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**Social Dumping Revisited: Some Lessons from Delaware?**

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**1. Introduction**

The existence of Community social policy can be justified for reasons of welfare of Community citizens, for reasons of integrating citizens into the Union, and for reasons of productivity:<sup>2</sup> that social rights and market regulation, far from being obstacles to economic and social progress,<sup>3</sup> should be seen as inputs into the productive process.<sup>4</sup> However, underpinning all such positive rationales for social policy is the negative concern: the need to enact European Community social legislation to avoid social dumping or a "race to the bottom".

Social dumping is said to arise when, in a deregulated internal market, a state unilaterally lowers its social standards in an attempt to attract business from other states.<sup>5</sup> In response, these states are induced to lower, or at least relax, their own standards in order to attract capital or, as a minimum, retain existing capital. This "race to the bottom",<sup>6</sup> or jurisdictional competition creates a cycle of disadvantage from which no state eventually emerges victorious.<sup>7</sup> The reasons for this suboptimal

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<sup>2</sup> See further, C. Barnard, "The Evolution of EC social Policy" in P. Craig and G. de Burca (eds) *The Evolution of EU Law* (Oxford, 1999).

<sup>3</sup> See, for example, the views of Addison and Siebert, "The Social Charter: Whatever next?" (1992) 30 BJIR 495.

<sup>4</sup> See S. Deakin and F. Wilkinson, "Rights v Efficiency: the Economic Case for Transnational Labour Standards" (1994) 23 ILJ 289. The Commission has also taken steps to recognise social protection as a productive factor (See the Commission Communication, "Modernising and Improving social Protection in the EU", COM (97) 102). In the White paper on Social Policy it says "the pursuit of high social standards should not be seen as a cost but also as a key element in the competitive formula" (COM(94)333, introduction, para.5). In the Medium Term Social Action Programme it talks of encouraging "high labour standards as part of competitive Europe" (Social Europe 1/95, 9, 18, 19).

<sup>5</sup> B. Hepple's definition of social dumping is "the export of products that owe their competitiveness to low labour standards" - "New Approaches to International labour regulation" (1997) 26 ILJ 353, 355. The definition of social dumping adopted here concerns the activity of states and not individual employers (see further C. Barnard, above nX, x). It also does not concern the American phenomenon of "dumping" social problems from one state to another.

<sup>6</sup> This is also described as the problem of "lowest common denominator" or regulatory meltdown.

<sup>7</sup> For the purposes of this article, social dumping does not, however, refer to the idea that producers in low-cost or low labour-standard systems enjoy an inherent competitive advantage which must be countered by the imposition of a 'level playing field' in labour costs. This

result at national level have long been recognised by game theorists who show how rational transactors may fail to reach welfare-maximising solutions.<sup>8</sup> In the eyes of certain commentators, the corporation laws of the State of Delaware provide the paradigm example of this phenomenon. Delaware, in its bid to attract high levels of incorporations and reincorporations, has given freedom to corporate management to operate with minimum interference from shareholders. This makes it, according to some, the victor of a race to the bottom; and federal legislation is needed to protect vulnerable shareholders. This view is, however, highly contested: the so-called “corporate federalists”, see Delaware as the victor in a competition between states to achieve optimal state laws which are presumptively efficient. As a result, they strongly argue against displacing state laws by federal legislation. Underpinning both theories is the presumption that capital is mobile and can take advantage of the ‘exit’ route.<sup>9</sup>

In this article I intend to examine the application of the competing theories of interjurisdictional competition to Delaware Corporation law and consider the lessons that they may provide for the adoption of European Community legislation. I intend to take social policy as my case study, although similar arguments may apply in the context of monetary dumping (competitive devaluation), and fiscal dumping (distortionary subsidies to industry).<sup>10</sup> Social policy is the area where concerns about race to the bottom have been most clearly articulated and there are inevitable overlaps between employment law and company law – as the worker participation debate in the context of the draft Fifth Company Directive and the European Company Statute makes clear. I intend to argue that despite the perception that a race to the bottom is occurring in the EU, there is little evidence of it in practice, although it does represent a useful bargaining tool for employers and Member States. I will then consider why a theory with such resonance in Delaware might not accurately represent the position in the EU.

## 2. Game Theory

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view was rejected at the outset of the Community’s existence in the Ohlin Report and in Article 117 of the Treaty of Rome, which embodied the perhaps optimistic assumption that labour standards would, for the most part, ‘level up’ of their own accord once the common market was put in place. It was also assumed that, for the most part, wage levels were roughly matched with productivity, so that high-wage systems were protected against the effects of low-wage competition by virtue of superior technology and modes of economic organisation. See C.Barnard and S.Deakin, “European Community Social Law and Policy: Evolution or Regression?” (1997) IRJ European Annual Review, 131.

<sup>8</sup> Cheffins, above, nX, 10-11.

<sup>9</sup> A. Hirschman, *Exit, Voice and Loyalty: Responses to decline in firms, organisations and states*, Harvard University Press, 1970.

<sup>10</sup> See the speech delivered by Pdraig Flynn, European Commissioner for Employment and Social Affairs, at the Institute of Employment Rights’ Conference, reported in A.Bolger, “EU urged to work together on job laws”, *Financial Times*, 19 July 1997. In the context of fiscal dumping, there is some evidence that Ireland’s 10% tax rate (to be phased out, in agreement with the European Commission, in favour of a standard 12.5% rate from 2003), has led to its spectacular success in attracting foreign, especially American, investment – J.Murray Brown, “World eyes Ireland for telesales growth”, *Financial Times*, 7 November 1997; K.Brown and J.Kelly, “Tax Harmony? No thanks”, *Financial Times* 1 March 1999.

The reasons why a race to the bottom is said to occur can be illustrated by two examples. The first is demonstrated by Revesz in the environmental field.<sup>11</sup> First, he looks at an island jurisdiction where a number of firms are engaged in industrial activity which pollutes the atmosphere and causes harmful effects to the island's citizens. He says that in the absence of regulation the firms will choose the level of pollution that maximises their profits by producing goods cheaply, and will ignore the social costs resulting from their activities. State regulation will therefore enact legislation adopting optimal standard. He then contrasts this with a "competitive jurisdiction", such as a state within a federal system, whose actions are affected by the actions taken in other jurisdictions and, in turn, whose actions have effects beyond its borders, and where firms can move freely from one jurisdiction to another with no entry or exit costs. Other factors being equal, firms will try to reduce the costs of pollution control by moving to the jurisdiction that imposes the least stringent national requirements.<sup>12</sup> As in the island situation, while competitive jurisdictions may want to set a pollution reduction level that takes accounts of benefits to its citizens they are aware that the location of firms can lead to the creation of jobs and thus the increases in wages and taxes. As a result the state may well consider setting standards that are less stringent than those of other jurisdictions.

Therefore, if state A initially sets its level of pollution reduction at the level that would be optimal if it were an island, state B will then consider that setting less stringent standards,<sup>13</sup> and industrial migration will occur from State A to State B. In order to recoup some of its losses in terms of employment and tax revenues, State A then lowers its own standards. This process of adjustment and readjustment continues until an equilibrium is reached and neither side has an incentive to change its standards further. At the end of this race both states end up with equally poor standards but do not experience the outflow or inflow of industry. In other words, each state has the same level of activity as an island state but with lower social welfare as a result of the race.

As Revesz points out, the race to the bottom is the result of non-cooperative action on the part of the states. If they could enter into an enforceable agreement to adopt the optimally stringent standard they could maximise social welfare without the need for federal regulation. Alternatively, states could push for the adoption of federal legislation in order to eliminate the undesirable effects of the race. If the federal legislation were to adopt standards that the states would find optimal if they were islands, the states would be precluded from competing for industry by offering less stringent standards. They would end up with optimal, rather than suboptimally lax,

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<sup>11</sup> "Rehabilitating interstate competition: rethinking the race to the bottom rationale for federal environmental regulation" (1992) 67 *New York University Law Review* 1254

<sup>12</sup> In other words, industrial migration will occur whenever the reduction in the expected costs of complying with the environmental standards is lower than the transaction costs involved in moving..

