

## **Moveable feast: modeling social dumping**

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### **Abstract**

This paper examines social policy autonomy in the light of increasing fluidity of trade and investment, and suggests that Cohen's Unholy Trinity model of reduced national monetary policy autonomy may be applied to social policy (narrowly defined to include labor market and other employment-related policies) as well. The presence of free trade and foreign direct investment mean that national autonomy on social policy is curtailed by forum-shopping under certain circumstances. A case study of the experience of shipping investment and policy autonomy in three countries -- Norway, Denmark, and Germany -- is used to test the model.

The globalization of the economy characterized in part by steady growth in world trade and a rapid increase in foreign direct investment (FDI) has presented serious challenges for national policymakers. In western developed countries there is a perception that a number of crucial developments, including this globalization, have placed great pressure upon national economies. There is growing concern that footloose capital is forcing governments to respond by offering regulatory regimes that at the very least do not place greater costs on firms than some "international norm," or risk exporting low-skilled jobs to low-cost countries. A "common policy thrust" among the developed countries on labor markets has been suggested because in many cases governments appear willing to lower regulatory standards in order to attract or retain investment and with it the jobs that are essential to the political survival of governments (OECD, 1990, pp. 85-6).

[Given the unemployment problems facing most countries, it is a frequent objective of governments in developed as well as developing countries to retain or attract [transnational corporation] operations with a view to maintaining or adding to jobs available. In fact, competition for FDI may tempt governments to offer concessions in the social and labour fields as an incentive to attract TNCs and to create much needed jobs (UNCTAD, 1994, p. xxvii).

Does this presage a scenario of "social dumping" -- where social standards are lowered remorselessly in the pursuit of capital investment? Or do mitigating factors protect high welfare countries such as those in western Europe? The purpose of this article is to explore the effects of increasing FDI and trade on the policy autonomy of states, particularly in certain social, fiscal, and labor market policies, and to suggest a framework of analysis that is borrowed in part from the analysis of monetary policy autonomy. It will

do this by examining the criteria firms follow in making investment decisions and suggesting that these may be categorized according to whether they represent public goods or costs to firms. The framework of analysis, it is hoped, will account for any loss of policy autonomy by states. I test this model by examining the empirical evidence in west European shipping. The intent is to push forward the debate over the effects of economic globalization on state policy autonomy, and also to partly refute the assumptions of some writers that social policy is insulated from globalization effects (Garrett and Lange; Lange; Leibfried and Pierson).

### **Social surfing? Economic globalism and political autonomy**

Two general arguments have been propogated about the effect of globalization on political autonomy, both of which assume that political leaders attribute paramount importance to national economic performance. The first suggests that states are increasingly at the mercy of free social riders in the form of mobile firms, and are in the process of adjusting economic policies in the social, fiscal, labor market, and financial areas to attract and retain capital investment (McKenzie and Lee; Encarnation and Wells). This has led to what has been termed a "regulatory deficit" in which firms arbitrage social and legal systems at the same time that (at least in some countries) the institutional environment has been weakened through deregulation and union decline (Campbell, p. 284). Though some domestic groups, such as taxpayers and labor, may suffer, the hope is that the employment-generating effects of investment will create positive gains in the long term. The practical manifestation of this argument may be seen in the social dumping and *delocalisation* debates in Europe, where howls of angry protest arose over the decision of Hoover to relocate production

facilities from Dijon to Scotland in 1993. More prosaic is the common reference to the multinational value-added chain in which firms source inputs globally, making greatest use of comparative advantage, aided by declining costs and the increased speed of telecommunications and transport (Campbell, pp. 274-5).

In fact, the possibility of social dumping has long been recognized as a potential problem (Hymer; Rhodes), and anecdotal evidence abounds to support the claim that social and fiscal costs are extremely important to company investment plans. Firms in developed countries are constantly seeking greater flexibility in industrial relations because of changes in the global economy. Consumer products change rapidly, technological progress has shortened the life of products and altered processes, markets are internationalized and this increases the exposure of domestic producers (and indirectly others in the domestic market) to foreign competition (Brunhes, p. 12).

Social costs are often cited as a prime consideration in relocation decisions (Cassell, 1993). A survey for Price Waterhouse showed that among more than 250 businesses indicating an interest in investing directly in Europe, the first and third most important investment criteria were labor productivity and labor cost, respectively (Plant Location International). According to one report, "the reasons for the growing exodus [of German firms such as Bosch, Bayer, Hoescht, BASF, and Volkswagen] are Germany's high wage and social security costs, short working week, and high corporate taxes, compared with an improvement in investment conditions elsewhere in Europe" (Paterson). LSI Logic, an American semiconductor manufacturer, closed its German facility in 1992 because legislation prohibiting round-the-clock operation of the plant meant that capital productivity was half that in

the US and Far East (Kehoe). Prior to Swedish elections in September, 1994, the heads of the country's four largest exporters (Volvo, Ericsson, Stora, and ABB Sweden) warned that labor market and economic policies must not upset investment decisions (Carnegy). The executives were concerned that changes to labor market and other economic policies could harm the competitiveness of Swedish industry.

