

**THE POLITICAL ORIGIN OF EMPLOYMENT PROTECTION:  
A COMPARATIVE STUDY OF THE UNITED STATES, GERMANY, AND  
SOUTH KOREA**

by

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# **THE POLITICAL ORIGIN OF EMPLOYMENT PROTECTION: A COMPARATIVE STUDY OF THE UNITED STATES, GERMANY, AND SOUTH KOREA**

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University of Pittsburgh, 2007

Why do countries have different levels of employment protection that make dismissals difficult? The recent comparative political economy literature is divided over whether labor protection is an outcome of class struggles or employers' rational choices. This dissertation provides an alternative explanation focusing on the role of counter-majoritarian political institutions. While theories and empirical evidence do not support the argument that some employers may support employment protection as government regulation, the power-of-labor-resources model is also limited because it does not explain the deviant cases where politically weak labor co-exists with strong employment protection. This study offers an analytical model in which vote-maximizing politicians respond to the popular pressure to establish employment protection that mainly comes from organized labor and/or the rising risk of middle-class job loss. It is argued that even if the popular pressure is strong, political institutions designed to limit the rule by the many – federalism and judicial review – constrain the popular demand for employment protection to become legislation. The empirical chapters examine the United States as a weak-employment protection case, Germany as a strong-employment protection case, and South Korea as a moderately strong-employment protection case. They demonstrate that the American political system where political power is dispersed to different branches and levels of government forestalled the rise of employment protection, while South Korea's highly concentrated political system responded to the public perception of declining job security by maintaining restrictions of

layoff. Germany represents a distinct model of federalism where labor legislation is centralized and subnational governments rely on extensive measures of fiscal equalization. In this type of federalism voters can readily attribute the responsibility of providing job security to the central government. Therefore, the German federalism has not provided effective checks on the popular pressure for employment protection.

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## **1.0 INTRODUCTION**

### **1.1 WHY STUDY EMPLOYMENT PROTECTION?**

Job security is a prominent topic of debates among experts in labor markets and comparative political economy around the world at the turn of the twenty-first century. In the United States, where the wave of deindustrialization during the 1970s and 1980s displaced millions of workers from their jobs, there is a growing concern that global outsourcing of brains is now threatening the job security of even high-income, professional workers. Between January 2001 and December 2003, 5.3 million American workers whose job tenures were three years or longer were laid off (Butcher and Hallock 2006). Academic research confirms the public perception that the job insecurity of American workers has significantly deteriorated between the 1970s and 1990s (Cappelli 1999; Schmidt 2000; Valletta 2000). Uchitelle (2006: iv) ruefully says, “the permanent separation of people from their jobs, abruptly and against their wishes, gradually became standard management practice in the United States.”

Although individual workers’ jobs are less secure, the United States has recently outperformed Continental European countries with respect to unemployment as an aggregated labor market outcome. As Figure 1 shows, the U.S. unemployment rate since the early 1990s has been significantly lower than the average unemployment rate of eleven West European countries and especially Germany.

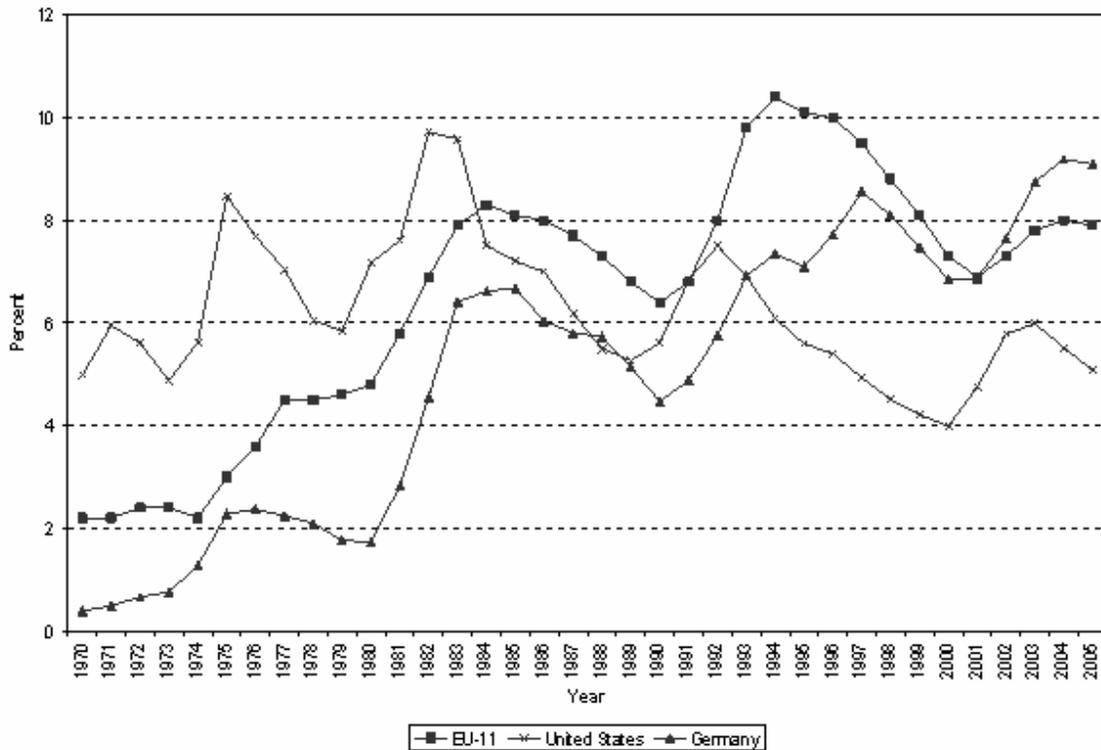
Large-scale layoffs have been rare in the Continental Europe for the most of the last century. Houseman and Abraham (1995)'s seminal work shows that while American firms primarily resorted to flexible layoffs as a response to overcapacity during 1973-1990, German firms maintained employment security through spreading available work or reducing work hours. When there was compelling need for a permanent reduction of workforce, German firms accomplished job cuts through natural attrition instead of firing redundant workers. Major German firms have been very conservative in executing layoffs. Thus, a Volkswagen employee said: "VW tries never to lay off" (Shlaes 1994: 114).<sup>1</sup>

Although this VW employee seems much better off than American auto workers, the pitfall of this strong job security seems to be that "it's much harder in Germany than in the U.S. to find a new job if you lose one."<sup>2</sup> Unemployment has progressively increased in Germany since the 1970s (See Figure 1). It finally reached a postwar record in March 2005 when 5 million working-age people or 12.7 percent of civilian labor force were jobless in seasonally unadjusted terms (Federal Statistical Office of Germany). Commentators have named this high and persistent unemployment a "German disease" (Werner-Sinn 2003; Wall Street Journal 2005), and labor market reforms to reduce unemployment are one of the top policy agenda.

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<sup>1</sup> Recently Germany's flagship companies such as Siemens and Volkswagen have planned large-scale job cuts. In June 2004 Siemens sought to move 2,000 jobs producing mobile phones from North Rhine-Westphalia to Hungary. The company eventually aborted the plan but instead it forced IG-Metall, Germany's largest industrial union, to accept extended weekly working hours without overtime pay ("Siemens Deal Launches Debate on Longer Working Hours." European Industrial Relations Observatory Online. Accessed November 11, 2006. <<http://www.eiro.eurofound.ie/2004/07/feature/de0407106f.html>>). As large German employers finally began to exercise a long-foregone option, that is, relocating their production sites to low-labor-cost countries in Eastern Europe, it appears that the job security of German workers is being eroded. The recent survey data from the German Socio-economic Panel Study shows that the confidence of employees in job security declined between 2001 and 2003 ("Working and Employment Conditions in Germany." European Foundation for the Improvement of Living and Working Conditions. 2006. Accessed February 25, 2007. <[http://www.eurofound.eu.int/ewco/surveys/DE0503SR01/DE0503SR01\\_7.htm](http://www.eurofound.eu.int/ewco/surveys/DE0503SR01/DE0503SR01_7.htm)>). This raises questions of whether German employers are copying the American employers' cost-cutting strategy of shedding redundant workers and whether the German capitalism will eventually converge with American capitalism.

<sup>2</sup> "The German Disease." Wall Street Journal. New York, NY. January 10, 2005, p. A12



**Figure 1** Price of Job Security?: Cross-country Comparisons of Unemployment Rates

Note: The statistics are seasonally adjusted. EU-11 includes Belgium, Germany (West Germany before 1991), Spain (since 1977), Finland, France, Greece, Italy, Netherlands, Norway, Portugal, and Sweden.  
 Source: OECD Economic Outlook, various years.

Economists have paid attention to the role of employment protection to explain these striking cross-Atlantic differences of job security and other labor market behaviors.<sup>3</sup>

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<sup>3</sup> Here I define employment protection as legal restrictions on employers' right to terminate employment relations at the employer's discretion. Therefore, employers' voluntary retention of employees is excluded from the definition of employment protection for this study. OECD (2004) provides the most reliable source of comparative data about employment protection across OECD members and I draw from the OECD definition of employment protection. OECD (2004) constructed a composite index of employment protection legislation (EPL) for regular employees under permanent contracts based on procedural inconveniences, advance notice and severance pay requirements, and difficulty of dismissal. While the EPL index used here mainly refers to the statutory protection against dismissals provided by the government, it also includes protection through the collective agreements to which governments provide a quasi-legal character. The OECD data excludes public sector employees because their employment status tends to be governed by public administration laws distinguishable from private labor laws. I also exclude the regulation of temporary workers that the OECD data cover because countries tend to deregulate the use of temporary workers in an attempt to eschew, not to deal with, the reform of firing restrictions on permanent workers.

Employment protection clearly distinguishes the United States from Germany: the level of employment protection in the United States is lowest among twenty-eight OECD countries while Germany provides the sixth-strongest employment protection in the same group (OECD 2004).<sup>4</sup> Some economic literature suggests that employment protection increases firing costs and therefore induce firms to refrain from adjusting employment to changes in demand through layoffs (Bentolila and Bertola 1990; OECD 1999). Although the effects of employment protection on overall labor market behaviors are still debated (See Buechtemann 1993),<sup>5</sup> experts tend to agree on the following arguments. First, employment protection weakens business demands for labor and therefore deters job creation in private sectors (See Garibaldi and Mauro 2002; Siebert 2004). Second, once adverse shocks give rise to high unemployment, employment protection makes high unemployment persist (See Blanchard and Summers 1988; Blanchard and Wolfers 2000). Finally, strong employment protection will induce firms to resort to atypical types of employment to avoid legal dismissal restraints, and this choice will encourage the differentiation of labor markets into two segments between the one for regular, full-time workers with decent pay and greater job security and the other for part-time, temporary low-skilled workers with low wages and weak job security (See Lindbeck and Snower 1990; Saint-Paul 1996).

Restrictions on layoff have become a political controversy in South Korea since the mid-1990s. In the time before the mid-1990s Korean big business provided lifetime employment and therefore layoffs were implemented mostly in small-medium firms. Lifetime employment as an

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<sup>4</sup> It should be noted that the OECD measure of German employment protection does not consider the effect of codetermination through the company board on layoffs. If this codetermination rule is considered, the strictness of German employment protection will increase.

<sup>5</sup> For example, Lazear (1990) and Scarpetta (1996) argue that employment protection increases unemployment, while Nickell and Layard (1999) find that their relationship is not statistically strong.

implicit corporate practice was weakened as economic growth was diminished during the 1990s and it was finally dismantled as the 1997 economic crisis ended the belief that chaebols, Korean business conglomerates, were too big to fail. Since the 1997 economic crisis, chaebols have become increasingly interested in adjusting the level of employment to increase corporate profits. The idea of working-time reduction widely accepted by German employers has never gained popularity among Korean employers (Cho 2004). However, chaebols have used early retirement plans rather than redundancy dismissals as a principal means to reduce workforce, which is distinct from the American case (Jung and Cheon 2006: 466).

South Korea provides a fairly stringent legal protection of standard workers against dismissal, which is stronger than the OECD average (OECD 2004). Although there has been little scholarly research about the economic effect of this regulation of dismissal in South Korea, business groups and the International Monetary Fund that provided bailouts in the 1997 economic crisis have put the relaxation of the regulation of dismissal as a condition for creating new jobs and halting employers' increasing use of nonstandard workers whose job security is rarely protected by law (FKI 2004; IMF 2004).

Despite the policy significance of employment protection and heated debates over its labor market effects, there has been surprisingly limited effort to answer where the employment protection came from. This study has been motivated to fill this theoretical gap. Based on the theoretical explanations this study draws on, it also aims to provide implications for whether and how Korean employers' preferences for long-run employment have been affected by the recent economic crisis and whether the cutback of employment protection regulations in South Korea will be likely in the foreseeable future. In this dissertation, I develop and apply a political institutional approach to explain the rise of employment protection in the United States,

Germany, and South Korea by using comparative case studies, that is, comparing a few cases. But a simple cross-country comparison is inadequate to explore the origins of employment protection. Therefore, I will combine cross-case comparisons with within-case comparisons to determine when employment protection was first established in each case. This longitudinal approach will also increase the number of observations and hence help discriminate between competing hypotheses.

## **1.2 EMPLOYMENT PROTECTION IN POLITICAL SCIENCE**

This study is firmly rooted in the contemporary political economy literature about the welfare state. Political scientists have long sought to answer the question of what accounts for the cross-country differences of the welfare state. A number of scholars have used a quantitative approach to find out whether domestic political variables affect government welfare spending against the effect of international economic integration since the early 1970s.<sup>6</sup> One weakness of these large-N studies is that their focus on aggregated government social spending as the dependent variable

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<sup>6</sup> The effect of globalization on social policy in advanced industrial democracies is a well-researched area. Cameron (1978) and Rodrik (1998) emphasize the positive effect of economic openness on the expansion of welfare states. As a variant of this globalization approach, Garrett (1998) argues that the welfare expansion effect of economic openness is conditional on the domestic distribution of power, especially the strength of the political left. But current research suggests that various domestic political factors have independent effects on government welfare spending. The partisanship literature focuses on the role of left parties and Christian centrist parties (Hicks and Swank 1992; Huber, Ragin, and Stephens 1993; Hicks 1999; Huber and Stephens 2001). Political institutional explanations pay attention to the roles of different types of democratic political systems (Birchfield and Crepaz 1998; Crepaz and Moser 2004), electoral institutions (Persson 2002; Iversen and Soskice 2006), and constitutional structures (Swank 2001; Castles 2004).

More recently, scholars began to study the effects of globalization and domestic politics on welfare states in less developed countries. Rudra (2002) points to the negative impact of globalization on welfare spending, but she suggests that the political power of labor measured by the share of skilled labor makes a difference in welfare spending. Another domestic political variable that scholars increasingly link to government social expenditures is the role of political regime types (Kaufman and Segura-Ubierno 2001; Brown and Hunter 1999, 2004; Avelino, Brown and Hunter 2005; Rudra and Haggard 2005). Empirical findings show that democracies increase government social spending, especially on human capital formation.

disregards qualitative, structural traits of welfare states (Esping-Andersen 1990: 19). Even same levels of government social spending do not produce invariable social policy outcomes, but they are used to fund distinct configurations of welfare programs in different countries. Esping-Andersen (1990)'s classification of welfare capitalism into liberal, conservative, and social democratic welfare regimes conveys the idea that welfare states are not simply government expenditures, but they are institutions of the "ways in which welfare production is allocated between state, market, and households" (Esping-Andersen 1999: 73). Similarly, Hall and Soskice (2001)'s influential work on comparative capitalism provides a broader distinction of welfare capitalism embedding redistributive institutions into overall capitalist institutional arrangements.<sup>7</sup> Hall and Soskice's innovative contribution to the new political economy is that each type of capitalism comprises a cluster of interconnected social and economic institutions supporting each other. This notion of institutional complementarities makes a strong case for institutional stasis: globalization is not making varieties of welfare capitalism converge into a lean welfare-state model, but their institutional diversity will persist.<sup>8</sup>

The continuity and change in welfare states remains a relevant research program. However, I argue that it should be complemented by research of where the institutional characteristics of existing welfare states come from. There are quite a few political scientists interested in explaining the historical emergence of landmark social policy. Skocpol (1992) explains the origins of social policy in the United States through the role of the World Wars.

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<sup>7</sup> Hall and Soskice do not distinguish Esping-Andersen's conservative and social democratic welfare states but merge them into "coordinate market economies" as opposed to "liberal market economies."

<sup>8</sup> While Hall and Soskice provides a functionalist system theory approach, Pierson (1996) and Moene and Wallerstein (2001) examine how different welfare-regime types shape the political support for social policy. They find that the median voters in the welfare regimes based on universal social citizenship rights will support their existing welfare programs against the globalization pressure for welfare retrenchment because they see welfare cutbacks hurt them. In contrast, median voters in welfare regimes targeting benefits to low-income people are likely to tolerate welfare cutbacks because they perceive welfare cutbacks will hardly affect them.

Swenson (2002)'s pioneering contribution to the employer-side account of welfare states addresses the puzzle of why the Swedish welfare state developed later than the American welfare state in spite of its strong social democratic politics. Similarly, Mares (2003) explains the adoption of major institutions of social insurance in France and Germany from a cross-class alliance perspective. Thelen (2004) finds that cross-class alliances played an important role in the establishment of skill formation systems in Germany and Japan, but not in Britain and the United States. But she also notes that characters of political regimes conditioned the political settlement between industrial workers and their employers.

