8-1-2009

Do Rigid Labor Laws Mean Higher Unemployment in Developing Countries?

Terence Lau
University of Dayton, tlau01@udayton.edu

made on a daily basis, while assessments of firm support reflect more stable, long-term views about the company.

The implications for this research are far-reaching with respect to efforts aimed at increasing employee involvement and participation. Butts and his colleagues' findings support the use of high-involvement work practices, including increased employee decision-making latitude, greater access to information and developmental opportunities, and doing more to link rewards to performance. That said, to maximize the effectiveness of such participatory initiatives, organizations need to consider additional factors such as employee empowerment. Organizations should empower employees through interventions aimed at increasing employee confidence, the importance of their work, and the impact they feel they can have on the job. Doing so may facilitate the relationship between high-involvement work practices and positive employee outcomes such as higher job satisfaction, organizational commitment, and job performance as well as lower stress.

Moreover, as this research shows, employees' belief that the organization cares for and values them is also important. Such beliefs can strengthen any preexisting relationships between employee empowerment and the positive outcomes, including increased commitment and lowered job-related stress.

Overall, these results underscore that for high-involvement work practices to be most effective, firms need to recognize that both formal (e.g., empowerment) and informal (e.g., social support) aspects of the organizational environment play important roles in determining the extent to which positive outcomes will be realized. Such positive outcomes can be beneficial for both the organization and employees. So are high-involvement practices "worth it?" Absolutely.

Source: Butts, M. M., Vandenberg, R. J., DeJoy, D. M., Schaffer, B. S., & Wilson, M. G. (2009). Individual reactions to high involvement work practices: Investigating the role of empowerment and perceived organizational support. *Journal of Occupational Health Psychology*, *14*, 122–136.

Do Rigid Labor Laws Mean Higher Unemployment in Developing Countries?

Research Brief by Terence Lau, Associate Professor of Management, University of Dayton

In 2009, labor unrest in France resulted in the kidnapping and hostage-taking of executives. Other French workers blockaded streets in Paris and burned piles of rubber tires to protest a plant closure. Most managers with experience in France would undoubtedly say that such labor action is not that unusual and is simply part of doing business in that country, as it is in other parts of continental Europe. Press those managers further and they might express a desire to relocate manufacturing facilities to the Czech Republic or Hungary—places where a "more relaxed" labor law environment is perceived to be better for business, supposedly resulting in economic growth and lower unemployment.

The use of "perceived" and "supposedly" might seem odd, especially since economists have a long history of studying what impact rigid labor regulations have on employment, wages, investment strategy, and worker productivity. But the majority of prior research on the impact of labor laws has focused on developed rather than developing countries. Indeed, only in the last few years have researchers turned their attention to the effects of labor laws in developing countries. In their recent study, Simeon Djankov and Rita Ramalho (both of the World Bank) aimed to provide some much-needed confirmation for what has, up to now, largely been conjecture about the impact of labor laws in developing nations. Specifically, Djankov and Ramalho examined studies conducted in the past five years to assess the connection between labor law rigidity and unemployment. Put simply, they set out to demonstrate that if laws make it easier and cheaper to hire and fire employees in developing countries, then the unemployment rate in those countries should be lower.

In doing so, Djankov and Ramalho found that unemployment rates are indeed lower when labor laws are less rigid. Moreover, labor laws seem to have differential effects on various groups of workers. For instance, developing countries with rigid labor laws tend to have bigger informal work sectors as well as higher unemployment rates, particularly among young workers. Put another way, "insiders" tend to benefit while "outsiders" suffer. This research has important implications for developing countries struggling to strike the right balance between providing worker protection and attracting more investment as well as cultivating a culture of entrepreneurship. Consequently, Djankov and Ramalho's results are important to corporate planners who routinely use labor laws and unemployment rates in the calculus of investment strategy.

Djankov and Ramalho took a bifurcated approach to their study. First, they examined the results of 30 studies, published in top journals since 2004, that focused on the effects of labor laws in developing countries. Significantly, they limited their examination to the law affecting the hiring and firing of workers. In short, they did not examine collective relations law, social security law, or civil rights laws. This limitation is important, because it allows for a more direct apples-to-apples comparison of laws across multiple jurisdictions and focuses the analysis on a type of labor law that is more likely to be broadly enacted than others.

As part of their study, Djankov and Ramalho reviewed results of labor laws in India, and confirmed suspicions that rigid labor laws result in a more inflexible labor market. While India as a whole has enjoyed tremendous economic development, a state-by-state analysis shows important differences. The state of West Bengal, for example, enacted rigid employment laws beginning in 1947. Output per capita is now falling at an average of 1.5% per year (at a time when India's overall output per capita is growing by 3.3% per year). The state of Andhra Pradesh, on the other hand, adopted a more liberalized set of employment laws in the same time frame. That state grew at 6% per year between 1958 and 1992. The studies suggest that changing the regulations would have resulted in 1.8 million fewer urban poor in West Bengal.