Studies by academics and international organizations have in part confirmed this trend (Kurzer; Rhodes). In a study investigating the political responses of German and British car manufacturers to the Single Market initiative, one reason Volkswagen reacted against possible market liberalization was the price competitiveness problems it faced vis-a-vis Japanese manufacturers (Camerra-Rowe). Moreover, reports by both the EU and UNCTAD have given a great deal of attention to the effect of non-wage social costs and labor market flexibility upon international competitiveness (Commission; UNCTAD, 1994).

The second general argument plays down the influence of free social riders and asserts that there are limits to this competitive deregulation. Writing about the experience of advanced industrial economies from 1974-87, Garrett and Lange found that "while interdependence has forced all governments to give primacy to the promotion of competitiveness and flexible adjustment, there are distinct supply-side paths that allow governments of the left and the right to pursue these ends and simultaneously further their partisan goals" (p. 543). In particular, "corporatist political economies have combined traditional welfarist concerns with interventionist government industrial, investment, and labor market policies designed to promote competitiveness and flexible adjustment" (p. 563).

Other analysts are also sanguine about the prospects for social dumping, pointing to the tendency of cost-driven cross-border investment shifts to be checked by important constraints (Leibfried and Pierson; Rhodes; Eichener). Leibfried and Pierson (1992, p. 350), for example, state with reference to the European internal market that

The ambiguous consequences of integration are revealed by the fact that Northern Europe's concerns about "sunbelt effects" are mirrored by Southern Europe's concerns about "agglomeration effects" in which investment would flow toward the superior infrastructures and high-skilled work forces of Europe's most developed regions. .... In short, the erosion of national standards envisioned in the "social dumping" scenario would undoubtedly result in strong popular demands for a governmental response.

Rojot, moreover, sees the pressure for flexible labor markets stemming not from internationalized production and a subsequent competitive downward spiral of social standards, but from the growth of services and from technological change, altering both products and processes (pp. 58-9).

There is plenty of evidence to support this view as well. Much of the shift of investment within Europe, for example, have taken place for reasons of market proximity as producers attempt to capture new markets preceding and following "1992" (Thomsen and Woolcock). Further, the Institute for Management Development and the World Economic Forum (1994) reported that several of the highest-cost west European countries (Germany, Switzerland, Denmark, the Netherlands, and Sweden) are among the most "competitive" countries in the world, surpassing Latin American and east European countries.<sup>1</sup> Well-trained, highly-skilled, motivated employees

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<sup>1</sup>Of course, this raises the question of what is meant by competitiveness. The ranking is based upon surveys of business executives using eight criteria: domestic economic strength; internationalization of the economy; government policies conducive to economic activity; finance; infrastructure; management strengths; science and technology; and human resources

often lead to higher productivity, cancelling out some or all of the cost differentials between high-wage and low-wage areas (Thomsen and Woolcock; UNCTAD, 1994). Unit labor costs in countries with high social costs may be held down by higher productivity, a point to which I shall return. There is, in short, no conclusive evidence that competition from low-cost jurisdictions is directly responsible for unemployment and falling labor standards in high-cost countries.

Nevertheless, while there are unquestionably important factors mitigating against social dumping, this paper joins the debate by suggesting that policy interdependence is exerting strong pressure on states to conform to an international norm on various economic policies related to employment. Policy interdependence -- the mutual effect of policy change by states -- is created and sustained by the forces of FDI and international trade.

The influences of FDI and trade -- unclear though they are -- have led to renewed concern over employment and competitiveness in developed countries and in the ability of governments to resist a trend toward social dumping. Do these competitive pressures necessarily lead to a reduction in levels of social and labor market protection?

*It may be that the autonomy of national labour market regulations or welfare systems could be eroded to some extent by the process of cross-border corporate integration through FDI. Local labour market policies and regulations may influence positively or negatively the attractiveness or advantages of a particular location (UNCTAD, 1994, p. 208).*

The answer to this question depends largely on how important these policies are to the investment decisions of firms. For the purposes of this study social and labor market policies are defined as non-wage social costs such as national insurance contributions and income tax, and labor market

policies such as restrictions on hiring and firing and wage adjustment (see OECD, 1990, pp. 75-77). Labor markets adjust through (and flexibility is thus a condition of) price and quantity changes both within and between firms. Within firms labor may be reallocated to new tasks, or it may suffer a drop in wages; between firms labor may be fired and rehired by another firm, perhaps at a lower wage. The main policy issues in terms of labor market flexibility are "redeployment of workers within firms (internal flexibility) and the mobility of workers between firms (external flexibility)" (OECD, 1990, p. 76).

