Using new institutional economics and the capability approach to make sense of layoff/dismissal law reforms: are we preparing a future of iniquity and inefficiency for the Italian enterprises?

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Two types of L&EC (Calabresi)

❑ **EAL** :

- **pre-existing** economic modelling are applied to legal norms **to criticize** them as they do not correspond to the **efficiency requirement** of the models.
  - Assumed an underlying competitive market exists , legal norms are criticized as far as they forestall the spontaneous efficient market equilibrium
  - Assumed a principal - agent relation, the legal norm is criticized because it doesn't implement the efficient incentive mechanisms
- the risk is that models may not fit the legal reality they are intended to criticize
- Then the efficiency improvement is doomed to fail

Two types of L&EC (Calabresi)

❑ L&EC as "understanding" of the law-logic

- Developing new economic theories to make sense of legal institutions for which otherwise there would be not place in the existing economic theory
  - i.e. the **firm** as a **hierarchical governance seen** as an alternative institutional arrangement to the market (Coase, Simon, Williamson etc…)
  - **Punitive damages** explained in terms of social (moral) preferences of the juries and the judges, (hence compatible with behavioral economic models of non self-interested preferences)

Two types of L&EC (Calabresi)

- Economic explanation does not require necessarily "efficiency" at the outset, but some improvement over an alternative state
  - What is truly **needed** for an institution to exist **is that equilibrium conditions are satisfied,** which **entail stability of a norm** (mutual best responses of the relevant agents' choices)
- L&EC is then a basis for normative improvements of the law both **from fairness and efficiency view points**

What institution are we trying to make sense of?

- Two regulatory regimes addressed to avoid/redress "**economically unjustified**" **dismissals**
- **The previous**: granting the judge a wide role in order to **assess** absence of economic justifications and **discretion** to order the employee **reintegration**.
- **The current**: in case the entrepreneur does not give a justified motive, he can nevertheless fire the worker by paying a prefixed compensation established by a national law.
- The role of the judge is entirely circumvented
  - an extra-judiciary agreement between the firm and the worker is also legally provided
  - due to tax deduction on the paid damage it allows a higher compensation (with respect to the fixed price) at smaller cost to the firm.

An example of bad economic analysis of dismissal law reforms

❑ **Adevrse selection in the recruitment stage**

- A permanent employment contract may contain an **insurance** component for the employees
- But it also allows to **exploit asymmetric information** : the worker doesn't declare his inferior quality
- Hence permanent contracts are **paid less** => qualified workers **signal** their quality by accepting fixed term contracts, which are paid **more**=> and the number of permanent contracts **declines**
- Making dismissal simpler should make permanent contracts more convenient
  - **Cheaper permanent contracts should be paid spontaneously a bit more**
  - **They should increase in number why respect to fixed term contracts**

An example of bad economic analysis of dismissal regulation (II)

- Nothing of this corresponds to reality **before** and **after** the reform
- Fixed terms contracts **continues to increase** in number, and to be paid less than the alternative
- Permeant contracts had to be **subsidized with tax reduction** (public money) what means that they are already **paid more** than fixed term contract
- The reason is that dismissal regulation doesn't concern adverse selection in recruitment
  - **the model does not fit reality**

Focus on organization (firms) not on labor market

- ❑ dismissal regulations affect long run relations inside hierarchical organizations, not recruitment market relations
- They affect the firms' and employees' disposition to undertake specific investments in human capital that have to be protected by regulated permanent contracts
- When such investments become improbable, the alternative of less paid and non permanent contracts , not entailing a long run employments relation, seem to be more convenient

The place of dismissal within the theory of the firm as an hierarchy

- Why do the firm exist?
  - **incomplete contracts** (bounded rat., unforeseen events or unverifiable terms of contracts) ,
  - **specific Investments**
  - **Opportunism**
  - ➢ renegotiation of incomplete contract allows appropriation of the value of specific investment undertaken by the counterparty

The place of dismissal within the theory of the firm as an hierarchy

- The firm consists of **authority relations** amounting to the discretion of deciding on variables that are not ex ante specified
- Residual control rights **ground authority** and **prevents opportunism in renegotiation**

➢ It consists of **the power to dictate the exit option** (or *status quo*) of ex post bargaining .