<sup>13</sup> State B can then "export" the pollution (ie create an "externality"). This is allegedly what occurs in Delaware(lax managerial standards have an adverse impact on shareholders located elsewhere).

standards and they would not suffer the resulting loss in social welfare: all states would be better off with federal regulation.

The famous prisoner's dilemma provides the second illustration of game theory. Sen describes the dilemma in the following terms.<sup>14</sup> Two prisoners are known to be guilty of a very serious crime, but there is not enough evidence to convict them. There is, however, sufficient evidence to convict them of a minor crime. The District Attorney separates the two and tells each that they will be given the option to confess if they wish to. If both of them do confess, they will be convicted of the major crime on each other's evidence, but in view of the good behaviour shown in squealing, the District Attorney will ask for a penalty of 10 years each rather than the full penalty of 20 years. If neither confesses each will be convicted only of the minor crime and get two years. If one confesses and the other does not, then the one who does confess will go free and the other will go to prison for 20 years.... What should the prisoners do?... Each prisoner sees that it is definitely in his interest to confess no matter what the other does. If the other confesses then by confessing himself this prisoner reduces his own sentence from 20 years to 10 years. If the other does not confess, then by confessing he himself goes free rather than getting a two year sentence. So each prisoner feels that no matter what the other does it is always better for him to confess. So both of them do confess guided by rational self-interest and each goes to prison for ten years. If, however, neither had confessed, both would have been in prison for only two years each. Rational choice would seem to cost each person 8 additional years in prison.

Prisoners' dilemmas involve a strategic decision in which each agent makes a choice in circumstances where the reward to each depends on the reward to all and the choice of each depends on the choice of all.<sup>15</sup> The basic structure of the prisoners' dilemma is that the players have the choice to cooperate (keep silent) or to defect (confess) leading to the following matrix:

	I CHOOSE	THE OTHER CHOOSES
1.	Co-operation (2 years)	Co-operation (2 years)
2.	Co-operation (20 years)	Defection (0)
3.	Defection (0)	Co-operation (20 years)
4.	Defection (10 years)	Defection (10 years)

Source: Langille "Debates on Trade Liberalisation and Labour Standards" in Bratton *et al*, *International Regulatory Competition and Co-ordination*, 483

Langille points out that the preference order of players is 3-1-4-2 but while their choice "should" be that which results in two years each (option 1), rationality operates perversely and leads them to a choice of 10 years each (option 4). The prisoner's dilemma and Revesz' island jurisdiction demonstrate how rational decisions of economic actors can yield inefficient or suboptimal results. Such arguments clearly influenced Cary, the leading critic of Delaware's corporation law, and others to advocate the need to enact centralised, federal regulation to avoid suboptimal results

<sup>14</sup> Sen, "Behaviour and the Concept of Preference" in Elster, *Rational Choice*, (New York: NYU Press), 1986, cited in Langille, *above*, nX, 482.

<sup>15</sup> Langille, *above*, nX,

at state level. First, however, I shall examine why Delaware, one of the smallest states in America, has attracted so much attention.

### 3. Delaware corporation law

The interest of Delaware lies in its success in attracting corporations and reincorporations. Over 40% of New-York stock-exchange-listed companies, and over 50% of Fortune 500 companies, are incorporated in Delaware. Eighty-two per cent of publicly traded firms that reincorporate move to Delaware<sup>16</sup> and 90% of New York Stock Exchange-listed companies that reincorporated between 1927 and 1977 moved to Delaware.<sup>17</sup> This level of incorporations accounts for a significant part of state income. In 1971 when amendments were made to Delaware's corporate legislation corporation franchise taxes represented \$52 million out of a total of \$222 million in state tax collections, approximately one quarter of the total.<sup>18</sup> Since then the revenue from charges imposed on businesses that incorporate under Delaware's laws<sup>19</sup> is more than \$200 million annually, which is nearly 20% of the total tax collected by Delaware.<sup>20</sup>

The explanation for Delaware's pre-eminence in the incorporation market is in part historic. In 1875 New Jersey passed the nation's first modern general incorporation law, which, at the time, was the broadest and most enabling general law ever passed.<sup>21</sup>

<sup>16</sup> Data provided by Joseph Grundfest, SEC Commissioner, to the Council of the Corporate Law section of the Delaware State Bar Association, reprinted in Charny, "Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities" (1991) 32 *Harvard International Law Journal* 422, 428.

<sup>17</sup> P.Dodd and R.Leftwich, "The Market for Corporate Charters: "Unhealthy Competition " versus Federal Regulation (1980) 53 *Journal of Business* 259, 263. Romano, *above*, n1, 244 found the figure to be about 82% of firms. According to Dodd and Leftwich, the states receiving the next largest numbers of changes were Connecticut, New Jersey, new York and Pennsylvania, each of which received only two switches (1.4%).

<sup>18</sup> Cary, *above*, nX, 669. As Butler explains (*above*, nX, 156), it is not surprising that New Jersey and then Delaware should enter the market for corporate privileges and therefore jurisdictional competition, since a liberal law would tend to raise a larger proportion of total state revenues for smaller states vis-à-vis larger states.

<sup>19</sup> These include an initial corporation fee, an additional fee for amendments to the corporate constitution that increase the authorised share capital, and an annual franchise tax calculated on the basis of the number of shares issued: B.Cheffins, *above*, nX,432

<sup>20</sup> See Cheffins, *above*, n.X, 432, citing R.Romano, *The Genius of American Corporate Law* (AEI Press, 1993). Delaware derives on average about 17% of its revenue from corporate franchise tax (R.Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle" (1985) 1 *J.L Econ & Org* 225, 240) (charging companies for incorporating or reincorporating in the state).

<sup>21</sup> Butler, *op cit*, nX, 157. See also Butler, "Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges" (1985) XIV *Journal of Legal Studies* 129, 156-7. This was a direct result of the decision of the Supreme Court in *Paul v Virginia* 75 US (8 Wall) 168 (1869) which by implication provided that a state had no power to exclude a foreign corporation from doing business. Prior to that the power to form corporations was vested in the state legislatures which issued corporate charters one by one by individual legislative acts, although some states offered a dual system whereby it was possible to incorporate under a

It provided a simple procedure for incorporation and allowed corporations to be formed without regard to the residency of the incorporations or the corporation's primary place of business.<sup>22</sup> Further amendments occurred and by 1894 it was estimated that almost all of New Jersey's state budget was funded by fees and taxes from firms incorporated in New Jersey but primarily conducting business in New York. Delaware, seeking new sources of revenue, looked to the laws of New Jersey to provide the model for its new statute, the Delaware Corporation Act 1899,<sup>23</sup> and several clauses were copied, almost verbatim, into the Delaware Law. Further, Delaware's Court of Chancery ruled<sup>24</sup> that the legislature, in adopting the language of the New Jersey statute, had intended that the courts of Delaware should adopt the New Jersey courts' construction of the statute. This had the effect of conferring a level of certainty on a new statute that normally would have taken years of local litigation to develop.<sup>25</sup> Therefore, the expected benefits of organising and operating under the new Delaware law were brought into line with the expected benefits under the older New Jersey statute. Although Delaware was not immediately successful in attracting large numbers of new incorporations this changed after 1913 when New Jersey drastically tightened its law relating to corporations and trusts by passing the so-called "seven Sisters Acts", at the insistence of the Governor General Woodrow Wilson. As a result, Delaware secured a lead which it has never lost since.<sup>26</sup> An advert placed in the *American Banker* by the Wilmington Trust Company reinforces this view. In answer to the question "Why Delaware?" it explains: "Exceptionally

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general incorporation statute. Butler, *above*, nX, 142. In the mid-1850s the articles of special charters usually included a provision authorising the corporation to carry on part of its business outside the state - the intention being that the corporation's primary place of business would be the chartering state (Butler, 151). At that time incorporation in a state implied that the corporation would locate and operate in that state, thus enabling states to extract monopoly rents. However, some states offered granted liberal special charters to out-of state capitalists in order to attract capital to the state (Butler, *above*, nX, 150). As a result of the decision in *Paul* an opportunity was opened up to states "to pass liberal general laws to attract incorporators from across the nation and to increase the revenues of the legislators' home states with taxes and franchise fees on the firms chartered under their laws by operating in other states. In essence state legislators were presented with the opportunity to export some of the costs of their state government" (Butler, 156).