Non-wage social costs are the other component of social policy giving rise to labor factor comparative advantage. In 1991 statutory charges on labor (personal income taxes and social security contributions) stood at 23.5% in the EU 12, 19.4% in the US, and 17.6% in Japan, suggesting that the differential had become prejudicial to European labor (Commission, 1993, p. 137). Even within the EC there were wide variations. In Denmark, for example, 83% of total labor costs were direct wages, with only 17% taken out for social security, paid holiday, and other non-wage costs. In France, by contrast, only 52% of total labor costs were direct wages. The higher non-wage costs in Europe prompted the European Commission to recommend reductions in order to stimulate employment. Thus, comparative advantage stemming from labor costs are bound to be influenced by both policy-derived non-wage costs as well as market-derived wages.

What part do these social costs play in investment decisions? As several reports have pointed out, they do seem to play a large part. A study by the European Commission pointed to "a mismatch between productivity and wage costs in the low skill part of the market," suggesting that EU countries had become less competitive than other countries in the sorts of

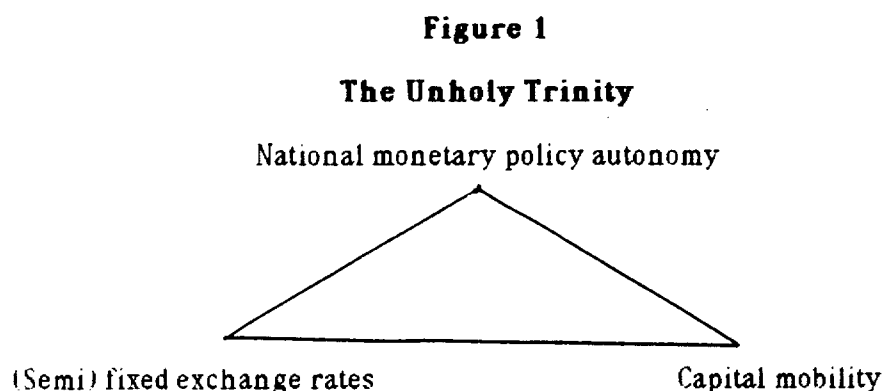


tasks performed by the low-skilled because of the higher non-wage labor costs in Europe (Commission, 1993, pp. 130, 136). Moreover, "pressure for greater flexibility in industrial relations is now being felt in all OECD countries" (Brunhes, p. 56). This is the case regardless of the cultural and institutional differences between industrial relations systems in these countries.

### **Modeling social costs and economic globalism**

To model the impact of FDI and trade on autonomy in social and labor market policies I turn first to monetary policy, where there is an expanding literature on the impact of financial flows on national policy autonomy (Andrews; Cohen; Padoa-Schioppa; Frieden). The claim is that, because of economic interdependence, national monetary policy instruments have become more costly to use when the intended goal deviates from what is in essence an international norm, such as price stability. It is asserted that exchange rate stability, capital mobility, and independent monetary policy are incompatible in the long term, because market forces will respond (through capital flows) to monetary incentives such as interest rate changes. This is sometimes referred to as an Unholy Trinity -- "the intrinsic incompatibility of three key desiderata of governments: exchange rate stability, capital mobility, and national policy autonomy" (Cohen, p. 134, see Figure 1). As a group of observers noted in Europe, "with perfect capital mobility and fixed exchange rates, interest rates in a small country will essentially be determined by those prevailing in the 'outside world.' The small country cannot have an independent monetary policy but must accept the foreign interest rate and use its domestic monetary instruments to

maintain the fixed exchange rate and an acceptable level of foreign reserves” (Padoa-Schioppa et al: 72).



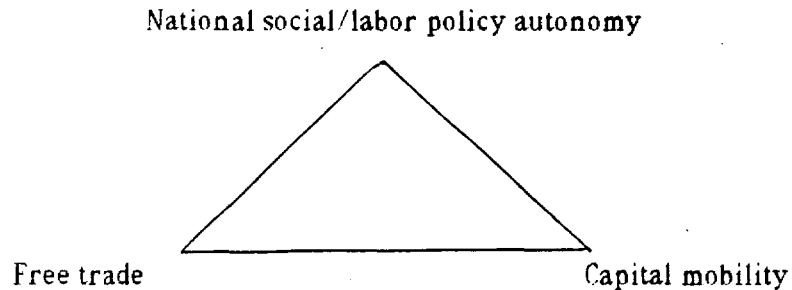
Of course, exchange rate flexibility is one way of ensuring that monetary policies may be adjusted by national governments to suit domestic priorities. However, exchange rates are only flexible to a certain degree, and there are costs associated with currency fluctuation. Firms engaged in international commerce seek stability and predictability which enable them to plan in advance. For example, the Exchange Rate Mechanism (ERM) of the European Monetary System sought to establish semi-fixed exchange rates as a means of bringing about economic discipline in advance of a putative economic and monetary union. This has facilitated intra-EU trade, but also had a dampening effect on the use of monetary policy to achieve domestic goals, and as an illustration we are often reminded of the French experiment with reflation that went awry in 1982-83. The ERM has also given international capital interests a great deal of power, since they may abandon a currency wholesale, necessitating the use of reserves to support the currency. This has prompted periodic calls for some "sand" -- such as a tax on currency transactions -- to be thrown into the wheels of these highly liquid financial movements.