This study builds on the research tradition focusing on the origin of social policy and extends the locus of analysis to labor market policy. The major difference between social policy and labor market policy is that the latter directly regulates transactions in labor markets, while the former aims to ameliorate social consequences of such labor market transactions *ex post*. The current political economy literature about welfare states stresses the linkage between social policy and labor market policy (Esping-Andersen 1990; Kolberg and Esping-Andersen 1992; Esping-Andersen and Regini 2000; Scharpf and Schmidt 2001; Bonoli 2003). They highlight varied ways of delivering employment and income security to wage-earners other than traditional social transfers. For example, employment protection could be seen as functionally equivalent with unemployment insurance because employment protection reduces unemployment risk. However, there are few works on the origin of employment protection done explicitly by political scientists. I will examine to what extent existing theories developed in the comparative welfare state literature can be applied to explain the rise of employment protection in Chapter 2.

### **1.3 POLITICAL ECONOMY OF EMPLOYMENT PROTECTION: THE ARGUMENT IN BRIEF**

The current comparative political economy literature emphasizes that formal political institutions provide incentives and constraints that induce political actors' policy choices (Persson and Tabellini 2002; Hallerberg 2004). Drawing from this approach, this study provides a political institutionalist explanation for the rise of employment protection.

The main argument of this dissertation is that employment protection is a product of the interplay between popular pressures and counter-majoritarian political institutions (CMPIs). Popular pressures are a necessary condition but not a sufficient one for employment protection: strong CMPIs limit politicians' choice for employment protection. CMPIs are political institutions constitutionally designed to constrain the rule of the many and the policy-making out of democratic impulses. The notable examples are federalism and judicial review. These political institutions lead to territorial and functional fragmentations of political power. As a result, it becomes very difficult for the political majority in the national legislature and the majority public opinion in the country to control policy-making processes under strong CMPIs.

The reason why institutional mechanisms to counteract the power of the majority matters for employment protection is that political elites may well attempt to regulate layoffs for the purpose of winning or maintaining political power. Historically countries experienced the kind of employment relations in which the state did not provide protection of workers against dismissal but the master-and-servant perspective was prevailing: the employer's right to fire employees was not regulated by political power. It was through industrialization and the formation of urban working classes that political elites faced popular pressures to intervene in labor markets to protect workers' job security.

Drawing upon the median voter literature, I argue that the consent of middle-class workers comprising white-collar workers and high-skill blue-collar workers is a crucial political condition for those who support employment protection to become the majority. Traditionally, these middle-class workers – especially white-collar workers – have been characterized by greater identification with management and economic privileges such as greater job security, higher earnings, and corporate welfare benefits that were unavailable to low-skill blue-collar and service workers. While the effect of employment protection is unambiguously positive for the lower-class workers, it is double-edged with respect to the middle-class workers. Employment protection could marginally strengthen their job security, whereas it could bring cutback pressures on their privileges indirectly through strengthening the organizational base of lower-class workers and increasing compensation to the proletariat in the same firms. Employers will be forced to adjust the privileges provided to the middle-class workers to maintain profit levels if they face wage increases for the lower-class workers.

My argument is that the organizational power of middle-class workers and/or the risk of their job loss are the two major factors that facilitate the alliance between middle- and lower-class workers on employment protection. If white-collar workers and craftsmen are well-organized, the fear of middle-class workers of the boomerang effect of employment protection on their traditional privileges will be reduced because they expect their own unions will play as checks against potential cutbacks. The strong union activism among middle-class workers likely reflects the overall labor power in the country, considering that middle-class workers, especially white-collars, are less prone to unionize than lower-class or blue-collar workers because of their greater identification with management and greater mobility between firms and jobs (Oskarsson 2003: 620).

Unemployment shocks that affect the job security of middle-class workers are also expected to encourage the cross-class alliance between the workers differentiated by occupations and skills. If the national economy suffers mass job losses and the public perception of job insecurity is severely worsened, the marginal utility of employment protection for middle-class workers will increase. The result is higher demand for employment protection among middle-class workers.

However, the cross-class alliance for employment protection within labor is not the end of our story. The empirical chapters of this book demonstrate that unitary political systems as in South Korea are more likely to be penetrated by popular pressures for stronger employment protection when one of the two conditions for a cross-class coalition within labor. In contrast, two kinds of CMPIs that originated from the United States play significant roles in channeling the popular pressure for greater employment protection to political systems.

First, federalism may work against the establishment of employment protection, but it depends on what type of federalism the political system has. The American-style, competitive federalism forestalls employment protection because interstate bidding for business investment in a federal system hampers the state ability to adopt legislation restricting the management right to layoff. Interstate competition also keeps the central government from making comprehensive regulations of layoff because of distributive conflicts between states winning and losing jobs resulting from corporate migration. In contrast, the German-style, interlocked-jurisdictional federalism is permissive of policy-making out of democratic impulses. In this political system, strong central legislative power reduces the prisoners' dilemma that would result in the race to the bottom among constituent states. In addition to the centralization of labor legislation, the fiscal federalism based on the pooling of tax revenues and interstate fiscal equalization makes

comprehensive national labor market policy more likely because poorer states will not oppose federal efforts to level out interstate differences of employment protection. Such interstate fiscal arrangement distorts the incentive structure of federal employment protection legislation for states in different economic conditions because it makes poorer states underrate the potential cost of strict federal employment protection legislation on regional economic development in the expectation of interstate compensation.

Second, a politically independent judiciary will be able to override employment protection legislation and to protect the freedom of contract and enterprise through judicial review of the constitutionality of employment protection legislation. However, the extent to which a judiciary can actually constrain legislative actions by democratic government depends on the prevailing ideologies of judges and founders of the constitution the judges seek to protect. If judges are leftist, they are more likely to deliver decisions sympathetic to labor. Also, if the creators of a constitution intended labor legislation to be centralized and recognized government intervention for the protection of labor, the judges are likely to accept employment protection as constitutional.

The CMPIs framework is applied to define the different types of democratic political systems and therefore confronts a measurement problem for dictatorships. Dictatorships are not necessarily associated with either weak or strong CMPIs. One might argue that dictatorships have a counter-majoritarian character in that the preference of dictators can prevail over those of the majority citizens in making public policy. Yet dictatorships concentrate political power in the hands of one or a few and hence lack the degree of division of power that could warrant CMPIs. I argue that the effect of dictatorship on employment protection depends on the preference of dictators and the degree of political openness allowed in the regime: all other

things being equal, employment protection is likely to be weakest in a hard dictatorship with rightist leaders and strongest in a hard dictatorship with leftist leaders.

#### **1.4 PLAN OF THE BOOK**

Chapter 2 critically reviews existing approaches and presents the main theoretical framework for this study. I will create a hypothesis from this theory and elaborate the research method to test the hypothesis.

Chapters 3 and 4 examine the case of the United States. The ease of firing workers under the employment-at-will law has been a distinctive feature of American employment relations. Although few employers over the world welcomed government interference with the managerial right to dismissal, the peculiar hostility of American employers toward employment protection can be seen as a result of the institutional characteristics of American capitalism: preeminence of securities in the American corporate finance, weak firm-based skill formation, and fierce competition in product markets, as the varieties-of-capitalism argument explains. Moreover, the cross-class alliance for employment protection within labor has been relatively weak in the United States. Although the organizational power of American blue-collar workers grew rapidly during the World War II, the growth of unions for their white-collar colleagues retarded. Craftsmen were often co-opted by management to become supervisors who were not allowed to join unions by law. However, the United States could have had a degree of employment protection when there were serious middle-class job losses such as in the Great Depression and massive closures of establishments during the 1970s and '80s. This chapter demonstrates that the American federalism characterized by inter-governmental competition and the politically

independent judiciary claiming the authority of reviewing the constitutionality of legislation checked the popular pressure arising from mass job losses for regulating dismissals from being legislated.

Chapter 5 looks at the German case. Germany provides an important counter-case against the United States. First, since the Weimar Republic, German middle-class workers showed greater propensity to organize than the American counterparts except for the Nazi period. White-collars have their own independent unions and craftsmen played a central role in strengthening industrial unions. Thus, the cross-class alliance for employment protection within labor has been much stronger in Germany than in the United States. Second, although Germany is nominally grouped with the United States in the federal state, these two federal systems are of different kind. The centralization of legislative power and the fiscal equalization scheme makes the German federalism way part with the American federalism. Chapter 5 demonstrates how this political institutional difference failed to preclude the popular pressure for employment protection from influencing policy outcomes in Germany.

Chapter 6 focuses on the case of South Korea, where large firms traditionally provided lifetime employment. The right-wing dictatorships during the 1970s and '80s provided employment protection through administrative guidelines that implicitly compelled chaebols not to implement mass layoffs in major economic crises. In 1987 South Korea became a democratic political system, which had a strong unitary character. Entering the 1990s, chaebols began to perceive lifetime employment to be a liability rather than an asset in response to challenges from international market competition and rising domestic labor costs. However, layoffs were being regulated by the conditions that the Supreme Court had introduced in 1989 and the government codified them in early 1997. Although the 1997 financial crisis eventually turned chaebols

against lifetime employment, politicians have been reluctant to cut back employment protection because of the public concern about job security.

Chapter 7 summarizes the cross-case comparisons and within-case comparisons elaborated in the previous chapters and highlights how empirical evidence fits the hypothesis of this study. Finally, it presents a future prospect for the Korean economic system from the varieties-of-capitalism perspective and provides a policy implication for employment protection reform in Korea.

## **2.0 COUNTER-MAJORITARIAN POLITICAL INSTITUTIONS AND EMPLOYMENT PROTECTION**

### **2.1 REVIEW OF EXISTING THEORIES**

I examine three major theoretical arguments about employment protection in the field of comparative political economy: power resources of labor, cross-class alliances, and the varieties-of-capitalism. The latter two represents an employer-centered approach that runs counter to the power-resources-of labor model. A major distinction between them is that the cross-class alliance approach focuses on sectoral differences of business preferences for social protection, while the varieties-of-capitalism perspective emphasizes national variations of business preferences for social protection. The main critical focus of this study is on the varieties-of-capitalism perspective.

#### **2.1.1 Power resources of labor**

The power-resources-of-labor theory is that well-organized labor and politically strong left parties are necessary for the development of labor protection because capitalists *a priori* oppose

it.<sup>9</sup> Quite interestingly, however, empirical evidence does not fully support this antagonistic theory of capital-labor relations. The power of labor measured by union density and the degree of centralization is found to be irrelevant to employment protection in seventeen OECD countries.<sup>10</sup> In Figure 1 of Appendix A, the impact of union density on employment protection is statistically indifferent from zero. In Figure 2 of Appendix A, the explanatory power of centralized bargaining is better than union density, but it is still insignificant at .10 level.<sup>11</sup> As shown in Figure 3 of Appendix A, when we take the political power of left parties as an average percentage of cabinet portfolios accounted for by left parties over the 1980s, its relationship with employment protection is still insignificant at .05 level.<sup>12</sup> These figures call into question the claim that well-organized labor is necessary for employment protection; even if the labor class is not powerful, strong employment protection could be established. For example, Korean labor lacks traditionally important labor factors such as high union density, centralized bargaining structures, and a strong social democratic party. Yet regular employees under permanent

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<sup>9</sup> Interestingly, two ideologically contrasting perspectives reach an agreement on this empirical issue. The class-based perspective's claim is that labor protection is a product of class struggle between capital and labor, assuming that working classes are the driving force of establishing labor protection against free markets (Korpi 1983; Korpi and Palme 2003). The government is often considered to be more favorable to labor groups' demand for social protection as its economy is more open to international markets (Cameron 1978, Katzenstein 1985).

The conservative perspective based on the rent-seeking theory (Tullock 1967; Stigler 1971; Krueger 1974; Posner 1974) argues that employment protection stems from the pressures of powerful interest groups seeking monopoly gains, or "rents" in the public choice term, which result from the government regulation of entry to the labor market. Inspired by the insider-outsider theory of unemployment (Lindbeck and Snower 1988), the rent-seeking behavior literature typically depicts insiders, who are currently employed, or labor unions representing the interests of insiders as doing the rent-seeking because they want their jobs to be safe from unemployment (Saint-Paul 1997, 2000).

<sup>10</sup> The 17 OECD countries are USA, Japan, Germany, United Kingdom, France, Italy, Netherlands, Belgium, Denmark, Spain, Austria, Sweden, Finland, Norway, Switzerland, Canada, and Australia. For employment protection data I used OECD indicators of the strictness of employment protection for regular employment in 1989 (OECD 1999). Labor unions data come from *Data Repository for the Golden-Wallerstein-Lange Project on Unions, Employers, Collective Bargaining and Industrial Relations for 16 OECD Countries, 1950-1995* (Downloadable from <http://www.shelley.polisci.ucla.edu/data>).

<sup>11</sup> In both figures, Spain may be seen as an outlier because Spanish labor groups are not well-organized but the job protection in this country is very strong. However, using robust regressions does not affect the result.

<sup>12</sup> The power of left parties data are from Duane Swank's Comparative Parties Dataset, which is downloadable from <http://www.marquette.edu/polisci/Swank.htm>.

contracts in South Korea enjoy fairly strict legal protection against dismissal among OECD countries (OECD 2004). How is it possible to have strict employment protection in the absence of strong social democratic parties and well-organized labor groups?

### **2.1.2 Large firms and cross-class alliances**

While the previous theory provides a labor-side approach to welfare states, the cross-class alliance theory is basically an employer-side approach. Scholars in this approach seek to explain when and why employers will favor social policy. Firm size is regarded as the most influential factor shaping employers' social policy preferences. Mares (2000, 2003) explains that as price-setters large employers can shift the cost of social insurance onto consumers. But Swenson (2002) also emphasizes the role of employers' organizations in labor markets in shaping welfare-state outcomes: the lack of strong employers organizations to police low-wage, low-benefit competitors in the United States made large employers support a minimalist social security system to reduce downward pressures of cutthroat competition on wages and benefits during the Great Depression. In contrast, the more generous welfare state of Sweden was established during the postwar economic boom when corporate welfare benefits were exploded to induce skilled labor. Swedish employers supported social legislation enforcing ceilings on wages and benefits.

The employer-side theory may be useful to explain why some employers are willing to contribute to social security. And yet, it is a limited account for the question of employment protection. According to the standard economic literature, giant corporations will keep the prices of their products from falling even during economic recessions because they have market power to set the prices and frequent changes in prices increase menu costs for firms (Mankiw 1987;

Rotemberg and Saloner 1987). Therefore, they may have to cut production and employment to maintain their profit levels because the prices are stable. If we hold the assumption that firms seek to maximize short-term profits, this economic theory will correctly predict that monopoly firms will prefer the flexible adjustment of employment level in response to business cycles to the protection of employees against dismissals and, hence, oppose any government regulation limiting flexible employment adjustment.

Social security contributions are generally considered as less cumbersome on employers because they do not conflict managerial prerogatives over employment and production. The heavy industries of Imperial Germany are a good example. Although they supported Bismarckian social security legislation, they sought to maintain a strict control over workplace issues. Employers might be reluctant to fire skilled workers, but employment protection legislation will necessarily constrain the business freedom to cut back unskilled workers as well as skilled workers.

### **2.1.3 The varieties-of-capitalism argument**

Recently a new institutionalist approach to welfare capitalism has drawn much scholarly attention. The whole thrust of this approach is that there are different kinds of capitalisms that have thrived in nationally-varied institutional contexts and employment protection is best explained by other economic institutions linked to it (Hall and Soskice 2001). According to this varieties-of-capitalism argument, employers will accept (or oppose) employment protection if they face institutional arrangements that reward (punish) long-term employment relations.

Thus, the varieties-of-capitalism literature draws upon the following complementary economic institutions to explain the difference of employment protection between Germany and

the United States, two major opposites in the capitalist world. First, Germany has a bank-based financial system in which banks and industries are bonded with each other. Banks may reduce layoffs in their client firms not only because their financial commitment enable firms to be less worried about market pressures to cut back labor costs, but also because they protect their client firms in firm markets against mergers. Second, product market competition arguably weakens employment protection because the downward pressure on commodity prices are likely to force companies to save on labor costs. However, German companies in the same industry are interlocked through cross-shareholdings and coordinated by employers' associations instead of being mired in cutthroat competition. Finally, the varieties-of-capitalism school has pointed to the role of skill formation systems in shaping the business preferences for employment protection (Estevez-Abe, Iversen, and Soskice 2001). Thelen notes:

In fact, one recent strand of scholarship sees skills and skill formation systems as causally central to the development and articulation of social policy preferences generally, and thus foundational for the development and maintenance of different systems of social protection across the developed democracies (Thelen 2004: 4).

The works on the formation of skills suggest that different types of skills are associated with different product market strategies, which affect how employers perceive employment protection. The postwar German vocational training system has been based on the apprenticeship designed to certify high craft skills and employers' strong commitment to in-plant training of workers. This system has produced abundant workers with firm-specific skills to pursue a high-quality product market strategy. Thus, German employers see it economically beneficial not to freely lay off workers they trained because employment insecurity can damage workers' willingness to invest in firm-specific skills and the product market strategy based on

this type of skills. Hall and Soskice underline the benefits employment protection brings to German employers as follows:

The complement to these institutions at the company level is a system of works councils composed of elected employee representatives endowed with considerable authority over layoffs and working conditions. By providing employees with security against arbitrary layoffs or changes to their working conditions, these works councils encourage employees to invest in company-specific skills and extra effort (Hall and Soskice 2001: 25).

However, Hall and Soskice (2001) left unaddressed the origin of economic institutions. We do not know yet much about where Germany's employment protection legislation came from. More specifically, it has not been examined when the "package" of economic institutions the varieties-of-capitalism literature emphasizes was historically formed in Germany and whether the degree of employment protection publicly mandated significantly varied in association with the formation of German capitalism. Furthermore, although the varieties-of-capitalism theorists tend to argue that major German employers would not be interested in the fundamental cutback of current employment protection system because their industrial competitiveness is based on stable employment relations (Thelen 2000; Thelen and Van Wijnbergen 2003), they do not explain why the same German employers vehemently opposed the policy change that would enable works councils to interfere with managerial prerogatives over employment and production during the Weimar Republic, why they subverted the industrial relations system by supporting the Nazi regime, and why in 1951 they sought to undo the parity codetermination set to the statute by the Occupied Allies, although the economic conditions the varieties-of-capitalism literature considers as important for employment protection were already in place.

