

EMPLOYMENT AND TRAINING
PAPERS

17

**Labour standards
and industrial restructuring
in Western Europe**

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Foreword

Among several academics and policy-makers concern has been expressed in recent years that the internationalization of economic activity has put pressure on labour standards worldwide. As multinationals take advantage of lower barriers to capital movements, of changing production and distribution technologies and global marketing strategies, the argument has been put forward that a form of regulatory arbitrage has taken place, as some mobile investment has been attracted to environments with relatively low levels of regulation. Such production transfers have not only heightened the awareness of the interaction between labour standards and investment flows, but also more generally of that between labour market regulation (including legal systems of employment protection and collective bargaining structures), workforce flexibility and corporate competitiveness. Despite limits being set at national level within which labour markets should operate, greater trade and investment integration between national economies is allowing a degree of leakage through both investment relocation and the potential cost disadvantage to firms based in higher-standard countries. The question is whether the seepage is likely to be long term and large enough to undermine higher labour standards.

In this paper, the author finds that on a global level, the threat has been exaggerated; it seems that economic globalization has not created serious threats to labour standards. Although many firms appear to give value to the differences in standards, most international production investment decisions continue to be swamped by other factors. The author notes that access to strong markets and key sources of productivity growth (especially labour skills and production technologies) has tended to concentrate the majority of investment activity among industrialized countries with similar labour standards. However, in Western Europe, with the increasing integration of national markets and greater similarity (at least as compared to the whole world) in technology and productivity levels, the role of regulatory factors has been heightened in recent years. With many industries undergoing deep restructuring, these factors can be expected to determine production changes in individual plants as well as shifts in investment between different plants.

This study identifies two sets of effects. First, labour standards have influenced the course of industrial restructuring in several key ways. In industries where improvements in productivity through greater production flexibility are central to business competitiveness, location decisions on new production investment have often been influenced by the degree of temporal and numerical flexibility in the workforce. Second, investment strategies have in turn catalysed changes in regulatory systems. Under the pressure of industrial restructuring, companies with existing investments in more regulated countries have frequently used the threat of withholding the incremental investment necessary for new plant developments in order to widen their scope for increasing workforce flexibility. As a result of these pressures, the author finds that labour market regulatory systems in Western Europe appear to be converging.

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Contents

	Page
Foreword	
1. Introduction	1
2. Industrial restructuring in Western Europe	3
2.1 Recent trends in industrial restructuring	3
2.2 Factors influencing industrial restructuring	5
3. National labour market regulation and production strategies	8
3.1 Introduction	8
3.2 Production flexibility and productivity	9
3.2.1 Numerical flexibility	14
3.3 Production flexibility and regulation	15
3.3.1 Recruitment and dismissal	17
3.3.2 Atypical work	18
3.3.3 Working time	19
3.3.4 Bargaining arrangements	20
3.4 The impact of regulation on production flexibility and productivity	21
4. National labour market regulation and investment strategies	24
4.1 Introduction	24
4.2 Production flexibility, productivity and investment	25
4.3 Impact of regulation on greenfield investments	28
4.4 Impact of regulation on existing investments	30
5. EU labour standards and investment strategies	35
5.1 Introduction	35
5.2 Recent trends in EU employment regulation	35
5.3 The impact on investment	37
5.3.1 Employees consultation	37
5.3.2 Working time	38
5.3.3 Future changes	39
6. Policy implications	40
Bibliography	44
Tables	
2.1 Selected EU foreign investment flows	4
2.2 Composition of FDI flows and cross-border mergers and acquisition activity in the EC, 1984-92	5
3.1 International comparison of productivity, 1990	9
3.2 Ranking of Western European labour standards	16
3.3 Selected European differences in recruitment and dismissal	18
3.4 Atypical working contracts	19
3.5 National differences in atypical working time	20
3.6 Comparative ranking of productivity and employment regulation	22
4.1 Foreign investment and labour market regulation in Western Europe	28

1. INTRODUCTION

The role of labour standards in influencing the pattern of industrial restructuring has been widely debated in a global context (Sengenberger and Campbell, 1994; Herzenberg and Perez-Lopez, 1990). It has been argued that 'stricter' forms of employment regulation - covering areas such as working conditions, collective bargaining procedures, health and safety issues, and equal opportunities - work to the disadvantage of businesses under pressure from increasing globalization, reducing their ability to change the organization of their workforces and production systems. If firms in higher-standard countries are less able to adapt to changing product and market conditions than those in lower-standard countries, their competitiveness can come under threat, putting strain on both systems. It can result in efforts to compel the lower-standard systems to comply with international 'norms' with respect to working conditions and rights, potentially to the economic detriment of these countries. At the same time, fears have been expressed that an international differential in employment regulations might lead to a general degradation of labour standards. The costs of compliance in higher-standard countries can put firms based in these countries at a competitive disadvantage, forcing higher-standard countries to consider deregulation.

Against the background of these anxieties, some companies have used 'competitiveness' arguments to wrest concessions from workforces (and ultimately, governments) over employment costs and conditions. On a large scale, this activity could also result in the deterioration - rather than the maintenance - of national competitiveness, as downward pressure on labour standards leads to increasing tensions between managements and workforces. Such a climate of hostile industrial relations might hinder efforts to raise productivity as firms based their competitive advantage exclusively on lower labour costs rather than higher skills and product innovation (Wilkinson, 1994).

The relationship between labour standards and industrial restructuring has been made stronger by the increasing mobility of capital and the trends towards international sourcing (UNCTAD, 1994). As multinationals account for increasing shares of global employment and economic activity, their sensitivity to international differences in labour standards can have potentially far-reaching consequences for the development of particular sectors. In sectors where labour standards can determine the scope for productivity and profitability changes, the relative absence of strong labour standards becomes a factor in influencing the location of investments. This is an issue of special concern in high-standard countries, which may be vulnerable to investment migration triggered by stricter employment regulation systems. Similarly, as multinationals make wider use of global sourcing, labour-intensive aspects of production are increasingly sub-contracted to countries that not only offer lower labour costs, but also more lax labour standards, as Nike's production sub-contracting in South-East Asia (and the recent controversy surrounding it) has underlined (Donaghu and Barff, 1990).

For the most part, these processes have been examined on a global scale, usually in reference to the pattern of investment flows between highly-industrialized and developing countries and the debate over establishing minimum international labour standards. Less analysis has been made of more localized restructuring and the impact of regulatory systems. In consequence, the following working paper focuses on regional trends, specifically the relationship between labour standards and production investment strategies in Western Europe.

Western Europe may seem an unusual choice: it is not normally considered as a global region where labour standard differentials affect the processes of industrial restructuring. In global terms, European labour standards are relatively high - not just in comparison with developing countries but with other parts of the industrialized world, such as the US, particularly in terms of regulation of employment contracts and working conditions (UNCTAD, 1994). Moreover, regulatory systems are broadly similar to each other; not only do countries have well-developed regulatory systems governing issues such as health and safety and equal

opportunities, but common standards have been increasingly expressed through an active international framework in EU social and employment policy.

Nevertheless, in recent years, restructuring in many parts of European industry has renewed attention in the way that production systems are organized and the factors which determine the ability to change these systems. Restructuring has increased in scale, as is evident from rising foreign investment flows in the region, particularly between Western European countries. Among EU countries, the level of inward investment flows has remained significantly higher in every Member State than in the early 1980s (Eurostat, 1995). Indeed, as a share of GDP, the importance of foreign investment increased in the majority of Western European countries between 1984-88 and 1989-94 (OECD, 1995).

European manufacturing firms have experienced increasing corporate pressures from several sources, both global and European. Among the new global challenges facing companies, the most prominent have been the rise in non-European competition in key manufacturing sectors (such as automobiles and electronics) and the influence of new, 'flexible' production systems. Greater global competition has been reinforced by new competitive challenges within the European economy. The much-heralded single market programme removed many of the trade and production barriers that fragmented multinational investment strategies, while the development of new markets (and potentially new investment rivals) in Central and Eastern Europe has increased the number of locations competing for mobile European investment.

Labour standards have been part of the industrial restructuring process in Western Europe. With the number of competitors growing and the size and nature of the European market continuing to change, many companies are aiming to maximise their productivity through decisions over how to allocate capital investment between plants located in different countries and the efforts to reorganize their workforces. That corporate strategies are influenced by differences in labour standards across Europe has been highlighted by well-publicized cases of investment relocation between countries. It has also given impetus to the extension of regulatory powers to new areas of national employment law by the European Commission.

As part of the wider debate on the economic costs of labour standard differences, the following working paper reviews the relationship between regulatory environments, organization of production systems and investment behaviour in Western Europe. Chapters are as follows:

- *Chapter 2* reviews the process of industrial restructuring within Western Europe, particularly in terms of changes in foreign investment patterns and the factors influencing them;
- *Chapter 3* considers the role of different types of labour market regulation in affecting production flexibility and the ability of companies to improve productivity at plant level;
- *Chapter 4* examines whether the impact of national labour market regulation on production flexibility has influenced investment strategies by multinationals, both in terms of new investments by non-European companies as well as the redistribution of investment by existing investors;
- *Chapter 5* reviews developments in EU employment policy and whether the emergence of localized international labour standards in Western Europe have affected investment flows; and lastly
- *Chapter 6* concludes with consideration of the future policy implications of these trends in Western Europe.

2. Industrial restructuring in Western Europe

2.1 Recent trends in industrial restructuring

Before considering the role of labour standards in shaping investment strategies, the evidence for restructuring in Western Europe should be reviewed. Rationalization of multinational investment structures has been taking place throughout European industry. It has been specially pronounced in declining industries, where severe retrenchment has resulted in both losses of output, employment decline and closures of less productive plants at the same time as the introduction of new working practices and production technology to increase productivity, as seen perhaps most spectacularly in the case of the steel sector (Hudson, 1994). However, restructuring has involved more than a 'shaking out' of vulnerable industrial sectors, as several of Europe's most competitive firms have also pursued strategies to reduce overall costs and improve productivity through consolidation of production in fewer plants and enhancing production flexibility; for example, ICI, Unilever and Nestlé have all initiated extensive rationalization strategies in recent years (Sparrow and Hiltrop, 1994).

As much of the restructuring in Western Europe has led to shifts in investment between different locations, the most useful proxy measure of restructuring has been levels of foreign direct investment (FDI). Western Europe - and the EU in particular - has witnessed increasing inward investment activity over the last few decades. Although in recent years the US has been the main *country* destination of FDI worldwide - in 1993 and 1994, its inflows were US\$ 74.8 billion - as an *economic region*, the EU has been the most important host of FDI in the world, gaining US\$ 102.4 billion in the same period (OECD, 1996a). Moreover, the EU's share of global foreign investment has been increasing - rising from 36.5 percent of total FDI stocks in 1988 to 43 percent in 1992 (UNCTAD, 1994).

After the US, the principal recipient countries in the world have been in the EU - the UK and France, which had inward investment flows of US\$ 25.6 billion and US\$ 22.7 billion respectively in 1993 and 1994 (Table 2.1). Other countries attracting large shares of FDI have included, perhaps surprisingly, several smaller European economies, such as Belgium and Spain. In contrast, a number of large economies have not performed as well in terms of FDI, notably Italy and Germany (indeed, the latter experienced a net disinvestment by foreign companies in this period). However, Germany did have the second largest outward investment flows in the EU in this period, though it trailed the UK, which - as well as being the main recipient of inward investment - was the largest source of FDI.

As is also clear from Table 2.1, FDI has been increasing in importance in the majority of European countries. Foreign investment accounted for higher shares of GDP in most countries between the 1984-88 and 1989-94 periods, growing by at least a factor of two in Belgium-Luxembourg, Sweden, the Netherlands, Denmark, Portugal and Germany (though the overall share in the latter country remains very small.). The only declines were registered in Italy and Ireland and the shares were the same across both periods in Greece.

As well as the rising volume and significance of inward investment, a key feature of recent inward and outward flows has been greater investment activity *between* Member States, suggesting that cross-border restructuring of investment is rising. Investment flows among EU-12 countries rose from 41.3 percent of total inward investment in 1984 to 56.6 percent in 1993, though the individual country with the highest share of investment in the EU remains the US (30.3 percent of total inward flows between 1984 and 1993) (Eurostat, 1995).

Table 2.1. Selected EU foreign investment flows

Country	Net inflows ¹			Net outflow ²		
	1993-94		1984-88	1989-94	1993-94	
	Total (US\$ mn)	As share of GDP	As share of GDP	As share of GDP	Total (US\$ mn)	As share of GDP
UK	25,596	1.1	1.5	2.2	55,402	2.9
France	22,651	0.8	0.5	0.9	22,888	0.8
Belgium/Luxembourg	19,354	3.9	1.4	4.4	18,713	3.2
Spain	14,967	1.7	1.5	1.9	6,840	0.9
Sweden	10,609	3.5	0.6	1.7	7,685	3.3
Netherlands	8,708	1.0	1.0	2.0	21,509	3.5
Denmark	6,574	3.3	0.2	1.4	5,420	2.7
Italy	6,228	0.2	0.4	0.3	11,505	0.4
Portugal	2,619	1.4	1.1	3.2	301	0.2
Greece	977	1.3	1.4	1.4	*	*
Ireland	88	0.2	0.4	0.2	*	*
Germany	-2,763	-0.1	0.1	0.2	29,260	0.7

¹ Net inflows are calculated by aggregating investments and disinvestments by foreign companies in the specific country.

² Net outflows are calculated by aggregating investments and disinvestments made abroad by companies based in the specific country.

* Negligible amounts.

Source: OECD, 1995.

Other measures also indicate that Western European countries have been concentrating investment activity and related employment in their European neighbours in recent years. For example, when examining employment in German companies outside of Germany, employment located in the EU increased relative to the rest of the world between 1980 and 1990, rising from 23.6 per cent of the total to 28.4 per cent (UNCTAD, 1994). The trends suggest a wider internationalization of European economies. Again using the case of Germany, total employment in (West) German companies accounted for by German affiliates abroad rose in every manufacturing sector between 1980 and 1994; only one sector (office machinery) had a share that was less than a quarter of total employment in German companies (Burger and Jungnickel, 1996).

Another measure of the scale of industrial restructuring is to examine one component of FDI flows: merger and acquisition activity. As recorded in successive competition policy reports by the European Commission, the number of mergers and acquisitions of majority holdings in manufacturing and construction sectors within the Community rose from a total of 673 between 1984 and 1986 to 6,850 between 1990 and 1992, an increase of over tenfold (CEC, various years). This has not only included domestic mergers and acquisitions, but a sharp rise in the number of deals taking place across Community borders - the share of cross-border of all mergers and acquisitions involving Community firms rose from 32 per cent in the 1983-85 period to 54 per cent between 1990 and 1992 (Ramsay, 1995).