### *The unholy social trinity*

Like financial capital mobility, FDI by international business constrains the actions of policymakers. The key argument put forward here is that if free financial flows coupled with fixed exchange rates restrict state autonomy and create an unholy trinity in monetary policy, it follows that FDI and free trade create an unholy trinity in policy areas that may be arbitrated by mobile business. In other words, if national monetary policy is constrained by the effects of capital flows on exchange rates, then we may say that public choices affecting FDI criteria (such as fiscal, financial, environmental, and social policies) will be constrained by the fear that excessive burdens (or insufficient subvention) will drive investment abroad. In this adapted model, therefore, the three variables of the triangle are capital mobility, free trade, and policy autonomy in certain key arbitrage-prone areas (see Figure 2). In its most mechanically idealized form, they are incapable of being sustained simultaneously by a state. The reason is that business will mobilize away from jurisdictions which impose high costs. Thus, if policy autonomy is maintained with free FDI, we would expect to see trade restrictions imposed in order to protect the competitive position of domestic industry. If trade is free and policy autonomy is maintained, we would expect to see investment restrictions imposed in order to stem outward movement of productive capital. If trade and FDI are free, we would expect to see a reduction in policy autonomy in order to establish competitive conditions not more onerous than those existing elsewhere in the world. This model, of course, relies on the assumption that government leaders are unwilling to permit a wholesale departure of capital.

**Figure 2**

**The Unholy Social Trinity**



The capital mobility that I refer to is, of course, FDI by firms, which is analogous to the movement of financial capital in Andrews', Cohen's, and Padoa-Schioppa's models. Mobile firms are those which are not rooted to particular locations through the presence of markets, highly skilled employees, and various public goods such as supporting infrastructure. The more mobile a firm is, all things being equal, the more likely it is to avoid high costs. Though source countries may attempt to place limits on FDI (and have done so at the behest of labor), such limits are unlikely to be successful (Enderwick, p. 131).<sup>2</sup>

Free trade is the counterpart to fixed exchange rates in the Cohen model: both permit international transactions with transparency and without uncertainty costs or barriers. Trade can be impaired by tariff and non-tariff barriers. As trade becomes less subject to interference, cross-border competition within sectors intensifies and (*ceteris paribus*) sharpens the divergence in policy costs between states. Extreme policy cost differentials, in turn, are likely to promote investment outward from high-

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<sup>2</sup>Of course, disinvestment may be either territorial or sectoral -- and the latter is not dependent on globalized capital.

cost areas. Conceivably, as long as trade was free, there would not necessarily need to be investment shifts to make this model valid. The reason is that low-cost producers would force adjustment in high-cost regions through competition (assuming a high degree of competition, no product differentiation, and transaction costs below production cost differentials). Indeed, Cohen (pp. 147-8) makes a related point: because governments have resigned themselves to capital mobility, "in most cases the Unholy Trinity reduces to a direct trade-off between exchange rate stability and policy autonomy." Of course, unlike the EMS or G7 attempts at monetary policy coordination, there is no multilateral social policy coordination. What this means is that trade regimes such as the GATT/WTO, by reducing trade barriers, act as de facto social policy coordinating mechanisms.

The third variable -- "policy autonomy" -- refers to the ability of policymakers to create policies affecting investment criteria which diverge significantly from international practice. This is the counterpart to Cohen's monetary policy autonomy. Policies are inextricably linked to firm investment criteria, and in certain policy areas -- notably those which impose avoidable costs upon firms -- national autonomy is reduced when free capital mobility and free trade exist. The reason, obviously, is that adverse policies affect investment criteria. However, policies need to be distinguished according to whether they impose costs rather than provide public goods.

*Policy costs, market costs, and public goods -- investment criteria reordered*

For analytical purposes investment criteria are usually divided into market-based and factor-based, the former including such things as market

access, reductions in transaction costs, access to distribution networks, and the latter including access to resources and technologies, and, of course, labor costs (Thompson and Nicolaides, p. 29; UNCTAD, 1994 p. 186; UNCTAD, 1995). A study of the behavior of US firms by Wheeler and Mody suggests that both comparative and agglomeration effects (that is, the concentration of investment due to infrastructural developments, the presence of other multinationals, and the like) are important, with some sectors, such as electronics, particularly susceptible to labor cost factors. Drawing on a number of sources I have established a list of investment criteria and incorporated it in Appendix 1.

However, a potentially more useful typology for analytical purposes is to distinguish between investment criteria which are public goods, and those which impose costs. In Appendix 2 I have reordered the investment criteria according to whether they represent a public good or a cost, and further ordered them by distinguishing between costs that are determined essentially by market forces and those derived by policy actions. It is this latter group of policies that should be subject to the autonomy-constraining forces suggested in this model. Governments often have little control in the short term over investment criteria -- particularly those related to markets - - though in the longer term they may create the right environment for investment through public goods provision. Indeed, they may be able to attract investment by providing public goods (including a stable and healthy economic climate, good roads, and skilled workforces) that outweigh high costs.<sup>3</sup> Thus, public goods provide an important inducement for investment.

