Bruegel Lunchtalk
"Rhineland exit?"
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On 23 October 2007, C.N. Teulings, director of the Netherland Bureau for Economic Policy Analysis, presented "Rhineland exit", a paper coauthored with A.L. Bovenberg, during Bruegel's Lunch talk series. In this paper, the authors argue against the so-called Rhineland corporate governance model where all stakeholders have a say in the firm management. They argue for a push towards the so-called Anglo-Saxon corporate model where the point is the shareholders' interests. According to the authors, the latter model is not only the best for shareholders but also for workers as it allocates optimally the different risks the firm faces.

In the first part of the presentation, the author boiled down to three dimensions the different risks a firm faces: the aggregate, firm-specific and individual specific risks. No difference is to be found according to Prof. Teulings between the two governance models when looking at the way the aggregate and the individual specific risks are managed. In both models, the aggregate risk is shared through wage setting whereas the individual risk is solved through a work contract where both workers and shareholders bear part of the risk and receive part of the corresponding surplus. The key difference therefore rests on the way the firm-specific risk is dealt with.

In the Rhineland model, this firm-specific risk is shared by both workers and shareholders, as is the remuneration. While it is often argued that this allows workers to be more protected as they are part of the decision-making process, the authors argue the contrary. The main reason for that is globalisation, which increases both firm-specific risk (through an increase in competition) but also the scope for diversifying it. Shareholders are therefore better equipped than workers to bear that risk, and this calls for a move away from the Rhineland model and towards more of the Anglo-Saxon model's features.

Difficulties remain however for firms to follow this path. The main one is likely to be workers' lack of commitment. For the shareholders to accept bearing a greater share of the firm-specific risk, they need to be positive that the workers will not claim part of the surplus when the firm performs well. This, however, is unlikely to happen. *Ex post*, incumbent workers have an incentive to demand part of the unexpected surplus even though, *ex ante*, it is better for them not to do so. A consequence of this *hold-up* problem is that, in countries closer to the Rhineland model, incumbent workers tend to receive higher wages than outsiders.

On that basis, the author assessed in the second part of his presentation how far Denmark, Portugal and the US were from the Anglo-Saxon model. To do this, the author relied on figures showing the different seniority premiums in those three countries. Portugal is far from the shareholder model and exhibits high seniority premia. Denmark, on the contrary, exhibits low premia, suggesting that it is closer to the optimum. According to the authors, Employment Labour Protection (ELP) seems to be a good candidate to explain these differences as it supports the claims made by incumbent workers and as these policies are more important in Portugal than in Denmark. The situation for the United States is however more mitigated, with high seniority premium and low EPL.

The discussant, Marco Becht, acknowledged the need for a comprehensive approach to corporate governance that takes into account the way workers, shareholders, creditors and management negotiate over a corporate project. As the authors stressed, there currently exists a disconnection between the labour and finance literatures which hinders progress in this field of research. The paper is thus welcomed as it sets a new research agenda that is likely to be fruitful. Prof. Becht however questioned the robustness of the authors' analysis and thus worried about the clear-cut policy recommendations made. Numerous questions remained about how a change in the different implicit assumptions would affect the analytical results. To make his point clear, Prof. Becht took as an example the absence of debt holders in the reasoning. If you add them to the picture, the authors' results are likely to be affected.

Comments from the participants were similar. Jean Pisani-Ferry, Director of Bruegel, underlined the need for making explicit the implicit assumptions at the root of the analysis as it would allow one to identify the critical parameters of the problem. Indhira Santos was especially concerned with one of the implicit assumptions: the superiority of the Anglo-Saxon model in terms of firm performance. She therefore asked for empirical support for this idea. More generally, Juan Delgado, Research Fellow at Bruegel, wondered what market imperfection was impeding the US from reaching the ideal of the Anglo-Saxon model as it appears to exhibit low ELP.