By sector, the measures show a relatively common pattern of restructuring (Table 2.2). In terms of FDI, the main sector experiencing substantial investment flows has been the food and drink sector, followed by electrical engineering and transport equipment (the latter two

Table 2.2. Composition of FDI flows and cross-border mergers and acquisition activity in the EC, 1984-92

	Intra-EU		Extra-EU		Mergers/acquisitions	
	Total (MECU)	% of all sectors	Total (MECU)	% of all sectors	Total no.	% of all sectors
Food/drink	12277	6.6	6130	4	1790	12.1
Metals	2187	1.2	-26	-	585	3.9
Mechanical	3494	1.9	1887	1.1	2501	16.8
Transport equip.	4888	2.6	10273	6.7	662	4.5
Electrical	7528	4	8732	5.7	1778	12
Chemical	9601	5.2	4683	3	1276	8.6

Source: Eurostat, 1995; CEC, various years.

particularly favoured by extra-EU investors, notably the US and Japan). Food/drink and electrical engineering sectors have experienced significant cross-border mergers and acquisition activity as well, but transport equipment has been relatively quiescent and significant concentration has been taking place in mechanical engineering sectors. All are sectors which have been identified as likely to undergo extensive restructuring as a result of European integration. Research by the European Commission calculated that these were sectors which had particular sensitivity to the changes introduced through the Single market programme (as described in more detail in the following section) (CEC, 1990).

2.2 Factors influencing industrial restructuring

Industrial restructuring in Western Europe can be attributed to the interaction of several factors. While it is important to distinguish between them, in practice, they tend to operate in conjunction, making it difficult to identify the precise influence of any one factor. What matters is that the factors have been combining to put pressure on domestically-based companies to internationalize and companies with an international presence to rationalize their investments across European locations.

At a global level, changing corporate strategies have led to the increasing mobility of parts of the production process, reflecting both the intensifying pressures on firms to internationalize and expand beyond domestic markets as well as greater ease in operating on a global scale (CEC, 1993). In examining the shift in multinational strategies, several inter-related processes of internationalization can be identified (Raines and Bachtler, 1993; Howells, 1990).

- For *technology and product development*, the greater costs of R&D in many industries have catalysed international cooperation agreements and joint ventures as companies have increasingly found it more difficult to carry innovation costs on their own. This can be seen in statistics for joint ventures in the EU, which have been consistently dominated by agreements between firms in high-technology sectors such as chemicals and electronics (CEC, various years). At the same time, new technological developments have enabled, as well as been the subject of, greater internationalization, particularly in communications and IT, making it possible to operate more diffuse administrative, production and distribution structures within multinationals.
- In *sales* markets, shorter product life-cycles and increasing international competition have

made it imperative for many firms to establish a local presence in different international markets. In some industries, where the speed of new product developments requires a swift recouping of innovation costs, firms have had to maximize sales in shorter time periods. Further, in assembly industries, closer integration of production processes has meant that supplier companies have often followed investments of larger industrial customers with their own plant locations in near proximity in order to maintain sales.

- Consequently, *sourcing* has also encouraged internationalization as greater competition has made sub-contracting and supply patterns more international. In order to improve their competitiveness, companies in some industries are increasingly separating out parts of their production, shifting the burden of achieving higher productivity to supplier firms in these parts while maintaining close links between the sub-contracted and the primary production systems. This reflects not only the ability of multinationals to coordinate their production strategies on a global scale, but the introduction of new production systems and techniques requiring the close proximity of companies - notably so-called 'lean production' and just-in-time - in both multinationals and their suppliers.

The global processes have been accelerated by range of internal factors altering the production and market characteristics of Western Europe as an investment location. They have not only given greater opportunities for European companies to internationalize, but they have brought increasing competition from non-European companies in Western European markets, contributing to over-capacity and the need for restructuring at a European level in some sectors (such as the car industry and electrical engineering) (Sparrow and Hiltrop, 1994). Of these factors, the most important are the single market programme and the opening up of new markets in Central and Eastern Europe.

(i) *Single market programme*

Following the introduction of the single market programme in the mid-1980s, the restructuring of multinational firms in many sectors seemed to be accelerated, changing FDI patterns in Western Europe. The '1992' programme involved the removal of remaining trade barriers with the intention of creating a pan-European market in industries that had been previously been fragmented into national markets by a variety of trade protection measures. As one of the key aims of the programme was to increase the competitiveness of European firms compared to US and Japanese companies by promoting competition in European markets, the programme was designed to induce industrial restructuring (Cecchini, 1988). It was argued that the key restriction on the competitiveness of European firms was the absence of a large internal market - on the scale of the US, for example - which would encourage higher productivity, product diversity and ultimately, employment growth through increased competition. Much of the changes would occur through realizing economies of scale, which in many European industries - estimated by the European Commission to amount to 40 per cent of manufacturing output in the Community - had not been fully achieved because of the diversity of firms acting in national markets (CEC, 1990).

From the perspective of multinationals, restructuring has been encouraged by increasing production economies of scale and rationalization of industrial organization as a result of price competition in protected sectors. This has been especially true for so-called 'multi-domestic' companies which pursued essentially national investment strategies on an international scale before the single market programme (ie. setting up subsidiaries to serve largely autonomous national markets) (Quilley, Tickell and Coates, 1996; Dicken *et al.*, 1994). The actual approach to restructuring will result from an interaction of existing corporate strategies and the

new investment environment arising from integration. How (and if) restructuring will take place depends greatly on variables relating to country, sector and type of investment. For example, in European industries already substantially internationalized (such as information technology), global factors are likely to be more important than European integration forces, whereas for industries that continue to be fragmented into a series of different markets (such as food and drink), changes resulting from the Single market programme will be more significant (Silbertson and Raymond, 1996).

Three different types of impact can already be identified. First, as anticipated in the original design of the single market programme, there has been consolidation within several European industries. The level of concentration in European manufacturing sectors increased as a result of the surge of merger and acquisition activity that characterize the 'external' aspects of restructuring (Ramsay, 1995). In EU manufacturing, between 1987 and 1993, the four largest firms increased their share of total turnover from 20.5 to 22.8 per cent (CEC, 1996a).

Second, as noted above, there has been a notable increase in the levels of new foreign investment. Academic research has shown that regional trade agreements tend to divert foreign investment as well as trade, thereby acting as a locational pull for the regional market (Dunning, 1997). Recent surveys of businesses in the EU have confirmed this by highlighting the role of single market deregulation in encouraging inward investment, though it has often been difficult to separate the influence of European economic integration from more global factors (CEC, 1997a). US multinationals alone recorded a rise in the capital expenditure of their foreign affiliates in the EC-12, increasing from 40.4 per cent of total expenditure on all affiliates around the world in 1985 to 46.1 per cent in 1990 (UNCTAD, 1992). Similarly, the number of Japanese affiliates with production bases in Western Europe increased from a total of 262 in 1985 to 727 in 1995 (JETRO, 1996).

Lastly, it has been hypothesized that a partial redistribution of foreign investment within Western Europe will occur as greater economic integration creates incentives for firms to change their production and distribution structures. Depending on the sector and the firm's existing organization, this can take a number of forms. Diversified firms can reorganize in order to allocate different product lines to individual production sites. For some companies competing in single-product industries, changes in investment strategies can lead to concentration of production investment in particular sites, resulting in expansions and reinvestments at certain locations, disinvestment and closures in others. Evidence for this type of restructuring has been difficult to collect systematically, but can be witnessed to some extent through anecdotal accounts reported in the media.

(ii) Central and Eastern Europe

Since 1989, trade and investment patterns between Western countries and Central and Eastern Europe (CEE) have change radically amid the opening up of new markets. Key economic reforms in CEE countries - notably Poland, the Czech Republic and Hungary - have already resulted in extensive economic restructuring, not just in CEE alone, but potentially in Western Europe.

Although the scale of foreign investment in CEE has been relatively limited, its dominance by Western European countries (such as Germany and Austria) suggests that a long-term integration of parts of the production chain in particular sectors may be taking place across both regions. At the end of 1989, cumulative foreign investment was approximately US\$ 2.5 billion, but by the end of 1994, it was estimated to have risen to US\$ 18.3 billion, a substantial increase though small relative to the volume of flows in Western European countries (UNCTAD, 1996). The countries neighbouring Western Europe have received the bulk of new

FDI: Poland has the largest share, attracting US\$ 5.2 billion in 1996, followed by Hungary with US\$ 2 billion and the Czech Republic with US\$ 1.2 billion. For these three countries, after the US, Western Europe has been the principal source of FDI, especially Germany (nearly a fifth of all FDI), Austria and France (just over a tenth each).

The motives of European investors in CEE involve a combination of market development and labour costs (Raines and Bachtler, 1995). Investors have been attracted by the prospect of skilled labour being relatively cheap compared to Western Europe (even when taking into account the far lower productivity levels). CEE locations appear to provide Western companies with the opportunity of setting up low-cost, manufacturing assembly operations in combination with good access to Western European markets. Moreover, and perhaps more importantly, CEE countries present Western companies with expanding consumer and industrial markets for which direct investment is often seen as a way of establishing a strong market presence.

3. National labour market regulation and production flexibility

3.1 Introduction

Against a background of restructuring in several industries, pressures have increased on firms based in Western Europe to improve their productivity performance in the face of increasing competition within an increasingly integrated (as a result of the single market programme) and expanding (through developments in CEE) European market. Competition has been raised with the entry of new investors from Japan and the US while the changes within Western Europe have made it easier to operate with fewer production plants. Multinationals in some industries have been aiming to rationalize their investments across their groups as a whole while applying new production techniques and working practices to increase productivity in individual plants.

The scope for companies to raise productivity is determined by several interdependent factors, among which technology levels, capital resources and investment, labour costs and skills, and the regulatory environment are most important. Increasingly, companies in Western Europe - in line with global trends - have not only focused on direct cost structures in improving productivity but also on how these different factors have indirect cost implications through the ways in which plant production systems are organized (Vickery and Wurzburg, 1996). In this respect, production flexibility has emerged as a key factor in the restructuring of European industry, as firms seek to augment the capacity for their production operations to adapt to rapid changes in markets, products and costs. Central to achieving this production flexibility is the ability and willingness of the workforce to make such adaptations, both in terms of their individual work (and the skills it requires) and in how they are organized at plant level.

In the following chapter, the role of production flexibility in raising productivity in European industry is examined in greater detail. In particular, the chapter considers the external restrictions that exist on firms trying to enhance workforce flexibility, notably through national employment protection legislation and collective bargaining rules. The issue is at the heart of the discussion on the role of labour standards in influencing industrial restructuring, for the means by which regulatory systems affect the pattern of change is through the impact of differing labour standards in Western Europe on the extent to which companies are able to increase production flexibility in different plant locations.

3.2 Production flexibility and productivity

Restructuring can be considered as a dual process. 'External' restructuring within industries reflects changes in the number of constituent firms, and takes place mainly through industry-level activity, such as mergers and acquisitions and the entry of new companies through new production investments. 'Internal' restructuring involves changes in the competitiveness of individual companies and plants, principally with improvements to productivity. It has been seen from the previous chapter that external restructuring has accelerated in Western Europe, but at the same time, companies have been pursuing internal restructuring through an increasing focus on ways of improving productivity.

The impetus for productivity changes has come from Western Europe's relatively poor record. Although care should be taken in generalizing across sectors, it is clear that European manufacturing as a whole continues to lag behind its principal competitors in the US and Japan in terms of productivity. In its first report on the competitiveness of European industry, the European Commission concluded that European labour productivity as a whole is "currently stuck on a plateau" (CEC, 1997b, p.8). Since 1960, the EU has experienced strong growth in productivity, but this was mainly achieved by improving the productivity of capital equipment through the substitution of capital for labour (with consequent negative employment effects). Labour productivity has not increased as rapidly. Indeed, when measured in terms of national currency, manufacturing unit labour costs in the EU have consistently increased at a faster rate than the US and Japan - though this has been partially modified by exchange rate fluctuations between the three - suggesting that productivity growth has been lower in the EU.

Productivity analysis is notoriously vulnerable to differences in employment and output categorization between countries as well as the effects of exchange rate changes. However, even when using a series of different ways of measuring productivity, EU countries perform less well than their US and Japanese competitors (Table 3.1). In all three measures, the US is more competitive than EU countries. While some EU countries appear strong when using GDP per worker (notably France, Belgium and Italy), Japan has a better performance when considering per capita manufacturing output. When relating productivity to nominal labour costs through manufacturing unit labour costs, both the US and Japan are significantly ahead of European countries, while within the EU, there is considerable variation (ranging from Portugal at the upper end to Italy and the Netherlands).

Table 3.1. International comparison of productivity, 1990 (UK = 100)

	GDP per worker	Manufacturing output per person	Manufacturing unit labour costs
Belgium	126.2	141.1	97.8
France	130.4	131.6	101.3
Germany	120.1	128.3	107.9
Greece	59.6	48.3	115
Ireland	98.8	n.a.	n.a.
Italy	125.3	130.8	92.5
Japan	102.8	145.3	81.8
Netherlands	110.9	141.9	93.1
Portugal	53.4	25.5	236.6
Spain	105	72.7	124.3
UK	100	100	100
US	138.7	180	79

Source: Oulton, 1994.

The importance of productivity gaps clearly depends on sectoral differences and the level of competition, but if it is a pattern repeated in several industries, it would suggest that much of the restructuring taking place in European industry would be focused on attempts to raise productivity. As plant productivity can be improved in several ways, in discussing corporate behaviour it is useful to link it directly with the costs of the production system rather than simply the value of output per employee. Company efforts to increase productivity tend to focus on the production system (as defined by the combination of machinery and labour resources), and so are limited by any resulting long-term changes in capital and employment costs. As a result, analysis of productivity improvements can be facilitated by a production function relating overall output to labour and capital costs, by which 'productivity' is raised if the volume of output increases relative to total costs - ie. $\Delta O > \Delta(K + L)$. Examining the different elements of the production function, this can take place in several ways:

- if *output* is increased without any change in labour and capital costs, or that output increases faster than labour and capital costs;
- if *capital* costs are lowered, or decrease by more than any fall in output (without a compensating increase in labour costs); and
- if *labour* costs are lowered, or decrease by more than any fall in output (without a compensating increase in capital costs).