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<sup>3</sup>This is the agglomeration argument and also the argument that focusses on the importance of markets.

On the other hand, firms are faced with specific costs associated with production in a certain location. Many of these are essentially market-derived, including property costs, communications, and materials. Unless there is direct intervention, public bodies have minimal influence over these costs, particularly in the short term. On the other hand, policies that redistribute resources -- and change the cost structure faced by firms in the process -- also create incentives or disincentives to investment. These policies, obviously, impose costs rather than provide benefits, and unlike most public goods, they may be altered rapidly. Given the intense pressure to attract investment, it is not surprising that they are susceptible to downward adjustment. We might therefore expect that political pressure to accommodate the concerns of investors would mitigate against policy costs exceeding those available in other "regulatory markets" regardless of whether negative externalities fall upon domestic social groups as a result.

But as it stands this model does not help us determine when social and labor costs will feature as particularly important investment criteria, and thus when policy autonomy is likely to be most constrained. There are two further dimensions which enable us to differentiate between "investment scenarios." The first is the type and function of investment: the type of investment (excluding portfolio investments) may range from joint ventures to mergers or acquisitions, to the establishment of new facilities.<sup>4</sup> The function of the investment refers to whether it is a corporate headquarters, distribution plant, research and development facility, assembly plant or manufacturing plant or some other facility. The labor requirement and the importance of labor costs vary in an important way between types and functions of investment. A research and development facility may be

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<sup>4</sup>For a typology of international strategies see Porter.

located in an area with high labor costs because of the presence of highly skilled workers and universities with cutting-edge facilities. On the other hand a new manufacturing facility may be labor intensive and thus sited with an eye to labor costs. A distribution facility would most likely be located near important markets. Investments that are labor-intensive will be more sensitive to social and labor policy costs than other types of investment, and it is likely that more downward pressure will be exerted on them as a result.

The second dimension is the degree of technological homogenization in a sector. A sector where productivity gains and technology advances have been spread across borders would be more sensitive to labor cost differentials than sectors where technology gains give certain firms or industries a competitive advantage (OECD, 1989b). Indeed, if productivity differences are responsible for the disparity between labor costs and unit labor costs then a convergence in productivity ought to lead to a sharper differential in unit labor costs, one that more closely reflects wage and non-wage costs. In the early days of a technological innovation the positive employment effects may accrue to a high-wage country. Only when the technology has become widespread and mature would low-wage countries be positioned to capture the jobs in that sector (OECD, 1989b, p. 110).

In fact, technology has spread across borders (on this general phenomenon see Sengenberger; Doz), and over the long run, productivity among the developed nations has converged, though there is little evidence of less developed countries sharing in this convergence (Baumol). The result is that factor-based investment criteria, such as labor costs, become more important to investment decisions as production processes become standardized. As one analyst stated, "when products such as telephones,



computer boards, disk drives, and televisions approached the status of a commodity, production and trade shifted to low-cost locations" (Yoffie, p. 430). With a higher level of education and skills, and a wider product mix, developing countries are predicted to be able to share in this productivity convergence more fully (Baumol, pp. 1080-81). This means that developing countries that do have the skills, infrastructure, and technology to begin competing in product markets could be good candidates for further investment and hence competitive industry. Recent data showing that inward FDI to developing countries almost quadrupled from 1990 to 1993 bear this assertion out (UNCTAD, 1995). Thus, certain sectors -- those without the benefits of firm-specific or national-specific technological advantages -- ought to be more prone to arbitrage by capital in search of lower factor costs.

There is, in short, more "sand in the wheels" of this unholy social trinity than there is in the unholy monetary trinity. Whence this sand? First, FDI, while perhaps a long-term possibility in any industry, is more problematic in the short term for most firms; where large capital investments have been made in a particular locality, firms may be unwilling to reinvest elsewhere for a period of time. Even if they are prepared to do so, FDI is never cost-free, and the expense may act as a barrier. Second, trade is also not cost-free. Transaction costs include transport, exchange rate differentials, and tariff and non-tariff barriers. While trade agreements may reduce barriers, the other constraints will remain unaffected. Transport and telecommunications may be less costly than in the past, but they still act as a constraint upon trade. Finally, as I have explained, the provision of public goods and the existence of market-related costs are investment criteria which are independent of policy variables. Does this "sand" make it

impossible to determine whether social policy costs are subject to autonomy constraints? Not necessarily, but to test the model rigorously it is imperative that all other variables be held constant. That will be the task of the case study.