  – I.e. the term to which the **counterparty is reduced** in case of conflict

- Preventing opportunism, it protects the owner's specific investments

The place of dismissal inside the theory of the firm as an hierarchy

- Admittedly it is quite an incomplete explanation of organizational authority
  - It reduces it to the power to exclude in case of opportunist renegotiation
  - Authority must also be able to elicit voluntary acceptation to carry out some task because it is functional to the goals of the legitimizing party.
- In any case it shows **how central "dismissal" is in the theory of the firm**
  - The **right to exclude** the counterparty from the firm assets in a labor contract **is dismissal**
  - And it is seen as constitutive of the **employment contract *as* an authority relation**

Unilateral control rights but **multilateral specific investments**

- In many cases specific investments **are multiple**
  - They can be **interdependent**
- Beyond investments there are complementary **human resources**
  - Some resources are essential since they allow the cooperation of others
- At the end of the days (under incomplete contracts) the **distribution of a surplus is at stake** - which is attributable to **joint production** and multiple investments
- **BUT NON controlling** parties, who make also investments, **aren't protected** by both the contract and residual control

Unilateral control rights but multilateral specific investments (II)

- Unilateral ownership and authority in this case becomes a **new form of opportunism**, exploiting incompleteness of contracts
- The surplus is e**ntirely appropriated by the party with residual control right** , even if the surplus results from joint production and multiple investments
- **Non controlling parties suffer unfairness in distribution and investment expropriation**
- If they predict abuse of authority they ex ante do not invest
- Equity and efficiency are **interlocked** in the firm

Layoff, injustice and inefficiency in the firm

- **dismissal is the typical place where abuse of authority may surface**
- An employee undertakes a specific investment conditioned on the accessibility of firm assets (essentiality).
  - When ex ante unforeseeable / un-contractible events occurs it has a positive outcome, producing surplus
  - He then asks for a recognition in terms of wage improvement or carrier advancement

➢ **A renegotiation stage emerges**

Layoff, injustice and inefficiency in the firm (II)

➢ **A renegotiation stage emerges**

- The employer threatens to fire the employees in order to induce him to give up her claim
  - Under normal situation this is enough to convince the employee to give up her claim
  - But sometime the conflict ensues and dismissal is executed
- Predicting such a structure of interaction the employee **doesn't really invest** into specific human capital capable of engendering non contractible surplus

The ubiquity of specific investments and complementary resources

- **an information technologist implements the company information system,** and **customizes** general scope programs to the needs of the company organization
- He then asks for a recognition of his idiosyncratic investment
- The employer resists by threatening dismissal since he thinks to be able of profiting from the employee investment thereafter without paying anything more
- **A pharmaceutical researcher is part of a team that jointly produce a new molecule**
- His human capital is idiosyncratically related to the project
- When registration is nearly achieved, he expresses his claim to be recognized some benefit or carrier advancement
- Before of the registration, the boss fires him in order to prevent any claim since he deems that the future benefit can be obtaining from now without the additional contribution of the researcher

The stakeholder approach to CG

- The need for a **balanced protection** of different stakeholders' specific investments **is the basic reason for the stakeholder approach to CG**
- **Extended fiduciary duties***: those who run the firm owe fiduciary duties to all stakeholders undertaking unprotected investment and contributing complementary resources*
- Different historical examples (USA managerial company as **mediating hierarchy**, German c**o-determination**, Japan model of managerial corporation seen as fiduciary of the employees)
- It is by definition **more efficient**