<sup>22</sup> Under British, Irish, Dutch and Danish law a company can have its headquarters in one state and be incorporated under the laws of another state. In all other Member States the "siège réel" doctrine applies. This means that a company's real seat is the country where its central administration or principal place of business is located. See B. Cheffins, , *Company Law: Theory, Structure and Operation*, Oxford, 1997, 429. See also P. Leleux, "Corporation Law in the United States and in the EEC: Some comments on the present situation and future prospects" (1967-8) 5 CMLRev 133, 139.

<sup>23</sup> See Note, "Little Delaware makes a bid for the organization of Trusts" (1899) 33 Am L Rev 418.

<sup>24</sup> *Wilmington City Ry. Co v People's Ry Co.* 47 A.245 (Del.Ch.1900) cited in Butler, *above*, nX, 162.

<sup>25</sup> Butler, *above*, nX, 162.

<sup>26</sup> Cary, *above*, n.X, pp664-6

favourable tax, trust, and corporation laws historically supported by sound court decisions”.<sup>27</sup>

### ‘Race to the Bottom’

Cary has been argued that Delaware has gained its pre-eminence in the corporate charter market due to its ability to attract managers at the expense of shareholder protection.<sup>28</sup> This view follows in the tradition of Berle and Means<sup>29</sup> who argued that the large modern business corporation is characterised by the separation of ownership and control. Since shareholders are highly dispersed they are unable to exercise effective control over corporate affairs, leaving the real power in the hands of managers. The Berle-Means thesis therefore lends itself to the inference that government intervention is necessary to prevent corporate managers from exploiting powerless shareholders.<sup>30</sup>

The concept of “race to the bottom” was first recognised by Justice Brandeis in *Liggatt v Lee*<sup>31</sup> when he described interjurisdictional competition leading to businesses moving to states with the least onerous regulatory requirements. He called this as a race “not of diligence but of laxity”.<sup>32</sup> Cary expressed similar sentiments in an early broadside against Delaware’s corporation law where he coined the actual phrase ‘race for the bottom’. He expressed concern about the deterioration in corporate standards, particularly in respect of fiduciary duties, in order to keep corporate managers favourably disposed towards incorporating in Delaware. He said

<sup>27</sup> *American Banker*, Feb 5, 1974 at 10, cols 3 &4 cited in W Cary, above, nX. He also cites Law of December 31, 1963, ch 218, [1963] 54 Del. Laws 724: “[T]he favourable climate which the state of Delaware had traditionally provided for corporations has been a leading source of revenue for the state. ... The General Assembly ... declares [this] to be the public policy of the state.

<sup>28</sup> W.Cary, “Federalism and Corporate Law: Reflections Upon Delaware” (1974) 83 *Yale Law Journal* 663, 669) “greater freedom to pay dividends and make distributions; greater ease of charter amendment and less restrictions upon selling assets, mortgaging, leasing, merging ... freedom from mandatory cumulative voting; permission to have staggered boards of directors; lesser pre-emptive rights for shareholders; [and] clearer rights of indemnification for directors and officers”. He adds that Delaware law also permits shareholders meetings to be dispensed with if a consent is signed by the number of votes necessary to take the intended action, thus offering a technique to avoid disclosure. S.Kaplan, “Foreign Corporations and Local Corporate Policy” (1968) 21 *Vanderbilt Law Review* 433, 436. Firms do not go to Delaware for tax reasons. Romano shows that about 74% of the tax-motivated reincorporations went to states other than Delaware (Romano, above, nX, 257-8), suggesting that Delaware is so desirable a site for incorporation that it is able effectively to charge firms “supercompetitive” prices for the privilege of incorporating there (J Macey and G Miller, “Toward an Interest Group Theory of Delaware Corporate Law” (1987) 65 *Texas Law Review* 469, 472).

<sup>29</sup> A.Berle and G.Means, *Modern Corporation and Private Property* (New York: Macmillan, 1932).

<sup>30</sup> Macey and Miller, above, 474.

<sup>31</sup> 288 U.S. 517, 559 (1933). Brandeis J dissenting.

<sup>32</sup> *Ibid*, 559

that the Delaware law has commensurately watered “the rights of shareholders *vis-à-vis* management down to a thin gruel”.<sup>33</sup> He also condemned the *laissez-faire* effect which, he said, has been exacerbated as a result of a “tight little club”<sup>34</sup> between the legislative process and the judiciary,<sup>35</sup> and the Delaware bar.<sup>36</sup> According to Cary, other states wanted to encourage companies to remain at home and therefore tried to emulate Delaware by revising their acts along similar lines.<sup>37</sup> For example, the aim of Michigan’s new code was, in the words of one of its sponsors, “to out Delaware Delaware”.<sup>38</sup> Only two or three jurisdictions resisted this temptation.<sup>39</sup>

According to Cary, as a result of this “race to the bottom” the New Jersey Corporation Law Revision Commission said in a 1968 report that:

‘It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts. ... Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions.’<sup>40</sup>

Cary therefore concludes that Delaware, “a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders, thereby increasing its revenue”.<sup>41</sup> He says that:

‘A civilising jurisdiction should import lifting standards; certainly there is no justification for permitting them to deteriorate. The absurdity of this race for the bottom, with Delaware in the lead - tolerated and indeed fostered by corporate counsel - should arrest the conscience of the American bar when its current reputation is in low estate.’

Consequently, he argued that there is a need for uniformity in standards to prevent the application of Gresham’s law<sup>42</sup>. Therefore, he proposed the enactment of a Federal

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<sup>33</sup> Cary, *above*, n.X, 666

<sup>34</sup> Cary, *above*, n.X, 693

<sup>35</sup> Cary, *above*, n.X, 690

<sup>36</sup> Cary, *above*, n.X, 692

<sup>37</sup> Romano, *above*, n1, 233-4, demonstrates this thesis graphically in an S-shaped (ogive) cumulative distribution curve. This shows, as the state competition theory would predict, the defensive moves of the states to preserve their positions - if they do not follow the leader they will lose incorporations at the margins, as the cost of the firm maintaining the domicile rises because of an outdated code.

<sup>38</sup> Cary, *above*, n.X, 666

<sup>39</sup> Cary, *above*, n.X, p666

<sup>40</sup> Cited in Cary, *above*, n.X, 666

<sup>41</sup> Cary, *above*, n.X, 701

<sup>42</sup> Cary, *above*, n.X, 698. Kaplan explains (“Fiduciary Responsibility in the Management of the Corporation” (1976) 31 *Business Lawyer* 883, 883), Gresham’s law “alleges that the lax drives out the exacting and commands a race of leniency in corporation act provisions presently being led by Delaware”.



Corporate Uniformity Act, allowing companies to incorporate in the jurisdiction of their own choosing but to remove much of the incentive to organise in Delaware or its rival states.<sup>43</sup>

His views have received endorsement from other academics working in the field.<sup>44</sup> For example, Brudney has agreed that Delaware courts have allowed standards to erode;<sup>45</sup> and Kaplan has described himself as “despondent about the direction of state legislative activities in the field of corporation law” and urged serious consideration of a national corporation act.<sup>46</sup> He cited an example of a bill on cumulative voting in corporations being killed in Illinois because of competition from Delaware.<sup>47</sup> Folk maintains that state corporation law, precisely because it is permissive, will probably be less and less significant, while federal corporation law, addressed to remedying evils, will grow in importance each year.<sup>48</sup> Jennings utters similar sentiments: he is “pessimistic” about corporate reform at state level.<sup>49</sup> He says that at the legislative level “Delaware has clearly won the “race for the bottom”; the spectre of Delaware casts a pall on reform efforts in all of its sister states”.<sup>50</sup>

### Corporate federalists

Free marketeers are, however, highly critical of these calls for federal intervention and suggest that commentators such as Cary disregard the discipline imposed by the market: in essence, they argue, if competition among widgets is a good thing, why not

<sup>43</sup> Cary, *above*, n.X, 701. Subsequently, other proposals have been made for federal legislation to fill the state regulatory gap, including the Corporate Democracy Act of 1980 and the Protection of Shareholders’ Rights Act 1980.