### **Testing the model -- the experience of European shipping.**

This section applies the "unholy social trinity" approach to a case study of the effect of fiscal, social, and labor policy changes upon patterns of investment in the shipping industry in three European states -- Norway, Germany, and Denmark. The reason these states were chosen is that they all introduced a particular policy innovation designed to cut shipowner operating costs, and together they provide a clear picture of the effect of capital disinvestment upon public policy. Moreover, it is possible to isolate certain costs imposed on shipowners while holding all other investment criteria constant, which will provide a robust test for the model set out above. In fact, the extraordinary experience of capital arbitrage in the three countries illustrates the way policy costs influence investment choices in conditions of free trade and unhindered capital movement.

From an historic high in the 1970s, tonnage under the flags of Germany, Denmark, and Norway fell steadily as owners sought relief from high operating costs (indeed virtually all European states experienced a similar decline). From nearly 43 million tons in 1977 the registries in the three countries had declined to less than 16 million tons in 1987 (Lloyd's Register of Shipping). This tonnage had been reinvested primarily in open registry countries where taxes and manning requirements are low, and environmental and safety enforcement often lax. Indeed, much of the growth in open registry shipping in the 1980s can be explained by the

decline in European shipping: the four largest flag of convenience (FOC) registries in 1991 (Liberia, Panama, Cyprus, and the Bahamas) had grown by 27% since 1979 (roughly 29 million tons).<sup>5</sup>

Faced with massive disinvestment from their national registries, governments in the three countries created "second registries" within the national legal regime of their country, parallel to the first registry, with liberal tax and labor requirements (for example, low-cost Asian crews may be substituted for European crews. OECD, 1991, p. 31). I focus here upon the experiences of Norway, Germany, and Denmark because they are the states that undertook this particular type of policy change, but in fact, virtually all EU member states, even the southern ones where shipping capital mobility is still lowest, have been forced to institute some form of international or offshore registry to stem outflagging, and many are encountering pressure to further liberalize them (Aspinwall).

The second registry was made available to the deep-sea fleet, while ferries, fishing boats, tugs, and other small craft were to remain under the conventional registry. Norway pioneered the regime in 1987 with its Norwegian International Ship Registry (NIS. See Kappel). Non-Norwegians could be employed on board, and taxes were cut. The effect was remarkable: from a level of roughly 6 million tons in 1987, the fleet had increased to 24 million in 1991 (Lloyd's Register of Shipping). The experience of the other countries was the same. In 1988 Denmark established its second registry, the Danish International Ship Registry (DIS); in 1989 Germany did the same (the German International Ship Registry, known as ISR).

In each of these cases the second registry was open to the deep sea fleet, was established within the legal framework and market of the original

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<sup>5</sup>On the advent and growth of FOCs see Carlisle.

country, and was created to mitigate the intensified competition shipowners faced against non-national shipowners. From a level of less than 16 million tons in 1987, these fleets had increased to nearly 34 million tons in 1991 (Lloyd's Register of Shipping).<sup>6</sup> Thus, the evidence suggests that the new registries arrested the decline in national tonnage very effectively and have been critical in resuscitating the domestic maritime industries 3 and 4 for an illustration of their importance relative to the traditional national registry). While the first registries declined by 82-92% in the three countries from 1979-91, in 1991 the second registries made up 65-92% of total shipping investment (see Tables 1 and 2).

### **Shipping and the unholy social trinity**

Why have these massive changes in investment occurred? A high degree of FDI and trade freedom exist in the shipping industry: FDI is extremely easy to effectuate in practice. Typically no more than a letter of intent is required, along with the transfer of documents and modest fees to the new registry (Stephenson Harwood). No ship under the flag of an open registry need ever visit the host state, and though most services are "exported," it is not from the physical land mass of the host country. Any physical presence required in the FOC country can typically be honored by establishment of a front corporation. It is not necessary to employ individuals in the host country in most cases.

In addition, trade in shipping services is quite free, particularly in the bulk trades, and there are very few barriers to competition (Parkinson and Sterling, p. 35). A vessel of almost any nationality may carry the export and import commerce of a state, and though there are some protectionist devices

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<sup>6</sup>1990 figures are used for Germany to control for the effect of unification.

in place, these are gradually being removed in developed states. Moreover, many European shipowners have a vested interest in a liberal shipping regime, and have themselves been the most outspoken opponents of protectionism. Danish shipowners derive 95% of their revenues from export markets known as cross-trades -- that is, outside their own national markets; the figure for Norway is 90%. These countries are extremely concerned about protectionism elsewhere in the world curtailing market opportunities, and their governments have consequently adhered to liberal shipping policies.

Even where the services provided are for national consumption, that is domestic industrial importers and exporters, there is a great deal of competition from foreign lines. In Germany, for example, only 13% of imports and 20% of exports were carried by German shipping in the mid-1980s (OECD, 1987). This figure is typical for north European countries. Furthermore, among EU states there has been a reduction in subsidization and protectionist devices such as cargo reservation, because of the spread of liberalism and deregulatory policies and the dictates of EC law, which has opened markets in Europe (Aspinwall). These changes reduce barriers to trade and act as a conduit for inter-state competition. "Head to head" competition intensifies the cost differentials faced by shipping lines, especially so since there are very few technological advantages that accrue to particular companies or states. Fiscal and labor costs are thus extremely important to shipowners.