By concentrating on the costs of the production system, such an analysis omits considerations of price, both in terms of the value of the company's outputs and the costs of its inputs. While changes in both sets of markets may determine the need to improve plant productivity; they do not directly affect the ways in which companies make such improvements. Competitive pressures on firms to raise productivity are weaker when they have some control over price-setting in both markets - ie. if companies operate in oligopolistic or monopolistic markets for their outputs or can create monopsonies for their inputs. If firms lack strong influence over external pricing - as tends to be the case in industries where such productivity pressures have been acute - they are more likely to increase profitability where they are able to affect changes, especially in the efficiency of their production process.

From the perspective of a company with more than one production site, achieving these changes in different plants involves a number of processes affecting each component (output, capital, labour) of the production system function. Although each process influences more than one component, it is worthwhile considering the different methods available to companies separately.

(i) *Raising output*

- *Utilizing spare capacity.* If the plant is operating under capacity, it may be possible to increase production volume without any equivalent rise in either capital costs (assuming that no significant equipment investments for additional machinery are required) or wages (assuming that volume increases do not require extra employees or overtime to achieve). If overall output for the group as a whole was to remain the same, this could create opportunities for companies to restructure capacity more radically by operating with fewer plants.

(ii) *Reducing capital costs*

- *Reducing spare capacity.* Again, when a plant is under capacity, productivity may be increased by reducing overall capital costs though taking some equipment out of service,

- potentially linked with equivalent reductions in manpower. In turn, this would lower equipment maintenance and replacement costs without necessarily reducing output levels.
- *New capital investments.* Although investing in new machinery would raise capital costs in the short term, if the increase in plant capacity leads to a larger-than-compensating growth in output, productivity could rise over the long term, especially where output can be expanded as a result of increasing demand. This could take place if the capital investment is made in a part of the production process which has been a bottleneck on overall output increases. If the new machinery has a longer lifespan or lower running and maintenance costs, long-term capital costs will fall as well, again boosting plant productivity.
 - *New production technology.* Similarly, technological changes to the production process can change the relationship between total costs and overall output, either by reducing the equipment and manpower required to achieve the same output or by raising output without significantly altering the capital and labour needed. The introduction of new production processes might involve a short-term rise in capital costs (and possibly labour costs, as workers may require training to operate the new machinery). However, if these costs are more than compensated for by increases in output over the long term, then productivity will have been raised.
 - *Sub-contracting.* A firm can cut down on capital costs if parts of the production process can be sourced outside the plant, especially those where it has difficulties in increasing productivity. This may occur where the sub-contractor has greater efficiency in this aspect of production process, perhaps through benefits of size (eg. fewer administrative costs than a large firm) or the possession of a specific advantage in technology or workforce skills. If the sub-contracting costs remain below the company's equivalent capital (and labour) costs, productivity will rise. However, where this process results in extensive vertical disintegration and the development of a closely-linked network of smaller firms supplying a large company, it is problematical referring to the productivity of individual firms. In these cases, it may be more useful to speak of the productivity of the production network as a whole, rather than the constituent sub-contractors, suppliers and final assemblers.

(iii) *Reducing labour costs*

- *Smaller workforce.* Reductions in the size of the workforce - without any concomitant change in working hours and wage rates - can lead to higher productivity if the remaining workforce can maintain output (or output falls by less than the fall in labour costs). This can happen where there is employment 'under-capacity', perhaps because changes in the organization of the workforce enable the same amount of work to be done with fewer employees, or through technological changes that reduce the necessary labour input into the production process (again without any compensating rise in capital costs).
- *Lower wage and non-wage costs.* Labour costs consist of direct wage payments and non-wage social security contributions made by companies. Productivity can be raised in the short term (again assuming all other variables remain unchanged) if a firm can cut these costs: either by securing pay cuts or lower wage rises among the existing workforce (often as part of deals to preserve employment levels); or by shifting the burden of social security contributions back to either the government (without compensating rises in other taxes likely to affect the company) or the workforce (without having to raise wages to

compensate for the extra expenditure by employees). This can also be achieved through the use of temporary and part-time workers - so long as the full-time equivalent total for the workforce and its output remains the same - as many 'atypical' employees are prepared to receive lower wages and companies face lower statutory social security obligations on their behalf. The reduction in the company's wage costs can improve productivity, though over a long term, there is a danger that these gains may be eroded if poor and declining compensation dissuades workers from achieving higher levels of productivity (or if other firms are able to draw away higher-quality employees because of higher wages).

- *Longer hours.* In some industries, extending machine operating times is seen by companies as an important aspect of achieving greater production flexibility, and this in turn has led companies to press for changes in working time. If employees work longer hours for the same wage compensation, clearly productivity will be influenced positively, but working time can influence productivity in other, less direct ways. Concessions by the workforce on overtime payments, participation in continuous shift systems and 'annualized' hours (whereby workers vary their working weeks over the year by agreeing to work longer hours during periods of heavy demand) can lead to an overall reduction in the labour cost of output on a hourly basis (and hence, productivity).
- *Upskilling.* Another approach to increasing productivity is to influence the quality of individual workers rather than either their organization within a production system or the overall costs to the firm. Efforts to upgrade the skills of workers through training can lead to short-term rises in labour costs (either through the direct cost of training or the anticipated increase in wages to the higher-skilled workers). However, over the longer term, it can raise productivity if such human resource investments result in more efficient production systems (eg. through training to use new production technology) and compensating increases in output.

Common to each method of improving plant productivity is the ability of the company to change the organization of the workforce and its pay and working conditions. It is explicitly involved in efforts to reduce labour costs, such as the use of 'atypical' employment and variations in working time, and to raise labour skills, but it is implicit in changes involving the introduction of new equipment and production technology, as this can be rarely achieved without some alterations to working arrangements.

Influencing the cost and organization of the workforce is also a strategy that may have greater appeal to companies because it can be easier to introduce changes here than in other components of productivity. In industries undergoing restructuring, output changes can be difficult to make because of wider market restrictions, particularly where demand may be declining as a result of greater competition. Similarly, scope to alter capital costs may be limited because of the level of 'sunk' costs in particular locations or financial constraints on the ability of companies to invest. In contrast, changes to workforce flexibility are less dependent on such external limits on management's freedom of action, depending on a mixture of the strength of national regulation, collective bargaining procedures and the extent to which workforce concessions can be made without triggering a flight of workers to companies offering better compensation.

Consequently, increasing workforce flexibility has been viewed by companies as an essential aspect of efforts to increase plant productivity. In general, workforce flexibility can be viewed as the ability of firms to adapt the organization of employment (collectively and individually) to existing and anticipated changes in markets, products and production processes

(CEC, 1995a). The pressure to enhance and the opportunities to achieve greater flexibility within firms has arisen because of several processes. As noted above, greater competition within many product and services markets has given companies incentives to become more responsive to market changes, both in terms of volume as well as of product developments. In several manufacturing industries, production systems have adapted to the need for faster market response through just-in-time working practices in order to cut down inventories and delivery times. For some service sectors, notably retailing, increasing competition has led to more firms making more use of longer working hours in their businesses.

At the same time as these changes in the demand for labour, the supply of labour has been altering in recent years as well (Beatson, 1995). The participation of women in the workforce has increased, particularly in atypical employment. As many women have to balance child-rearing responsibilities with the desire for employment (and indeed the need for income), there has been greater demand for more widespread use of flexible contractual forms, such as part-time work. Many other workers also appreciate the ability to combine a more flexible working life with the pursuit of other activities (Brewster, Hegewisch and Mayne, 1994a).

The role of workforce flexibility in increasing productivity has been acknowledged in numerous studies (as reported in OECD, 1996b). In a Swedish study by NUTEK, firms with a more flexible organization were estimated to have 20 per cent higher productivity than those without. Similarly, research on the US steel industry showed that the introduction of more flexible working practices was associated with productivity increases. Although individual working practices have rarely been identified as having a significant impact on company performance, in combination, a series of changes in workforce flexibility have been widely regarded as having positive effects.

Different types of workforce flexibility need to be distinguished within these more general trends. These can be considered under two broad categories: external and internal flexibility (Beatson, 1995; Treu, 1992). *External* - or 'numerical' - flexibility refers to the ability of companies to alter the size and cost of their workforce, principally by changing the number of people employed, though it can also involve changes to the type of worker employed (eg. part-time and temporary workers). *Internal* flexibility corresponds to the changes in the organization and cost of the existing workforce, through flexibility in working time, pay and wage arrangements, and task capability (or so-called 'functional' flexibility, in which the workforce is sufficiently skilled to undertake an increasing number of more complex activities).

The two sets of flexibility are not necessarily compatible. In particular, companies aiming to make short-term cost savings often pursue external and aspects of internal flexibility (especially over working time and pay), but may be less willing to invest in the upskilling required to achieve functional flexibility. Retaining highly-skilled workers often requires the creation of stable employment conditions and concessions on pay and the working environment, which limit the degree to which other forms of flexibility can be increased, especially where there is strong demand for skilled workers.

Nevertheless, companies try to use the different types of flexibility in tandem, rarely eschewing one approach to the exclusion of all others. From the perspective of labour standards, only a few types of flexibility are affected by the external regulatory environment - for example, functional flexibility exists largely independent of such regulation. The issue of regulation is examined in a later section, but at this stage, it is important to review the link between productivity performance and the two key areas of flexibility affected by labour standards: numerical and temporal flexibility.

3.2.1 Numerical flexibility

Numerical flexibility can be defined as the employers' ability to alter the overall size and composition of the workforce. Its influence on a company's ability to increase production flexibility relates to the costs in companies changing the size and composition of its workforce in line with changing market conditions. From the perspective of firms, expansions and reductions in the workforce tend to be made in response to significant changes in output (resulting from market trends) and changes in the relative cost of capital and labour (because of relative variations in these costs and developments in production technology). Flexibility can take place within the 'core' (usually full-time) workforce through the latitude of firms in taking on and shedding labour. It can also influence the cost of maintaining a 'peripheral' labour force, which includes the use of atypical (temporary and part-time) employment on non-core business activities or tasks in which there is relatively low transaction costs involved in high personnel turnover. The use of atypical employment by employers is often viewed as less costly than using full-time employment because of the reduced exposure to employers' contributions for social protection. Extending the argument further, many companies have decentralized their production by sub-contracting more of their business activities to external firms, consequently shifting out the burden of adapting to market changes.

The ability to alter the core workforce of a firm (within the limits laid down by recruitment and dismissal legislation) and its peripheral labour (such as part-time and fixed-term workers) depends on the relative importance of several strategic issues to the firm. One that has often been attributed to firms needing to vary the size of their workforce is the need to accommodate substantial fluctuations in output. These changes can be sudden (as when there are unanticipated changes in market demand and reductions in the supply of essential components or raw materials) or regular and expected (such as seasonal demand for a product or service). The most-cited example of an area where these changes are very relevant is the retail sector where staff have to be taken on and disposed in line with shopping demand - consequently, some international retail companies will be considering this kind of flexibility as a location factor in addition to market proximity and property cost issues. However, it has also been notable in sectors such as electronics and office equipment, where the use of fixed-term contracts may be widespread.

Atypical employment is also common in the service activities of multinationals. For example, it is important in the customer service functions of large computer firms, call centres for airline companies, and the data-processing and administrative units of financial service firms because of the mundane nature of the work and the need for long manning hours.

Evidence for greater numerical flexibility in the EU demonstrates that it has been increasing in some areas of the labour market. Between 1987 and 1993, part-time employment as a share of the total labour force rose in all EC-12 countries apart from Denmark, Greece and Italy (System, 1995). Similarly, using data for the UK for the mid-1980s, businesses were found generally to be making greater use of sub-contractors, particularly in manufacturing and transportation sectors (Beatson, 1995). For temporary employment however, the picture is more mixed: the number of temporary contracts as a percentage of employees in the labour force only grew in France, Ireland, Italy, the Netherlands and Spain in the 1987-1993 period.

3.2.2 Temporal flexibility

Working time has become a more important aspect in strategies for raising plant productivity for several reasons. Partly there is a direct cost element to the issue, as longer hours worked by employees can theoretically reduce the costs of training new people to take over the tasks. However, to a large extent it is a response to the increasing need for firms

either to maximize production output through continuous plant operation or to reduce and expand output in markets characterized by significant variation (such as the retail sector, where shopping demand changes at different times of year) (OECD, 1996b). Temporal flexibility includes not only the number of hours worked in a certain period of time (where adjustment can take place through overtime or shorter working weeks) but also the arrangements for working time within a period, such as shift work and flexitime (Beatson, 1995).

Working time has become a particularly important issue for firms in capital-intensive sectors within the EU. Where sectors face increasing international competition and shortening product life-cycles (which can lead to relatively frequent replacement of production equipment), firms have incentives to utilize their plant capacity fully and maximize machine running times (Mueller and Purcell, 1992). The ability to organize the workforce for maintaining round-the-clock production - either through extending working time of existing staff or taking on new staff and being able to deploy them in night-time and irregular shifts - is dependent in part on regulatory legislation and national bargaining structures.

While temporal flexibility is a concern for a range of businesses, firms in capital-intensive sectors are more likely to be subject to its effects, especially those characterized by mass production of homogeneous goods - examples of these sectors include paper, automobiles, consumer appliances and electronics. Examining trends within the EU, temporal flexibility appears to be occurring at the same time as overall working time is declining. Community labour force surveys have shown that in all Member States, the average working week was reduced during the 1980s (CEC, 1994a). Nevertheless, the share of employees working longer than 48-hour weeks has gone up in the same period, suggesting that there is greater variation in the number of hours worked within each labour force.

3.3 Production flexibility and regulation

Government policy has had a major role in determining the type and extent of workforce flexibility available to companies in Western Europe. Employment regulation and labour standards have influenced the development of flexibility in two ways, both by limiting it where flexibility is seen as unacceptably damaging to the welfare and rights of employees as well as in encouraging it where flexibility can assist in overall job creation. In this context, labour market regulation has been shaped by two sets of objectives which have frequently been perceived to have contradictory effects. Regulation has primarily been inspired by welfare goals, especially the need to provide a guarantee for the rights and conditions of employees. However, through its role of institutionalizing social protection, certain aspects of regulation have been criticized for creating labour market rigidities at a time when persistent unemployment within Western Europe has been identified as one of the key concerns of public policy (Deakin and Mückenberger, 1992). As a result, there has been significant deregulation of labour markets in many countries, usually as part of wider and longer-term national debates on job creation policies (Sysdem, 1996).

Before proceeding, labour market regulation should be defined. Grubb and Wells (1993, p.9) defined it as existing "when an individual employer cannot, even by agreement with his or her own employees, use particular working arrangements or forms of employment contract, without risking legal sanctions or the invalidity of the relevant provisions in the contract". This definition can be extended to include the scope for employees to negotiate - or be informed of - any alteration to either those conditions or the provisions of employment contracts (through collective bargaining and worker consultation procedures).