<sup>44</sup> See, also R.Nader *et al*, *Taming the Giant Corporation* (New York: Norton 1976); Folk, “Corporation Statutes:1959-1966” (1966) *Duke LJ* 875; G.Young, “Federal Corporate Law, Federalism and the Federal Courts” (1977) 41 *Law and Contemporary Problems*, Summer 1977, 146; Eisenberg, “The Modernisation of Corporate Law: An essay for Bill Cary” (1983) 37 *Univ of Miami Law Review* 187, 188-91, 196-8, 202-09; Schwartz, “Federalism and Corporate Governance” (1984) 45 *Ohio St L.J* 545. J.Seligman, “The Case for Federal Minimum Corporate Law Standards” (1990) 49 *Maryland Law Review* 947, 971. See also R.Karmel, “Is it time for a Federal Corporation law?” (1991) 57 *Brooklyn Law Review* 55.

<sup>45</sup> Brudney, “Corporate Governance, Agency Costs, and the Rhetoric of Contract” (1985) 85 *Columbia Law Review* 1403.

<sup>46</sup> Kaplan, *above*, nX, 884.

<sup>47</sup> Kaplan, *above*, nX, 886.

<sup>48</sup> Cited in R Jennings “Federalization of Corporation Law: Part Way or All the Way” (1976) 31 *Business Lawyer* 991.

<sup>49</sup> Jennings, *above*, nX, 992.

<sup>50</sup> *Ibid*. Jennings refers to the words of Folk, who served as Reporter to the Delaware Corporation law revision Committee, “Almost without exception, the key movement in corporation law is toward ever greater permissiveness.... Explicitly positing an objective of “flexibility”, statutory revisers ... have usually sought to enlarge the ambit of freedom of corporate management to take whatever action it may wish” (“Some Reflections of a Corporate Law Draftsman” (1968) 42 *Conn. Bar. J* 409, 410.

among producers of regulatory policy?<sup>51</sup> For example, Winter argues that competition among states works to ensure the production of laws that are distinguished not merely by their innovative and responsive nature but by their capacity to enhance shareholder welfare.<sup>52</sup> Fischel argues that the race to the bottom thesis is based on a model of shareholder irrationality.<sup>53</sup> Why, he asks, given the infinite number of alternative investment opportunities, would shareholders voluntarily entrust their money to managers who have no incentive to maximise their welfare?<sup>54</sup> Given the incentives on management to perform well<sup>55</sup> the operation of these forces aligns managerial interest with those of the shareholders insofar as the corporation decision is concerned.<sup>56</sup> He therefore suggests that Delaware has achieved its prominent position because its permissive corporation law maximises rather than minimises, shareholders' welfare.<sup>57</sup> He concludes that Delaware's pre-eminence is "in all probability attributable to success in a 'climb to the top' rather than to victory in a 'race to the bottom'".<sup>58</sup>

This view is supported by some empirical evidence: Dodd and Leftwich found that firms in their sample experienced positive abnormal returns of an average of over 30.25% over the two year period prior to incorporation in Delaware.<sup>59</sup> Cheffins also

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<sup>51</sup> B.Langille, "Competing conceptions of Regulatory competition in debates on trade liberalisation and Labour Standards" in W.Bratton, J.McCahery, S.Picciotto and C.Scott *International Regulatory Competition and Coordination*, Clarendon, 1996, 480.

<sup>52</sup> R.Winter, "State Law, Shareholder Protection and the Theory of Corporation" (1977) 6 J Leg Stud 251.

<sup>53</sup> D.Fischel, "The 'race to the bottom' revisited: Reflections on recent developments in Delaware's Corporation Law" (1982) *Northwestern University Law Review* 913, 916.

<sup>54</sup> As Winter explains if management chose a state whose laws were adverse to the shareholders' interests, the value of the firm's stock would decline relative to stock in a comparable firm incorporated in a state with value maximising laws, as investors would require a higher return on capital to finance the business operating under the inferior legal regime. This impact in the capital market would affect managers by threatening their jobs. Either the lower capital would attract a take-over artist who could turn a profit by acquiring the firm and relocating it in a state with superior laws, or the firm would go bankrupt by being undercut in its product market by rivals whose cost of capital would be lower because they were incorporated in value maximising states. In either situation, in order to maintain their positions managers are compelled by natural selection, to seek the state whose laws are most favourable to shareholders. Winter, *Government and the Corporation* (1978) [CHECK] cited in Romano, "The State Competition Debate in Corporate Law" (1987) 8 *Cardozo Law Review* 709., Arshnt, "Reply to Professor Cary" (1976) 31 *Bus.Law* 1113; Manning, "Thinking Straight about Corporation Law Reform" (1977) 41 *Law & Contemp Probs* 3, 15-17.

<sup>55</sup> For example, stock option plans, risk of mergers displacing inefficient managers.

<sup>56</sup> L.Bechuk, "Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law" (1992) 105 *Harvard Law Review* 1437, 1445.

<sup>57</sup> Fischel, above, n.X, 913

<sup>58</sup> Fischel, above, n.X, 920. See also F.Easterbrook "The Economics of Federalism"(1983) 26 *Journal of Law and Economics* 23, 28.

<sup>59</sup> Dodd and Leftwich, above, nX, 261

suggests that the studies of price movements indicate that share prices typically increase when a reincorporation under Delaware law is announced.<sup>60</sup> He therefore concludes that a competitive market for incorporation works to the advantage of investors. He does, however, add a caveat. He says that in the studies in question the reincorporation was often accompanied by another development, such as a merger or an initial public offering of equity. He therefore suggests that it is possible that the increase in the value of the shares occurred not because of the move to Delaware but because investors viewed the accompanying transaction favourably.

In the light of these arguments, Charny concludes that firstly, managers will choose to incorporate in the state where the corporation laws are most efficient from the shareholders' point of view. Therefore, Delaware attracts incorporations not because its laws are lax but because they are efficient: its dominance is attributable to its adoption of optimal rules. Secondly, this "market for incorporation" creates an incentive for each state to offer the most efficient laws: the state thereby increases its revenues from incorporation fees.<sup>61</sup> Romano's work emphasises the advantages enjoyed by the Delaware system:<sup>62</sup> Delaware offers comprehensive statutes and case law;<sup>63</sup> the continuity in and small size of Delaware's courts of Chancery provide an experienced judiciary specialised in corporate matters; Delaware's large population of corporations quickly generate legal controversies and thereby new precedents and rules;<sup>64</sup> Delaware's reliance on incorporation fees bonds Delaware to maintaining the stability<sup>65</sup> and serviceability of its system.<sup>66</sup> Further, Romano has shown that

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<sup>60</sup> Cheffins, *above*, nX, 446.

<sup>61</sup> Charny, *above*, n.X, 431-2.

<sup>62</sup> R.Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle" (1985) 1 J.L.Econ & Org. 225, 240. This is described by Bubchuk, *above*, nX, 1446 as a race for predictability and stability and offered as an alternative theory to the race to the bottom and race to the top.

<sup>63</sup> Brandeis J, *above*, nX, 558 refers to an official pamphlet containing the corporate laws of Delaware (1901) where the Secretary of State wrote in the preface that "It is believed that no state has on its statute books more complete and liberal laws than these".

<sup>64</sup> Recognising the importance and value of legal expertise, Delaware takes a variety of steps to facilitate its growth by circulating unpublished judicial opinions and developments in the state and by consulting leading members of the bar in states other than Delaware on its corporate law revisions (Romano, *above*, nX, 276).

<sup>65</sup> Delaware's corporation code can be revised only by a two-thirds vote of both houses of the state legislature, although this could impede the adoption of desirable corporate innovations.