In short, the highly mobile nature of shipping investment and the lack of trade barriers fulfills two corners of the unholy trinity model, leading us to suspect that policies imposing costs would come under serious political pressure unless there were mitigating public goods or market costs. In all

**Table 1**  
**Disinvestment from the first registries, 1979-91**  
**(gross registered tons x 1000)**

Country	1979	1991	% decline
Denmark	5,524	745	87
Germany	8,563	1,501*	82
Norway	22,349	1,863	92

\* 1990 investment figures were used to control for the effect of unification.

SOURCE: OECD, 1991). Lloyd's Register of Shipping, 1991.

**Table 2**  
**Second registries**

Registry	tonnage in 1991 (x 1000 GRT)	% of total national registry
DIS -- Denmark	5,126	87
ISR -- Germany	2,800*	65
NIS -- Norway	21,723	92

\* 1990 data were used to control for the effect of unification.

SOURCE: Lloyd's Register of Shipping, 1991. OECD, 1991.

these countries, high labor costs and expensive fiscal regimes were blamed for their declining competitiveness and the need to flag out (Yannopoulos: Goss).

Throughout the 1980s the massive growth in the use of FOCs and quasi-FOCs (such as Hong Kong, Bermuda, and the Cayman Islands) had led to the creation of an "international norm" in the form of labor market flexibility (particularly the use of east and south Asian crews), low non-wage social costs, and low corporate and income taxes. In 1989 the European Commission published data showing crew cost differentials between German, Italian, Portuguese, and Cypriot (one of the largest FOC registries) vessels (see Table 3. Similar data are shown in Table 4). The differences were striking, especially on bulk ships. Shipowners increasingly made use of this vast pool of cheap labor and low flag-state regulatory and fiscal standards to boost competitiveness. The perilous fortunes of shipowners in the 1980s -- a time of overtonnaging, increasing costs, and evaporating national protection -- left them little choice.

The high cost of domestic European registry might have been offset by protectionist devices such as subsidies and cargo set-aside, but as I stated above, other factors undermined most attempts to institute them. The lack of public goods or beneficial market costs -- such as domestic markets, local infrastructure, or low input costs (for example, fuel and insurance) -- available to national shipping investment sufficient to offset these high costs led to the disinvestment in the 1980s I outlined above. Indeed, there is virtually no investment criteria from Appendix 2 apart from policy costs and the market costs of cheap labor that were relevant to shipowner investment

decisions between first registries and FOCs.<sup>7</sup> A direct juxtaposition between the social, fiscal, and labor market policies of the three European countries and the FOCs was inevitable. The lack of offsetting productivity or technological advantages, the lack of transaction cost barriers, and the labor cost sensitivity of shipping brought intolerable pressure upon policy costs in Norwegian, German, and Danish shipping.

Under these circumstances it is hardly surprising that massive disinvestment occurred or that governments who wished to retain some semblance of a fleet reacted by creating second registries. They chose to adjust their policies to the emerging "international norm" -- permitting wide labor flexibility in terms of use of low-cost crews and large reduction of social security and income tax obligations for those European nationals who were employed. The second registry has the benefit that the national flag is flown from the vessel, thus avoiding the any anti-FOC stigma. It should be noted, however, that the public good of a high reputation is not enough to overcome high operating costs: the relatively low percentage of vessels in the German second registry (see Table 2) is partly due to the fact that non-wage social costs were not reduced.<sup>8</sup> Labor market flexibility was the only inducement, and as a result German shipowners were successful in demanding subsidy levels of more than DM100 million per year in the early 1990s (Fairplay 1992a and 1992b).

What this case demonstrates is that under conditions of low investment and trade restrictions, holding other investment criteria constant,

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<sup>7</sup>The one (occasional) exception to this is the stigma that occasionally attaches to the FOCs in general following an oil spill or some other disaster involving one of their number. The International Transport Workers' Federation has kept up a steady campaign to highlight their safety record (Northrup and Rowan). Thus, the better reputation of west European shipping may be considered a minor but discernible public good.

<sup>8</sup>Union strength was also partly a factor. Titeo.



**Table 3****Crew cost differentials**

(in ECU per annum, for a 1500 TEU container vessel)

	<u>Germany</u>	<u>Portugal</u>	<u>Cyprus</u>
Social insurance	232.000	183.000	0
Wage taxes	248.000	99.000	0
<u>Net salary</u>	<u>628.000</u>	<u>288.000</u>	<u>490.000</u>
TOTAL	1.108.000	570.000	490.000
Percentage difference	100.00%	51.44% 100.00%	44.22% 85.96%

• • •

(in ECU per annum, for a 30,000 DWT bulk vessel)

	<u>Italy</u>	<u>Portugal</u>	<u>Cyprus</u>
Social insurance	495.000	183.000	0
Wage taxes	222.000	99.000	0
<u>Net salary</u>	<u>599.000</u>	<u>288.000</u>	<u>350.000</u>
TOTAL	1.316.000	570.000	350.000
Percentage difference	100.00%	43.31% 100.00%	26.59% 61.40%

Source: EC Commission, Financial and Fiscal Measures.