For the purposes of this paper, it specifically excludes the complex issue of health and safety regulations. In recent years, there has been a tendency for employment rights and health

and safety issues to overlap in Western Europe, as demonstrated most visibly in the European Commission's introduction of EU working condition policies as health and safety measures in order to circumvent the UK's opt-out from EU social policy measures (Adnett, 1996). However, sectoral differences in the type and importance of specific health and safety regulations have effects that are too minor when considered individually and too diffuse when considered as a whole. In addition, equal opportunities issues have been excluded as regulatory differences do not appear to have been a major influence on industrial restructuring

Although broadly similar in global terms, within Western Europe, employment regulatory standards vary significantly. Using OECD data, Nickell (1997) scored Western European countries between 1 and 7 according to the 'severity' (from a company perspective) of their regulations in five areas: working time, employment protection against dismissals, fixed-term contracts, minimum wage legislation and workers' consultation procedures (Table 3.2). Individual scores in the five areas were then averaged for each country to provide an indication of overall labour market flexibility. Such an approach alone cannot capture the subtleties of labour market variations and indeed, suffers from the imprecisions arising from how 'severity' is assessed within each indicators and the way in which cardinal measurements are aggregated over several different indicators. However, it can still provide a useful snapshot of the overall level of regulation across a series of areas likely to affect businesses. Such a snapshot has a certain weight given that it can reflect the process by which investors assess the level of flexibility in different countries (location consultants use similar methods for ranking the labour market environments of potential sites for client companies).

From the table, it is clear that the most liberal countries have traditionally been the UK and Denmark (as well as Ireland in many areas of labour market regulation, as seen in the sections below), while the heaviest regulation of labour markets has generally occurred in southern Europe (Italy, Spain) as well as some northern European countries (Finland, France, Germany, Sweden). It should be noted that a trend towards greater deregulation has been evident in most countries, such as Germany where efforts to raise flexibility in working time has become the focus of employers-unions negotiations in recent years (as discussed in more detail below) and France where the government has introduced incentives to encourage

Table 3.2. Ranking of Western European labour standards

Austria	5
Belgium	4
Denmark	2
Finland	6
France	6
Germany	6
Ireland	4
Italy	7
Netherlands	5
Norway	5
Portugal	4
Spain	7
Sweden	7
Switzerland	3
UK	1

Source: Nickell, 1997.

businesses to make more use of part-time employment. Nevertheless, a key division in Western Europe remains between the employment policies traditionally espoused by most Continental countries and the less interventionist approach favoured by the UK.

National differences in regulation will potentially limit the ability of multinationals to maximize workforce flexibility in some plants and enlarge it in others. However, specific types of labour market regulation should be examined individually, as these constrain production flexibility in different ways. To understand the link between labour standards and both numerical and temporal flexibility, four categories of regulation are examined below, relating to different aspects of employment and pay conditions: recruitment and dismissal; atypical work; working time; and bargaining arrangements.

3.3.1 Recruitment and dismissal

A key part of national labour market regulation is legislation governing job security. Restrictions exist on the ability of companies to recruit, as some countries oblige employers to use public employment offices which can have a strong influence on deciding the workers that can be hired. More importantly, limits have been placed on the freedom, timing and scale of dismissals, the levels of redundancy payments and the mechanisms for ruling on unfair dismissals. In some countries, prior authorization is required before certain types of dismissals can be made (eg. Spain), which has led companies to take the costs of dismissals into consideration when setting wage rates. Regulations of mass dismissals are especially important, as they can not only involve statutory protection but also collective agreements between management and unions. Many countries insist on consultation with workers representatives before company action, sometimes requiring firms to present a 'social plan' showing how laid-off workers can be found other jobs (eg. France).

Regulation in this area varies substantially across the EU. Using an approach similar to Nickell's, Grubb and Wells (1993) provided relative rankings of countries for a series of labour market areas, again using unweighted averages for each country's score in different aspects of each area. In the area of dismissal (measured by several aspects, including procedural inconveniences, notice period, severance payments and overall difficulty of dismissing individuals) and using information by the OECD on both hiring and firing regulations (again using the same methodology), a comparative table can be put together for selected European countries (Table 3.3). Although there are some differences between the different rankings, Denmark and the UK have significantly low regulation while Italy, Portugal and Spain emerge as the two countries with the most restrictive dismissal legislation.

Looking in more detail at Italy and Spain - the two most regulated countries in this area - the impact of the relatively greater restrictions can be seen in their workforce patterns. In both countries, it has been reported that the lack of flexibility in recruitment and dismissal has contributed to an extensive use of contract workers (though this area is also subject to tight regulation, especially in Italy) and the operation of a large 'black' economy in parts of the country (Blyton and Martinez Lucio, 1995; *The Economist*, 1997a). In response to the problems arising from the traditional system, deregulation has been introduced gradually in both countries to make it easier for companies to dismiss workers without significant procedural problems. However, regulations remain relatively stringent on hiring - for example, in Italy, a quota of 12 per cent of total recruitment from the long-term unemployed and other problem groups is still mandatory (OECD, 1996c).

Table 3.3. Selected European differences in recruitment and dismissal

Country	Dismissal	Recruitment & dismissal
Belgium	4	7
Denmark	2	1
France	5	5
Germany	7	6
Greece	8	n.a.
Ireland	3	4
Italy	9	10
Netherlands	5	3
Portugal	10	8
Spain	10	9
UK	1	2

Source: Grubb and Wells, 1993;

3.3.2 Atypical work

Increasingly, non-standard employment contracts are becoming popular in certain countries and for certain types of work. In 1991, temporary employment through fixed-term contracts affected approximately one in eleven workers in the EU, an increase in absolute numbers of 34 per cent over the previous four years (inforMISEP, 1994). Similarly, part-time employment is particularly important in many service sectors, such as retailing. Regulation can determine not only the extent to which employers can make use of these different contractual forms (eg. in avoiding claims of unfair dismissals), but also the costs of their use, mainly through employer liabilities for social security contributions. Statutory or collective agreement limits have been placed on the number of renewals of fixed-term contracts as well as the maximum duration of all atypical employment for individual workers. Some countries require companies to consult with unions before introducing atypical work.

Evidence for the relationship between regulation of atypical employment and its incidence is strong (Raines, 1996). Table 3.4 compares regulatory levels with the shares of each form of employment in the national workforce. With respect to part-time employment, regulation is lightest in Ireland and the UK, strongest in Italy, Greece and Spain. The latter three countries also had the lowest shares of part-time employees in their workforces, while the UK was among those that had the highest. The Netherlands had the highest share of part-time employment overall, a reflection of its moderate level of regulation and its active promotion in collective bargaining negotiations as a means of bringing about a general reduction in the working week (*Financial Times*, 1997a).

A less strong relationship between government regulation and the actual constraints of national labour markets is found with regard to temporary employment. Again, the most-regulated countries are Italy and Greece (with the addition of Germany), while the least-regulated are the UK and Ireland (as well as Denmark). However, when examining the statistics for temporary employment in the workforce, the differences between European countries are much less pronounced than for part-time employment. The outstanding exception to this is Spain, whose share of 32 per cent is considerably ahead of the countries with the next highest figures, Denmark and France with 11 per cent each. As noted above, the high share of temporary employment is linked to the country's regulations on dismissals, which underlines the potential trade-off that occurs among different types of flexibility as a result of the choice

Table 3.4. Atypical working contracts

Country	Incidence (% of workforce) ¹		Regulation (ranking by ease) ²	
	Part-time	Fixed-term	Part-time	Fixed-term
Belgium	13	5	8	11
Denmark	23	11	5	1
France	14	11	3	8
Germany	15	10	6	9
Greece	4	10	9	7
Ireland	11	9	1	1
Italy	5	6	9	10
Netherlands	35	10	4	4
Portugal	8	10	7	6
Spain	6	32	9	4
UK	24	7	1	1

¹ Sysdem, 1995.
² Grubb and Wells, 1993.

of regulatory approach.

3.3.3 Working time

Working time issues consist of several areas where national regulation has been influential: ceilings on the length of working week, holiday and leave entitlements, and night shifts. With respect to working week regulations, restrictions on the maximum length of working week can have a restrictive impact on employment in certain sectors and economic activities. Regulations also often govern the entitlements to employees of paid holiday time as well as parental leave. Where regulations affect the pay and conditions of workers on night shifts, these can affect the business costs of maximizing plant capacity for production.

In terms of the actual length of working week, the difference between the highest and lowest countries is significant - approximately 11 hours, or one third of the average time of the shortest average working week in the EU (Sysdem, 1995). Employees in Greece, Ireland and Portugal on average work the longest weeks, while the shortest weeks are in Belgium, Denmark and the Netherlands. The impact of government regulation is apparent where labour standards are relatively high - according to Grubb and Wells (1993), the most stringent regulations on working weeks are operated in Belgium and Denmark, which would be anticipated given their average working weeks. However, the least-regulated EU countries - the UK and Ireland - do not work the longest weeks. They do, however, have the highest shares of the labour force working over 48 hours a week - 27.8 per cent in the case of the UK, 12.9 per cent in Ireland - which indicates that working time restrictions has greater impact in particular sectors rather than generally throughout the labour market (Sysdem, 1995).

A stronger link between regulation and the level of temporal flexibility can be seen in the area of atypical working hours. Regulations on weekend working and night shifts have been assessed by Grubb and Wells (1993) as strongest in Germany, Portugal and Spain and weakest in Denmark, Ireland, Italy and the UK. As can be seen in Table 3.5, there is a broad correlation in the ranking of countries by temporal flexibility in practice and by regulation, though with some exceptions (notably Greece).

Table 3.5. National differences in atypical working time

Country	% of male workforce working (1992) ¹			Degree of regulation ²
	Saturdays	Sundays	Night shifts	
Belgium	29	18	17	5
Denmark	48	46	20	2
France	49	23	18	7
Germany	43	23	21	6
Greece	45	26	19	10
Ireland	n.a.	n.a.	n.a.	3
Italy	55	19	15	3
Netherlands	38	21	8	7
Portugal	26	13	n.a.	11
Spain	35	13	10	9
UK	63	43	27	1

¹ CEC, 1994b. ² Grubb and Wells, 1993.

3.3.4 Bargaining arrangements

Industrial relations institutions place important limits on the ability of companies to alter pay and employment conditions unilaterally. The institutional backgrounds of EU countries can differ considerably both in terms of the extent of unionization in the national labour force as well as the degree of centralization and coordination in negotiations over pay and employment conditions. In this context, what is important to businesses is the level at which wage and employment issues are decided and the resulting autonomy for individual companies to negotiate plant-specific agreements.

Levels of unionization differ across Western Europe, ranging from 10 per cent of the total workforce in France to 83 per cent in Sweden (OECD, 1994b). These do not always reflect the strength of collective bargaining, as some countries can have high shares of union membership but relatively low levels of coordinated bargaining at sectoral or national level. For example, in 1990, Germany had a unionization rate of 33 per cent of its workforce, but collective bargaining covered 90 per cent of the workforce; similarly, in Portugal, the respective figures were 32 and 79 per cent. France has a small unionized workforce, but French unions can have a powerful influence over setting national pay and employment standards through their participation in national collective bargaining, which covers 90 per cent of the workforce (*The Economist*, 1997b).

European collective bargaining procedures vary in their degree of centralization (Adnett, 1996). Countries tend to be characterized by the level at which bargaining takes place, although even in the most centralized countries, several aspects of pay and working conditions will be negotiated at enterprise level (within guidelines laid down by wider collective agreements). Single employer bargaining at individual enterprise level distinguishes the UK and non-European countries such as the US. Bargaining within broad sectors - in which agreements between employers' associations and large unions can set guidelines for negotiations at individual company level - is prevalent in Austria, Germany and the Netherlands. Lastly, more centralized bargaining at national level predominates in countries as diverse as Belgium, the Netherlands, Portugal, Spain and Sweden.

At the individual company level, differences in representation are just as marked in Western Europe. For example, the right of workers to be informed about company activities and consulted on major business changes has been institutionalized in Germany through the system of workers councils. While general issues of pay and working conditions may be set within collective bargaining agreements, other issues not covered by agreements - and the application of collective agreement guidelines to individual plants - are normally determined through negotiation between employers and workers councils. The formal organizational structures here contrast with the freedom companies have to establish their own forms of employee representation at enterprise level in the UK, even in being allowed to decide against representation (Kortekaas, 1996).

Although industrial relations enter into all the different forms of flexibility discussed above, it is worthwhile drawing attention to how the nature of industrial relations can influence investment patterns. For example, one of the major claims that has been made about the German investment climate is that its consensus-based industrial relations has guaranteed a low level of strikes and wage settlements in western Germany, at least until recently as far as wages are concerned (Tüselmann, 1995). Germany had the fewest working days lost between 1983 and 1992 in the EU apart from Luxembourg and the Netherlands, in contrast with Greece and Spain, which lost *twenty* times as many days as Germany (System, 1994). Yet the gains at macro-economic level can be lost at company level if individual firms are not allowed to negotiate deals in line with their specific circumstances. EU labour force surveys have shown that companies were more concerned by the restrictions of collective agreements on weekly operating hours in Germany and Portugal than in other Member States (CEC, 1995b).

3.4 The impact of regulation on production flexibility and productivity

As is evident from the previous section, there is a strong relationship between labour market regulation and different types of workforce flexibility across Western Europe. What needs to be examined is whether there is a link between the strength of labour standards and regulation in different countries and the ability of multinationals to use the resulting flexibility to increase productivity in different plants.

An initial indication of a possible link can be found by combining the different measures of productivity in table 3.1 with the rankings of regulatory severity used by Nickell (1997) from OECD data, divided between 'employment protection' (hiring and firing regulations) and 'labour standards' (working time, atypical employment and employee consultation). If production and workforce flexibility were key to overall macro-economic efficiency, it might be assumed that productivity would be highest in those countries providing the greatest scope for flexibility (ie. least regulation). From table 3.4, it is by no means clear that a link can be established, at least not for selected European countries. Although there is an approximate correlation in the cases of the Netherlands (in terms of employment protection) and Belgium (in terms of labour standards), it cannot be proven for the UK, the main exponent of labour market deregulation in Western Europe. Similarly, labour market regulation does appear to be inversely proportional to productivity in Spain and Portugal (only in the case of employment protection), but again, Italy's relatively high levels of regulation did not hinder the country from having the lowest unit labour costs in the rankings.