<sup>66</sup> D.Schaffer, *above*, n.X, offers two examples of this: the first concerns the Revised Code of 1967, the second concerns the amendments made in response to the liability crisis created by the collapse in the directors and officers insurance market. As Schaffer explains (p.687) "The market works; corporate law is amended; and the Delaware legislature and judiciary continue to provide efficient legal rules for the conduct of American business". He also points out that Delaware increased the number of new incorporations by 28% in the six months following the enactment of the amendments, and derived an additional \$1.4 million in fees from the new incorporations. Indeed, some commentators argue that Delaware's laws have proved so effective that they have functioned as a uniform national law. See, *inter alia* Leleux, *above*, nX, 151.

Delaware is highly responsive to new ideas on corporate laws.<sup>67</sup> She finds a direct correlation between a state's proportionate level of franchise tax and its corporate law responsiveness. She concludes that the appeal of Delaware as a reincorporation site has two components: a direct cost-reducing aspect concerning the firm's projected activities as well as the reduction of litigation uncertainty.<sup>68</sup>

### Conditions for competitive federalism

If the corporate federalists are correct and competition between jurisdictions leads to efficient state legislation, could such arguments apply to the European Union? The literature on the economics of federalism identifies six conditions under which competition between local jurisdictions would be efficient.<sup>69</sup> These are:

- (i) full mobility of people and resources at little or no cost;
- (ii) wide choice of destination jurisdictions to enable the citizen to have sufficient choice to make meaningful decisions about migration;
- (iii) full knowledge of each jurisdictions' revenue and expenditure patterns;
- (iv) resource constraints and economies of scale which result in an optimal size for any jurisdiction;
- (v) jurisdictional latitude in selection of laws (ie jurisdictions must not be subject to external constraints in the production of their laws), and
- (vi) internalisation of costs and benefits of laws onto their direct suppliers and consumers. This means that the innovator jurisdiction must be able to prevent competitor jurisdictions from duplicating successful innovations (the "free rider" problem).

As McGowan and Seabright point out, it is evident that in the European Union context these conditions are far from being met. There are very major costs (including linguistic and cultural costs) to the mobility of citizens between Member States. Fifteen is a small number of competing jurisdictions given the large number of regulatory questions on which each pronounces and there are many aspects of regulation in which external effects between Member States are quite significant.<sup>70</sup>

<sup>67</sup> Romano, *above*, nX, 240. She demonstrates that while Delaware was the first state to enact only one of the four laws under study, it adopted the other three within four to seven years from their introduction in another jurisdiction and, as a result, it ambiguously outpaced the other states.

<sup>68</sup> Romano, *above*, nX, 265. However, Romano (Law as a product) is not a wholehearted supporter of the Winter thesis. Her ambivalence concerns state anti-takeover statutes. Economic theory indicates that reincorporations motivated by a desire to take advantage of state anti-takeover legislation should have generated negative and not, as she found, positive returns. While there may be explanations for this, Romano cannot discount the possibility that reincorporations motivated by the benefits of anti-takeover protections were designed to vindicate managerial rather than shareholder welfare objectives. That being said, Romano has declared her position to be closer to Winter than Cary ("The State Competition debate in Corporate Law" (1987) 8 *Cardozo Law review* 709, 753.

<sup>69</sup> See CM Tiebout, "A pure theory of local expenditure" (1956) 64/5 *Journal of Political Economy* 416-424; Easterbrook, *above*, , "Antitrust and the Economics of Federalism" (1983) 26 *Journal of law and Economics* 23, 34 and Daniels, *above* nX 146.

<sup>70</sup> McGowan and Seabright, "Regulation in the European Community" in M.Bishop, J.Kay and C.Mayer, *The Regulatory Challenge* (Oxford: OUP), 1995, 230-1.

Further, adequate information on all aspects of the rival jurisdiction's regulation may be difficult to obtain or to assimilate.

Given the lack of these key conditions, the likelihood of efficient, beneficial regulatory competition is remote in the EU. However, given the perception that capital is more mobile than people, the spectre of race to the bottom has haunted the political and legal imagination. For example, since the early days of the EU, concerns have been expressed about the risks posed by 'Company law Delawares'.<sup>71</sup> As Conard points out, "The founders of the Community had no intention of letting one of the Member States become the 'Delaware of Europe'".<sup>72</sup> Such concerns have also been expressed in the context of social policy. In the political arena Neil Kinnock, a European Commissioner, expressed his fears that as a result of the UK's opt-out from the Social Chapter, "Britain would become a place for social dumping".<sup>73</sup> The French economic minister, M.Arthuis, when unveiling a series of measures to make investment in France more attractive "warned against social dumping that at present takes place between countries and regions in their attempts to attract business from abroad".<sup>74</sup> Even Jacques Chirac, the French President, has jumped on the band wagon. Writing in *La Liberation*, he argued that Europe needed to give itself a big

<sup>71</sup> Kolvenbach, "EEC Company Law Harmonisation and Worker Participation" (1990) 11 U Pa J Int'l Bus Law 709, 711-712. See also C.D.Stith, "Federalism and Company Law: A 'Race to the bottom' in the European Community" (1991) 79 *Geo.L.J* 1581, 1603-6, 1609-11. The EU's company law programme has been designed to reduce incentives businesses might have to seek out favourable statutory regimes in other states. Germany, in particular, has been worried that its companies will, if possible, incorporate under foreign laws, in order to avoid worker participation requirements. See Lord Wedderburn, "European Community Law and Worker's Rights After 1992: Fact or Fake?" in *Labour Law and Freedom: Further Essays in Labour Law* (London: Lawrence and Wishart, 1992) 247, 249-50. In reality, there is little evidence of race to the bottom in company law. As Cheffins explains, (above, nX, 427-431), the absence of a race to the bottom is largely attributable to the fact that most Member States operate the "real seat doctrine". This doctrine prescribes that the company's real seat is the country where its central administration or place of business is located. That country's laws govern the business enterprise, including its legal personality and internal regime.

<sup>72</sup> A. Conard, "The European Alternative to Uniformity in Corporation Laws" (1990) 89 *Michigan Law Review* 2150, 2161. These concerns are not unique to the Community context. The long term origins of the International Labour Organisation lay in the inhumanity of the industrial revolution, and the resistance of employers, who feared international competition, to the reform of working conditions. As one commentator observed at the time: "The only answer was to try to find a way to dilute unrestricted international competition by establishing minimum living conditions throughout the world below which workers should not be allowed to fall yet leaving the theory of comparative advantage intact". See K.Ewing, *Britain and the ILO*, London: Institute of Employment Rights, 2nd ed., 1994, 2.

<sup>73</sup> I.Owen, "Kinnock will urge participation in Maastricht Social Chapter", *Financial Times*, 30 July 1994.

<sup>74</sup> A.Jack, "France will meet Maastricht criteria", *Financial Times*, 30 April 1996. The minister added that he was working with other EU ministers on the idea of developing a "Code of Good Conduct" which would reduce unfair distortions between those regions fighting to attract investors". A plan to combat social dumping formed the central pillar of the French presidency of the Council in 1995 (EIRR 253, 219). In the wake of the French truckers dispute the French government indicated that it intended to make a fresh push to harmonise working conditions within the European Union because it was concerned about social dumping: C.Southey, "Call for Social Security Reform", *Financial Times*, 3 December 1996.

political project to revive citizens' hopes and win their support, and he wanted to stop social dumping.<sup>75</sup>

Such concerns have also influenced the legal debate. In its recent White Paper on Social Policy<sup>76</sup> the Commission talks of:

“the establishment of a framework of basic minimum standards, which the Commission started some years ago, provides a bulwark against using low social standards as an instrument of unfair economic competition and protection against reducing social standards to gain competitiveness, and is also an expression of the political will to maintain the momentum of social progress.”<sup>77</sup>

Later it says:

“Legislating for higher labour standards and employee rights has been an important part of the Union's achievements in the social field. The key objectives have been both to ensure that the creation of the single market did not result in a downward pressure on labour standards or create a distortion of competition, and to ensure that working people also shared in the new prosperity. The main areas of focus have been equal treatment of men and women, free movement of workers, health and safety, and - to a limited extent - labour law.”<sup>78</sup>