The critique of the varieties-of-capitalism argument is two-fold. First, Hall and Soskice's institutional complementarity thesis provides a strong explanation for why it is hard to retrench strong employment protection in CMEs, but it does not perform as well in explaining the rise of employment protection because they left unaddressed the origin of employment protection. From the varieties-of-capitalism argument, we still do not know when and how the national pattern of employment protection was formed. One possible strategy to fill this theoretical gap, which Hall and Soskice failed to deliver, is to examine when the "package" of economic institutions the varieties-of-capitalism literature emphasizes was historically formed in a country and whether the degree of employment protection publicly mandated significantly varied in association with the formation of capitalist institutions in that country.

The second critique is empirical. The varieties-of-capitalism argument does not explain how the United States came to have extraordinarily weak employment protection, often called "employment at will," in contrast to other LMEs. This employment-at-will regime is not generally found in LMEs. For example, the United Kingdom, another LME case, traditionally required reasonable notice for no-fault dismissal, whereas the United States embraced the at-will employment law in lieu of the English rule (DeGiuseppe 1981, 4-6). The divergence between these two Anglo-American countries increased when the United Kingdom created a series of employment protection legislation after World War II.<sup>13</sup>

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<sup>13</sup> The Redundancy Payments Act 1965 required employers to provide financial compensation for those severed from jobs due to mass layoffs (Root 1987). The Contracts of Employment Act 1972 strengthened the term of notice to be observed before dismissals (C.D.D. 1972). The Employment Protection Act 1975 introduced employers' duty to consult with labor unions over redundancies (Freedland 1976; K.W.W. 1976). These three laws were consolidated into the Employment Protection Act 1978.

#### **2.1.4 Political institutionalist argument**

The political institutionalist approach to social and labor policy is a relatively recent development in comparative political economy. Comparative political scientists in this approach stress the importance of political institutions in making some countries redistribute more than others. Major political institutional variables comparative works on this subject take are the difference between majoritarian and consensus political systems (Birchfield and Crepaz 1998; Crepaz and Moser 2004), electoral systems (Persson 2002; Iversen and Soskice 2006) and centralized versus decentralized constitutional structures (Swank 2001; Castles 2004). Also there has been an increasing effort to apply the veto players theory to analyze social and labor policy (Bonoli 2001; Tsbelis 2002), although the veto players theory is more useful to explain the magnitude of changes in existing policies rather than their origins. In the context of less developed countries, Rudra and Haggard (2005) focus on the effect of a democratic political regime where redistributive policy is determined by majority rule, based on the insight from Meltzer and Richards (1981).

However, the current research with a political institutional approach focuses on redistributive issues. The roles of political institutions in the establishment of employment protection have been little studied. The crucial difference between employment protection and redistributive policies is that the latter requires government's financial commitment because it aims to transfer incomes from the rich to the needy through taxation, but the former does not. Employment protection aims to reduce the risk of becoming unemployed by limiting the manager's right to fire workers, while unemployment compensation seeks to relieve the hardship of being unemployed. Therefore, although the assumption of taxation plays an important role in

explaining redistributive policies by the existing literature based on the median voter theory (See Iversen and Soskice 2006), taxation does not matter in the politics of employment protection.

Further, the current literature about the effect of constitutional structures on welfare states does not consider how different types of federalism affect social and labor policy outcomes.<sup>14</sup> For example, although American federalism is clearly distinguished from German federalism for students of comparative federalism, the current political institutional literature about welfare states rarely considers this important distinction in explaining welfare states. This study seeks to bridge between the political economy literature about welfare states and the study of comparative federalism.

## **2.2 THE ROLE OF COUNTER-MAJORITARIAN POLITICAL INSTITUTIONS**

### **2.2.1 Definition of CMPIs**

This study focuses on the role political institutions play in shaping employment protection. I build on the institutional literature about the development of American welfare states to develop a theoretical framework to explain the origin of employment protection. I argue that counter-majoritarian political institutions (CMPIs) constrain the rise of employment protection. CMPIs are constitutionally designed to limit the rule by the majority or the government policy-making in response to popular pressure. Bednar, Eskridge, and Ferejohn (2001: 9) said: “Opportunism by the national government is best constrained by fragmenting power at the national level.” The

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<sup>14</sup> One notable exception is Obinger, Leibfried, and Castles (2005).

fragmentation of national power may be accomplished in three ways: the horizontal division of power, the territorial division of power, and the delegation of specific policy authority to experts.

The horizontal division of power introduces checks and balances between different branches within the national government. But particularly important in the counter-majoritarian context is the division between political branches (executive and legislative bodies) and the judiciary, or an independent judiciary, because the same political majority may control both executive and legislative bodies following elections.

The territorial division of power relates to federalism. It provides divisions of power between levels of government, that is, between the national government and state governments. One of the major institutional characteristics of federalism is that different levels of governments rule the same people in the same territory. The conventional definition of federalism strictly divides the jurisdictions of different levels of governments, emphasizing elements of regional self-rule (Ware 1964). However, the contemporary definition tends to see that elements of shared-rule between different levels of governments are also essential to federal arrangements (Riker 1975; Watts 1996).<sup>15</sup>

Finally, a political system may create CMPIs by delegating specific policy authority to bureaucratic institutions. This is increasingly found in the area of monetary policy in which politically independent central banks composed of financial experts decide on the supply of money and credit to the economy. However, this kind of CMPI has not been found in the area of social and labor policy.

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<sup>15</sup> Riker says, “Federalism is a political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has *some* activities on which it makes final decisions... the essential institutions of federalism are ... a government of federation and a set of governments of the member units in which **both kinds of governments rule over the same territory and people and each kind has the authority to make *some* decisions independently of the other**” (emphasis in bold and italic added by author) (Riker 1975: 101)

I will use federalism and an independent judiciary as indicators of CMPIs. I take these two institutional factors together because the current political institutional literature suggests that there is a close association between federalism and an independent judiciary (Lijphart 1999: 187-188; Bednar, Eskridge, and Ferejohn 2001; Tsebelis 2002: 143). The reason might be that a federal system necessitates an independent judiciary to resolve jurisdictional disputes among multiple centers of power. Yet the analysis of why federal systems tend to produce greater judicial power is not an objective of this research.

### **2.2.2 Theoretical background of CMPIs**

Modern political thinkers dealt with judicial independence and federalism as important constraints on the power of the majority. Montesquieu first argued in his *Spirit of the Laws* that the judiciary should be independent of both the executive and the legislative branches to constrain the “momentary and capricious will of a single person to govern the state” (Montesquieu 1989, 2-4). While Montesquieu contemplated the division of power in a monarchical system, later thinkers focused on the roles of independent judiciary and federalism in a democratic political context. James Madison raised a fundamental concern about the mischief of democracy in *The Federalist* No. 10:

“Complaints are everywhere heard ... that our governments are too unstable, that the public good is disregarded in the conflicts of rival parties, and measures are too often decided, not according to the rules of justice and the rights of the minor party, but by the superior force of an interested and overbearing majority.” (p. 54)

As a cure for this defect of democracy, Alexander Hamilton espoused the need for the power of judicial review in *The Federalist*, No. 78. He argued that the independence of the judiciary from the other branches and its power to declare legislation in violation of the

constitution to be void are essential to protect minority rights against the majority controlling the legislative and executive branches. Later, Tocqueville also explicitly recognized the role of strong judiciary in mitigating democratic vices. In *Democracy in America* he saw the strong judiciary as a bulwark against the tyranny of the majority and a stabilizer of political order in the United States.

In the same vein, Madison suggested the use of federalism designed to provide a check against the tyranny of the majority. In *The Federalist*, No. 10 he supported a large republic, by which he meant a federal system, over a small republic as a way to prevent the majority faction of the society from monopolizing the popular government to advance its own interests. In *The Federalist*, No. 51 he explicitly mentioned the counter-majoritarian nature of federalism. He saw that federalism would provide an enhanced security for civil liberty against the government via checks and balances between different levels of government in addition to those between different branches within the government. He also argued that a federal system was superior to a unitary system in constraining the majority because it absorbed such diverse and divided social interests that it would be very improbable to form a unified majority of the whole.

The horizontal and territorial divisions of power became the major character of American political system. When Dahl (1956) dubbed this political system Madisonian democracy as opposed to populistic democracy, he considered the prevention of the tyranny of the majority to be a basic rationale for the fragmentation of power characterizing the American political system. Pioneering works were done by researchers of American political development who paid special attention to the constraining effect of fragmented constitutional structures on the development of American welfare state. Their research presents how federalism (Lowi 1984; Gordon 1994;

Pierson 1995; Robertson 2000) and the strong judiciary (Orren 1991; Hattam 1993) hampered the legislative efforts to bring comprehensive regulations of national labor markets.

More recently, comparative political scientists began to study explicitly CMPIs (Lijphart 1999; Armingeon 2002). Lijphart uses the executives-parties dimension and the federal-unitary dimension to classify democratic political systems. Lijphart's federal-unitary dimension is closely related with Dahl's distinction between Madisonian democracy and populist democracy because it comprises major CMPIs such as federalism, judicial review, and central bank independence. On the contrary, his executives-parties dimension mainly concerns electoral systems and has little to do with CMPIs, although political scientists often dub the first-past-the-post (FPTP) electoral system as a majoritarian system. Pure democracy means majority rule (Meltzer and Richards 1981), whether power is exercised by a single party under the FPTP system or coalition parties under PR. The role of CMPIs is to constrain this majority rule.

### **2.2.3 Social preferences of employment protection**

Who supports employment protection and who opposes it? In distributive politics, the old political economy literature focused on the conflict between capital and labor (Korpi 1983; Esping-Andersen 1990). However, the new political economy literature pays attention to the divergent interests of employers (Mares 2000, 2003) or the cleavage inside labor comprising workers with different levels and types of skills (Iversen 2006). Do these within-class divisions matter for employment protection? If so, how do they matter?

I argue that the divergent-interests-thesis on employer's side is misleading because it does not distinguish employment protection as government regulation of labor markets from employers' voluntary retention of skilled workers. As the new political economy literature

argues, employers tend to restrain layoffs if they actively invest in the skills of their employees because they want to keep skilled workers they trained from wandering off during downturns. However, their preferences for long-term employment relations do not necessarily ensure their support for the government regulation of layoff. First, employment protection protects low skill workers as well as high skill workers, although employers tend to see the employment of the former as fluid and replaceable. Second, private employers may well see employment protection as the government interference with their right to manage because employers' control over employment matters is critical to their control over workplaces and also determines the ability of employers to initiate changes in production technologies and locations.

The final reason why employment protection gives more harms than benefits even to employers who invest in the skills of their employees is that employment protection creates a division between incumbent workers (the "insiders") and job seekers (the "outsiders") in labor markets (Lindbeck and Snower 1988; Saint-Paul 1996; Rueda 2005). Employment protection strengthens the bargaining power of insiders over outsiders in wage negotiations because of firing costs, and it increases wage pressures.

On the contrary, the division-within-labor hypothesis provides an important insight to understand how workers differentiated by occupations and skills would see employment protection. Table 1 draws from Iversen's classification of types of workers. Low-skill industrial workers would most strongly support employment protection because they are most vulnerable to job loss during downturns. They are easily replaceable due to their low skills, and once they are displaced their firm-specific skill profiles limit their chances of finding jobs in other firms and may bring them into to long-term unemployment. Low-skill service workers tend to have greater mobility between firms and jobs, but they would also support employment protection

because they expect that employment protection will not only improve their job security but also raise wages and benefits by making it difficult to fire them. High-skill industrial workers dislike layoffs because the kind of skill they have invested in is firm-specific. However, their gains from employment protection might not be significant because they already enjoy greater job security and higher wages than their low-skill colleagues. Finally, demand for employment protection will be lowest among white-collar workers such as administrative and managerial workers and engineers because their jobs are relatively secure and also they tend to have strong identification with their employers.

**Table 1** Types of Workers in the Private Sector

		<b>Level of skill (income)</b>	
		Low	High
<b>Type of skill</b>	Specific	Low-skill industrial workers	High-skill industrial workers
	General	Low-skill service workers	Managers and professionals

Source: Iversen (2006: 4)

Political support from low-skill workers is not a sufficient condition for bringing employment protection in a democracy. In a democratic political system, where employment protection is determined by majority rule, the middle class will play a crucial role as a decisive voter (Meltzer and Richards 1981; Iversen and Soskice 2006). The meaning of the middle class varies among scholars, but they tend to agree that white-collar workers are central to the middle class (Mills 1953; Kocka 1980). Traditionally, blue-collar workers were not considered as middle-class. In terms of income, however, high-skill industrial workers might belong to the middle class as well. In Table 1, therefore, the level of skill or income distinguishes the middle-

class workers from the lower-class workers. The former includes high-skill blue-collar workers and white-collar workers, while the latter encompasses low-skill blue-collar and service workers.

Business and labor historians show that employers traditionally provided greater job security, higher earnings, and generous corporate welfare benefits to white-collar workers than to blue-collar workers (Kocka 1980; McColloch 1983; Speier 1986). White-collar workers were paid by salary and therefore their jobs were less dependent upon market fluctuations than waged, blue-collar workers. In the United States before the Great Depression, white-collar workers were exempt from layoffs and enjoyed paid vacations and pensions that were unavailable to blue-collar workers (Jacoby 1997: 11). These privileges of white-collar workers were not simply compensations for their skills, but they were also the inducements for these workers to play as shields against industrial proletariats. In Germany before World War II, for example, middle-class workers tended to have antipathy toward socialism even in favor of Nazism (Speier 1986; Suh 2002: 115).<sup>16</sup> White-collar workers with a blue-collar social background regarded their positions as an ascent (Speier 1986: 55).

Iversen and Soskice (2006) suggest that the middle class has dual incentives on redistribution: they want to ally with the poor to exploit the rich but they also want to ally with the rich to exploit the poor. Likewise, white-collar workers could make alliance with blue-collar workers on employment protection to increase their job security. However, the marginal utility of introducing employment protection is not significant to middle-class workers because their employment is relatively secure. Instead, middle-class workers could oppose employment protection because it could empower proletariat organizations, raise blue-collar wages and

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<sup>16</sup> It should be noted that the division between clerks and other white-collar workers at higher levels became rigid during the 1950s and '60s because skill-biased technological changes such as office automation increasingly routinized clerical jobs. The result was that most clerical and administrative workers were degraded to low-skilled, white-collar proletariats (Crompton and Jones 1984).

benefits, and eventually give downward pressures on white-collar earnings and benefits. Therefore, the solidarity across the collar and skill lines is not always achieved although it crucially affects the degree of popular pressures for employment protection.

Building upon Iversen and Soskice's argument, I argue that the strategic alliance for employment protection between middle-class and lower-class workers is likely to emerge if one of the following two conditions is met. First, strong labor unions for white-collar workers and craftsmen will play an important role in reducing middle-class workers' antipathy toward employment protection. If middle-class workers are better-organized, they will worry less about the boomerang effect of employment protection on their salaries and benefits because their independent unions will constrain white-collar cutbacks. In addition, strong left parties will help integrating labor movements across collar and skill lines. The key to the success of integrating labor movements consists in the party's ability to facilitate the negotiated outcome between white-collar and blue-collar labor organizations in which the former provides support for employment protection and the latter gives up the socialization of firms.

Second, if economic downturns hit only low-skill workers, middle-class workers would not have a need for employment protection. However, massive unemployment shocks that affect middle-class workers as well will deteriorate their perception of job insecurity and increase their marginal utility of introducing employment protection. Therefore, the rising risk of middle-class job loss will induce these workers to support employment protection.

#### **2.2.4 CMPIs and employment protection: The hypothesis**

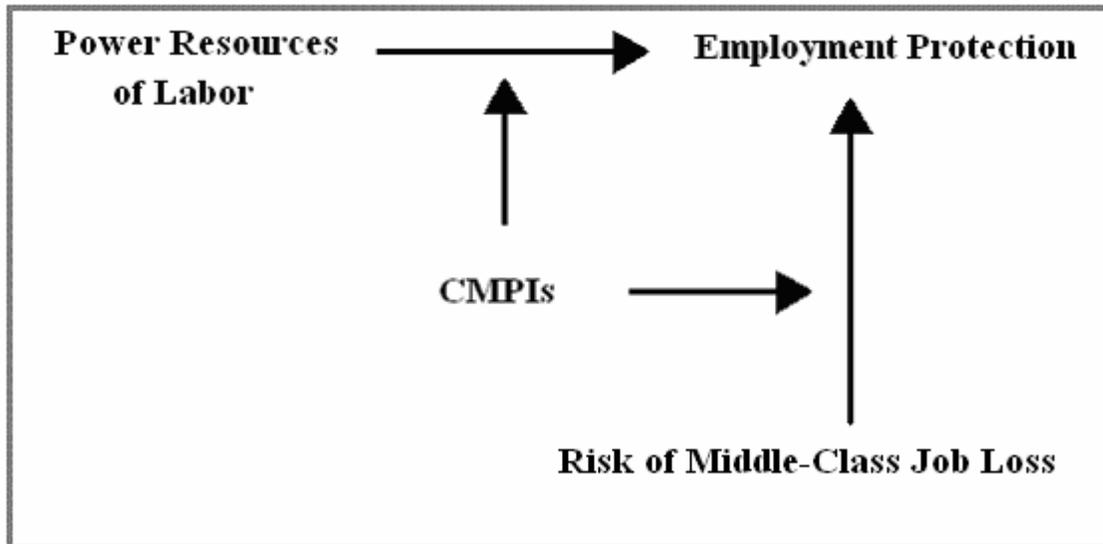
The 1896 German Civil Code that required employers to give advance notice before firing workers is one of the oldest employment protection laws in history, although its degree of protection was very weak compared with contemporary standards. In most industrialized countries, the government protection of workers against dismissal has existed for a period not longer than a century. Historically, countries had times when the employer's right to fire workers was not regulated by political power. It was through industrialization and the formation of urban working classes that political elites began to face popular pressures for the government intervention in labor markets to constrain the employer's right to fire workers.