The evidence indicates that the influence of regulation on production flexibility and productivity only appears to exist in certain situations. Indeed, when examining the specific types of regulation, the impact on production organization at plant level is easier to distinguish. This is particularly true where regulation restricts the operation of certain types of employment flexibility but allows companies to pursue others. Given that companies often have a range of

Table 3.6. Comparative ranking of productivity and employment regulation

	Productivity (1990) ¹		Employment regulation (1989-94) ²	
	Manufacturing output per person	Unit labour costs	Employment protection rigidity	Labour standards
Belgium	2	3	5	2
France	3	5	3	5
Germany	5	6	4	5
Italy	4	1	8	7
Netherlands	1	2	2	4
Portugal	8	7	6	2
Spain	7	8	7	7
UK	6	4	1	1

¹ Oulton, 1994. ² Nickell, 1997.

options in achieving workforce flexibility, it can be the case that a higher incidence of a particular type of flexibility is evidence of restrictions in other areas.

The process can be best demonstrated by considering the impact of employment protection legislation in Spain. As noted above, the Spanish labour market has been more visibly affected by severe regulation on dismissal than almost any other Western European country, apart from Italy. A legacy of the Franco period, Spain's employment laws for a long time made redundancy subject to a relatively complex bureaucratic approval process (OECD, 1994a). Substantial compensation payments - which are the highest in Western Europe - continue to be associated with dismissal, even though lay-off procedures have been considerably eased over the last decade (Financial Times, 1997b).

Spain's dismissal procedures have resulted in companies making use of other types of flexibility, especially fixed-term contracts. Of all Western European countries, Spain has the largest share of temporary workers in its workforce (32 per cent against an EU average of 9 per cent), accounting for 90 per cent of all employment contracts agreed annually (Blyton and Martinez Lucio, 1995). Employers have been able to avoid some of their redundancy payment obligations by using contract workers more heavily. Further, the Spanish emphasis on job security - as expressed through its dismissal legislation - has been partially held responsible for the country's levels of unemployment, still one of the highest in the EU (Eurostat, 1996). The barriers to redundancy may have made job security more difficult to achieve as they make it more difficult for companies to use restructuring to avoid bankruptcies.

Another example of the influence of regulation on the type of workforce flexibility used by companies is Germany. Working time flexibility has become one of the dominant issues in contractual negotiations between management and unions, mainly because of restrictions in other areas of flexibility. Pressures for industrial restructuring have grown substantially in Germany as a result of the recession of the early 1990s, forcing many German companies to find ways of improving productivity (OECD, 1996d). Industrial relations over the last decade have been characterized by increasing efforts by both sides to expand workforce flexibility in the few areas allowed within Germany's highly-regulated labour market (Financial Times, 1997c). In terms of numerical flexibility, there has been little room for manoeuvre, as Germany has relatively strict regulation of recruitment and dismissal procedures as well as the use of fixed-term workers. Within working time itself, flexibility has been restricted by the continuing reduction of the working week through sectoral collective agreements - eg. 35 hours

in the case of engineering, 38 hours in the confectionery industry (EIRR, 1995a).

As a result, industrial negotiations have tended to focus on the organization of working time as a source of improved productivity. Overtime has been one of the traditional ways in which companies have attempted to extend working time, and this has continued to increase in recent years - from 39 per cent of all workers doing some overtime in 1993 to 45 per cent two years later (EIRR, 1996a). However, the use of overtime has been a concern to many German employers because of the scale of overtime payments, so in recent years industrial agreements have attempted to reduce the wage costs by offering time off in lieu. At the same time, the concept of 'annual hours' has become more popular, in which working time maxima are calculated on an annual basis. It has allowed employees to work longer-than-average working weeks during periods of high demand, making up for the time with shorter weeks later (EIRR, 1995b). This has also included greater freedom for employers to allocate workers to weekend and night shifts without incurring overtime payment costs. For some large companies (such as BMW), this has taken the form of 'time banks', in which longer working hours by employees can be 'saved' up and taken as later holiday (EIRR, 1996b).

The link between regulation and productivity can also be considered in terms of the freedom that companies have to set pay and working conditions appropriate to their operations. Companies aim to maximize their flexibility in this regard, both in terms of the level at which negotiations (especially plant or enterprise level) and the ability to adapt agreements rapidly in line with changing market and production conditions. Pay and condition policies within multinationals are rarely set at international level, but are largely determined by national headquarters (Hegewisch and Brewster, 1993). Consequently, the capacity of multinationals to maximize their workforce flexibility is shaped by the structure of industrial relations within different countries, especially collective bargaining.

As noted above, collective bargaining structures and trade union membership vary widely across Western Europe. National or sectoral bargaining is lowest in the UK - which in turn has the highest share of bargaining at company or establishment level - while it is most extensively used in Germany, Italy, the Netherlands and Spain (Adnett, 1996; Hegewisch and Brewster, 1993). In the UK, plant-level bargaining has been particularly associated with foreign investors, which have often insisted on autonomous industrial relations procedures when establishing plants (Peck and Stone, 1992). Given the UK's reputation as having one of the most flexible labour markets in Western Europe (in terms of numerical and temporal flexibility), there would appear to be a strong correspondence between the weakness of national and industry-wide collective bargaining and workforce flexibility.

Nevertheless, the existence of multi-employer bargaining does not necessarily prevent the existence of plant-level bargaining. First, wider collective bargaining does not preclude the ability of firms to set company-specific agreements. In Germany, large companies have been able to secure 'exclusions' from wider collective bargaining agreements where a strong case can be made that the concessions will help to secure the future of the workforce. Such derogations have been particularly prevalent in the eastern Länder, where companies are increasingly making local agreements with their workforces to set pay rates below those agreed at national level (*Financial Times*, 1997c). These national agreements apply across Germany but often do not take into account significant regional differences in productivity (and consequently, profitability). Second, the existence of large unions can assist individual companies to negotiate flexibility agreements. Again, in the case of Germany, IG Metall, the main engineering industry union, has played a key role in securing the support of local workforces to agreements on flexibility in the car industry (EIRR, 1995c).

Several conclusions about the relationship of labour standards, workforce flexibility and

industrial restructuring in Western Europe proceed from these observations. In general, labour market regulation does not appear to have a decisive impact on productivity, at least as measured at national level. It does, however, relate to the type and extent of production flexibility that companies can enhance in different countries. Some countries offer companies a wider range of options in terms of workforce flexibility, such as the UK with its extensive numerical and temporal flexibility. In other countries, regulations have to a large degree dictated the type of flexibility that companies have aimed to maximize - for example, the use of fixed-term employment in Spain (as a response to the difficulties of dismissing full-time workers) and flexibility in the organization of working time in Germany (in response to limits on the length of the working week and the use of temporary workers).

The pressures of industrial restructuring in Western Europe have created loopholes in all national regulatory systems, so that while there are differences in the workforce flexibility available to companies, there is always scope for increasing some form of flexibility. Even where collective bargaining structures are very strong, the systems have become sufficiently malleable to allow companies to increase workforce flexibility within existing regulations, again, as seen most clearly in the case of Germany, where unions have proved to be relatively amenable in negotiations. However, regulatory differences may have a greater impact where firms have more options for increasing their productivity through multinational investment strategies. Where this is the case, the issue is no longer how companies can enhance flexibility in particular environments, but whether the cost of achieving that flexibility within that environment is less than the cost of moving production to a less regulated environment.

4. National labour market regulation and investment strategies

4.1 Introduction

In assessing the relationship between employment regulation and workforce flexibility in Western Europe, there is strong evidence that regulation can influence the scope that companies have for altering the organization of production. Although many companies have been able to standardize their work systems across national boundaries, significant variation remains in the types of flexibility to which companies can resort in order to raise plant productivity, and this variation in large part derives from a combination of national employment protection legislation and collective bargaining structures.

Do these differences in production flexibility and regulatory environments influence multinational investment strategies? Workforce flexibility has been linked with investment, particularly in industries where competition compels a drive for greater plant efficiency. Through modernization of capital equipment and training to raise labour skills, productivity improvements often require higher levels of investment, and companies would tend to invest in locations - both existing and new - where increases in productivity can be maximized. Similarly, if production flexibility and productivity cannot be augmented because of regulatory restrictions, investment is not only less likely to occur but divestment - perhaps even plant closure - may result if competitive pressures are strong enough.

In theory, industrial restructuring in Western Europe could be determined by labour standards, i.e. through the effects of labour market regulation on corporate investment decisions. This chapter considers the issue from several perspectives. In the first section, the links between plant productivity, production flexibility and multinational investment strategies are considered in the context of the 'social dumping' debate in Western Europe. The last two sections review the evidence for social dumping, first in terms of the impact on greenfield investment (especially by companies from outside Europe) and then on the redistribution of

investment between existing locations.

4.2 Production flexibility, productivity and investment

Production flexibility can be influenced by investment decisions through a number of inter-related mechanisms. Investments in new capital equipment - particularly those embodying new production technologies - can allow (and indeed, often require) changes in the way that production is organized within plants. As was seen in the previous chapter, companies making substantial investments in new machinery often aim to maximize the value of their outlays by increasing machine running time, which can necessitate alterations in shift patterns and the organization of working time among the workforce. In multinational companies, new investment can result in an overall expansion of total plant capacity, or it can involve reorganizing production between different plants, with little change to investment levels for the group as whole. In either case, investment can be concentrated in those individual plants which have the highest potential for achieving greater production flexibility (and productivity), leading in some cases to a widening of productivity differentials between different plants.

Similarly, production flexibility is enhanced by investments in the workforce. Changes in the organization of production may require the workforce to acquire new skills. Productivity increases would then result from greater training, allowing employees to undertake new responsibilities in their jobs, work in flexible teams and switch between different production tasks as required. Often, these labour investments are made in parallel with capital investments, as the operation of new equipment can require workers to develop new skills.

Divestments can also be a part of efforts to increase overall production flexibility. In recent years, some sectors have experienced considerable vertical disintegration of the production process. Assembly industries - such as automotive and electronics manufacture - have been reshaped by the contracting out of parts of the production process. Increased subcontracting - in combination with just-in-time supply - can give multinationals greater flexibility with respect to market and product changes, effectively shifting some responsibility for productivity increases to supplier companies through their adaptation to new distribution systems.

In more extreme cases, plant closures can increase the flexibility of the multinational group as a whole, by allowing companies to concentrate on plants which offer greater opportunities for raising productivity. Such cases may occur where the importance of being able to compare plant costs and productivity has been raised, as for example, when the original factors determining investment have diminished - such as national market access, as a result of European economic integration.

However, just as production flexibility and productivity can be determined by investment, investment strategies are in turn influenced by productivity differentials and the scope for increasing production flexibility in plants. Where production flexibility is a key factor in these strategies, investment will tend to gravitate towards locations where such flexibility can be increased at the least cost to the company. Depending on the type of flexibility which is to be promoted, different sets of investment determinants may be influential.

If functional flexibility is to be maximized, the availability and cost of highly-skilled labour will be particularly significant. In many industries, companies place great importance on being able to build up a loyal and cooperative pool of skilled workers, in which case, the sunk costs of an existing investment - whether in terms of the capital costs or the skills pool of the workforce - are too great to consider substantial shifts in investment.

If other types of flexibility are critical - notably numerical and temporal - investors are likely to be sensitive to national differences in labour protection frameworks and collective

bargaining structures. In this context, the regulatory environment can influence both new and existing investments. With greenfield location decisions, all other factors being equal, multinationals may be attracted to countries offering minimal labour market regulation. Similarly, the impact can also be felt on the existing investments of multinationals, especially during a period of restructuring. Plant expansions are more likely to occur in relatively more liberal regulatory countries while contractions and closures may take place in more restrictive environments.

On a global scale, this process has been described as 'social dumping'. Although social dumping is principally used to discuss the role of labour *costs*, it also has a clear application to labour *standards* as well. Where national differences between labour standards are sufficiently wide, the production cost structures of rival locations will in turn be large enough to influence investment decisions. Companies can be attracted to countries with lower labour standards, not just because their direct costs will be less in relation to the non-wage costs of the workforce (eg. social security contributions; entitlements to sickness, maternity and holiday payments), but also because the flexibility of employment regulations and collective bargaining will allow firms to organize their workforce to maximize productivity and reduce labour costs overall. Investment migration and the cost advantages of producers in lower-standard countries would force industries in higher-standard countries to restructure and press for more 'competitive' labour standards in their own countries. On a large scale, the resulting effects on such shifts in investment could lead to greater convergence in global standards.

For the world as a whole, social dumping has been a persistent, though ultimately muted force. While multinationals have been responding to regulatory differentials, the wider impact has been limited because of the small volumes of investments which are highly sensitive to such regulatory differences - in general, developing countries associated with lower labour standards have persistently received very low shares of global flows of production investment (UNCTAD, 1996). In the case of Western Europe, it would seem that regulation would have even less of an impact, given the smaller differentials in labour standards between countries. Few decisions to invest in Western Europe as a whole are likely to be influenced by the level of labour standards relative to the rest of the world. Nevertheless, within Europe, decisions on particular sites can be influenced by differences in national capacities for workforce flexibility, both in terms of new investments as well as restructuring of multinational groups of plants.

The clearest example of this to date was the Hoover case in 1993. Hoover Europe - the US-owned manufacturer of vacuum cleaners - closed down its factory in France and shifted production to another plant in Scotland, in large part because the Scottish workforce had been able to make concessions on pay and working conditions that the French employees could not (IDS, 1993). The agreement with the Scottish workers involved a one-off payment in exchange for, *inter alia*, a pay 'freeze' for 11 months, the hiring of all new workers on a two-year fixed-term basis (allowing Hoover to forego certain social protection costs liable for full-time employees), removal of distinctions between certain groups of workers through multi-skilling and training, and a no-strike clause (EIRR, 1993). Although it would have been possible for French workers to make many of these concessions, on two key issues they were constrained by national legal restrictions and collective agreements:

- *no-strike clause*: this would have set a highly unusual precedent in French collective bargaining which would have been difficult to justify on a one-off basis; and
- *the exclusion of new employees from the occupational pension scheme for at least two years*: in France, a collective agreement cannot exclude one group of workers from the

pension scheme that employers are obliged to operate.

Over 400 jobs were lost with the closure of the French plant, leading to condemnation in Europe of the then-Conservative UK Government's espousal of greater employment flexibility, as symbolized by its insistence on opting-out of the EU Social Chapter. It galvanized a debate over the dangers of removing the remaining technical barriers to trade through the single market programme without creating common regulatory standards across Europe in other areas. As a result, it gave greater impetus to the EU's efforts to extend a common social and employment policy through the Social Chapter.