Further, in the Commission's Green Paper on European Social Policy it said that “a commitment to high social standards and to the promotion of social progress forms an integral part of the [TEU]. A ‘negative’ competitiveness between Member States would lead to social dumping, to the undermining of the consensus making process ... and to danger for the acceptability of the Union”.<sup>79</sup> Indeed, the Commission is reported to have proposed to extend the rules on worker consultation because “There have been suspicions that different labour standards caused ‘social dumping’ - where some countries with lower standards can give companies a competitive edge - and there was a need for common rules”.<sup>80</sup>

Concerns about social dumping were exacerbated by the highly publicised Hoover and Renault affairs. In the case of Hoover, the company decided to close its factory in Longvic, near Dijon in France, with the loss of 600 out of 700 jobs, and transfer its activities to the Cambuslang plant, near Glasgow in Scotland, resulting in the recruitment of 400 workers on 24 month fixed term contracts. This followed the conclusion of a collective agreement between management and the British trade union Amalgamated Engineering and Electrical Union (AEEU) providing for improved flexibility of labour, new working patterns, a no-strike deal and a pay freeze. At the same time Rockwell Graphic systems announced that 110 jobs were to be lost out of 272

<sup>75</sup> Cited in D.Buchan, “France to reduce border controls”, *Financial Times*, 26 March 1996.

<sup>76</sup> COM (94) 333, 27 July 1994

<sup>77</sup> *Ibid*, Introduction, para.19. This is internally inconsistent. If there are genuine concerns about race to the bottom, why set only minimum standards?

<sup>78</sup> *Ibid*, chap III, para. 1.

<sup>79</sup> COM(93) 551, p.46

<sup>80</sup> C.Southey, “EU looks to extend laws on worker consultation”, *Financial Times*, 23 September 1996.

at its Nantes plant with production being relocated to Preston in England. Martine Aubry, the French Minister for labour and the French Prime Minister both said that Hoover's decision constituted "social dumping".<sup>81</sup> In the case of Renault announced the closure of its Vilvoorde plant which employed 3,100 workers as part of its global restructuring plan.<sup>82</sup> Even though the Belgium labour tribunal declared Renault's actions unlawful in that Renault had failed to respect collective agreements and Belgian law on worker consultation, the company remained unmoved.<sup>83</sup> However, movement is not a one way street – while Hoover was moving its plant to Scotland, Rowntrees, the confectionery manufacturer announced that it was to transfer a part of its activities from a factory in Glasgow to Dijon.<sup>84</sup> More recently Osram, the German lightbulb manufacturing company moved some of its specialist manufacturing operations from Berlin to Shaw near Manchester due to cheaper labour costs. On the other hand, the company chose its German plant in Augsburg to be the recipient of new investment and not Bari in Italy, where wage costs are 40% lower. It did this partly, it says, out of commitment to Germany as an industrial manufacturing location and partly because its German workforce is more skilled and productivity is higher in Augsburg than in many other plants worldwide.<sup>85</sup>

#### 4. Social Policy and the EU

##### *From theory...*

The Hoover example, in particular, suggest that the UK's regulatory - or rather deregulatory - policies have led Hoover to move its plant for France, a state with high standards of social protection to the UK with its lower standards. If these arguments are correct they could be represented in the form of Langille's model described above based on the prisoner's dilemma. This would suggest the following matrix:

	STATE A CHOOSES	STATE B CHOOSES
1.	Existing optimal social	Existing optimal social

<sup>81</sup> EIRR 230, 16. John Major, the then British Prime Minister, is reported as saying in response "France can complain all it likes. If investors and business choose to come to Britain rather than pay the costs of socialism in France, let them call it "social dumping". I call it dumping socialism" - *Financial Times*, 6 March 1993.

<sup>82</sup> EIRR 279, 4

<sup>83</sup> EIRR 280, 5. In France, the Nanterre labour tribunal went further and declared the Renault decision to be null and void (see also EIRR 280, 5). Subsequently, it nominated a consultant to undertake a study on the future of the Belgian plant (EIRR 282, 6). This study concluded that closure was the only viable option for the plant (EIRR 283, 4) and the workers accepted the terms of the social plan, designed to cushion the effects of redundancy. In the meantime the social partners negotiated an agreement strengthening sanctions against companies which contravene national regulations on collective redundancies (EIRR 282, 5). See generally "The repercussions of the Vilvoorde closure" EIRR 289, 22.

<sup>84</sup> EIRR 230, 14.

<sup>85</sup> EIRR xxx. West German labour costs are 70.16 DM per hour compared to 37.46 in Italy, 32.11 in Ireland, 29.42 in the UK, 22.74 in Portugal and 18.12 in Greece: *Bundesarbeitgeberverband Chemie* cited in EIRR 285, 28.

	legislation (no change in location of businesses)	legislation (no change in location of business operations)
2.	Existing optimal social legislation (loss of businesses and therefore of employment)	Suboptimal social legislation (gain in business operations and therefore of employment)
3.	Suboptimal social legislation (gain in business operations and therefore of employment)	Existing optimal social legislation (loss of businesses and therefore of employment)
4.	Suboptimal social legislation (no change in location of businesses)	Suboptimal social legislation (no change in location of businesses)

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Based on Langille "Debates on Trade Liberalisation and Labour Standards" in Bratton *et al*, *International Regulatory Competition and Coordination*, 483

Therefore, the preference order for state A in terms of attracting external capital would be 3-1-4-2. If both states cooperate the choice should be option 1. However, rationality operates to produce option 4. The EU's concern has been that the UK was putting itself in the position of state A. It worried that the rational response of the other Member States would be to produce option 4 ie that the wealthier countries with high standards of social protection such as Germany, Denmark, the Netherlands and France would seek to reduce the levels of their social protection in order to compete with the UK, Greece, Spain and Portugal which in turn would further lower their standards of social protection.

As we have seen, equivalent conduct on the part of Delaware in respect of its corporation law led to passionate calls for federal legislation. Yet, crucially, the EC has no competence over pay<sup>86</sup> and it has only limited competence in respect of other types of working conditions, so its hands are severely tied preventing it from protecting Member States with higher standards from the decisions of others. Where competition comes from outside the EU, especially Eastern Europe, the Community has, of course, no competence.

### **...To reality**

As we have seen, social dumping is one of the principal reasons for the enactment of Community social legislation. I would like to suggest that despite the examples of Hoover and Renault, there is little evidence that the Member States are using regulation or rather deregulation of labour standards as a tool of competition. Indeed, at times the converse seems to be true: labour standards both in the wealthier and poorer countries continue to be raised. Further, movement of capital that does occur can often be explained on other grounds.

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<sup>86</sup> Article 2(6) SPA, Article 118



It is hard to prove a negative – that there is no race. It would require a full comparative study of the laws of all fifteen Member States. All I can do is to offer some thoughts. First, although the Hoover and Renault examples are cited as evidence of social dumping, they are the only two examples, and increasingly ageing examples at that. Further, as we have seen, the move to the UK by Hoover was accompanied by a move by Rowntrees to France. Second, regional disparities in respect of levels of pay and terms and conditions exist within most member States. There is little evidence of a migration of business to the areas with the highest levels of unemployment and thus of pay which are typically among the most deprived in the state. Intuitively we can understand this. Why then should the picture be different at transnational level when language and cultural differences compound the problem?

It therefore comes as no surprise that the OECD finds that despite pressures on labour standards “there is no compelling evidence that ‘social dumping’ has occurred so far in OECD countries”.<sup>87</sup> This view is shared by other observers. Goodhart says that “social dumping has not materialised in Europe”.<sup>88</sup> Ross says “there has been very little North-South social dumping in the European Union and remarkably few signs that southern EU Member States are eager to exploit their relative economic and social policy backwardness as a competitive tool. By and large, the South seems persuaded that it should cast its lot with the higher-wage, stronger welfare-state northerners”.<sup>89</sup> Schonfield’s unpublished study on pay and collective bargaining for the Commission as part of its evaluation of the impact of the Single Market concludes “The dangers of ‘social dumping’ have been exaggerated with only isolated examples of competitive undercutting of pay and conditions by firms exploiting labour cost differences between countries”.<sup>90</sup> He did, however, add that there is evidence from Germany that companies are increasingly using the possibility of relocation as a bargaining counter to achieve changes in working practices at home.<sup>91</sup>

Even in the United States, the picture of a frenetic race to the bottom in corporation laws is not as complete as the Delaware literature would indicate. As Manning points out,<sup>92</sup> when California conducted a major corporate law revision, the legislature did not adopt the Delaware statute, did not strive to outdo Delaware in permissiveness, and in fact increased the level of regulation in some respects. Similarly, the successive modifications of the Model Corporation Act [CHEFFINS, P.33], the predominant corporation act in the country, have not sought to race Delaware to the

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<sup>87</sup> OECD, “Labour Standards and Economic Integration”, in *Employment Outlook 1994* (OECD, 1994), 138.