Other studies from around the world have yielded similar results. One study concluded that if Indonesia had adopted the same level of flexibility in labor regulation as Finland, Indonesia's unemployment rate would have been 2.1% lower overall and 5.8% lower among younger workers. In fact, the net effect of rigid labor regulation is so great that it can negate other efforts by the government to stimulate growth, such as trade liberalization. One particularly interesting derivative of this research examined the effect of rigid labor laws on the level of entrepreneurial activity in developing countries, finding that flexible regulation increases the probability that young people will start new ventures.

In the second part of their study, Djankov and Ramalho conducted a cross-country correlation analysis using data from the World Bank and the World Economic Forum. This effort, while unable to produce conclusive interpretations, clearly reinforced their initial assessment of previous research. Overall, their results all point to the same conclusion—namely, rigid labor laws tend to be associated with larger informal sectors and higher unemployment, especially among younger workers.

Of course, labor laws can evolve over time. Before the Great Depression, the employment-at-will doctrine held sway with lawmakers in the United States. Yet there has always been a distinct level of discomfort at the unequal balance of power in the employer-employee relationship. That discomfort accelerated in the Great Depression and resulted in a sea change of regulation, from workplace safety rules (OSHA) to minimum wage and maximum working hours. In fact, the development of modern U.S. labor law can be viewed as the outcome of a democratic process whereby citizens make an informed choice about the way they wish to order their society, including the worker-employer relationship. This may have negative effects on unemployment.

Indeed, Djankov and Ramalho acknowledge as much, noting that in Latin America new laws aimed at providing more protections to workers coincided with the restoration of democracy after years of rule by military dictators. Indeed, as economies develop, democratic processes may coincide with labor law changes that, in essence, result in less flexible legal regimes, even though efficiency and total employment would benefit from more flexibility. Naturally, the opposite is true as well, with some countries adopting more flexible labor laws as they develop. If nothing else, this underscores the need for more research on how labor laws—and their effects—evolve over time, particularly in developing countries.

Source: Djankov, S., & Ramalho, R. (2009). Employment laws in developing countries. *Journal of Comparative Economics*, *37*, 3–13.

Founder- and Heir-Controlled Firms: Is There a Connection Between Transparency and Performance?

Research Brief by Brett P. Matherne, Assistant Professor of Management, Loyola University New Orleans

There's an old saying: "Don't air your dirty laundry in public." But does that admonition apply to family-controlled firms? Clearly, in privately owned firms the degree of transparency is something directly controlled by the founder or family members. Generally speaking, public firms are more transparent (or less opaque) than private firms across a wide range of issues. However, when family firms become publicly traded, does a pattern of opacity persist? How do these now-public firms wrestle with the disclosure of information for minority shareholders and analysts, especially since in private companies there's no outside impetus for such transparency? Finally, and perhaps most important, what is the impact of all of this? For instance, does the degree of opacity have any effect on firm performance, and if so, does the type of CEO (founder, heir, or outsider) somehow play a role?

Underscoring the importance of these questions is that founders and heirs are often significant, undiversified shareholders in public firms. Indeed, a large percentage of today's Fortune 500 corporations began as privately held family businesses and are now publicly traded firms that still retain a large founder or heir controlling presence (e.g., Ford Motor Company, Johnson & Johnson).

Moreover, the ability of outside investors and analysts to monitor controlling shareholders' opportunistic behavior is affected by the degree of transparency in a firm. Of course, founders and heirs have an incentive to collect information and actively monitor the managers responsible for their often sizable ownership interests. Yet opacity in a firm may make it difficult for outside owners and analysts to assess what founders and heirs are doing in the process of "monitoring" management. For instance, one worry is that as controlling owners, founders and heirs may use opacity to extract value for their own benefit at the expense of unseeing minority shareholders in publicly traded firms. On the other hand, an argument can be made that increased opacity may help protect a firm's competitive advantages from prying eyes.

Naturally, the issues associated with corporate transparency have been studied for some time. But relatively little is known about some key questions. In their well-crafted investigation, Ronald Anderson (American University), Augustine Duru (American University), and David Reeb (Temple University) tested several ideas about corporate transparency in publicly traded founder- and heir-controlled firms. In doing so, they created an opacity index (based on various proxies, including stock trading volume and analyst forecasting errors) to examine the role of founder and heir ownership on transparency as well as the influence of the CEO.

Specifically, Anderson and his colleagues examined the largest 2,000 U.S. firms from 2001 to 2003 using COMPUSTAT. In their sample, 22% of firms were founder-controlled firms (founders had an average equity stake of 18%), while 25% of firms were heir-controlled (heirs had an average equity stake of 22%). A key goal was to assess the impact of opacity (e.g., might it promote the ability of founders/heirs to extract wealth or otherwise undercut firm performance?). In addressing this goal, Anderson and his colleagues were careful to collect data on other direct and indirect control mechanisms (e.g., board power, dual-class shares, and management positions available to founders and heirs).

The results showed, after controlling for indus-