The incident highlighted the social dumping debate in Europe in two key ways. First, it focused on the UK's exploitation of its more liberal regulatory environment and greater workforce flexibility (at least in numerical and temporal issues) to attract inward investment, potentially at the expense of other European countries. In the face of French accusations that the UK was aiming to become the 'sweatshop' of Europe, fears were expressed that the UK's lower labour standards in certain areas would compel other European governments to change their own regulation in order to prevent investment flight.

Political rhetoric clouded the actual impact of the UK's different approach to labour market regulation. Indeed, in the case of Hoover, the Scottish workforce had not set out to outbid French workers for the investment, but had made the pay and conditions agreement in response to threats to its own competitiveness during the global recession, in advance of the news of the French closure. However, the example does highlight the second aspect of the social dumping debate: the *indirect* competition between workforces in Europe for investment.

It was noted during the Hoover debate that companies might increasingly place workforces in different countries in competition against each other. In the US, such practices have been noted in industrial relations research. Industrial restructuring over the past two decades has increasingly been left to market forces by the withdrawal of an active government policy role, with the result that some firms have used their relatively greater scope for action against workers to force through changes in pay and employment conditions (Craypo, 1994). Concessions have been extracted during periods of intense pressure to restructure within industries and in circumstances where investment mobility is relatively great (especially between plants) (Birecree, 1993). Protection is often lacking because of limited employment legislation and the absence of wider collective bargaining structures, allowing companies the use of external support to their position - the threat of moving investment elsewhere - but leaving workers with little or none.

In Western Europe, this might not happen so directly - at least in terms of a kind of 'auction' for new investment between different plants - but it could be encouraged by the tendency of companies to favour more flexible workforces with new investment while closing down plants where workforces are unable to make the concessions felt to be necessary to increase plant productivity. This puts pressure on standards at three levels. At the plant level, it encourages workers to make concessions more readily. At the collective bargaining level, it promotes greater negotiating flexibility for individual plants, often requiring the suspension of sector or national agreements. Lastly, it focuses the attention of governments on international rather than merely domestic economic and social factors in setting their employment legislation, particularly the level of labour standards in potential investment rivals.

To examine these effects, it is necessary to distinguish between the importance of labour standards for different types of investors. For new investors, companies have considerable freedom in examining different regulatory environments before making greenfield location decisions. Existing investors face greater constraints, but are still in a position to take advantage of regulatory differences to redistribute investment. Moreover, their ability to shift

investment can have a powerful role in changing workforce flexibility in existing plants. The following two sections discuss each group separately.

4.3 Impact of regulation on greenfield investments

When making a straightforward comparison of foreign investment flows and levels of labour market regulation in Western Europe, it is clear that labour standards do not appear to be a critical factor in determining flows (Table 4.1). Taking net inward investment as a share of GDP over the period 1989-94 (as presented in Table 2.1) and the ranking of labour standards by Nickell (1995), there are few clear links between the intensity of FDI and the apparent level of deregulation in the national labour market. There may be some correlation in the case of the UK (at one end of the spectrum) and Italy and, to a lesser extent, Germany (at the other end) but for other countries, employment regulation cannot be isolated as a major determinant, especially for Belgium, the Netherlands and Portugal, which are able to attract relatively high levels of FDI despite the restrictions of their labour markets. This conclusion is reinforced by OECD work, which has shown that while there is a strong inverse relationship between FDI flows and labour costs, labour standards provide a far weaker link (OECD, 1994b).

It would have been surprising if a close relationship could be established between labour standards and investment flows. Investment decisions are affected by a combination of different factors, and while some determinants can be commonly identified, they tend to relate to costs. Market factors - whether access to general markets or proximity to key customers - have consistently emerged as the key determinants in greenfield locations in Western Europe, though continuing European economic integration has put increasing emphasis on production cost issues (CEC, 1993). Labour standards have a more indirect impact on cost structures, and their influence depends greatly on individual company circumstances, especially where the strength of local collective bargaining is a factor.

Table 4.1. Foreign investment and labour market regulation in Western Europe

Country	FDI flows as share of GDP	Labour standards ¹
UK	2.2	1
France	0.9	6
Belgium/Luxembourg	4.4	4
Spain	1.9	7
Sweden	1.7	7
Netherlands	2	5
Denmark	1.4	2
Italy	0.3	7
Portugal	3.2	4
Ireland	0.2	4
Germany	0.2	6

¹ - including working time, atypical employment and workers' representation.

Source: OECD, 1995; Nickell, 1997.

In recent years, market factors have diminished as a primary determinant in Western European investment decisions and companies in restructuring industries have been investigating new ways of lowering their cost structures. Regulatory and flexibility issues have

been more regularly cited in business surveys as influencing location, particularly with regard to the choice of country (Christodoulou, 1996). Specifically, workforce flexibility and employment protection have been linked to the UK's success in attracting greenfield investment (*Financial Times*, 1996a). Evidence for the role of the regulatory environment in influencing UK locational attractiveness has not been systematically collected, and the foundation for the assertion has been based on individual company accounts as reported in the media. In particular, reports of the motives of non-European investors have often listed the importance of the UK's 'flexible' workforce as important reasons for investing (*Financial Times*, 1997d). Moreover, the country's reputation has been heavily promoted by UK inward investment agencies as one of the main location advantages in its marketing literature, distinguishing it from its main European rivals (IBB, 1996).

Foreign investment has been associated with more flexible workforces and higher productivity in the UK. For example, a higher proportion of foreign investors have non-unionized workforces than domestic firms in the same sectors - according to a study by Peck and Stone (1992), the difference was 66 to 38 per cent, with some variation according to the investor's country of origin (as US investors were more likely to have non-union plants) and whether the investment was recent (newer investments were also more likely to forego unions). Japanese investors have been particularly responsible for the introduction of new working practices, such as just-in-time production, team-working and reorganization of labour-management structures to shift more problem-solving production tasks to workers (Oliver and Wilkinson, 1988). These have contributed to greater workforce flexibility, especially in functional flexibility as reflected in the higher productivity of these plants as compared to domestic producers. Companies such as Nissan - which located in Sunderland in 1985 - placed such great emphasis on securing workforce cooperation to its approach to organization production that it was unusually selective when recruiting workers for the plant (Hudson, 1995). The resulting productivity increases in turn put great pressure on domestic producers to achieve similar flexibility in their workforces and production systems.

The UK's success has often been cast in terms of the debate between a system promoting numerical and temporal flexibility at the expense of functional flexibility (see, for example, Beatson, 1995; Blyton and Martinez Lucio, 1995). While the UK system does not support the creation a highly-skilled workforce comparable to Germany, it is not clear that at the individual plant level, such an absence of functional flexibility has constrained the ability of investors to achieve high productivity. Indeed, it has been argued that foreign investors have been able to combine the UK's relatively low labour costs with its low regulatory restrictions to raise productivity without a compensating increase in wage compensation (*The Economist*, 1993). In past decades, relatively low labour costs and productivity went together in British manufacturing, but with the surge of new investment during the 1980s, foreign investors were able to take advantage of labour costs while being able to increase the productivity of their British workforces through flexible working practices. In other words, the attractiveness of the UK may not so much be its productivity levels (especially in terms of unit labour costs), but the *scope* for achieving higher productivity, a feature that seems to be particularly attractive to non-EU investors such as Japanese and US firms.

Relatively high regulation has also been claimed as a factor dissuading investors from locating in other Western European countries, again particularly non-EU and first-time investors. In Germany and Italy, labour market 'rigidity' has been noted by investors as an active disadvantage to locating greenfield production investments in these countries, though a strong reputation in skilled labour - especially in Germany - has helped to attract R&D investment (*Financial Times*, 1996b; Kahraß, 1997). In contrast, recent changes in the

regulatory system in France have made investors more sympathetic to locating there. Although the stringency of dismissal legislation continues to deter some investors, the recent increase in FDI flows into France points to an increasingly positive attitude to investors by the government (Rowe, 1997). For example, there have been a number of recent legal reinterpretations of French regulations of mass dismissals arising from production transfers which have widened the circumstances in which companies can scale down plants (EIRR, 1995d).

4.4 Impact of regulation on existing investments

Investment restructuring can be difficult to detect from existing official statistics. Current statistical measures reflect significant changes in the scale of flows between countries, but can conceal considerable activity in the redistribution of investment between existing sites. Restructuring can take several forms, involving positive, negative and 'neutral' net changes in the volume of investment by a multinational. Positive changes can involve plant expansions and modernizations, while negative impacts reflect contractions and closures of sites. Neutral changes can escape statistical overview, especially where companies reorganize their production processes - either in minor terms with alterations to working conditions or more substantially through wholesale changes to product manufacture - with little additional capital investment. In these circumstances, evidence for the impact of regulation on investment behaviour cannot be gleaned from investment figures, but from business survey and sectoral studies.

One measure of the importance of labour market regulation in influencing company behaviour is the extent to which it is perceived by firms as a business barrier. In a recent UNICE (1995) report, employment law was listed by companies as second to taxation as a factor in reducing their competitiveness and acting as a constraint on their business activities by making their workforces more inflexible. According to the report, particular concern had been voiced about regulation in the areas of recruitment and dismissal and overtime restrictions, arguing that legislation has become too prescriptive in many European governments. It was highlighted as a key difficulty in plant closure and major staff reductions.

As a result, labour market rigidities have not only influenced new investments - especially by first-time, non-European investors - but in several cases, it has been a major determinant of changing investment patterns by EU multinationals. To date, it seems highly improbable that companies will shut plants principally as a result of employment regulation, mainly as a result of 'disengagement' costs, such as sunk capital, redundancy payments and lost output (UNCTAD, 1994). What is more likely is that an existing investment may be segmented and parts relocated, particularly where labour-intensive aspects of production are involved. Moreover, established plants owned by European companies can lose out in terms of new *incremental* investment because of problems of workforce inflexibility. In the short term, such losses may be of minor importance, but sustained over a period in which other plants are benefiting from investment expansions and modernizations, the plant's status within a multinational group may weaken, ultimately putting the plant at risk if the company needs to close down part of its production.

Evidence for such marginal shifts in investment is difficult to establish comprehensively because of the absence of relevant statistics. However, from case studies and media reports, the majority of cases in which the process can be clearly seen come from Germany. A combination of the country's high labour costs - both wages and social charges - and strict employment and collective bargaining systems have led to several large German firms setting up new plants in neighbouring countries. Examples are abundant. In late 1994, the car manufacturer, Mercedes-Benz, decided against production of its new 'Swatch' car in Germany

but instead established a new plant in France (Swinden, 1996). Shortly after, Siemens announced that its major semi-conductor plant was to be located in the north-east of England, in part because of the difficulties in operating round-the-clock, three-shift production in Germany (Flaherty, 1997). Bosch shifted some production in its automotive components group out of Germany to a new factory in Wales for similar reasons of production flexibility (Sadler and Amin, 1995). More recently, the light-bulb manufacturer, Osram, transferred part of production of its specialist photo-optic lamps from its Berlin factory to another near Manchester in the UK, to a large extent because of the latter's record on production flexibility (*Financial Times*, 1997e).

The trend has given rise to the political debate over *Standort Deutschland*, and the sources of what are perceived to be declining German competitiveness (IDS, 1996; Tüselmann, 1995). The scale of investment flight has been difficult to determine. As was seen in table 2.1, German investment outflows have greatly exceeded its inflows by a factor greater than for any other country in Western Europe. More importantly, investment to Central and Eastern Europe (CEE) locations, where production costs are substantially lower than in Germany, has grown in recent years, heightening concerns that the recent investment surge is related to the relocation of German production abroad.

It is difficult to determine the extent to which German outward investment flows reflect differences in labour costs and standards between Germany and CEE. In a study for the European Parliament on investment relocation outside of Western Europe, Burger and Jungnickel (1996) noted that there was significant outward processing trade between the EU (and Germany, in particular) and CEE - amounting to 18 per cent of total CEE exports to the EU - with concentrations in labour-intensive industries such as textiles and clothing. While the authors concluded that the principal motives for investment remain the attraction of emerging markets rather than lower cost structures (ie. it is employment and trade creating rather than involving a shift of employment out of Germany), recent business surveys of German companies continue to highlight the fact that the cost pressures for relocating investment out of Germany are likely to increase in future. In a 1996 survey by the German chambers of commerce, over a quarter of German manufacturing firms surveyed were planning to shift production abroad over the next three years, and the key factor behind the decisions was Germany's higher labour costs (*Financial Times*, 1997f). In many cases, such relocations are seen as the only means of preserving domestic plants, as labour-intensive parts of production are moved abroad but 'core' activities (such as R&D) are retained in Germany. For example, the glass-maker, Schott-Zwiesel decided to set up a glassworks just across the Czech-German border in 1996, partly to make it cost-effective for the company to maintain higher value-added aspects of its business at its German location (*Financial Times*, 1996c). In a study of German plant and equipment manufacturers in 1997, companies transferring production abroad argued that by making them more competitive, such relocations helped to stabilize the number of jobs in Germany in R&D activities (*Financial Times*, 1997g).

Investment decisions to relocate out of Germany are frequently conditional on whether domestic plants can be altered to increase their productivity. An unpublished report for the European Commission concluded 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" (as reported in *Financial Times*, 1997h). This does not necessarily take place in a climate of industrial relations conflict, but often as a recognition that the organization of production in domestic plants has to be changed if competitiveness is to be maintained. In the chemical industry, employers and the union, IG Chemie, reached agreement on a wide-ranging deal to increase working flexibility, partly in response to the increasing level

of production investment abroad by Germany's large chemical companies (*Financial Times*, 1997i).

In some cases, it has even been the workforce itself offering concessions in order to preserve production in Germany. In 1997, the workforce at the Augsburg plant of Osram agreed to the introduction of regular Saturday working in order to secure investment from less costly locations in CEE (EIRR, 1996c). The threat was sufficiently real for both the IG Metall union and the Bavarian authorities to allow special dispensation from collective agreements and legislation on weekend working. There are examples of the local workforce being prepared to act in defiance of wider regulatory systems. For example, when a manufacturer of heating systems, Viessmann, planned to construct a factory in the Czech Republic for its new product range, the company's German workforce were sufficiently alarmed to extend their working week without extra pay, a move which led IG Metall to take the company to court for making such a deal without prior approval from the union (a case which the union lost) (*Financial Times*, 1996d).