<sup>88</sup> D. Goodhart, “Can Europe Compete”, *Financial Times*, 28 February 1994.

<sup>89</sup> G. Ross, n. X above, 368.

<sup>90</sup> Reported by Taylor, “Wage Bargaining diversification under EU Single Market”, *Financial Times*, 7 April 1997

<sup>91</sup> See, for example, the concessions made by German workers at Bosch and Daimler Benz because of threats of locating new plants abroad (see “Can Europe compete”, *Financial Times*, 28 February 1994).

<sup>92</sup> B. Manning, “Thinking Straight about Reform”, (1977) 41(3) *Law and Contemporary Problems* 3, 17.

bottom. Even Nevada which has duplicated the provisions of Delaware's statutory and common law as it applies to incorporations, has not made substantial inroads into the monolith of Delaware's chartering business.<sup>93</sup> Manning concludes "Delaware has over several generations made a speciality of incorporation (corporations are among the few things for which there is always plenty of space in a tiny state) and corporate franchise taxes make up a significant part of that state's revenues. But that situation is atypical."<sup>94</sup> He points out that for most states corporate franchise taxes based on incorporation provide an insignificant part of other states revenues. From the perspective of tax revenues, states do far better to attract the business operations of enterprises.

I am not arguing that states have not legislated in the social field: far from it. The 1980s and 1990s have seen dramatic changes in domestic legislation, largely in the name of flexibility. In Spain, for example, the Franco regime's Labour Ordinances - statutory regulations governing a wide range of terms and conditions of employment - were repealed,<sup>95</sup> on the grounds that they were considered largely obsolete. They have, however, largely been replaced by collective agreements.<sup>96</sup> Considerable steps have also been taken to introduce more "flexible" types of employment contracts. This led to legislation in 1984 extending the circumstances in which employers can offer fixed term contracts, and further reforms in 1994 designed to encourage part-time working were introduced and restrictions on the operation of temp agencies were also lifted.<sup>97</sup> The desire to achieve labour market flexibility is not confined to Spain. The United Kingdom has, of course, been at the vanguard of this process where the Conservative government abolished the Wages Councils, extended the length of service requirement for employees to claim unfair dismissal and removed restrictions on working hours for women and young people.<sup>98</sup> On the other hand, the Labour government has proposed the introduction of a variety of employment rights, including the minimum wage, the protection of whistleblowers, compulsory recognition of trade unions and substantially raising the ceiling on unfair dismissal compensation.<sup>99</sup> In Germany the Employment Promotion Act 1994 formed part of a wide ranging programme of labour market reform and the Arbeitsrechtliches Beschäftigungsförderungsgesetz passed in September 1996 amended existing

<sup>93</sup> Macey and Miller, *above*, nX, 488

<sup>94</sup> Manning, *above*, nX, 17-18.

<sup>95</sup> The 1980 Workers' Statute authorised the Ministry of Labour to repeal the Ordinances where their content was substituted in their entirety by collective agreements. Amendments to the Workers' statute made in 1994 provided that the labour ordinances had no force from December 1994. An interconfederal agreement (AIOR) between CEOE, UGT and CCOO on replacing the labour ordinances was concluded in October 1994.

<sup>96</sup> See further EIRR 272, 29. The Ministry of Labour has published figures suggesting that the labour market reforms have been a success, creating almost a million new open-ended jobs (EIRR 293, 12).

<sup>97</sup> Law 14/1994 of 1 June 1994.

<sup>98</sup> EIRR 196.

<sup>99</sup> See generally the Fairness at Work White Paper and now the Employment Relations Bill. However, see *Financial Times*, 16 March 1999.

provisions on sickness payments, protection against dismissals and fixed-term contracts.<sup>100</sup> This Act introduced various new measures including legalising private employment agencies<sup>101</sup> and relaxed the legal restrictions on fixed term contracts.<sup>102</sup> Similarly, in Italy a law of 1997 has legalised temp agencies.<sup>103</sup>

There is little evidence that these reforms were introduced in response to concerns about social dumping but rather as steps to modernise employment regulation in the light of changing technology and methods of production, accompanied by a desire to encourage as many people into work as possible. It is inevitable that such steps would have taken place at some stage, with or without the impetus of the single market. What seems to be clear is that there is little actual desire on the part of the states to compete: there is no race. While there may be demand on the part of employers to have more relaxed rules, on the supply side, governments seem reluctant to design legislation solely with a view to attract business. Thus, the situation in the Member States of the EU contrasts markedly with that in Delaware.<sup>104</sup>

I am also not arguing that capital movement has not occurred. I am, however, suggesting that the cause of movement is largely attributable to factors other than as a response to state deregulation of labour standards. One explanation may lie in more favourable tax regimes in countries such as Britain and Ireland;<sup>105</sup> another in the regional aid available (in circumstances closely defined by the Commission) to attract capital to a particular region. Another explanation may lie in a desire by companies in Europe to streamline operations by rationalising the structure of businesses that were originally designed for more fragmented markets.<sup>106</sup> Therefore there is a tendency for multinationals to establish one European headquarters, rather than one in each Member State, and to consolidate their European manufacturing operations in their most efficient or low cost plants. The American company, Gillette, closed its razor blade factory in Spain and transferred production to its plants in London and Berlin which had newer technology.<sup>107</sup> Similarly, CPC(UK), an American subsidiary, moved its production of Knorr soups and cubes from Scotland to more modern plants

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<sup>100</sup> EIRR 284, 25.

<sup>101</sup> This move was forced in part as a result of pressure from the ECJ in Case C-xx *Macroton v Höfner xx*

<sup>102</sup> EIRR 252, 17. EIRR 284, 25.

<sup>103</sup> See R.Del Punta, 'La 'Fornitura di Lavoro Temporaneo' nella L.N.196/1997.

<sup>104</sup> There also seems little willingness on the part of governments of the EU Member States to compete in respect of company law: see Cheffins, above, nX, 431-2, 435-40.

<sup>105</sup> See n.X, above.

<sup>106</sup> V. Houlder, 'Survey of Relocation in the UK', *Financial Times*, 27 March 1994.

<sup>107</sup> See D. White, 'Fury over Gillette's Spanish closure plans', *Financial Times*, 21 March 1994 and 'Gillette rejects rescue offer', *Financial Times*, 25 March 1994. The Spanish trade unions alleged that Gillette was engaged in social dumping by shipping production to Russia, Poland and China. Gillette said that its ventures in these countries were unconnected with the European market. See, further, Barnard, above, n.1.

in France and Italy. Movement of business operations *from* Spain or, even the UK, to Germany and France flies in the face of concerns about race-to-the-bottom.