However, the degree and timing of introducing employment protection varied across countries, although different countries faced similar pressure to regulate dismissals. For example, although white-collar labor movements were weak, craft unions withered away, and social democratic parties failed to threaten the two-party system in the United States, unemployment shocks have occasionally jeopardized the job security of the American middle class. The Great Depression affected white-collar jobs, although it hit blue-collar workers harder. During the few decades between the New Deal and the early 1970s, layoffs were largely inflicted upon low-skill blue-collar workers, executed based on a seniority rule, and they were only temporary layoffs in which the date for a recall to work was specified. When the postwar economic boom ended, however, layoffs increasingly became permanent job losses hurting even high-skill blue-collar workers and white-collar workers found themselves no longer immune to layoffs (Time 1970; McCulloch 1983: 156). As American firms were entangled in the wave of mergers and acquisitions linked to the rise of maximizing shareholder values since the 1980s,

managerial and professional workers finally became victims of mass layoffs widely accepted as a standard strategy in American business (Uchitelle 2006).

Nevertheless, the United States currently provides only minimal legal protection against layoffs to workers. The advance notice requirement in the 1988 federal legislation is too modest and has too many exemptions to reduce permanent layoffs. Unlike German employers, American employers still have no legal obligation to bargain with workers on plant-closing decisions and they are not compelled to bargain with non-unionized workers on layoff decisions.

Politicians might introduce employment protection to win elections when there are popular pressures to regulate the business freedom of layoffs, no matter how hard business may oppose. But the extent to which the logic of electoral politics affects government regulation of layoff depends on the characters of political system that either amplify or reduce popular pressures to curb employers' freedom of layoff. Strong CMPIs produce a high degree of fragmentation of powers and prevent any political groups who aspired to winning majority votes in elections from pushing through popular policies. As I previously discussed, the degree of popular pressures for employment protection depends on the power resources of labor and/or the risk of middle-class job loss. Thus, CMPIs are a condition variable constraining the power resources of labor AND the job security of middle-class workers. My working hypothesis is that the stronger political power of labor and the greater risk of middle-class job loss lead to stronger employment protection, but only if CMPIs are weak. Figure 2 highlights these causal relationships in my model. I consider federalism and judicial review as two major elements of CMPIs. I will show how these institutions affect employment protection in the following discussion.



**Figure 2** The Theoretical Model

#### **2.2.4.1 Varieties of federalism and employment protection**

Unitary political systems concentrate political power in the central government, while federal political systems disperse it to constituent states. Therefore, if the strategic alliance between blue-collar and white-collar workers is formed on employment protection under unitary systems, the policy preference of this political force will be a powerful predictor of employment protection because political parties representing this policy preference will constitute the majority in the national government. However, even if workers are united for employment protection, the national majority based on united workers will be constrained if labor legislation is decentralized.

There is abundant literature showing that if labor legislation is decentralized to states of a federation and capital is mobile across the states, there emerges a collective action problem that forestalls state-level regulations of labor (Pierson 1995; Weingast 1995; Thomas 2000).

Business investment is important to state policy-makers because it catalyzes industrial development, reduce unemployment, increase per capita income, and raise state tax revenues. Since mobile capital can choose states that do not limit the managerial freedom of making dismissals, individual states would have the incentive not to establish employment protection so that they can induce more business investment. Thomas (2000: 9) says, “The cost of not offering location subsidies when other jurisdictions are doing so is lost investment.” Likewise, the cost of introducing employment protection *when other states are not doing so* might be lost investment. Therefore, this inter-state competition for capital makes it unlikely that employment protection is introduced at state levels.

In addition to the decentralization of labor legislation, fiscal sovereignty compounds the problem of inter-state competition for capital. Rodden (2006: 8-9) points out how different structures of intergovernmental fiscal relations affect the fiscal behaviors of subnational governments. He argues that fiscal institutions focusing subnational governments’ independent local taxation will prevent them from having bailout expectations and therefore will help establish fiscal discipline in the overall federal system.

This fiscal federalism literature has an important implication for inter-state competition for capital. The fiscal federalism emphasizing fiscal sovereignty of subnational governments provides both incentives and tools for inter-jurisdictional competition for capital. Fiscal sovereignty will embolden the disutility of low business investment for state policy-makers because they rely on independent tax bases for providing public goods to their constituents. Moreover, fiscally sovereign units can use lower corporate taxes and location subsidies to attract business investment.

However, if states lack independent tax bases and rely on grants and revenue sharing, they will be less interested in inter-state competition for capital because their expectation of bailouts from the center will reduce the disutility of low investment. Further, states will not have effective fiscal instruments to use in competing with other states for capital without independent tax bases.

While the decentralization of labor legislation and fiscal sovereignty promote inter-state competition for capital, these two elements are not commonly found in all federal systems, but they are characteristics of a specific type of federalism. Students of comparative federalism suggest that there are two different types of federalism (Braun 2000; Obinger, Castles, and Leibfried 2005; Burgess 2006). The Anglo-American type (“competitive federalism”) is based on a jurisdictional division of power in which constituent states possess executive, legislative, and judicial powers semi-autonomous from the central government. Therefore, the central authority and the state authority are parallel under the Anglo-American type, and subnational governments have independent tax bases underpinning their policy autonomy. On the contrary, the Continental European type (“interlocked federalism”) promotes a functional division of power in which the central government has the power to decide and the constituent states possess the power to implement centrally chosen decisions. But it should be noted that the constituent states may directly participate in the decision-making at the central level through the federal chamber of the national legislature. The central authority and the state authority are not parallel but interlocked, and extensive revenue sharing schemes have been developed to finance operations under interlocked jurisdictions.

To sum up, the national majority supporting employment protection is not constrained under unitary systems. Federal systems could constrain the rise of employment protection

through inter-state competition for capital, which is effective only under the Anglo-American type of federalism.

#### **2.2.4.2 Judicial review and employment protection**

The politically independent judiciary is another pillar of CMPIs. Alexander Bickel (1962) pointed to the “countermajoritarian difficulty” of judicial review created, when he wrote: “when the Supreme Court declares unconstitutional a legislative act or the action of an elected executive, it thwarts the will of representatives of the actual people of the here and now; it exercises control, not in behalf of the prevailing majority, but against it” (Bickel 1962: 16–17).

Recently, there has been criticism that the U.S. Supreme Court, traditionally conceived as a counter-majoritarian institution, has in fact made decisions in response to public opinion (Mishler and Sheehan 1993; McGuire and Stimson 2004). However, this critique is limited because it does not empirically show that public opinion has direct AND contemporaneous effects on Supreme Court decisions. Mishler and Sheehan’s justices follow public opinion with average 5 years’ time lag. This long time lag weakens their claim that Supreme Court decisions reflect popular influence on the Supreme Court. McGuire and Stimson find a contemporaneous effect of public opinion, but they fail to determine the extent to which the effect of public opinion is mediated by the political appointment of the Court justices and the change in the prevailing ideology on the Court.

But the effect of the independent judiciary on a specific policy issue such as employment protection is complex. It cannot be determined without considering additional factors. First, it has been established that the ideologies of U.S. Supreme Court justices profoundly affect their decisions (see Segal and Spaeth 1993). If judges are rightist, they are more likely to use judicial

review to bust pro-labor legislation such as employment protection. But if leftist judges prevail in the court, the independent judiciary will support employment protection.

Another factor that influences the choices of judges with the power of judicial review of employment protection legislation is the prevailing ideology of the founders of the constitution they seek to protect. If the constitution is based on free market liberalism, the judges will be able to use their power of judicial review to limit employment protection when they face a left or populist government. In contrast, if the constitution recognizes the legislative power of government for the protection of labor, even the independent judiciary will have few options but to accept employment protection legislation as constitutional.

### **2.2.5 Democracy, dictatorship, and employment protection**

Are democracies prone to greater employment protection than dictatorships? Because employment protection has the effect of redistribution of income between workers and their employers, this question might be examined in view of the vast literature about the political regime type and redistribution. The current political economic literature inspired by the median-voter theory (Meltzer and Richard 1981) and the rent-seeking theory (Tullock 1967) tends to associate greater redistribution from the rich to the poor with democracies than dictatorships. Recently Rudra and Haggard suggest, “electoral competition and, particularly, interest group pressures might drive democracies to be more concerned than nondemocracies about the poor” (Rudra and Haggard 2005: 1042). By contrast, defining “redistribution” in a non-conventional way, Wintrobe argues that dictatorships tend to redistribute more than democracies because their political base of support is typically insecure and they do this in a regressive term by “adopting

measures which transfer rights over the control of labor from labor to capital” (Wintrobe 1998: 161).

The argument that democracies are more prone to employment protection than dictatorships implicitly assumes that dictatorships are counter-majoritarian by nature. The institutional characteristics of dictatorships might be seen to suppress the majority demand for employment protection. Dictatorships are political systems in which the policy preference of one or a few always prevails over other citizens’ preferences. Further, dictators either eliminate or control electoral competition to avoid real challenges from oppositions. Dictators do not commit themselves to the majority rule, although it could be possible that they mobilize political support from a majority of citizens for the dictatorship regimes as in the origin of the German Nazi regime.

However, I argue that dictatorships are not necessarily associated with either weak or strong CMPIs although dictators have greater capacity to act against the will of many than democratic leaders do. If dictator’s policy position deviates from the rest of people, the dictatorship is more likely to behave as a CMPI. However, it is also possible that a dictator seek to win loyal support from a majority of citizens by giving them rewards. In that case, the preference of the majority backed by the dictator will be forcefully implemented without considering minority interests. Therefore, dictatorships could be extremely majoritarian at times.

Since the relationship between dictatorships and CMPIs is mixed, the difference that a dictatorship makes on employment protection will hinge upon the preference of the dictator for employment protection and the degree of political openness of the dictatorship regime. First, right-wing dictatorships will provide less employment protection than left-wing dictatorships. Employment protection is likely to be weaker (or stronger) in a rightist (leftist) dictatorship than

in a pure democracy where employment protection is determined by the majority rule, but a strongly counter-majoritarian democracy might have employment protection as weak as a right-wing dictatorship.

Second, dictatorships vary in terms of the level of oppression (Wintrobe 1998; Linz 2000). In totalitarian regimes where the official state-party led by the dictator purges the political scene of contenders political power seeks to penetrate into even the private sphere of individuals. But, bureaucratic authoritarian regimes allow limited political competition and tend not to interfere with private freedoms. The more oppressive the dictatorship is, the less constrained the influence of the dictator on employment protection will be. Therefore, greater oppression will further reduce employment protection in the right-wing dictatorship, while it will bring greater employment protection in the left-wing dictatorship. A right-wing totalitarian state such as Nazism will have weaker employment protection than a left-wing totalitarian state such as communism.

### **2.3 METHODOLOGY**

I trace the origins of employment protection in the United States and Germany since the late nineteenth century and in South Korea since the 1960s. Students conducting this kind of small-*n* research confront two major methodological questions. The first question is whether the cases chosen are free of selection bias. King, Keohane, and Verba (1994: 128-149) warn that selecting observations on explanatory variables, dependent variables, or both explanatory and dependent variables will bias the result. I choose these three countries because they represent three worlds of capitalism. Hall and Soskice (2001) selected the United States and Germany to represent

liberal market capitalism and coordinated market capitalism respectively. I build upon Hall and Soskice's case selection in order to test the causal validity of the varieties-of-capitalism argument on employment protection. But I add South Korea because my preliminary information of the country shows that Hall and Soskice's dichotomy of capitalism does not account for the kind of capitalism that has prevailed in the country for the most of its history (See Table 23 of this dissertation). South Korea before the 1997 financial crisis deserves to be labeled as "statist capitalism" because the role of state in building capitalist institutions from corporate finance to skill formation was overwhelming. It is of great interest to see how the state as an entrepreneur and planner of the economy dealt with employment protection that might have potentially hurt business competitiveness and also to see where this kind of capitalism is going after it was attributed to the 1997 financial crisis.

The second methodological question is whether comparing the three countries evokes the problem of underdetermination: a situation where there are more inferences to make than observations. King, Keohane, and Verba (1994: 221) provide a useful suggestion to increase the number of observations, especially by making multiple observations over time within a case. I follow exactly this strategy. A simple cross-country comparison would not be able to discriminate between competing hypotheses, especially the varieties-of-capitalism argument. To examine the causal validity of the varieties-of-capitalism argument it is necessary to compare different time periods within each case because this method will show whether there was a fundamental change in employment protection while the nation's basic capitalist economic institutions were constant. Therefore, this study uses both cross-case and within-case comparisons. The American case includes three observations: pre-New Deal period, the New Deal period, and the 1970s and '80s. The German case also provides four observations: the

Imperial Germany, the Weimar Republic, the immediate postwar period, and the 1970s. The Korean case consists of three observations: dictatorship periods (1961-1987), the decade after democratization, and the post-1997 economic crisis period.

Are these observations independent? If there are perfect feedback effects of initial observations within individual countries, making multiple observations over time will be of no use because the initial observations are the only observations needed to make causal inferences. Although it is possible that there might be a degree of feedback effect, my research design does not expect complete dependency among observations because the observations made under the study are distinguished by major historic events such as economic crises, wars, and political regime changes. But I will demonstrate that employment protection at  $t_n$  is not determined by employment protection at  $t_0$ , but it is a result of the interplay between cross-class coalitions and political institutions at  $t_n$  in the empirical chapters.

### **3.0 THE RISE OF THE EMPLOYMENT-AT-WILL DOCTRINE IN THE UNITED STATES BEFORE WORLD WAR II**

Anchoring its control over wages and hours, as over all labor matters, was management's absolute right of discharge. --- Karen Orren, *Belated Feudalism*, 1991.

#### **3.1 INTRODUCTION**

The labor-management relations are at the heart of a capitalist system. Laws governing employment relationships are divergent across industrial countries and they shape capitalist systems of different types. From a comparative point of view, what is peculiar to the American experience throughout the twentieth century is that American firms implemented layoffs for flexible labor market adjustment, while German and Japanese firms sought to stabilize the level of employment through spreading available work (Houseman and Abraham 1995; Jacoby 2005).

The established practice of flexible reduction of workforce in the United States coincides with the lack of legal protection of workers against layoffs with only a few exceptions. American employers have legally fired workers without advance notice for a good reason, a bad reason, or no reason at all, unless the dismissal violates labor contracts or provisions of specific statutes such as the National Labor Relations Act and the Civil Rights Act. This employment-at-will law, a common-law theory peculiar to the United States, has governed the employment relations in the United States for more than a century. The employment-at-will law constitutes

an important part of the so-called American exceptionalism in which the United States is standing apart from the employment practices of other industrialized democracies.

The employment-at-will as a practice had existed since the making of the United States (Orren 1991), but it became a predominant rule governing the termination of employment after Horace Wood articulated this rule in 1877 (Shapiro and Tune 1974; Feinman 1976; DeGiuseppe 1981). Many scholars have argued that the American labor movement in the late nineteenth century was politically active as much as the European labor (Foner 1984; Wilentz 1984; Montgomery 1987; Hattam 1993; Voss 1993). Labor groups such as the Knights of Labor pushed for progressive labor legislation that would change the hostile environment to labor movement. Further, even after the American labor movement took the current pattern of development at the turn of the century, American workers could still influence politicians by electoral votes to enact a degree of legal restrictions on the termination of employment at will. In fact, the U.S. Congress and state legislatures were not entirely hostile to labor on the issue of labor discharge.

The puzzle to be explained, then, is why the employment-at-will doctrine became the fundamental principle of employment relations in the United States as it did by the early twentieth century. This paper seeks to answer how the United States has established the most laissez-faire system of employment protection among industrial countries by examining the American history from the 1870s through the 1930s. My argument is that the adoption of the employment-at-will doctrine can be best accounted for by the two strong counter-majoritarian political institutions, the federal political system based on inter-state competition and the politically independent judges in the Supreme Court who were imbued with free-market capitalism.

The regulatory prowess of the U.S. federal government was severely constrained during the period until the mid-1930s. The constitutional division of power placed labor at a further disadvantage compared to employers. The American federalism has been underpinned by a written constitution and politically independent judiciary claiming the authority of reviewing the constitutionality of legislation. This unique political structure provided a useful opportunity for employers to make void federal and state legislation limiting their freedom to dismiss workers through litigation. In response to employers' litigation, the judges of federal and state courts determined to promote business interests consistently busted government intervention in labor markets. The role of courts as the defender of freedom of contract and freedom of enterprise narrowed the policy agenda for labor law reform in the New Deal period, forestalling the Roosevelt government from challenging the core of employment-at-will doctrine.

### **3.2 THE RISE OF THE EMPLOYMENT-AT-WILL DOCTRINE, 1877-1914**

It was in 1877 that Horace Wood published a treatise presenting the basic idea of employment-at-will. It was the year when the Great Railroad Strike occurred. Before Wood wrote his treatise, the employment-at-will had not been a well-established legal doctrine in the United States. Unlike Wood's claim, court decisions on employment termination were inconsistent and rules governing the termination of employment were still in the air (Shapiro and Tune 1974, 340-341; Feinman 1976, 126; DeGiuseppe 1981, 6).<sup>17</sup> However, after his treatise was published, his

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<sup>17</sup> Ballam (1996) opposes the traditional view, arguing that Wood's rule reflected the legal practice of the day. As Jacoby (1982) suggested, however, Wood may genuinely have omitted a few court decisions that did not accept the employment at will. On this debatable issue, it would suffice to note that courts' views before 1877 were at most nebulous and the employment-at-will doctrine became clearly predominant later on.

rule gained judicial support and almost every state court adopted his rule by 1909.

