare-maximizing. In contrast, our conclusions change if we introduce the possibility of capture of the institutional design process by a grabbing hand.[3] Altogether, the effects of legal competition crucially depend on whether the underlying political process responds to either market failures or rent-seeking activities.

The remaining of the paper is organized as follows. In Section 2, we consider the relation between bargaining power and the law. Section 3 presents the model. The specificity of the model is that it leads to holdup problems because the respective parties must invest before they agree on a specific labor contract. In Section 4, we identify the first-best solution. Next, we derive in Section 5 the parties' investment decisions and solve the regulator problem in autarchy. In Section 6, we consider the result of legal competition with no capture of the political process. Following, we analyze the effects of capture by labor in Section 7. Finally, Section 8 offers some concluding remarks.

2. Bargaining power of labor and the law

In order to analyze the impact of legal competition, we propose to study an example of labor market institutions. What we have in mind are rules governing job security (redundancy pay laws), unionization, training (vocational training programs) and unemployment (unemployment benefits and wage subsidies). Our objective is to understand the impact of these rules on the bargaining power of parties and indirectly their influence on the organization of firms.[4]

Naturally, to subsume everything into one variable measuring a representative worker's bargaining power in wage negotiations could appear quite optimistic. However, the problem here is not to describe precisely rules governing labor relationships. Rather

[2] As emphasized by Berkovitz et al. (2003), this kind of signals is particularly crucial for developing countries which have to decide for or against "legal transplant".

[3] Pagano and Wolpin (2006) demonstrate for instance how the political process determines the degree of investor protection arguing that the legal rules result from a political agreement between entrepreneurs and workers.

[4] Labor market institutions have already been formalized in the economic literature (see e.g. Saint-Paul, 2002).

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