Given the lack of evidence for the existence of a race to the bottom in the context of EU social policy, why then has the idea taken such firm hold in political circles. The response must lie in its appealing simplicity: it represents an easy way to comprehend complex situations and to communicate with a susceptible audience worried about loss of jobs. It is a powerful argument. Commenting on the effect of the Hoover affair in Burgundy, Buchan says “‘Social dumping’ has since proved to be more of a term of political abuse than a description of economic reality. But the incident left scars...’, with the inhabitants feeling vulnerable to decisions taken elsewhere.<sup>108</sup> Easterbrook develops the idea. He says that movement is a fact of life ‘and it is hard to avoid the impression that enough of the movement is influenced - at the margin, of course - by laws and regulations that the movement itself strongly influences governments. It may take only a few searchers and movers to cause powerful responses by competing governments’.<sup>109</sup>

Put into context, however, the likelihood of businesses moving to state A from state B just because the social standards are lower is unlikely. Movement will only occur if a variety of factors justify the move: infrastructure, the existence of a skilled workforce, a good supply network and so forth. Labour standards, and pay in particular where levels of pay reflect the productivity of the workers, are just one factor in a complex equation. As we saw with the Osram case considered above, it would seem that financial incentives by states to encourage companies to a particular area, infrastructure investment, training of workers and their level of productivity are factors which are as important as the level of social protection and possibly more so. In Canada it is also reported that there is no evidence of a race to the bottom between states. Beck *et al*, noting that “‘Province shopping’ has never been in vogue,<sup>110</sup> attribute this in part to the fact that the differences among the provincial acts and federal acts were not as pronounced as those among various state laws in the US. A similar observation can be made about the labour laws in the European Union. All Member States have, relatively speaking, a highly developed system of labour protection. While the detail and methods may vary considerably between states, Member States share common standards in terms of protection against unfair dismissal and sex discrimination and permit certain collective rights.

Ross offers another explanation for the absence of social dumping. He argues that well-constructed regional development policies, designed to redistribute wealth from richer to poorer regions, can counteract tendencies to downward harmonisation. He says that ‘since 1987–8 EC/EU regional policies have become the most significant instruments for preempting any “race to the bottom” in labour standards and labour-market regulation’.<sup>111</sup> He continues that ‘the social policy goal is to buy backward EU

<sup>108</sup> D. Buchan, ‘Survey — Burgundy 97’, *Financial Times*, 25 February 1997.

<sup>109</sup> F. Easterbrook, ‘Antitrust and the Economics of Federalism’ (1993) 26 *Journal of Law and Economics* 23, 44.

<sup>110</sup> S.M. Beck *et al*, *Cases and Materials on Partnerships and Canadian Business Corporations* (Toronto, Caswell, 1983), 152 cited in Daniels, 150.

<sup>111</sup> G. Ross, n. X above, 364.

regions into the 'European model of society' and preempt races to the bottom'.<sup>112</sup> As Scott and Mansell explain, regional development policies were designed to reduce economic problems and disparities which in the past Member States have addressed through the traditional mechanisms of exchange rate manipulation, interest rate flexibility and public borrowing.<sup>113</sup> In Ross' view such policies have also prevented governments from deregulating social standards.

There may be a further and more principled explanation for the absence of a race to the bottom. State competition in labour law may be perceived as undermining widely held views about fairness and social cohesion in the European Union, particularly at a time when social democratic governments predominate in the EU. The Member States committed themselves in the Preamble of the Treaty to "the constant improvement of the living and working conditions of their peoples ... balanced trade and fair competition ... to strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions". A race to the bottom between Member States would undermine this consensus. States should have an equal opportunity to compete for capital based on productivity and efficiency and not deregulation. High labour standards, whether at State or Community level constitute an integral part of this process.

It therefore seems that Delaware represents the exception rather than the norm. As we have seen, Delaware derives a very high proportion of its income from incorporation fees and taxes. This puts it in a unique situation. As Trachtmann explains, where the motivations of the state are less purely oriented towards the fisc, the process of regulatory competition grows more complex. A state has multiple policies to integrate: fair and competitive domestic markets, protection of the environment, and maintenance of a stable financial system. Differential mobility will operate differently in respect of each policy.<sup>114</sup>

Further, the prisoners' dilemma model upon which, as we have seen, the race to the bottom thesis is based is highly stylised and presupposes that there is no communication and co-operation among the parties. This is clearly not the case among the Member States of the EC which work with each other on a daily basis. As Majone points out,<sup>115</sup> a non-co-operative game such as the prisoner's dilemma has no Pareto-efficient solution<sup>116</sup> if it is played only once since, as we have seen, it resulted in the suboptimal solution: 10 years' imprisonment for the prisoners, suboptimal legislation and no change in levels of incorporation for the states in the context of environmental law. If the game is played on an indefinite number of times, however,

<sup>112</sup> G. Ross, n. X above, 366.

<sup>113</sup> J. Scott and W. Mansell, 'European Regional Development: Confusing Quantity with Quality' (1993) 18 ELRev 87.

<sup>114</sup> Trachtmann, *above*, nX, 77

<sup>115</sup> G. Majone, *Regulating Europe* (London: Routledge) 1996, 42

<sup>116</sup> A Pareto efficient situation is one where there is no rearrangement of resources (no possible change in production and consumption) such that someone can be made better off without, at the same time, making someone else worse off (see Majone, *above*, nX, 28). This results from efficient allocation of resources in competitive markets.

“cheating” is no longer the dominant but inefficient strategy since a collapse of trust and co-operation carries a cost in the form of a loss of future profits. If this cost is large enough, cheating will be deterred and co-operation sustained.<sup>117</sup> For this to be the case the discounted value of all future gains must be larger than the short-term gain from non-co-operation.

#### 4. Conclusions

If my thesis is correct and there is little or no race to the bottom occurring in the EU, why the is there so much reference to it in Community documents? One explanation may lie in the “purposeful” opportunism of the Commission,<sup>118</sup> disguising legislation which is, in essence protective of workers, in language acceptable to the political mood. A change in government in the UK may have helped shift the focus of the debate away from transnational labour standards as a defensive mechanism towards a more positive construction of labour standards as a key component to growth.

In its *Fairness at Work White Paper*<sup>119</sup> the Labour government sees a direct link between labour regulation and a more productive workforce. The dialogue has also begun to change in the EU. The Social Policy Directorate of the Commission, DGV issued, in the second half of 1997, a Green Paper, *Partnership for a New Organisation of Work*<sup>120</sup> and a Communication, *Modernising and Improving Social Protection in the European Union*.<sup>121</sup> The two Commission documents are notable for their attempt to marry social and employment protection to an economic agenda based on the achievement of competitiveness through ‘high trust’ employment relations.<sup>122</sup> According to the Partnership Green Paper, the challenge for social policy is ‘how to reconcile security for workers with the flexibility which firms need’.<sup>123</sup> The answer lies in an ‘improved organisation of work’ which, although unable ‘of itself to solve the unemployment problem’, may nevertheless ‘make a valuable contribution, firstly, to the competitiveness of European firms, and secondly, to the improvement of the quality of working life and the employability of the workforce’.<sup>124</sup> More specifically, ‘the flexible firm could offer a sound basis for fundamental organisational renewal built on high skill, high productivity, high quality, good environmental management - and good wages’.<sup>125</sup> In terms of labour

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<sup>117</sup> However, if games are repeated infinitely, cooperation does break down. See S.Heap. *The Theory of Choice*, 1992, 112-129 and SEE CHEFFINS, 170-171.

<sup>118</sup> L. Cram, *Policy Making in the EU: Conceptual Lenses and the Integration Process* (Routledge, 1997).

<sup>119</sup> Cm 3968.

<sup>120</sup> COM(97) 127 final.

<sup>121</sup> COM(97) 102 final.

<sup>122</sup> See Barnard and Deakin, above, n.X, 140.

<sup>123</sup> COM(97) 127 final, Executive Summary.

<sup>124</sup> *Ibid.*, para. 4

<sup>125</sup> *Ibid.*, para. 24.

law this means 'the likely development of labour law and industrial relations from rigid and compulsory systems of statutory regulations to more open and flexible legal frameworks'.<sup>126</sup> Flexibility within organisations is to be encouraged, it suggests, by reinforcing mechanisms for employee participation at the level of the plant or enterprise; 'the role of workers in decision making and the need to review and strengthen the existing arrangements for workers' involvement in their companies will ... become essential issues'.<sup>127</sup> Thus, the EC will continue to set labour standards but these will be more procedural, providing the social partners the space to develop the substance of these standards at national level. This is a far cry from either the corporate federalist or the race to the bottom school of jurisdictional competition.

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<sup>126</sup> Ibid., para. 44.

<sup>127</sup> Ibid., para. 44.