There is literature that employment protection in the United States is weak because it is a common law country like United Kingdom (Djankov et al. 2004). Yet Wood in fact suggested the employment-at-will doctrine in order to distinguish the American rule from the English rule.

He wrote:

“In England it is held that a general hiring, or a hiring by the terms of which no time is fixed, is a hiring for a year... With us the rule is inflexible, that a general or indefinite hiring is prima facie a hiring at will, and if the servant seeks to make it out a yearly hiring, the burden is upon him to establish it by proof... unless their understanding was mutual that the service was to extend for a certain fixed and definite period, it is an indefinite hiring and is determinable at the will of either party.” (Wood 1877: Section 134)

Unlike the English rule that indefinite contracts were presumed to have one-year term and therefore reasonable notice of termination was needed, Wood suggested, the law in the United States presumed any indefinite term contract to be terminable at will by either employer or employee. This American rule of employment-at-will became the primary doctrine governing employment termination in almost every state by the beginning of the twentieth century (Shapiro and Tunc 1974, 342; DeGiuseppe 1981, 6). For example, New York Supreme Court adopted the rule by citing Wood as follows:

“The decision on this point in the lower courts have not been uniform, but we think the rule is correctly stated by Mr. Wood and it has been adopted in a number of states.... It follows, therefore, that the hiring of the plaintiff was a hiring at will and the defendant was at liberty to terminate the same at any time.”<sup>18</sup>

While state courts accepted Wood’s rule, federal and state legislatures enacted legislation limiting the employer’s right to terminate employment at will. In 1887, the State of New York enacted legislation that imposed criminal penalties on employers who discharged employees

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<sup>18</sup> *Martin v. New York Life Ins. Co.*, 148 N.Y. 117, 42 N.E. 416 (1895).

because of union membership. Twenty-one states followed New York to pass similar legislation outlawing discriminating against union members (Jacoby 1982, 122). Congress also passed the Erdman Act in 1898 to punish interstate railroad companies that discharged workers due to union membership.

However, the state and federal supreme courts declared all these laws unconstitutional in cases between 1895 and 1924 (Jacoby 1982, 122). Two U.S. Supreme Court decisions are noteworthy because they present the rationale of the employment-at-will doctrine. In *Adair v. United States*, the U.S. Supreme Court declared unconstitutional the 1898 Erdman Act.<sup>19</sup> Subsequently in *Coppage v. Kansas*, the Court declared unconstitutional state legislation that forbade employers to require their employees not to be members of unions.<sup>20</sup> In those cases, the Court upheld the employment-at-will doctrine on the basis of freedom of contract and freedom of enterprise as the essence of individual property right and further foreclosed federal legislation to limit employer's right to dismiss employees.

In sum, American workers in railroad industry and in many states were granted the legal protection against discharges because of being union members during the late nineteenth century. By the end of the First World War, these legislative measures were almost removed and the United States had a laissez-faire system of employment relations. The constitutional principle of judicial review were used to reverse any legislative success in limiting the employment-at-will by a few judges, which frustrated labor groups in the United States and led them to adopt a strategy of business unionism.

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<sup>19</sup> *Adair v. United States*, 208 U.S. 161 (1908).

<sup>20</sup> *Coppage v. Kansas*, 136 U.S. 1 (1915).

### **3.3 ECONOMIC FOUNDATION OF THE EMPLOYMENT AT WILL**

What are the interests of American firms underlying the employment-at-will doctrine like? The recent political economy literature suggests that different political economic systems, classified as liberal market economies (LMEs) and coordinated market economies (CMEs), nurture different types of capital which adopt divergent business strategies toward labor (Hall and Soskice 2001). According to this variety-of-capitalism literature, employers in CMEs tend to follow a production strategy based on long-term employment, while employers in LMEs tend to hire and fire workers more flexibly. This section will examine the institutional characteristics of American capitalism in the early twentieth century and see whether and how capitalist institutions complement employers' extensive resort to flexible layoffs.

#### **3.3.1 Inter-firm relations**

The varieties-of-capitalism literature stresses that institutions governing inter-firm relations induces firms to adopt different product-market strategies (Hall and Soskice 2001). In Germany, firms resort to non-market coordination mechanisms in which inter-firm collaboration and strong industrial associations play a central role. By contrast, firms in the United States seek market-oriented strategies based on innovative product development and price competition (Casper 2001: 389).

The institutional foundation of the inter-firm relations as we currently observe in the United States was first laid down at the turn of the nineteenth century. After the Civil War, the United States had embarked on a large scale of industrialization, moving from basic need industries based on small proprietries to heavy industries consisting of gigantic corporations.

Whereas the first industrialization in the early nineteenth century led to the rise of textile manufacturing predominantly in the New England region, the second industrialization in the latter half of the century transformed the American economy in terms of technology and production scale. The railroad industry became the first nation-wide capital at the end of the 1860s. As Chandler (1977) suggested, the expansion of railroads integrated segregated local markets into the single national market and brought in large industries based on economies of scale. In 1871, John D. Rockefeller established Standard Oil. In 1875, Andrew Carnegie founded steel works near Pittsburgh, which eventually evolved into the Carnegie Steel Company.

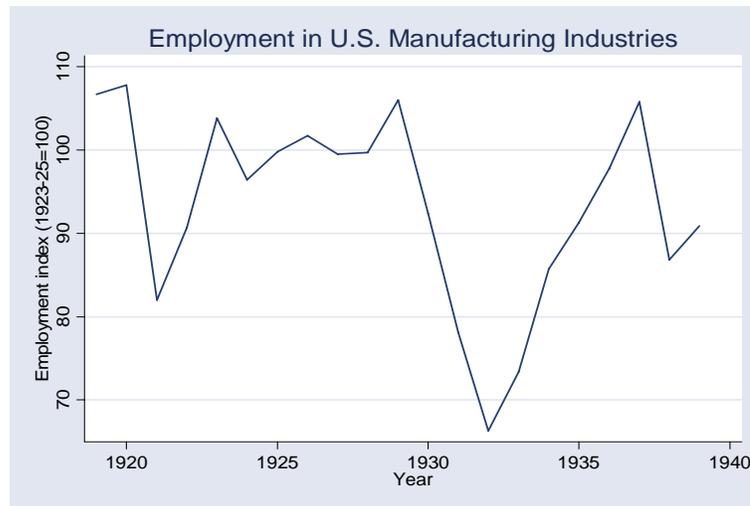
Similar to Germany, the United States during the 1880s was a cartel-ridden country. Major cartels with the purpose of setting prices were found in petroleum refining, cotton oil refining, linseed oil refining, whiskey distilling, sugar refining, and lead smelting and refining (Navin and Sears 1955). However, as the U.S. federal government enacted a series of anti-trust laws underpinned strict interpretation by courts, American firms became entangled in cutthroat competition with their rivals in the same industry. The Sherman Act of 1890 that prohibited cartels was a watershed in the U.S. competition policy. Although firms were still able to merge into larger entities as a way to reduce competition, this strategy also became restricted by other key legislation enacted in 1914, the Clayton Act and the Federal Trade Commission Act. The rigorous U.S. anti-trust laws have prohibited various forms of non-market coordination from price-fixing agreements, mergers-and-acquisitions to exercise market dominance, interlocking boards of directors, to industrial associations with strong legal competencies.

### 3.3.2 Skill formation

The United States did not develop systems of training for manual workers with firm-specific skills, but the U.S. government efforts to enhance education primarily focused on college-bound schools (Thelen 2004: Chapter 4). As a result of the industrialization in late-nineteenth-century America, firms in the United States suffered the increasing scarcity of skilled workers as in other industrial countries. Craftsmen, most notably machinists, were able to negotiate with employers over work rules and production processes until the early twentieth century (Montgomery 1979). However, while Germany developed an occupational training system based on skill certification in reaction to skill shortage, the United States sought to “rationalize production and reduce dependence on skilled labor” (Thelen 2004: 177). Frederick W. Taylor introduced to the public the idea of scientific management in 1911, which enabled managers to take control of the workplace by rationalizing the production process. Skilled workers were coopted into management hierarchies as lower-level supervisors or “foremen” who oversaw their unskilled crews in the rationalized production system (Thelen 2004: 149). As the Taylor method became widespread, the American industry entered a new phase characterized by the mass production of consumer products. A key factor in this industrial trend was the changing nature of immigration after the 1890s, which brought huge numbers of peasants from southern and eastern Europe (Thelen 2004: 185). Thus, American workers had a virtually infinite supply of unskilled workers.

The rise of mass production system raised a sore problem to ordinary workers in the United States. With the trend toward simple, mechanized processes, skilled craftsmanship became less relevant and the great mass of industrial workers was more easily replaced. Skill-displacing technology increased the risk of unemployment and compounded the economic

insecurity of industrial workers.<sup>21</sup> As Figure 3 shows, the level of employment in manufacturing industries was volatile in correspondence with business fluctuations.



**Figure 3** Employment in U.S Manufacturing Industries

Source: U.S. Census Bureau, *Statistical Abstracts of the United States 1940* (U.S. Government Printing Office: 1941), p. 340.

### 3.3.3 Financial system and corporate governance

The historical difference between American and German financial systems appears to be obvious. While with industrialization German concerns had a long-term relationship with a few large commercial banks which “accompanied the industrial enterprises from the cradle to the grave” (Gerschenkron 1962: 14), the markets for industrial securities in the United States became of age at the turn of the nineteenth century (Navin and Sears 1955).

During most of the nineteenth century, the markets for industrial securities in the United States were not well-developed. Most of companies during the three quarters of the century were

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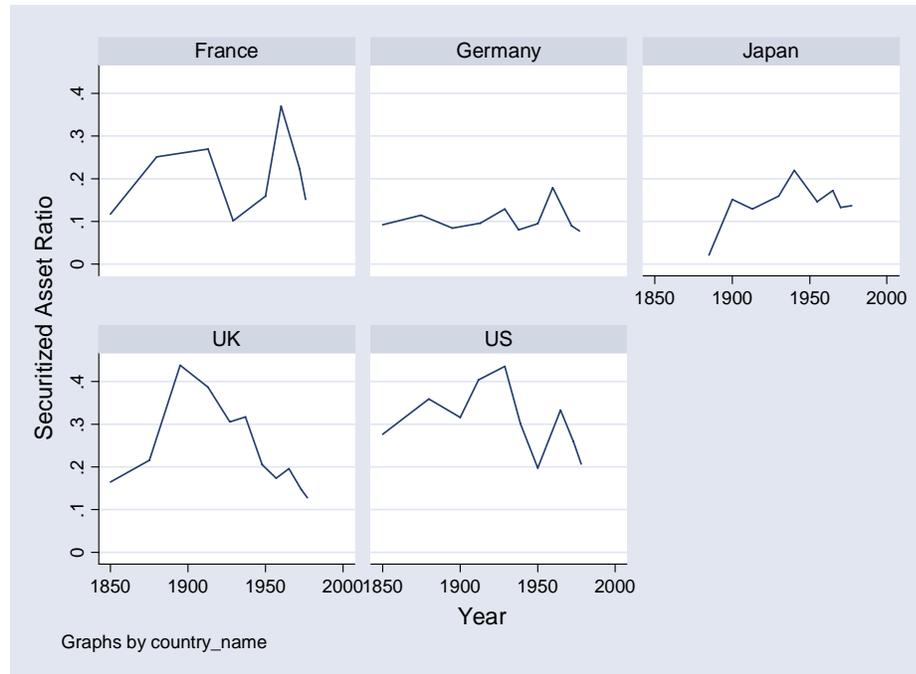
<sup>21</sup> Cyclical depressions doubled in frequency between the periods of 1825-84 and 1884-1920 (Feldman 1925: 11). During the 1920s only, the American economy experienced three economic recessions in 1921, 1924, and 1927.

not publicly held modern corporations but they were sole proprietorships or partnerships (Haber 1991). Although the cotton textile industry in New England was benefited from the Boston Stock Exchange during the antebellum period, the subscription to the capital stock of textile industry was limited to a small group of local investors (Florida and Samber 1999). People with excess capital were reluctant to invest their money into industrial securities except for those issued by railroads because numerous industrial companies were not well-established as railroads and people questioned the stability of the securities of those companies.

After the 1880s, however, the growth of big business in the American economy brought about structural changes in markets for industrial securities. In this period, the development of securities markets was stimulated by two major events in the U.S. financial history: the trust movement in the 1880s and the great merger movement between 1898 and 1902 (Navin and Sears 1955).<sup>22</sup> Trusts and mergers provided for a good deal of stable securities marketable to the public, which expanded and deepened U.S. securities markets to a great degree. As Figure 4 shows, firms in the United States during the interwar period had more advanced securities markets than any other industrial country, in terms of the ratio of corporate bonds and stock to national financial assets. This meant that American firms were dependent upon securities markets for corporate finance while countries such as Germany and Japan had financial systems based on loans from commercial banks.

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<sup>22</sup> According to Navin and Sears, the six industries with major trusts were petroleum refining (1882), cotton oil refining (1884), linseed oil refining (1885), whiskey distilling (1887), sugar refining (1887), and lead smelting and refining (1887). After the U.S. government prohibited these cartels by the 1890 Sherman Anti-Trust Act, American firms adapted to their inability to collude by merging into single, dominant corporations (Robertson 2000: 24). Major mergers between 1898 and 1902 included the creation of U.S. Steel, Consolidated Tobacco, International Harvester, and Du Pont. For the detail of the great merger movement, see Richard B. DuBoff, *Accumulation and Power: An Economic History of the United States* (Armonk, New York: M.E. Sharpe, 1989).



**Figure 4** International Comparison of Financial Systems, 1850-1980

Source: Goldsmith (1985).

Based on the market-oriented financial system, the United States developed the corporate governance system characterized by high concentration of managerial control in the executive and dispersed corporate ownership (Roe 1994). While in German firms corporate control is shared by the executive board consisting of managers and the supervisory board representing a wide range of stakeholders including shareholders, client banks, and employees, in the United States the executive board solely exercises corporate control. Instead, the performance of managers is evaluated by securities markets based on the quarterly balance sheets and publicly available information of the firm (Hall and Soskice 2004: 29). In Germany’s bank-based system, commercial banks are not only providers of corporate loans but they are also large block-shareholders of their corporate clients. By contrast, in the United States the development of

German-style universal banks was restricted by the Glass-Steagall Act of 1933 that kept banks out of the stock market.

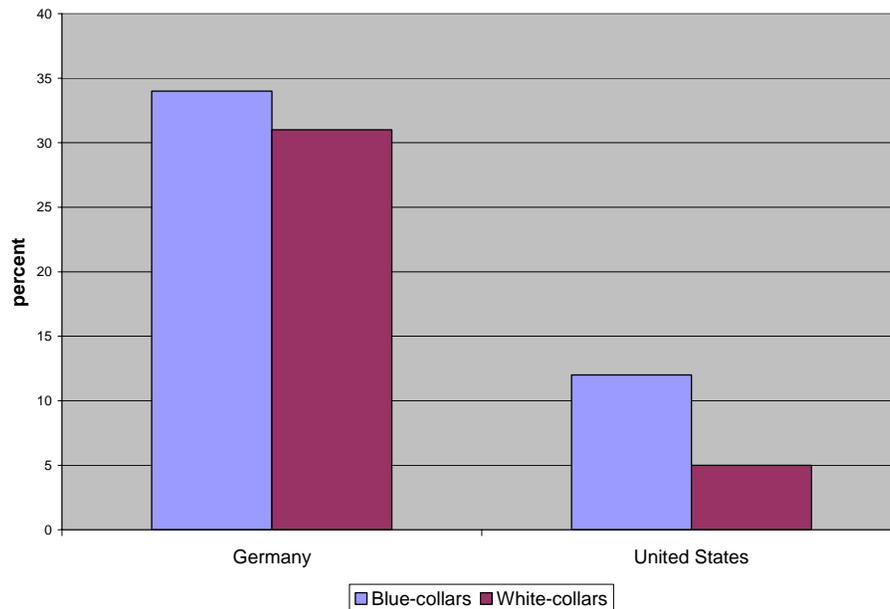
Although few employers over the world welcomed labor's control over employment, the peculiar hostility of American employers toward employment protection can be explained partly by the preeminence of securities in the American corporate finance. While large firms in Germany and Japan had close relationships with banks guaranteeing long-term finance and protecting the firms against mergers, large American firms raised funds through securities markets lacking financiers' long-term commitment. The dominance of securities markets in the United States encourages American employers to use labor flexibly. The standard business behavior of large corporations at that time was to maximize investors' short-term interests because if they failed to maintain dividend and interest payments, the market value of the firms would shrink and then they could be taken over by other firms. The American employers' focus on the market value of their companies was at odds with employees' interests in higher wages and stable employment tenure.

### **3.4 POLITICAL FOUNDATION OF THE EMPLOYMENT AT WILL**

#### **3.4.1 Weak power-resources of labor**

Strong labor unions and labor parties representing labor's interests are two major organizations that workers can rely on as a way to protect themselves against the managerial right to terminate employment at will. Compared with German workers, however, American workers suffered limited power resources especially in the period before the New Deal. First, the United States

was a laggard in terms of union membership. As Figure 5 shows, the percentages of workers in blue-collar and white-collar unions in the United States were substantially lower than those in Germany as of 1932.