Only certain industrial sectors have faced pressures from labour market regulation, and the impact on investment strategies have differed depending on the characteristics of the sector. Highly mobile and labour-intensive investments have naturally been most commonly associated with relocation, both through direct shifts of investment and the indirect transfers of production to sub-contracting, largely because they are not burdened with significant sunk assets which raise the cost threshold of closure decisions (Hollinshead and Leat, 1995). However, most cases reported in the media have been in other sectors, particularly mechanical and electrical engineering (and to a lesser extent, chemicals), industries characterized by high levels of 'embedded' capital and skilled labour costs. The apparent contradiction can be explained by the assembly nature of many of these industries. For many, companies are increasingly under pressure from greater global as well as European competition to divide up their production processes and enhance productivity in the individual components. This can involve wholesale transfer of the more labour-intensive parts of production, or in efforts to increase the flexibility and productivity of the core workforce. Such efforts can involve deals to retain labour-intensive production in exchange for flexibility concessions or with the threat - whether explicit or merely understood - of diverting incremental investment to other locations.

The sector that has been most characterized by these trends - in Western Europe as a whole as well as Germany - is the automobile industry. In Western Europe, the industry consists of a mixture of European and international producers with production investments in several countries. The structure of investments differ depending on the company, but in general, European firms have developed a clearer hierarchy of investments, with core value-added activities located in home regions with some mass assembly manufacture located in 'peripheral' areas where production costs are lower. Restructuring pressures on the sector have been intense over the past decade, resulting from a mixture of increasing competition in global markets, greater non-European competition in Europe (especially from Japanese firms, in large part in response to the emerging single market in Western Europe) and the diffusion of new production techniques and working practices (Bordenave and Lung, 1996). Over-capacity in the industry has meant that companies have had to cut back on production - occasionally by closing plants - while developing ways of increasing their productivity, thereby putting more pressure on capacity.

The need to raise plant productivity has been a particularly significant factor in the investment strategies of Western European producers, as there has been a persistent productivity gap with US and Japanese companies. Although performance has steadily improved since 1980, European companies continue to lag behind in terms of the number of

hours to assemble a standard car - in 1993, it took European companies an average of 29 hours, as opposed to 22 for US firms and 18 for Japanese (Ernst and Young, 1997). European companies have trailed US and Japanese firms by other measures of productivity as well, including average production per employee, units sold per employee and revenue per employee. As a result, European manufacturers have experienced the brunt of the resulting restructuring - for EU firms, employment declined by 12 per cent in the decade to 1994.

Strategies for increasing production flexibility have differed among as well as within multinationals. For new investors in Europe, the attraction of sites with low costs and extensive workforce flexibility seems to have been a key factor in location decisions. This has widely been hailed as a major determinant of the UK's success in attracting the bulk of Japanese car investment into Western Europe in the 1990s. Of the five major greenfield investments in car production between 1985 and 1996, three (Nissan, Toyota and Honda) were Japanese investments in the UK, while the other two involved the establishment of plants by national companies in their own countries, Opel (though admittedly owned by the US firm, General Motors) in eastern Germany and a Fiat plant at Melfi in Italy (Ernst and Young, 1997). As noted above, production flexibility and innovative approaches to workforce organization have long been associated with Japanese companies in the UK. Whether Toyota's recent decision to set up a new plant in France heralds a change in this trend remains to be seen.

In terms of the type of flexibility associated with the assembly of parts for car manufacture - ie. numerical and temporal flexibility - new companies appear to have been drawn to environments offering the least restrictions. However, for R&D aspects of production - where functional flexibility and high workforce skills are more important - non-European firms have invested in a wider number of locations. Between 1987 and 1995, Nissan have set up R&D facilities in Germany and Belgium as well as the UK, while Honda chose Germany and Toyota selected Belgium as sites in preference to the UK (Ernst and Young, 1997).

For existing investors, faced with the problem of sunk costs in existing sites, there has been a greater dilemma - deciding between investment in new locations with modern capital equipment and new working practices, or in existing locations, linked to changes in working practices and skills levels. Most companies have adopted a combination of both approaches, but there have been variations in emphasis between firms which have core investments located in a particular site (European companies for the most part) and companies with a group of equivalent plants (especially non-European firms such as Ford and General Motors).

European firms have used both strategies, but with the aim of maintaining the dominance of their core locations. In recent years, several companies have internationalized their production outside of Western Europe, but for production serving the European market, companies have largely concentrated on existing sites (though there are notable exceptions, such as the afore-mentioned Mercedes-Benz establishment of its Swatch model factory in France). However, where new investments have been made, production flexibility has been a key issue. Firms have aimed to take advantage of the new production and distribution techniques popularized by Japanese firms, notably just-in-time and lean production, and to structure investments to maximize the impact of these practices. In some cases, this has led to a spatial centralization of investment, with the clustering of component suppliers around assembly sites, such as the new Fiat plant at Melfi in Italy (Quilley, Tickell and Coates, 1996). Such investments may be made in the same country, but often at different locations in order to develop new working practices in fresh environments. For example, BMW's establishment of a factory at Regensburg in Germany was partly based on the weaker influence of union

power in a rural location, as novel shift and working time systems had to be introduced at the new plant (Wells and Rawlinson, 1994). Indeed, only some aspects of assembly need to be retained within close proximity to this plant, and the manufacture of lesser value-added components has been located according to a wider set of production cost criteria (Bordenave and Lung, 1996).

With existing investments, investment strategies have been used to achieve greater workforce flexibility in existing plants by European companies, especially in Germany. In 1994, Mercedes-Benz decided to locate a new engine factory at its existing German site of Untertürkheim, but only after securing a flexibility deal with its workforce which included longer and more flexible working time (to maximize plant operation) through a system of annualized hours. Temporal flexibility was viewed as necessary to the investment decision, as management had been considering locating the factory in Alsace, where wage costs were up to 30 per cent lower (EIRR, 1994). Another decision on the construction of a different type of engine was also made by the company in favour of an existing German location - Rastatt - but only when the workforce was able to make concessions on shift payments and the use of paid holiday time for training in order to bring its overall costs closer to a rival site in the Czech Republic (IDS, 1996). Similar exposure to the competitiveness of other locations influenced the agreement of greater flexibility in working time between plant workforces and management in BMW, Opel and VW (Schamp, 1995; EIRR, 1995c).

In apparent contrast to European firms, non-European firms have been more willing to carry through threats of lost incremental investments to secure workforce concessions. US companies such as Ford and General Motors have made more active use of differences in plant productivity to press for changes in working flexibility. General Motors was the first major manufacturer to introduce a continuous, round-the-clock shift system following a review of its production system in the late 1980s, using productivity improvements in one plant as pressure to secure agreements the other plants (Mueller and Purcell, 1992). The company explicitly linked further investment at its Ellesmere Port plant in the UK with changes in working practices and bargaining procedures (Wells and Rawlinson, 1994). Ford carried through on an investment threat, 'punishing' its UK plants following a prolonged strike in 1990 at its Halewood site by shifting promised investment to one of its German plants (Hudson, 1995).

The different behaviour of European and non-European firms in the automobile industry points to where regulatory environments have had the most significant impact on industrial restructuring. Non-European investors in sectors where workforce flexibility is important have been drawn to more deregulated environments, at least in terms of their major production investments. Where they made several investments in different countries - as in the case of General Motors and Ford - they often do not have a commitment to concentrating investment in a core location, allowing them to shift - and threaten to shift - investment between plants in line with where productivity and production flexibility can be maximized.

In highly competitive and internationalized industries, this has put greater pressure on European firms to match this productivity growth by increasing the scope for workforce flexibility wherever possible. While this is not a feature of some industries - such as food and drink, where international competition between companies on the one hand, and plants within the same group on the other, is less evident - it does characterize the industries in which Western European competitiveness has been felt to lie (CEC, 1990). At a national level, it has manifested itself in greater labour market deregulation, as recent changes in Italy and Spain demonstrate. At the level of collective bargaining, countries covered by sector-wide agreements experienced a gradual retreat in certain labour standards as unions have made concessions in supporting company demands for greater flexibility, most clearly seen in

Germany.

5. EU labour standards and investment strategies

5.1 Introduction

In many ways, Western Europe presents a smaller model of how the extensive fears and more limited reality of the processes of social dumping may be influencing industrial change on a global scale. National labour standards in Western Europe have had an impact on the way that companies organize their production systems and consequently, their investment strategies. Although the effects have been most evident only at plant level - notably through management securing greater workforce flexibility as part of deals to guarantee the future of particular sites - it has encouraged some convergence in approaches across Western Europe, albeit in a piecemeal fashion. As a result, at national level, these trends have often prompted wider concerns that national systems of employment protection could be eroded by investment flight to lower-standard countries - both inside Western Europe (especially the UK) and outside (CEE countries) - which were most openly expressed during the Hoover controversy in 1993.

The EU has provided a system for setting minimum protection in different areas relating to labour market regulation, such as health and safety, equal opportunities and increasingly, employment protection. Although policy activity has been considerably smaller than in other areas of EU action - such as agriculture and regional development policies - it has been an important feature of the debate on labour market flexibility, both in reflecting the perceived need to remove key regulatory differences in the Community as well as highlighting areas where those differences are most relevant.

Moreover, while EU social policy has largely been inspired by general social welfare concerns, it relates to wider competitiveness and foreign investment issues. Much of the political interest in the direction of EU policy was generated by media reports of the influence of differing labour standards on investment within the EU. Interest has also been developed against a background of European Commission action to prevent governments entering into damaging competitive bidding for mobile investment projects with other policies. In the area of industrial subsidies, the Commission has long operated a strict competition policy which regulates the use of aids to support domestic businesses and attract foreign investments, largely in order to prevent market distortions arising from the unrestrained use of subsidies by Member States in competition with each other. Similar concerns have underlain the EU approach to social policy regulation, even if they have not been manifested in a comparable system of controls.

This chapter considers the role of EU labour standards in industrial restructuring, giving particular attention to whether such issues as the UK's opt-out from the 'Social Chapter' influenced investment patterns. It reviews the background to EU action in the 'social dimension' before examining the impact of existing EU measures in a series of specific areas.

5.2 Recent trends in EU employment regulation

The importance of social cohesion among Member States has long been a major objective of the Community - the founding Treaty of Rome included broad commitments by the Member States to improve working and living conditions - but an active 'social dimension' has only appeared over the last decade. Apart from commitments to non-discrimination in employment policy, the number and range of measures in employment areas have increased dramatically with the agreement to the so-called Social Chapter in the 1991 Treaty of Maastricht.

Activity in this area should be understood in the context of two objectives that dominate

much of policy-making within the EU. The first has been employment creation. It has long been recognized within the Community that Western Europe's unemployment and job creation record compares poorly with that of its main global competitors, the US and Japan. In identifying the obstacles to employment growth in Europe, regulation of trade and capital markets at national level was seen as an area where the Community could effectively take action. This became the main impetus behind the single market project, whose extensive programme of deregulation was hailed as a key step in enhancing the competitiveness of European industry by removing the remaining barriers to trade, investment and factor flows in the Community (Cecchini, 1988). One of the principal results anticipated from the completion of the internal market was an overall increase in the level of employment in the Community.

At the same time, it was stressed that the single market programme should not conflict with the second policy-making objective in the area of employment issues: improvements in social and working conditions (or at least, the prevention of deterioration in those conditions). Consequently, special emphasis was given to harmonizing health and safety standards out of concern that increasing competition among European firms should not lead to worsening employment conditions. To accompany the deregulatory measures of the single market programme, it was increasingly felt necessary within the Community to prevent deregulation taking place in social and employment standards, prompting the landmark statement of objectives relating to a European social dimension in the Social Charter in 1989 (McDonald and Dearden, 1992). Among the commitments listed in the document (signed by all the Community Member States, apart from the UK) were the following areas:

- improvements in living and working conditions, such as employment contracts and the organization of working time;
- fair remuneration of workers not subject to 'normal' employment contracts;
- rights to social security or a minimum wage; and
- rights to information, consultation and worker participation.

The Social Charter formed the basis for the discussions of the social and employment aspects of the Treaty of Union in 1991. New articles in the treaty included employment and social protection, dialogue between European representatives of management and labour on the drafting of specific measures, the development of human resources and reducing social exclusion. Unlike the approach adopted for the single market programme - which aimed at the mutual recognition of differing standards, to be followed by longer-term harmonization - social policy measures were to provide common minimum requirements in the participating countries. Under the Treaty, the Council was allowed to act by qualified majority voting on health and safety issues, working conditions, sexual equality in the workplace and the integration of the socially-excluded into the labour market. Issues requiring unanimous support included social security, protection of redundant workers, representation of workers' and employers' interests, and financing measures for employment and job creation. Pay and the rights of association and striking were specifically excluded.

As a result of the UK Government's opposition to EU action in many of these areas, the other eleven Member States agreed to these issues in a protocol attached to the main body of the Treaty. UK opposition - which came to an end with the incoming Labour government's agreement to the Social Charter in 1997 - became the defining issue of the development of EU social policy during the 1990s. It led to extended, often bitter arguments about the application of its measures to the UK - particularly over working time - and exacerbated the apparent

differences in regulation between the UK and the rest of the Continent. At the same time, political caution on the part of the Commission resulted in the proposal of fewer measures than were originally anticipated at the time of its signing.

5.3 The impact on investment

The impact of the Social Chapter on investment patterns has depended mainly on the extent to which its implementation has changed differences in national labour market regulations sufficiently to influence the investment decisions of multinational companies. This has not only taken place by *removing* existing differences as a result of harmonization, but by *exacerbating* differences between participants and non-participants of the agreement (ie. the UK and the rest of the EU until recently). It is the latter trend that has received the most attention in terms of the effects on investors. As, to date, few regulations have been introduced and made fully operational through the Social Chapter (EIRR, 1996d), the effect on investment patterns was largely expected to derive from a re-enforcement of the UK's existing attractions in terms of a flexible labour market, even if only in terms of image rather than any actual changes resulting from Social Chapter measures.

However, the evidence to support a significant change in the scale or direction of investment is lacking. Certainly, media reports about attractiveness of the UK's opt-out to foreign investors were made use of by the country's inward investment authorities (IBB, 1996). Actual changes to investment decisions were less evident. Businesses located in the UK may have expected the Social Charter to change their working practices more than companies elsewhere in Western Europe - in the Price Waterhouse Cranfield survey, a higher share of firms in the UK anticipated altering their operations because of the Social Chapter than in any other country apart from Spain (Brewster and Hegewisch, 1994) - but investors have not highlighted the Social Chapter in business surveys. In a JETRO (1996) survey of Japanese investors in Europe, nearly 60 per cent even regarded the introduction of one of the key areas of the Social Chapter - works councils - as having an overall positive effect on their business. A common EU labour policy ranked behind environmental regulations as a matter of interest to Japanese investors.