The stakeholder approach to CG

- **Nonetheless** there are standard **objections** :
  - how to manage a corporation in the name of conflicting interest?
  - How to define the objective function when stakeholders' objectives may be conflictual?
- The multiplicity problem is easily resolved by considering the firm as the **cooperative game** ensuing a **bargaining game amongst stakeholders**,
- the firm is a collective actor pursuing as a coalition the joint plan of action **agreed during a bargaining stage** which maximizes

$$\prod_i (u_i - d_i)$$

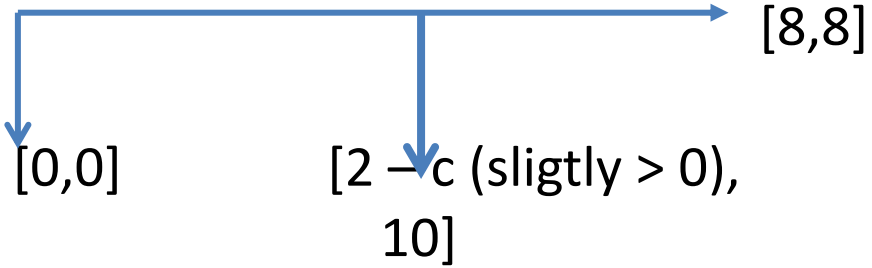
- Maximization is applied to a function combining the different stakeholders' surpluses

The stakeholder approach to CG

- **the Nash bargaining solution** also explains the artificial legal person as the result of a stakeholders' agreement
  - As an artificial agent it can undertake actions that single individuals cannot perform (joint strategies with super additive payoffs) , such actions are beyond the reach of single agents
- **Joint actions of the artificial person** pursue the **joint objective** to maximize a **uniquely defined function** of the individual agents' surpluses, representing their agreement
  - Within this constraint it also pursues each different stakeholder objectives.
- Hence under multi-fiduciary governance the management u**ndergoes the fiduciary duty not to abuse authority in order to expropriate employees** .

Can we expect that prevention of abuse of authority emerges spontaneously under the shareholder value doctrine? Unfortunately NO

- **One-shot PD** games are possible and **abuse** is there rational ,
- Not only, but **unilateral** symmetrical opportunistic behaviors, as the **ultimatum game ,** or a mix of **TG and ultimatum games**



- It means that sometime for the strong player a **larger slice of a smaller pie is better than a smaller slice of a grater pie**
- No repetition is relevant if the **investor has short term view** or **interest**
- **Bounded rationality** entails that there are unforeseen events to which positive probabilities are not assigned

➢ Hence the employer may underestimate the future contribution of the employees

Why we cannot expect that prevention of abuse of authority emerges spontaneously under the shareholder value doctrine (II)

- In repeated games the only reason for long run interests may discipline the firm behavior are **reputation effects**
  - **But reputation effects need concrete and verifiable commitments**
- Under incomplete contract commitments are **unspecified**
- The solution is to undertake broader even if vague commitments, not on specific actions **but on the conformity to principles of just treatment**

➢ But this means to establish by an explicit principle/norm that the firm **departs form strategic pursuance of shareholder value maximization**

  ➢ **I.e. The committment to fairly sharing joint surpluses**

- To make it as **clear and credible** as possible it must be part of the **legal regulation** of the firm by means of its corp. charter etc.

Alice's in the Wonderland economics

- According to Ichino **neither opportunistic behavior nor unfairness is** involved in **unjust dismissal**
  - It is only a matter of **calculating the expected loss** associated to maintenance of a particular job position with respect to the best alterative ……
  - And to decide to which level a permanent contract **must function as an insurance against adverse events** that may affect the worker productivity - without her negligence being involved
- Hence by comparing **these two value** you determine the threshold of expected loss that economically justifies the layoff, admitted a compensation is **paid**
  - redressing the worker is more convenient for the firm and at the same time it pays the worker her insurance premium
- Since the employer is the **only capable** to calculate the expected loss , **no role of judge is admitted**

Alice's in the Wonderland economics(II)

- **BUT**…..assume the information expert claims a carrier advancement because of her contribution
- Is this an **expected loss** with respect to enrolling a less deserving but cheaper information technologist?
- Summing up: **there is a distributive problem** at stake and the employer is **not necessarily** an **impartial** evaluator of costs and benefits
  - It **could** be so under a **governance structure** that recognized fiduciary duties owed to employees.
  - But Ichino does not quote **any complementarity** of his model with industrial democracy

Institutions matter: how do we make sense of the old dismissal regulation regime in Italy (art. 18)?