**Figure 5** Union memberships in blue-collar and white-collar workers, 1932

Source: Kocka (1980: 206)

The weakness of labor party also hindered the adoption of progressive labor legislation. Although Socialists fared better at local and state levels (Robertson 2000: 24), they did not gain enough votes to participate in the government at either federal or state level. By contrast, the Social Democratic Party of Germany was the largest party in the Reichstag and participated in several state governments in 1920. Lowi (1984: 37) phrased a puzzle about this relative weakness of American labor:

History and theory inform us that the conditions of industrial capitalism in the United States beginning at some point during the nineteenth century should have produced a significant mobilization of labor around socialism in a Labor party or a Socialist party. The fact that no such mobilization occurred is a source of fascination and consternation to all serious social scientists.

The classical American exceptionalism literature tends to claim that American labor was qualitatively different than European labor from the beginning of class formation in that American workers lacked class consciousness and therefore did not create a socialist party based on the class line. It provides various explanations for the classlessness of American labor movement, which include pervasive liberal values resulting from the absence of feudalism (Hartz 1955; Lipset 1963; Burnham 1970), the relative affluence of American workers (Sombart 1974), and ethnic and racial diversity (Commons 1906).

However, there have been attempts to re-interpret American labor history by uncovering the class-conscious behaviors of urban workers, at least, in late-nineteenth-century America (Foner 1984; Wilentz 1984; Montgomery 1987). The counterclaim of these revisionist works is that American labor was as politically active and class conscious as European labor at certain point. Recent research has sought to answer why the American and European labor movements since then developed along divergent paths by highlighting on the American electoral system discouraging a third party (Oestreicher 1988) and the constitutionally divided political structure making progressive labor reform extremely difficult (Hattam 1993; Voss 1993).

### **3.4.2 The American federalism**

Riker defined federalism as a “political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has some activities on which it makes final decisions” (Riker 1975: 101). From this definition, we infer that federal systems should provide solutions, first, on functions for the government at each level to perform and, second, on fiscal arrangements to finance those functional activities.

In terms of federal-state responsibilities, the history of American federalism after the Civil War could be divided into two periods that displayed distinct patterns of inter-governmental relations. In the United States before the New Deal states were dominant players in national politics. From property rights, banking, education, to labor, major legislative powers shaping the economic development at state levels belonged in the jurisdiction of states (Lowi 1984: 46-47). The U.S. Constitution limited the jurisdiction of the federal government to the matters related with commerce across states and a list of functions that the Constitution explicitly delegated to the federal government such as national defense, foreign affairs, internal improvements, subsidies, tariffs, public lands disposal, patents, and currency.<sup>23</sup> Before the New Deal, the Supreme Court provided a very narrow interpretation of the “interstate commerce” clause, and therefore the federal competencies were very restricted compared with those of states. But the New Deal brought about the intrusion of the federal power, especially in the area of regulation, into formerly states’ exclusive turfs via the Supreme Court’s reinterpretation of the interstate commerce clause. As Peterson notes, “At first the courts retained remnants of the doctrine of dual sovereignty in order to protect processes of industrialization from governmental intrusion. But with the advent of the New Deal, the constitutional power of the national government expanded so dramatically that the doctrine of dual sovereignty virtually lost all meaning. Court interpretations of the constitutional clauses on commerce and spending have proved to be the most significant” (Peterson 1995: 11).

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<sup>23</sup> Grodzins claims that the division of power between federal and state governments has never been rigid and there was constant intergovernmental cooperation even throughout the nineteenth century, drawing upon various federal grants to states as evidence of such cooperation (Grodzins 1966: 32-37). However, although the postwar development of power-sharing between the federal and state governments is conspicuous (See Elazar 1972: Table 8), Grodzins might have exaggerated the significance of intergovernmental cooperation in the period before the New Deal (See Riker’s comment on Grodzins in Riker 1975: 104). The grant-making power of the federal government had already been recognized by the Constitution as one of the exceptional areas under the federal jurisdiction and therefore it did not challenge the states’ legislative supremacy over the federal government.

As the functions of the federal government have been significantly expanded over the last century, states were deprived of their monopoly power in many areas. Therefore, the contemporary relationship between the federal and state governments is correctly depicted as “cooperative federalism” (Elazar 1991). However, competition between governments at the same level appears to be a lasting feature of American federalism. Breton (1991) and Chubb (1991) mention as evidence of interstate competition that American states have sought to lure business capital by providing tax breaks and other financial incentives. In the last few decades, interstate competition seems to have become intensified as the United States underwent adaptation to the changing economic environment. As Kincaid notes, “Today, the national government has comparable difficulties coping with the international economy. Hence, state and local governments have entered the global economy on their own as direct competitors with jurisdictions worldwide. Domestic interjurisdictional competition is being augmented by globalized interjurisdictional competition” (Kincaid 1991: 110).

### **3.4.3 The judiciary**

American courts played a decisive role in sustaining the employment-at-will rule against pro-labor legislation. In the late nineteenth century, democratic institutions in the United States – Congress and some state legislatures – sought to limit the employers’ freedom to terminate employees at will by reform legislation. When democracy threatened the economic freedom of capitalists, the politically independent judiciary provided opportunities for employers to repeal legislation that encroached upon their freedom of terminating employment. Especially, the Supreme Court was the bastion of laissez-faire capitalism in the United States during the period between the 1868 Fourteenth Amendment and its decisions on the New Deal legislation in the

late 1930s.<sup>24</sup>

But, why did the Supreme Court make the decisions that they did on the termination of employment? Researchers sought to explain why the Supreme Court was inclined toward laissez-faire capitalism in that period. Twiss (1942) focused on the role of leading lawyers who propagated laissez faire in the interest of their corporate clients and who themselves were the future judges. Miller (1968) saw that the Supreme Court succumbed to corporations because of their preeminence in American society in comparison with other interest groups such as labor unions. Gillman (2002) attributed the laissez faire of federal courts to the social and professional background of most Republican-appointed federal judges who came with Reconstruction to promote a more unfettered national market. Yet there still remains a question how the employment-at-will rule could be sustained despite the changes in the ideological composition of the Court over time and the fury of politicians and labor leaders toward the intransigent Court.

I argue that the institutional foundation of American judiciary matters and they are its constitutional power and the norm of judges. First of all, the stability of the employment-at-will rule can be attributed to the institutional capacity of the American judiciary founded upon the constitutional principle of division of power between different branches and across different levels of government. As Alexander Hamilton wrote in *The Federalist Paper 78*, the power of politically independent judiciary to declare void all legislation contrary to the federal constitution was considered as essential to the preservation of limited government. Although the U.S. Constitution did not mention this judicial review, the U.S. Supreme Court has exercised the power to declare a federal law unconstitutional since its landmark decision in *Marbury v.*

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<sup>24</sup> For major cases in which the Supreme Court upheld the freedom of contract either to contain labor's collective action or to invalidate reform legislation, see *Lochner v. New York*, 198 U.S. 45 (1905) and *Adair v. United States*, 208 U.S. 161 (1908).

*Madison* (1803).<sup>25</sup>

The institutional capacity of the Supreme Court was not of static but dynamic nature partly contingent upon whether the political branches were ideologically united (Bednar, Eskridge, and Ferejohn 2001: 233). While the preservation of divided power was the rationale for the Supreme Court, the political independence of the Court was facilitated by the fragmentation of power at the national level. This was exemplified by the Supreme Court decision to uphold the National Labor Relations Act in 1937 after Democratic party won a landslide victory in both presidential and congressional elections in 1936.

But institutional capacity is insufficient to explain why the Court continued to prescribe the employment-at-will rule in periods when *laissez faire* was not the *Zeitgeist* any more. Political scientists have paid attention to the norm of *stare decisis*, a common-law principle of conformity to precedent, which discouraged a great departure from existing law in judicial decisions (Brenner and Stier 1996; Brisbin 1996; Knight and Epstein 1996; Songer and Lindquist 1996).<sup>26</sup> American lawyers are trained and experienced in *stare decisis* in a legal system where “the lawyers of today are the judges of tomorrow” (Twiss 1942, 150). Thus, the common-law legal system as normative political institutions played a decisive role in locking the employment-at-will rule in the American judicial system once the courts established it as precedent. As Orren aptly put it, “by far the largest share of disputes before them [judges], they did in fact follow precedent... Judges by their ritual enforcement held up a structure of domination that had existed since time out of mind” (Orren 1991, 81).

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<sup>25</sup> As a result of this landmark decision, state supreme courts have routinely reviewed the constitutionality of state legislation (Berkowitz and Clay 2005, 79).

<sup>26</sup> For the alternative “attitude model” of judicial decision-making, see Segal and Spaeth (1996).

Although the employment-at-will rule was not set in stone and the Supreme Court did not always follow precedent in opposition to any modification of the rule, it continued to be a governing principle of American labor-management relationship. The employment-at-will rule was circumvented in 1937 when the Supreme Court changed course and sustained the National Labor Relations Act, which legally protected the workers' right to organize unions and prevented workers from being discharged for union activities. And yet, this change fell short of the displacement of the employment-at-will rule. The protection of union members against dismissal was merely an exception to the rule (Muhl 2001) and courts in many cases during the first three decades after World War II ruled in favor of employers' discretion to dismissal (DeGiuseppe 1981). Further, although unions bargained hard to control layoffs and to set up arbitration procedures in case of unfair dismissal, the impact of unions was limited because of the relatively low level of unionization in American workplaces.

### **3.5 EMPLOYMENT PROTECTION DURING THE NEW DEAL**

#### **3.5.1 Labor market situations during the Great Depression**

The 1929 Great Depression brought about a devastating impact on job security. The unemployment rate skyrocketed from 3.2 percent to 24.9 percent between 1929 and 1933 (Mitchell 2002). Large companies were not exceptions to the reductions in workforce. For example, the Ford Motor Company laid off all but 37,000 of its 128,000 workers by the fall of 1930 (Zieger and Gall 2002, 50). On March 7 of 1932, thousands of unemployed autoworkers paraded to the Ford River Rouge plant in Dearborn in Michigan, presenting a list of demands to

Henry Ford. One of the demands presented was to rehire all laid-off Ford workers.<sup>27</sup> But the Dearborn police quelled the parade with gunfire. Four marchers were dead and nineteen other workers were wounded by the police gunfire in this Ford Hunger March.<sup>28</sup>

Despite the employment crisis during the Great Depression, labor unions did not step up political struggles to bring in legislation making layoffs more difficult. Frustrated by anti-union courts making null legislative successes, Samuel Gompers of the American Federation of Labor insisted that American labor be staying away from political action, including lobbying and demands for pro-labor legislation (Hattam 1993). Now the focus of labor strategy was on organizing skilled workers and taking back control of wages and working conditions through collective bargaining (Zieger and Gall, 24-25). In doing so, labor unions limited their goal to incorporating a seniority-based layoff system into labor contracts because they expected it would prevent employers from laying off workers arbitrarily and it would also protect union leaders from losing their jobs (Schatz 1983; Golden 1997).

### **3.5.2 Could American employers reduce layoffs?**

How did American employers respond to the increase in the irregularity of employment and the rising discontent of labor that cyclical depressions brought about? Employers did not have incentives to restrict layoffs voluntarily because of the employment-at-will rule. The business response to employment crises was very inadequate and limited to a temporary relief for displaced workers.

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<sup>27</sup> Maurice Sugar, "Bullets - Not Food - for Ford Workers," *The Nation*, March 23, 1932; Robert L. Cruden, "Bloody Monday at Ford's," Unpublished paper, New York, NY: Labor Research Association, 1932, p. 31 [Copy at Reuther Library, Wayne State University, Detroit, Michigan].

<sup>28</sup> *Detroit News*, 8 March 1932.

As the irregularity of employment increased, workers in the mass production industries came to desire long-term employment relationship.<sup>29</sup> However, a vast majority of American workers' employment hinged upon the will of their employers. Under the employment-at-will rule, executing layoffs did not incur any substantial business cost to the employer because he was legally free to dismiss workers at any time without having to consider any relief measure for the unemployed. Therefore, most of employers did not feel it necessary to prevent layoffs.<sup>30</sup> Although prior to 1929 there were progressive managers who set up voluntary plans providing to their employees a degree of employment protection such as advance notice, severance pay, employment guarantee, and work-sharing, these voluntary plans were extremely limited in application.<sup>31</sup>

As the Great Depression forced a lot of companies to close plants and to execute mass layoffs,<sup>32</sup> more companies began to adopt voluntary compensation plans for dismissed workers in emergencies (Schwenning 1931). However, voluntary dismissal compensation plans were not a generalized business practice. According to the Bureau of Labor Statistics survey in 1932, only 8 percent of the 224 plants sampled in the survey paid some sort of severance pay to men

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<sup>29</sup> A huge decrease in labor turnover between the 1910s and 1920s reveals the growing preference of American workers for stable employment. For example, Ford's turnover rate peaked at 370 percent in 1914 (Zieger and Gall 2002:11), but in 1924 the average turnover rate in American industries plunged to 45.2 percent (Bureau of Labor Statistics 1929: 64-65).

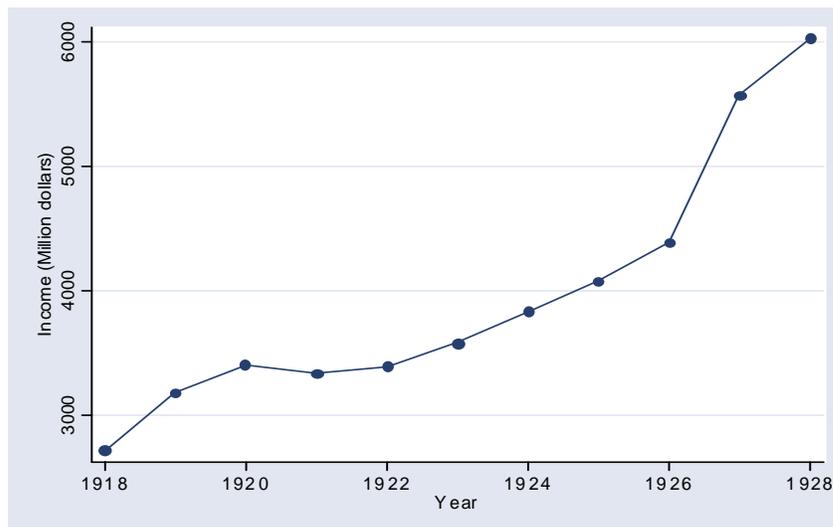
<sup>30</sup> One survey on 248 companies employing about 750,000 wage earners reported that approximately 75 percent of the companies laid off workers in 1927 although the 1927 recession was not major. See Bureau of Labor Statistics, *Monthly Labor Review*, (Sep., 1930), pp. 19-25.

<sup>31</sup> The earlier examples of companies with a formal plan for the protection of workers against dismissal were Dennison, Firestone, General Electric, Proctor & Gamble, and U.S. Rubber. But the number of those progressive employers was very small and the degree of protection provided by the most generous plan was relatively weak compared to provisions in other countries. For example, although the Dennison plan made almost every employee eligible regardless of length of service, dismissed employees received only two weeks' notice or pay at most. Whereas Firestone paid one month's salary to dismissed workers having 5 years' service, the German government in 1926 required employers to give 3 months' advance notice or to pay salary for the notice period to dismissed workers with the same length of service. See Bureau of Labor Statistics, *Monthly Labor Review* (Apr., 1930), pp. 1-5; G. T. Schwenning, Dismissal Legislation, *American Economic Review*, Vol. 22, No. 2 (Jun., 1932), pp. 241-260.

<sup>32</sup> The number of establishments in manufacturing industries declined from 210,959 in 1929 to 141,776 in 1933. See Bureau of Labor Statistics, *Monthly Labor Review* (Aug., 1935), pp. 431-432.

who were laid off through no fault their own and these plants accounted for only 15 percent of the total number of employees on their pay rolls.<sup>33</sup> It was also reported that as of December 1931, at most 226,000 employees out of more than 4 million workers on payrolls were eligible to some sort of company unemployment benefit plans.<sup>34</sup>

Why were American employers so reluctant to provide even rudimentary protection against protection to their employees? The available data show that American employers sought to protect investors' interests at the expense of employment and wage security. Figure 3 indicates that the American economy suffered three economic depressions during the 1920s: one severe depression in 1921 and two less severe ones in 1924 and 1927. Although the level of employment in manufacturing industries fluctuated in correspondence with business cycles, Figure 6 shows that dividend and interest payments paid to investors steadily increased in every single year over the 1920s except in 1921 when returns to investors were only slightly reduced despite the major depression.



**Figure 6** Dividend and Interest Payments in the United States, 1918-1928

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<sup>33</sup> Bureau of Labor Statistics, *Monthly Labor Review* (Nov., 1932), pp. 1005-1017.

<sup>34</sup> Bureau of Labor Statistics, *Monthly Labor Review* (Dec., 1931), pp. 1295-1310.

Notes: Included are industrial and traction companies, banks and trust companies, the National Government and the New York City government.  
 Source: U.S. Census Bureau, *Statistical Abstracts*, Various years.

Another source of data confirms that the flexible adjustment of labor costs through layoffs and wage cuts was the effective method of stabilizing the incomes of investors. According to Table 2, the average annual income of wage-earners decreased by \$16 per capital in 1924 from 1923 and by \$12 per capital in 1927 from 1926. But, net dividends on common stock increased steadily both in 1924 and 1927 in spite of business recession.