Further, a 1997 report for the European Commission on the UK labour market concluded that "specific measures brought forward under the social chapter of the Maastricht treaty are likely to have very little effect on the UK labour market" (as reported in *Financial Times*, 1997j). This conclusion is strengthened when examining the specific measures with the largest potential for affecting business - notably employees consultation and working time - as well as future areas of action - such as atypical employment. These are reviewed in turn below.

5.3.1 Employees consultation

Initially, the most controversial social policy measures was the European Works Council Directive, which was given full approval by the Council in 1994. The directive required multinational enterprises on a 'Community scale' (ie. those with at least 1,000 employees within the European Economic Area of 17 countries (EEA), including at least 150 in each of two or more of those countries) to establish an information and consultation procedure, usually taking the form of a workers' council. The council would meet at least once a year with management to be informed of current cross-border developments within the company and where significant business changes are being planned. The costs of maintaining this system were to be met by the company.

The aim of the directive was not to dictate the precise procedure adopted by companies, but to ensure that some form of consultation is introduced. Companies were given considerable

freedom to adapt the directive to their organization. Nevertheless, it was still viewed as constraining the flexibility of firms in taking international business decisions as two sets of criticisms were levelled. First, it was argued that the directive would impose direct costs on companies as they had to pay for the consultation meetings. Second and more importantly, establishing the procedures could increase several indirect and uncertain costs for the company, as management's freedom to change workforce size and conditions would be more circumscribed. By the directive, workers councils were entitled to know about any corporate reorganization that would involve changes in employment levels through cross-border shifts of production and the introduction of new production methods. While the councils would not be able to prevent management taking any decisions that would reduce the workforce or their pay conditions, the process of informing and consulting could delay decisions that might be important to implement quickly. Planned closures or plant reductions could not be prevented, but widespread dissemination of company plans might allow local (and national) resistance to the business decisions making their implementation more costly (if not jeopardizing them altogether). Even over less adversarial issues, the directive could make it difficult for companies to make major business decisions where speed was crucial.

Evidence that workers councils would greatly influence production flexibility and perhaps investment strategies has been weak. Research by Hall *et al* (1995) showed that of the 458 companies in Western Europe to whom the directive would apply, 41 had not only established workers councils already but had had largely positive experiences with them. In the case of the UK, the directive's criteria already applied to many multinational companies based in the UK through the subsidiaries and plants located elsewhere in Western Europe. Although UK workers would not formally be subject to the directive, several firms companies decided to set up workers councils that included their British workforce.

5.3.2 Working time

A greater controversy arose over the Working Time Directive, though mainly because of the fact that it *does* apply to the UK. Introduced as a health and safety rather than a strictly Social Chapter measure, the UK was compelled to adapt it, once the European Court of Justice ruled against the British Government's objections to its application.

Although several EU countries have been to make the necessary changes to their national legislation, in theory, it could have a significant impact on temporal flexibility in Europe. The directive required Member States to adopt a number of provisions:

- a maximum length of working week of 48 hours (including overtime) on average;
- rest breaks after six hours of consecutive work;
- rest periods of 11 hours daily and 35 hours weekly (including Sunday in principle);
- an average eight-hour shift for night workers; and
- a minimum four weeks' annual paid leave.

The force of the directive was weakened by a series of exemptions covering type of job (such as managers and family workers) and task (such as work necessitating permanent staff presence or accident emergency responsibilities). The 48-hour maximum could be averaged over a year, giving companies greater flexibility, and over an interim period, workers could agree voluntarily to work longer hours.

However, the directive's impact may rise in future. The Commission has announced its intention of trying to close many of these loopholes in future measures (*Financial Times*, 1997k). This could lead to significant readjustments in countries where a significant proportion

of labour work over 48 hours a week, notably Ireland and the UK. Consequently, while the effect of the directive may be limited at present, its longer-term ramifications could lead to a substantial reorganization of working time in certain British manufacturing sectors. Moreover, the effects may be more substantial for some non-EU Western European countries. For example, a business survey of attitudes to the effects of EU social policy on working hours and shifts showed that the highest shares of companies anticipating changes were in Switzerland and Norway, as well as the recent EU entrant, Sweden (Brewster, Hegewisch and Mayne, 1994b).

5.3.3 Future changes

In recent years, the two objectives of EU policy-making in employment areas - job creation and job protection - have been pursued in parallel. Employment creation has resurfaced in the EU's policy agenda in response to the persistence of relatively high unemployment in Western Europe. A series of Commission initiatives to mobilize EU resources for job creation have been forthcoming as Single market policy activity has diminished, most recently through its 'Employment Agenda for the Year 2000' with its emphasis on demand growth measures (such as boosting EU venture capital sources) (CEC, 1997c). Recent EU approaches to employment protection have aimed to accommodate this renewed priority by arguing for reductions in working time (as part of a reorganization of work to create new jobs) and encouraging greater functional flexibility through upskilling (CEC, 1996b). As both policy objectives have been subject to widespread criticism - especially from proponents of the UK's liberal market approach to numerical and temporal flexibility (see, for example, *Financial Times*, 1997i) - the future of the EU social dimension (and consequently, its potential impact on restructuring processes) remains unclear.

Nevertheless, areas have been proposed for action within EU social policy in the coming years. The two likely to have an impact on industrial restructuring relate to atypical work and national consultation procedures.

(i) *Atypical work*

EU measures on atypical employment have not been fully agreed, but specific areas have been identified for action (*Financial Times*, 1997k). Proposals that are currently under discussion include providing some part-time and temporary employees treatment equivalent to full-time workers as regards vocational training, social security rights, holiday and leave allowances, and dismissal protection (Addison and Siebert, 1992). Although the effects on companies will depend greatly on the final measures agreed, EU action in these areas could potentially influence numerical and temporal flexibility in many countries.

By increasing the cost of using atypical employment for many firms, it has been argued that it could reduce the competitiveness of firms that rely heavily on this type of employment. For example, measures to protect part-time employment could lead to significant restructuring in the UK (assuming any final measures are applicable there), the Netherlands, France and Ireland, given the high share of part-time employment in their workforces and the relatively lack of restrictive regulations. For fixed-term contracts, the impact on Spain, where this form of atypical employment accounts for a large share of labour, could be particularly widespread. In a survey of company attitudes to potential EU social policy measures, Spain had the highest share of businesses which anticipated changes to their use of atypical employment as a result of new measures (Brewster and Hegewisch, 1994).

(ii) *National-level information and consultation*

Discussions have been taking place at the EU level on the possibility of introducing measures to ensure that worker information and consultation procedures, similar to those operating in the European Works Council Directive, are implemented at national level (EIRR, 1996d). Depending how any proposed directive is framed, the effects of such a measure could be more extensive than the existing directive for international information and consultation, as more companies might be affected by the new legislation. The nature of the effects can be expected to be similar, though again, the crucial question is likely to be to which countries will the policy measure be applied.

6. Policy implications

Among several academics and policy-makers, concerns have been expressed in recent years that the internationalization of economic activity has put pressure on labour standards worldwide. As multinationals take advantage of lower barriers to capital movements, of changing production and distribution technologies, and global marketing strategies, the argument has been put forward that a form of regulatory arbitrage has taken place, as some mobile investment has been attracted to environments with relatively low levels of regulation. Such production transfers have not only heightened the awareness of the interaction between labour standards and investment flows, but also more generally of that between labour market regulation (including legal systems of employment protection and collective bargaining structures), workforce flexibility and corporate competitiveness. Despite limits being set at national level within which labour markets should operate, greater trade and investment integration between national economies is allowing a degree of leakage through both investment relocations and the potential cost disadvantage to firms based in higher-standard countries. The question is whether the seepage is likely to be long term and large enough to undermine higher labour standards.

On a global level, the threat has been exaggerated; it seems that economic globalization has not created serious threats to labour standards. Although many firms appear to value the differences in standards, most international production investment decisions continue to be swamped by other factors. Access to strong markets and key sources of productivity growth (especially labour skills and production technologies) has tended to concentrate the majority of investment activity among industrialized countries with similar labour standards. While some investment relocation continues to take place, it is limited to a few sectors, mainly labour-intensive industries such as textiles and clothing, which represent a declining share of employment and output in industrialized countries.

Within a more limited region though, labour standards may have a more magnified impact. In Western Europe, with the increasing integration of national markets and greater similarity (at least as compared to the whole world) in technology and productivity levels, the role of regulatory factors has been heightened in recent years. With many industries undergoing deepening restructuring, these factors can be expected to determine production changes in individual plants as well as shifts in investment between different plants.

In this study, two sets of effects have been identified. First, labour standards have influenced the course of industrial restructuring in several key ways. In industries where improvements in productivity through greater production flexibility are central to business competitiveness, location decisions on new production investment have often been influenced by the degree of temporal and numerical flexibility in the workforce. Countries such as the UK have even marketed themselves to potential investors on the basis of their reputation for deregulated labour markets and a 'flexible' labour force.

The impact of other types of flexibility on investment strategies has been more ambiguous. The attractions of a highly-skilled and productive workforce have operated in favour in countries traditionally associated with functional flexibility, as witnessed by the success that Germany has had in attracting R&D investment. Although receiving none of the major production investment from Japanese automobile companies in Western Europe, Germany has still secured major R&D investment from Honda and Nissan as well as the Korean producer, Daewoo (Ernst and Young, 1997). However, R&D investment decisions are subject to a more limited set of determinants than are production investments, such as the location of specific industrial and technological clusters. Moreover, functional flexibility may be converging across Western Europe; research by Mueller (1992) points to a common approach to enhancing the skills level of individual workers in the automobile industry - as much in countries in which functional flexibility has been regarded as limited (notably the UK) as in countries like Germany. With the diffusion of new working practices and the skills requirements of new production technologies in many industries, it is becoming increasingly difficult to speak of a trade-off between the different types of flexibility (and consequently, the different kinds of investment) advocated by various European countries.

The issue of convergence in workforce flexibility approaches leads into the second set of effects considered in this study. Not only have labour standards influenced investment decisions in Western Europe, but investment strategies have in turn catalysed changes in regulatory systems. Under the pressure of industrial restructuring, companies with existing investments in more regulated countries have frequently used the threat of withholding the incremental investment necessary for plant developments (and in the longer term, survival) in order to widen their scope for increasing workforce flexibility. In some cases, these manoeuvres may represent strategies by multinationals to force productivity improvements across all plants - usually non-European companies - but for firms with core European locations, they are part of more cooperative attempts by both management and workforce representatives to maintain the competitiveness of key plants compared to other companies, not just to other plants within a multinational group. The process has been most dramatic in Germany, where companies have won a series of concessions in collective bargaining over working time issues, leading to a wider questioning of the German approach to employment regulation.

As a result of these pressures, labour market regulatory systems in Western Europe appear to be converging. While the scale of social dumping that was predicted during the aftermath of the 1993 Hoover relocation has been greatly overestimated, in essence convergence has largely been taking place through a partial erosion of labour standards. In particular, many Continental systems are beginning to emulate the UK approach in areas of temporal and numerical flexibility. Countries such as France, Italy and Spain have started to examine what areas of the labour market should be deregulated, while at the same time, nearly all Western European countries have been seeking ways of reducing the cost of employment protection to businesses.

Under these circumstances what are the implications for the future development of employment policy in Western Europe? Is competitive deregulation likely to result in a further levelling of standards in Europe? The three areas of regulation where this might take place are considered in turn below: collective bargaining (sectoral and enterprise level regulation); national labour standards (national regulation); and EU labour standards (international regulation).

Collective Agreements

The ability of companies to negotiate at the level of the enterprise is increasing in Western Europe. In the UK and Ireland, the absence of national or sector-wide collective agreements and the weakness of trade union legislation has resulted in a diversity of practices, including centralized bargaining for different plants within a company, plant-level negotiations with workers representation and in the case of non-unionized companies, relatively little negotiation between management and workers. Even where companies have plants in countries with stricter collective bargaining procedures, an increasing use has been made of productivity measures of individual plants. This underlines a greater focus on the factors influencing the performance of specific plants and the ability of companies to make whatever changes are regarded as necessary to enhance that performance, irrespective of the constraints imposed by external regulation.

Nonetheless, this is unlikely to lead to the undermining of collective bargaining systems throughout Western Europe, at least in the medium term. In Germany, the system appears to be proving relatively robust. It has provided a mechanism for negotiating the changes in workforce flexibility necessary to maintain competitiveness in German companies and plants without a rapid disintegration in pay and working conditions. In contrast to the sometimes bitter character of similar negotiations in firms in the US, it appears that a constructive approach has been accomplished in Germany by both management and unions, though whether it will continue to remain so is difficult to ascertain. The pressures on the German labour market remain, while some unions - in France as well as in Germany - are advocating further restrictions in flexibility with calls for shorter working weeks, a contentious issue among many employers.

National Labour Standards

For many countries, further deregulation of labour markets is bound to occur. For example, it has been widely accepted in Italy and Spain that national labour standards will need to be reformed further, once the political difficulties associated with such changes can be overcome. Continuing high levels of unemployment and increasing pressure on industrial restructuring is likely to maintain the policy debate on the scope for increasing workforce flexibility.

This may produce convergence in some areas of labour market regulation, but not a widespread adoption of the UK approach. Areas of flexibility which affect companies' ability to take on more employment will probably receive most attention from policy-makers. These include employment protection legislation - especially regulation of dismissals - as well as working time restrictions (particularly where they affect the ability of companies to operate continuous shifts). For example, in an EU survey in 1995, insufficient flexibility in shedding staff was identified as a more significant obstacle to increasing employment by companies than any other regulatory factor (CEC, 1995b). Changes in these areas may forestall the need to alter other areas of regulation, such as the rights of part-time and temporary workers.

EU Labour Standards

So far corporate investment strategies have had as great an, if not a greater impact on the harmonization of labour standards in Western Europe as EU social policy. If anything, the latter may have exacerbated differences in labour standards by highlighting the gap between UK and Continental approaches to regulation in well-publicized disputes on the application of EU measures.

With the agreement of the UK to the Social Chapter, it is still not clear to what extent

EU social policy will do more than ratify any existing convergence in labour standards. However, as with other EU policies, the institutional mechanisms of policy have often preceded its active formulation and application. A more active social policy is by no means unlikely, especially if - as occurred in the case of industrial subsidies - labour standards were found to distort greatly industrial competition and the location of investment. While the chances of this occurring in the current EU appears to be diminishing, enlargement into Central and Eastern Europe - where competition for investment on cost and regulatory grounds may increase - could renew the need for an international regulatory body within a wider Europe.

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