**Table 4**

**Crew cost comparison -- UK & Asian**

Crewing option	Daily cost (£)
UK officers UK sailors (all at UK rates)	1796
UK officer (offshore rates)* Filipino sailors	1171
Four UK officers (offshore rates) Six Indian officers Filipino sailors	986
Four UK officers (offshore rates) Six Indian officers Hong Kong/China sailors	956
Filipino officers Filipino sailors	767
Indian officers Indian sailors	902

\* Offshore rates are lower because no social security or income taxes are paid by either the shipowner or the crewmember.

SOURCE: Parkinson and Sterling.

social, labor, and tax policies that exceed an international norm are unsustainable. Governments in high cost states were forced to adjust policy costs to firms so that they did not exceed this international norm. Labor market flexibility in the form of low-cost Asian and east European crews became widespread on second registry ships; income and social security taxes were cut. The result has been a large-scale reduction in tax receipts and in the employment of west Europeans. This is the "unholy social trinity."

### **Conclusions**

I have tried to show that social and labor market policy autonomy under conditions of economic globalism is subject to the same sorts of constraints as monetary policy autonomy. Growing FDI and freer trade act as de facto social policy coordinating mechanisms between states, because firms can arbitrage between competing jurisdictions, all of whom seek investment. In its most mechanically stylized form, the three variables of free trade, free FDI, and social/labor policy autonomy cannot be sustained simultaneously by a state. This relationship, however, may be offset by public goods provision, advantageous market costs, and by technological or productivity advances in some sectors. It also depends upon the nature of the investment -- labor-intensive investment is likely to be more prone to this effect than knowledge-intensive or capital-intensive investment.

In addition, this paper has suggested that a re-ordering of investment criteria according to whether they represent public goods, market cost, or policy costs is useful to discern the extent to which public policy may be affected by the competition for investment. This represents a departure from traditional models, which generally order criteria according to whether they are agglomeration, factor-based, or market-based.

APPENDIX 1  
INVESTMENT CRITERIA

I. Cost Aspects

**Investment Cost**

- Site
- Building

**Operating Cost**

- Labor (including income tax/social security)
- Electricity
- Gas
- Water
- Rental/lease
- Telecommunications
- Corporate/property tax
- Materials/components

**Incentives/disincentives**

- Grants/loans/accelerated depreciation
- Tax incentives
- Performance requirements

II. Quality Aspects

**Business Environment**

- Stable political situation
- Healthy economic situation
- Presence of multinational companies
- Presence of natural resources
- University presence/research capabilities
- Attitude of authorities toward foreign investors
- Image
- Ambience/charisma
- Cost of living
- Regulatory environment

**Human resources**

- Stable social climate
- Labor productivity
- Availability of skilled workers
- Availability of skilled employees
- Availability of experienced managers
- Labor market flexibility
- Foreign language skills

**Environmental Issues**

- Environmental legislation and control
- Complexity and timing of permit procedures

**Market Proximity and Infrastructure**

Market proximity/access

Highways

Railways

International airport

Seaport

Advanced telecommunication services

SOURCES: Plant Location International; Dunning, 1993; Schmenner; Cassell, 1992b, 1994.

\* \* \*

APPENDIX 2  
INVESTMENT CRITERIA BY PUBLIC GOOD AND COST CATEGORIES

**Public Good**

- Stable political situation
- Healthy economic situation
- Presence of multinational companies
- Presence of natural resources
- University presence/research capabilities
- Attitude of authorities toward foreign investors
- Image
- Ambience/charisma
- Stable social climate
- Labor productivity\*
- Availability of skilled workers
- Availability of skilled employees
- Availability of experienced managers
- Foreign language skills
- Market proximity/access
- Highways
- Railways
- International airport
- Seaport
- Advanced telecommunication services

**Cost -- market derived**

- Cost of living
- Site/Building
- Labor -- wages\*\*
- Electricity, Gas, Water
- Rental/lease
- Telecommunications
- Materials/components

**Cost -- policy derived**

- Regulatory environment
- Labor - non-wage\*\*
- Labor productivity\*
- Labor market flexibility
- Grants/loans/accelerated depreciation
- Tax incentives
- Corporate/property tax
- Performance requirements
- Environmental legislation and control
- Complexity and timing of permit procedures

\*Both public good and private cost. The public good aspect of labor productivity includes the skill levels of workers; the private cost aspect includes non-wage social costs and labor market flexibility -- thus there is some overlap between labor productivity and other criteria listed under policy derived private costs.

\*\*I have broken labor costs into wage and non-wage components to distinguish between those elements subject to policy change and those subject to market forces.

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