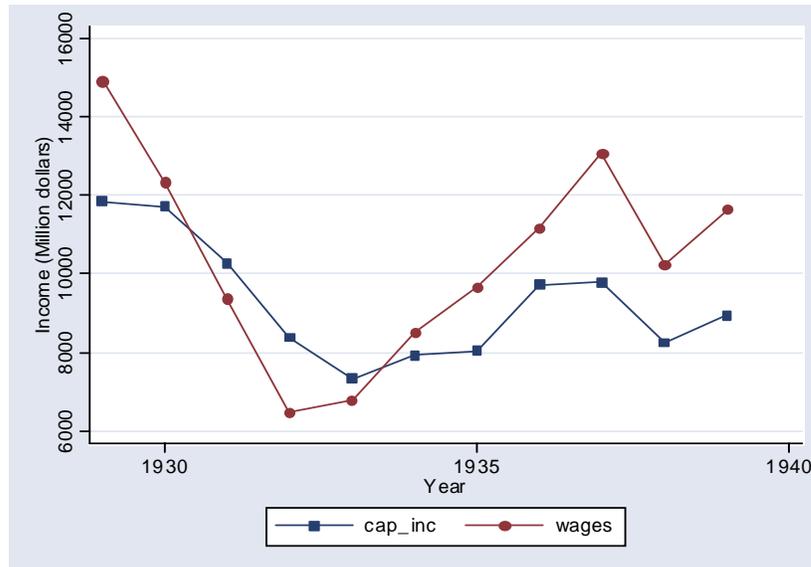
**Table 2** Average Annual Wages v. Estimated Net Dividends on Common Stock, All Industries

Year	Wages	Dividends
1920	1273	2337
1921	983	2217
1922	1012	2026
1923	1150	2672
1924	1134	2863
1925	1176	3337
1926	1217	3823
1927	1205	4233

Notes: Wages are in dollars and dividends are in million dollars.  
 Source: King (1930).

The Great Depression hit severely investors as well as workers because of the collapse of stock markets and great business failure. But again the economic depression unevenly affected investors and wage-earners. As Figure 7 shows, the incomes of investment fluctuated less than

the incomes of labor. Whereas total wages plunged by maximum 56.5 percent between 1929 and 1932, stock dividends and interest payments decreased by maximum 38 percent between 1929 and 1933.



**Figure 7** Capital Income v. Labor Income, 1929-1939

Notes: Industries covered here are mining, manufacturing, steam railroads, pullman, railway express, and water transportation.

Source: U.S. Census Bureau, *Statistical Abstracts*, Various years.

### 3.5.3 Policy agenda on the table: Employment stabilization versus income stabilization

The business commitment to the freedom of dismissal was underpinned by the importance of equity markets in the American corporate finance. Since American employers were generally hostile to the protection of workers against dismissal, the policy agenda for the government intervention in labor-management relations were limited to the measures that would minimize the restrictions on the manager's right to dismiss.

Since the end of the First World War, scholars began to introduce ideas based on European experiences to limit the employment at will. Until the early 1930s, at least three ideas

were known to the American public as restrictions on the employment at will: employee representation, mandatory severance pay, and collective bargaining led by independent unions.<sup>35</sup> The idea of employee representation as embodied in the 1920 Works Councils Law of the Weimar Republic in Germany was to require employers to obtain the consent of the works representative body before giving notice of dismissal. But this idea was not brought to any serious policy debate at either federal or state level because employers thought it was a menace to employers' right to manage and labor unions also criticized it for a rival of trade unionism (Leiserson 1929). The other two ideas – mandatory severance pay and union recognition – became policy agenda in the New Deal, but it was only union recognition that was finally adopted for legislation.

Severance pay is money that an employer gives to an employee when the employee is laid off or fired without his fault. Since the financial burden of severance pay increases in correspondence with the frequency of dismissal, severance pay provisions may reduce layoffs by providing to employers the incentive to keep unemployment down to the unavoidable minimum. Mandatory severance pay places the cost of layoff completely on individual companies from which workers are displaced and therefore it is distinguished from the compulsory unemployment insurance designed to redistribute unemployment risk among different employers and industries.

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<sup>35</sup> There is a plethora of interwar-period literature about American trade unionism and I will not repeat them here. For employee representation, see Walter G. Merritt, Employee Representation as a Step toward Industrial Democracy, *Annals of the American Academy of Political and Social Science*, Vol. 90, Industrial Stability (Jul., 1920), pp. 39-44; Emil Frankel, The German Works Councils, *Journal of Political Economy*, Vol. 31, No. 5 (Oct., 1923), pp. 708-736. For mandatory severance pay, see Edward A. Ross, A Legal Dismissal Wage, *Monthly Labor Review*, Vol. 8, No. 3 (Mar., 1919), pp. 15-19; Royal Meeker, Industrial Hazards, *Monthly Labor Review*, Vol. 9, No. 3 (Sep., 1919), pp. 1-8; Ernest G. Draper, A State Dismissal Wage Act, *The Survey*, Vol. 6 (Jan. 15, 1931), pp. 426-427; G. T. Schwenning, The Workers' Legal Right to His Job, *The American Federationist* (Jan., 1932), pp. 26-32.

In the United States, the debate over mandatory severance pay took the form of contestation between two different views on the legitimate type of unemployment compensation that should be enacted. The "Wisconsin plan" led by John Commons, was that each employer was required to make all contributions to his own separate company reserve, from which compensation was dispensed to the workers he laid off (Commons 1930). Employees were not forced to contribute under this plan. The primary goal of the Wisconsin plan was to prevent layoffs by making each employer charged with the cost of compensation payable to the workers he laid off. Thus, the unemployment compensation under the Wisconsin plan was functionally equivalent to mandatory severance pay in that this plan sought to penalize employers who freely laid off workers.

The alternative "Ohio" plan formulated by William Leiserson, Chairman of an Ohio Commission on Unemployment Insurance, was that all contributions from both employers and employees were commingled into one single state-pooled fund and payments of compensation were made from this common fund. Leiserson's claim was that the Wisconsin idea of employment stabilization was not a realistic goal and many workers would actually fail to receive benefits because company reserves were likely to be exhausted. Therefore, he argued that it was desirable to focus on stabilizing the level of income of workers regardless of economic fluctuations by enlarging the pool of unemployment risk (Leiserson 1931).

While the Ohio legislature failed to pass Leiserson's proposal, the plan for separate company reserves as Commons advocated was adopted in Wisconsin in 1931. In late 1934 Washington, Utah, New York, and New Hampshire enacted unemployment insurance laws following the Ohio plan. However, prior to the 1935 Social Security Act, either idea did not gain nation-wide support because of the fear that the establishment of unemployment insurance would

put the local industry of the state at a competitive disadvantage with industries of other states which did not have such systems.<sup>36</sup> Federal legislation was needed in order to establish some sort of nation-wide unemployment compensation systems.

#### **3.5.4 A federal, but limited treatment of the unemployment crisis**

After Roosevelt set up the Committee on Economic Security to make recommendations on the three aspects of social security including old-age pension, workers' compensation, and unemployment compensation in June 1934, the most heated controversies over unemployment compensation were federal control versus state autonomy and pooled funds versus company accounts.<sup>37</sup> The 1935 Social Security Act solved these conundrums by allowing each state to choose and administer its own unemployment compensation system, whether a state-wide pooled fund or a separate company account. At the same time, however, the Roosevelt administration failed to introduce legislation embracing the idea of employment stabilization in its entirety.

When the Committee on Economic Security was created, there were a few progressive employers participating in the Advisory Council to the Committee who favored the Wisconsin plan instead of the Ohio plan.<sup>38</sup> These corporate liberals close to the Roosevelt administration were already good at stabilizing employment and therefore they expected that the Wisconsin plan would level the competitive playing field with the low-standard employers who treated labor as a highly variable factor (Swenson 2002: 203, 227).

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<sup>36</sup> Statement of Sen. Byron Harrison, U.S. Congress, Senate, Floor Debate on Social Security, 1935, 14 June, p. 9271 [Available at <http://www.ssa.gov/history/pdf/senate2.pdf>].

<sup>37</sup> Edwin E. Witte, *Major Issues in Unemployment Compensation*, Feb. 1935 [Available at <http://www.ssa.gov/history/reports/ces/ces1witte1.html>].

<sup>38</sup> The business members in the Advisory Council were Gerard Swope of General Electric, Morris E. Leeds of Leeds & Northrup, Sam Lewisohn of Miami Copper, Walter C. Teagle of Standard Oil, and Marion B. Folsom of Eastman Kodak.

However, it is questionable that the Wisconsin plan gained support from most employers. Although those corporate liberals close to the Roosevelt administration liked the unemployment reserves, the business community represented by the National Association of Manufacturers was generally opposed to any type of unemployment compensation.<sup>39</sup> The final report of the Committee on Economic Security and the Economic Security Bill President Roosevelt submitted permitted states to choose the pooled unemployment-insurance, the separate reserve account, or the mixture of both. While the House passed a bill requiring states to establish pooled unemployment insurance, the Senate passed an amendment to the House bill, restoring states' discretion to choose any type of plan, because the House bill would force Wisconsin to change its existing law. Further, the Senate anticipated that the House bill that deprived states of the freedom to choose their own unemployment compensation plans would not pass the constitutional review by the Supreme Court.<sup>40</sup>

The Social Security Act levied a 3 percent unemployment tax on payrolls, but allowed employers to offset 90 percent of that tax by contributions they had made under a state unemployment compensation law. This device was to induce state legislatures to pass laws providing for unemployment compensation in accordance with federal requirements. By May 1937, unemployment compensation had been adopted by 45 states, the District of Columbia and Alaska, covering a total of about 18.5 million wage earners while bills were pending in Florida, Illinois and Missouri.<sup>41</sup>

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<sup>39</sup> Statement of James A Emery, U.S. Congress, House of Representatives, Committee on Ways and Means, *Economic Security Act*, 74<sup>th</sup> Cong. 1<sup>st</sup> sess, pp. 1020-1036 [Available at <http://www.ssa.gov/history/pdf/hr35emery.pdf>].

<sup>40</sup> Statement of Sen. Robert La Follette Jr., U.S. Congress, Senate, Floor Debate on Social Security, 1935, 15 June, pp. 9359-9360 [Available at <http://www.ssa.gov/history/pdf/senate3.pdf>]

<sup>41</sup> For the state adoption of unemployment compensation laws I heavily depended upon the following article: George H. Trafton, State Unemployment Compensation Laws, *American Labor Legislation Review* (Jun., 1937), pp. 53-58.

The distribution of state unemployment compensation laws in 1937 suggests that the Wisconsin idea of inducing employers to minimize layoffs was generally rejected by the States that feared the Wisconsin idea could drive out business. As Table 3 shows, only Wisconsin and Nebraska adopted a separate establishment account plan in its entirety, although all but a few states included definite provisions for the promotion of stabilization through merit-rating. The merit-rating provisions on employers were introduced to adjust individual employers' contributions according to their actual unemployment experiences. However, the merit-rating system was an inadequate measure to stimulate employers' efforts to minimize layoffs first because the upper bound on unemployment compensation tax rates made it possible for many high-unemployment-risk firms to make layoffs without incurring additional charges, once they were at the maximum tax rate. Secondly, many layoffs were not charged to the layoff firm but instead to a common pool if workers were laid off for reasons outside of employer's control (Burgess and Low 1992). As a consequence, the U.S. unemployment compensation system provided an incentive for employers to lay off too many employees, as unemployment compensation became subsidy to layoff firms (Feldstein 1978).

**Table 3** State Adoption of Unemployment Compensation Laws, May 1937

<b>Separate reserves (2)</b>	Wis., Neb.
<b>Separate reserves complemented by auxiliary pooled funds (4)</b>	Ind., Ky., Or., S.D.
<b>State-pooled funds with employers' option to withdraw under certain conditions (3)</b>	Calif., Idaho, Mass.
<b>Each employer free to choose either (1)</b>	Vt.
<b>State-pooled funds for benefit purposes and separate reserves for merit-rating purposes only (22)</b>	Ariz., Ark., Colo., Conn., Del., Iowa, Kan., La., Mich., Minn., Miss., N.H., N.J., N.M., N.D., Ohio, Okla., S.C., Tenn., Tex., Utah., Wyo.
<b>State-pooled funds with definite merit-rating provisions (7)</b>	Ala., D.C., Mont., Nev., Wash., W. Va., Alaska
<b>State-pooled funds without merit-rating (8)</b>	Ga., Me., Md., N.Y., N.C., Pa., R.I., Va.

Source: Trafton (1937).

### 3.5.5 Roosevelt and the Supreme Court

While the American unemployment compensation system was basically a relief measure for the maintenance of income and lacked substantial restrictions on layoffs, American labor got a degree of protection against the employment-at-will through the National Labor Relations Act (NLRA) of 1935 or the Wagner Act. Reminiscent of the 1898 Erdman Act, this act legally protected workers' right to organize unions and prevented workers from being discharged for union membership.

However, the NLRA was not the first New Deal legislation affecting the employment-at-will rule. In 1933, the Roosevelt government adopted the National Industrial Recovery Act (NIRA), which delegated to President the authority to rationalize industries for dealing with the problem of overproduction and falling prices. While the NIRA was basically an industrial regulation code, it also declared workers had the right to collectively bargain with employers through representatives of their own choosing. However, employers could live with and exploit the NIRA because it lacked the real authority to enforce labor protection (Harris 1982: 20-21). Moreover, the Supreme Court invalidated the NIRA in *Panama Refining Co. v. Ryan*<sup>42</sup> and *A.L.A. Schechter Poultry Corporation v. United States*.<sup>43</sup> The Court held that Congress had exceeded its authority to delegate legislative powers and regulate interstate commerce in enacting the NIRA.

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<sup>42</sup> 293 U.S. 388 (1935).

<sup>43</sup> 295 U.S. 495 (1935).

After the NIRA was declared unconstitutional, the Roosevelt government immediately passed the National Labor Relations Act that included more definite and stronger provisions protecting union members against discharge and empowering the federal government to adjudicate upon labor disputes. Although a majority of employers were compelled to accept unions as a fact after strong opposition, many employers still anticipated the Supreme Court would invalidate the act (Harris 1982: 23-32).

As the 1936 elections resulted in a landslide victory for Democratic party as in Table 4, tensions grew between the Supreme Court and the Democratic government controlling the executive and both chambers in Congress. In February 1937, shortly after his landslide reelection, President Roosevelt submitted a bill to Congress that would empower him to appoint additional justices to the Supreme Court in an attempt to change the ideological position of the Court hostile to the New Deal legislation. Although even Democratic-controlled Congress did not support Roosevelt’s “Court-Packing Plan,” Roosevelt insisted on the bill being passed and launched a personal campaign on behalf of this bill. The bill was defeated by a Senate vote of 70 to 20 in July 1937, but in the meantime Roosevelt got what he wanted for the New Deal legislation. The Supreme Court capitulated to President’s threat when it upheld the constitutionality of the National Labor Relations Act and the Social Security Act by a vote of 5 to 4 between April and May 1937.<sup>44</sup>

**Table 4** Unified Government after the 1936 Elections

Party	Electoral votes cast for President	House Seats	Senate Seats
Democratic	523	331	76
Republican	8	89	16

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<sup>44</sup> *N.L.R.B. v. Jones & Laughlin Steel Corp*, 301 U.S. 1 (1937); *Chas. C. Steward Mach. Co. v. Davis*, 301 U.S. 548 (1937).

Other	0	13	4
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Source: U.S. Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970*, Part II, (Washington D.C., 1975), Chapter Y.

In sum, the Roosevelt government did not attempt to establish comprehensive restrictions on the employment at will. Instead, anticipating the judicial opposition to more fundamental federal regulation of the at-will termination of employment, the Roosevelt government adopted a very modest form of legislative changes. Even the New Deal legislation might not have been upheld, had it not been for the extraordinary political situation in the late 1930s, which gave Democrats a landslide electoral success. Thus, the scope and degree of state effort to limit the employment-at-will rule were constrained by the long-standing policy of the Supreme Court toward free-market capitalism.

### **3.6 STILL THE CENTURY OF THE AT-WILL EMPLOYMENT?**

Orren (1991: 29) and Mettler (1998: 47) claimed that the National Labor Relations Act displaced the employment-at-will rule bringing the workplace within the reach of legislative activity. However, the NLRA only added one statutory exception to the employment-at-will rule. Although the NLRA eroded the employment-at-will rule by protecting union members from dismissal, the impact of the New Deal legislation on the employment-at-will rule was limited. Although labor unions won recognition, it remained a question whether they would be able to limit the broad management right to layoff in the collective bargaining process.

The employment-at-will was not displaced but instead it continued to affect labor-management relations. First, although labor unions got legal recognition, they had to get over hostile employers to take control over layoff decisions. To make layoff more difficult was the

last thing that labor unions would expect to gain from the employers determined to preserve their right to manage. This was well illustrated by a clause in the 1937 contract between the Steel Workers Organizing Committee and the U.S. Steel Corporation:

The management of the works and the direction of the working forces, including the right to hire, suspend, or discharge for proper cause, or transfer, and the right to relieve employees from duty because of lack of work, or for other legitimate reasons is vested exclusively in the company, provided that this will not be used for purpose of discrimination against any member of the Union (Cooke and Murray 1940: 84).

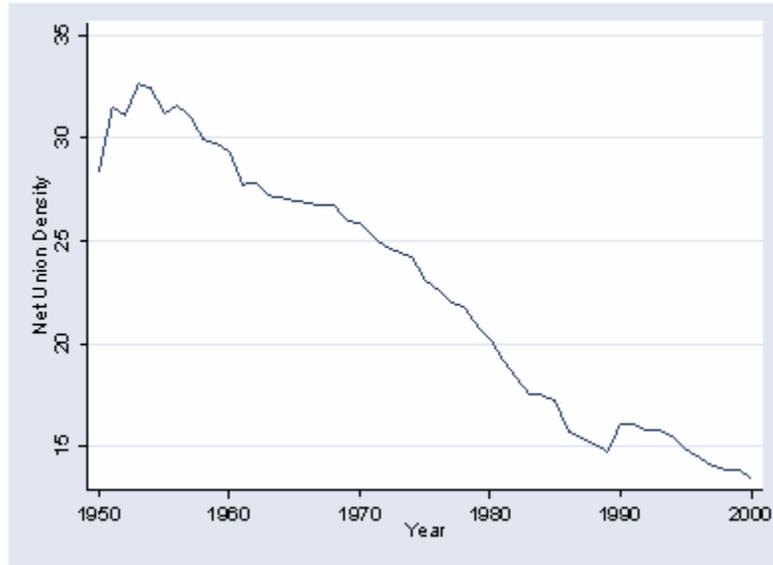
Secondly, American courts applied the employment-at-will rule in many postwar cases where dismissals were disputed. State courts have upheld the employment-at-will rule where employees had reported employer kickbacks, refused the sexual advances of their employer, refused to take psychological stress tests, filed workmen compensation claims, indicated their availability for jury duty, filed unemployment insurance claims, expressed concern about the safety of the employer's product, and filed complaints with governmental regulatory agencies concerning allegedly improper conduct by their employers (DeGiuseppe 1981: 9-10). After the early 1980s, however, a greater number of courts began to consider the common-law exceptions to the employment-at-will such as the public-policy exception and the implied-contract exception and the covenant of good faith and fair dealing" exception (Muhl 2001). I will discuss this development in more detail in the next chapter.