- Much **before** than the last reform was introduced , lawsuit behind the court declined in number and were reduced at a minimum
- Parties were capable to reach agreement of mutual interest
  - Clearly enough the judge is less informed than the parties.
  - ➢ Under an incomplete contract terms are unverifiable.
  - Hence the parties rested on their better information to achieve an agreement.
- **Which was then the role of the judge power to order reintegration**?
- **It was an expected counteraction to the imbalance of the ex post bargaining status quo**

Institutions matter: how do we make sense of the old dismissal regulation regime in Italy (art 18)?

- Consider ex post bargaining
  - **after an investment has been carried out, the appropriation of it value is at stake**,
- the employer holds the control right that affects the bargaining status quo
  - **So this is strictly biased in the favor of the employer: the employee can simply loose his job**
- Any bargaining improvement must be calculated from this asymmetric and biased status quo point
- The **role of the judge** was to c**hange the expected value** of the exit option for both
  - **With some positive probability the very bad exit option for the worker is counterbalanced with a bad option for the employer** .
- This induces them to agree on better conditions for both that improves mostly the bargaining position of weaker party (the worst off) with respect to the first bargaining scenario

Institutions matter: the new regime

- The legislator is **not better informed** than the judge
- A moderate level of **fixed compensation** paid to the unjustly fired worker will entail that
  - **when** specific investments at stake are **substantial**,
  - and the distributive conflict is **effective**,
  - ➢ the employer will **always resort to unjustified dismissal** by paying the damage - which is by definition below the value of the investment
- Hence a fixed redress level entails that opportunism will take place **in all the cases** in which what is at stake really counts to the parties
- A direct prediction is that **only small specific investments** in human resources will be undertaken under this new regime

Especially CG institutions matter

- Labor laws are not the only remedy to the problem
  - **it should be considered as complementary with corporate governance**
- Reduced discretion granted to the judge **could be counterbalanced by co-determination rights** of employees on the effects of reorganizations on dismissals
- Multi-stakeholder CG entails employees supervisory rights to render the **management accountable** about its compliance with fiduciary duties owed to weaker stakeholders
- Legal Co-determination rights (at factory level) on the effects of reorganization plans in term of worker conditions and employment, **prevents opportunistic** dismissal by substantially **counterbalancing** the **right of excluding**

Not just a matter of corporate equity/efficiency but a matter of social justice and welfare

- Co-determination on dismissal decisions is a **limitation of ownership** rights in the corporate domain
- This is a matter of **social justice and welfare**
- To **see why,** take the perspective of constitutional and post-constitutional contracts (Buchanan)
  - At the **constitutional** level basic rights on **resources and primary** goods are **distributed impartially** (**Rawls**)
  - At the **post constitutional** level, given basic rights **various forms of cooperation (firm) are started** and each agent is rewarded according to her contribution (**Shapley value**)
- But assume that justice is not only a matter of primary goods, but of functioning and capabilities:
  - **transformation functions from goods to functioning well** in some domain of human flourishing

Not just a matter of corporate equity/efficiency but a matter of social justice and welfare

- A capability is the opportunity to choose available **transformation functions**
- Capabilities are twofold
- **Skills or abilitis** to function
- **Entitlements i.e.** legal rights to choose any transformation function in order to transform resources into functionings
- **As legal rights they** are understood as both liberties and claims
  - **Liberty** to exercise skills
  - **A positive claim** to access some skill formation process
  - **A negative claim not to be excluded from some resources** which are essential for the liberty to function in a given domain

Not just a matter of corporate equity/efficiency but a matter of social justice and welfare (III)

- What does it happen if the post constitutional step doesn't include these entitlements?
  - **Unconstrained property rights** (the right to exclude) may **deny** the capability **to access assets**
    - **essential for the exercise of capabilities**
  - If dismissal denies basic capabilities without improving equally or more important capabilities of the worst-off then **injustice ensues** ,
- In the macro perspective it entails the **Penelope's canvass paradox**: what at morning the welfare state does in terms of skills-formation, at night is dismantled by the lack of entitlements in the GC domain
- So social wellbeing **becomes impossible**