Finally, while collective bargaining became available to American workers as a way to limit the employment at will, the power of labor unions increasingly became depoliticized and ghettoized during the postwar era because the Taft-Hartley Act passed in 1947 restricted burgeoning labor activism (Lichtenstein 2002: 117). It outlawed the closed shop that required employers to hire only union members and permitted the union shop that required the newly hired to join unions within a certain amount of time on the condition that a majority of the

workers must vote for it. It also authorized states to adopt “right-to-work” laws that prohibited the union shop. Sooner than later, most of the states in the South and the Southwest became right-to-work states not least to gain competitive advantages against the industrial North.

Another important anti-union clause in the Taft-Hartley Act was the removal of legal protection for labor unions of managerial workers. Before the Taft-Hartley Act, the National Labor Relations Board and the U.S. Supreme Court held that the definition of “employees” under the Wagner Act included foremen and therefore the legal protection against dismissal under the Wagner Act was also available to foremen’s unions (Witney 1949: 176-177). However, the Taft-Hartley Act excluded these first-level supervisors from the definition of employees, allowing employers to fire them for their union activities (Voos 2005). Therefore, this law critically restricted the growth of labor unions for managerial and professional workers in the United States.

Although the long-run effect of the Taft-Hartley Act should be scientifically tested, the anti-union offensive in the immediate postwar years appeared to succeed in limiting the organizational power of American labor. As Figure 8 shows, the U.S. union membership has been declining since the early 1950s. Now, approximately 13.5 percent of workers in the combination of private and public sectors joined labor unions. This means that a vast majority of American workers still can be dismissed regardless of length of service without advance notice or severance pay.



**Figure 8** The Decline of U.S. Union Membership over the Postwar Era

Source: Data Repository for the Golden-Wallerstein-Lange Project on Unions, Employers, Collective Bargaining and Industrial Relations for 16 OECD Countries, 1950-1995 (Downloadable from <http://www.shelley.polisci.ucla.edu/data>).

## **4.0 THE REGULATION OF LAYOFFS IN THE POSTWAR UNITED STATES: THE CASE OF PLANT-CLOSING LEGISLATION**

### **4.1 INTRODUCTION**

The previous chapter shows that the United States had established exceptionally liberal rules governing the termination of employment relations compared to other industrialized countries before World War II. Regulations widely adopted in Western Europe and Japan such as mandatory severance pay and employee participation in layoff decisions are largely unknown to the American public. While most industrialized countries introduced the employer requirement of pre-notification of layoff before the late 1960s, the United States adopted in 1988 the Workers Adjustment and Retraining Notification (WARN) Act, which was the first federal legislation requiring employers to give advance notice to workers affected by plant closings and mass layoff.

This chapter addresses the question of why the WARN Act was enacted as late as 1988, although numerous attempts had been made in the U.S. Congress to pass legislation regulating mass layoff since 1974. Much of what has been written about the WARN Act focused on the 100<sup>th</sup> Congress in which the law was passed. This one-snapshot approach is limited because it does not account for why previous Congresses did not pass plant closing legislation although the conditions that it claims explain the adoption of the WARN Act had existed prior to the 100<sup>th</sup>

Congress. This paper addresses this gap in the literature by using both a detailed historical analysis since the first bill was introduced in 1974 and a statistical analysis of congressional votes on plant-closing bills during the 100<sup>th</sup> Congress.

When the first federal plant-closing bill was introduced in 1974, it required employers to provide at least 2 years' notice to affected workers before closing plants. It also provided the federal government with the authority to investigate individual plant-closing cases and to deny federal benefits to employers who have closed plants against the will of the federal government. While the mandatory notice period proposed was reduced year after year, proponents sought to mandate severance pay and consultation with labor unions to limit plant closings and mass layoffs. However, the 1988 WARN Act finally adopted put no other requirements on businesses than 60 days' advance notice for firms with 100 employees and more, which is extraordinarily weak by OECD standards (OECD 2004).

How could the United States end up with the most permissive rule of layoff among industrialized countries after the tidal wave of plant closings during the 1970s and 1980s? The answer lies not in the opposition from American capitalists and their allied politicians, although their opposition was truly vehement, nor in the anti-big-government culture among American citizens. The role of political institutions designed to limit and counteract majority rule is the explanation. The division of powers characterizing the American political system prevented the swift adoption of comprehensive plant-closing legislation in a couple of ways. First, the 1988 WARN Act could not possibly contain other provisions more restrictive than the employer requirement of advance notice prior to layoff because the U.S. Supreme Court in 1981 overruled the National Labor Relations Board's decision that employers were required to consult with labor unions regarding plant-closing decisions. With the managerial prerogative of allocating

capital being untouched, the remaining option for legislators was to minimize the impact of job loss on affected workers.

However, even the requirement of advance notice did not make it out of committees in either Houses of the Congress until 1985 because of the distributive effect of potential plant-closing legislation on the competitive advantage of each state. Plant closures during the 1970s unevenly affected states. Between 1969 and 1979, only 14 out of 50 states experienced net job losses in manufacturing sectors and most of them were located in the Northeastern region. Although plant closures and mass layoffs increasingly became a nation-wide problem during the early 1980s, variations of net job loss remained considerable among different regions. Therefore, proponents of plant-closing legislation were forced to water down their bills to soothe members of the Congress from states that reaped relative gains from corporate migration.

Understanding the legislative history of the WARN Act helps control competing hypotheses. The U.S. Congress spent 14 years to pass plant-closing legislation since the first bill was introduced in 1974. This time span is sufficient to examine the validity of other explanations for the WARN Act. For example, various efforts have been made to explain the adoption of plant-closing legislation in terms of large-scale domestic job losses in manufacturing industries (U.S. Congress Senate 1987), labor unions' effective political actions (Dark 2001), or the impact of the election year politics in 1988 (Susser 1988). And yet, all these explanations are limited. The deindustrialization hypothesis does not address why the U.S. government did not respond to massive job dislocations engendered during the 1970s in the same fashion as European countries that substantially strengthened the government regulation of layoff. The strategy of labor is also irrelevant because it does not explain why the U.S. Congress passed plant closing legislation as late as 1988 although American labor would have been better served

during the late 1970s with the Democratic administration and greater union membership, compared to constrained union resources under the Reagan administration. Finally, although Democrats successfully engineered the WARN Act by framing it as their primary election issue in 1988, the election-year-politics hypothesis ignores the question why they were not successful in previous election years.

## **4.2 PLANT CLOSURES: THE EXTENT AND RESPONSES**

### **4.2.1 The end of prosperity with job security**

The two decades after the Second World War was a heyday of American capitalism, in which economic growth accompanied worker job security. The United States emerged from the war as the dominant economic power in the areas of trade, money, and finance (Gilpin 1987). Major American manufacturers dominate world markets, international monetary order was built on the U.S. dollar, and the U.S. was the largest creditor in the world.

Against this backdrop, an implicit social contract between capital and labor was possible. After the National Labor Relations Act was enacted in 1935, labor militancy became a matter of great concern to American employers.<sup>45</sup> However, after the Second World War ended, class struggle became increasingly negotiated and institutionalized between business and labor unions protected by the National Labor Relations Act. Major unionized firms tended to provide their workers with higher wages and corporate welfare because they wanted labor peace for making

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<sup>45</sup> One notable example was the 44-day Flint sit-down strike in 1937, which led to the first United Automobile Workers contract with General Motors.

investments. As can be shown in Table 5, increasing corporate profit during the 1950s and 1960s made possible rent-sharing with workers. Labor unions' strategies were focused on greater economic benefits from business, while they deferred to the managerial decisions on "larger" issues such as shut-downs and cutbacks (Bluestone and Harrison 1982: 139). They expected that layoffs would be temporary and those unemployed due to lack of work would be recalled sooner than later. Further, they sought to make labor contracts that would require employers to lay off the people with the least seniority first. Under the seniority rule, therefore, even temporary layoffs were inflicted on relatively young, less-skilled workers. Core blue-collar workers in large corporations came to anticipate that their jobs would be held for lifetime, as indicated in the secular decline in manufacturing job separation between 1936 and 1958 (Dewey 1960, 280). Because skilled blue-collar workers and most white-collar workers were distant from the risk of job loss, the popular demand for introducing government regulation of layoffs was rarely heard. Strikes over job loss almost never occurred in major unionized firms (Golden 1997).

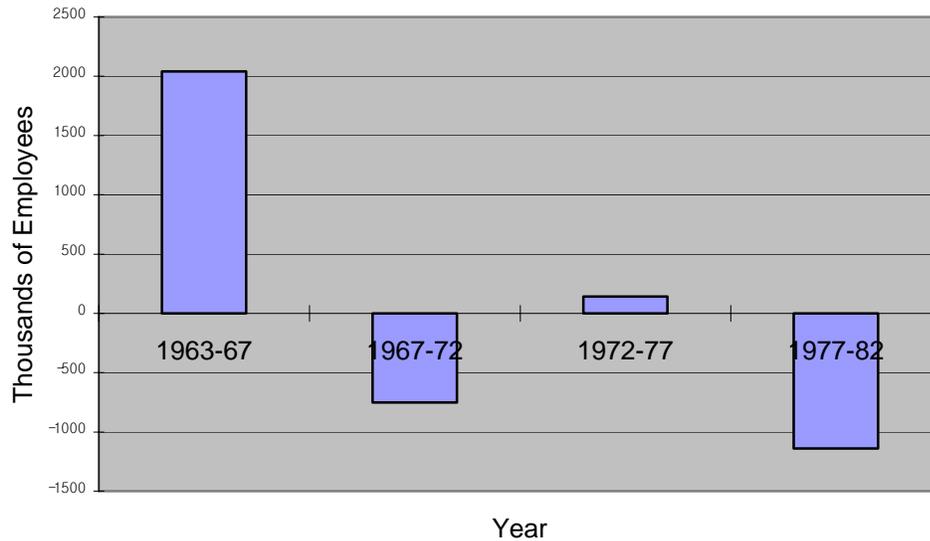
**Table 5** Rates of Return on Capital for Manufacturing Corporations, After-tax

Years	1951-54	1955-58	1959-62	1963-66	1967-70	1971-74	1975-78
Percent	6.9	6.8	7.7	11.4	8.5	6.0	6.3

Source: Holland and Myers (1980: 321)

This postwar boom of American economy ended during the early 1970s. Between 1970 and 1975, real gross national product increased only 2.1 percent per year, compared with 3.8 percent during the 1960s. Between these two periods, annual labor productivity growth in manufacturing sectors measured by output per man-hour was also reduced from 2.9 percent to

1.9 percent. The slowdown of economic growth resulted in the rise of unemployment rates since 1970. Especially, U.S. manufacturing employment was seriously affected. As Figure 9 shows, the United States lost over 500,000 jobs in manufacturing industries between 1967 and 1972.



**Figure 9** Changes in U.S. Manufacturing Employment

Source: Roberts (1986: 9)

Note: Establishments with greater than 19 employees

The problem of plant closures and permanent layoffs posed a very serious threat to the job security of skilled blue-collar workers, rendering traditional job-security measures ineffective. It also hurt union organizations. Between 1973 and 1975, unions in manufacturing corporations lost 15 percent of their members, largely due to the decline of manufacturing employment (Hirsch and Macpherson 2003). As a sign of major unions' concern about this situation, a delegation of ten unionists from the United Auto Workers, United Steelworkers and International Association of Machinists visited Sweden, West Germany and the United Kingdom in 1978 to study policies and practices to cope with plant closures and mass layoffs. The joint report of this Economic Dislocation Study Tour concluded:

Advance notice of impending layoffs, dismissals and plant shutdowns should be given to government, affected trade unions and individual workers as soon as the employer contemplates the decision. Since in many cases in the United States the lag time between shut-down and a new startup or conversion of an abandoned facility is three to five years, and in many other cases conversion is never made, then a one-year mandatory prenotification period is not unreasonable.<sup>46</sup>

Organized labor began to change their strategies in response to the problem of economic dislocation. Previously, the focus of union initiative had been on income security of workers. However, unions began to fight for general measures to limit the freedom of corporations to decide unilaterally where and how to produce, which included advance notice of plant closures or relocations and workers participation in managerial decisions (Beckman 1980). They also began to recognize legislation as a supplement to collective bargaining in this struggle. Therefore, they provided strong support for the efforts by a group of Congressmen from Northeast and Midwest regions – William Clay, Silvio Conte, and William Ford – to pass plant-closing legislation.<sup>47</sup>

#### **4.2.2 Legislative efforts to regulate plant closures and mass layoffs**

As a large number of plant closures and permanent layoffs affected major manufacturing industries, legislative efforts were made to put into effect the government regulation of plant closures driven by business reasons during the mid-1970s. Although there were some states that adopted different types of plant-closing legislation in advance of federal action, state action was limited in number and minimal in scope. Before 1988, Maine, Hawaii, and Wisconsin were the

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<sup>46</sup> Economic Dislocation: Plant Closings, Plant Relocations and Plant Conversion. Policies and Programs in Three Countries: Recommendations for the United States. Joint Report of Labor Union Study Tour Participants. May 1, 1979. p. 33.

<sup>47</sup> Statement of Marc Stepp, vice president of UAW, in Hearings before the House Committee on Education and Labor on H.R. 76, 95<sup>th</sup> Cong. 1<sup>st</sup> sess. August 15, 1978. Washington D.C.: Government Printing Office. Also, William Ford said that the proponents of plant-closing legislation had worked very closely with the UAW and its counsel in drafting this bill. *Ibid*, p. 79.

only states that required employers to give advance notice of plant-closings to affected workers. These state laws stipulated 60-days' advance notice, while Maine required severance pay as well. Connecticut did not require advance notice, but required non-bankrupt firms to maintain health insurance and other benefits for up to 120 days for workers plant closings affected. Massachusetts, Maryland, and Michigan had voluntary programs in which firms were urged to provide advance notice or to continue benefits (U.S. Congress Office of Technology Assessment 1986).

At the federal level, plant-closing bills were introduced in every Congress except for once since 1974. However, as Tables 6 and 7 show, those bills did not make it out of committees in either House until 1985. In 1985, the Labor-Management Notification and Consultation Act reached the House floor but it was defeated by a vote of 203-208. In 1987, the Senate incorporated the Economic Dislocation and Worker Adjustment Assistance Act into its version of Omnibus Trade Act, which was passed by both Houses but vetoed by Reagan in May 1988. After the Senate failed to override the veto, Senator Metzenbaum removed plant-closing provisions from the Trade Act and introduced them as the WARN Act. Both Houses passed the new bill with vote margin to override the presidential veto. The WARN Act was finally enacted without President Reagan signing on it.

Tables 6 and 7 demonstrate that proponents of federal plant-closing legislation had to significantly water down their bills to increase the possibility of passage. The National Employment Priorities Act during the 1970s focused on empowering the federal government to judge the business decision to close plants by requiring justifiable reasons for plant shutdowns. After unsuccessful legislative campaigns to promote this bill, proponents of plant-closing legislation shifted their focus to the requirement of severance pay in 1979 and subsequently in

1985 to the employers' duty of consultation with labor unions prior to plant closures. None of these efforts were successful and after all 60-day advance notice was the only restriction on business when the Congress finally passed the WARN Act.<sup>48</sup>

Although the WARN Act was certainly a victory for pro-labor groups, they had to make compromise to earn it.<sup>49</sup> They reduced the notice period to 60 days compared with 90 days of the 1985 Labor-Management Notification and Consultation Act. The WARN Act raised the small business exemption from 50 to 100 employees and exempted layoffs in which less than one-third of the workforce was affected. Moreover, the WARN Act put a provision exempt employers unable to comply the notice requirement because of unforeseeable business circumstances. In the next sections, I will demonstrate how this legislative outcome was brought about by focusing on political institutional factors.

**Table 6** Major Plant Closing Bills Introduced in the House

Congress	Bill number	Bill title	Date introduced	Sponsor	Employer requirements at time of last legislative action				Last legislative action
					Advance notice	Consultation with unions	Severance pay	Justifiable dislocation	
93	HR 13541	National Employment Priorities Act	1974-03-18	William D.Ford	X (2years)			X	Referred to House Committee on Education and Labor
94	HR 76	National Employment Priorities Act	1975-01-14	William D.Ford	X (2years)			X	Referred to House Committee on Education and Labor

<sup>48</sup> It should be noted that while the provision of advance notice had been included since 1974, the length of notice was significantly reduced from the minimum 6 months under the 1979 bills to the flat 60 days under the 1987 bills.

<sup>49</sup> The original legislative compromise was made on the plant-closing provision in the 1987 Omnibus Trade Act, which basically re-appeared in the WARN Act. For the legislative history of plant-closing legislation during the 100<sup>th</sup> Congress, see Bureau of National Report. *Plant Closings: The Complete Resource Guide*. Washington D.C.: The Bureau of National Affairs. 1988. pp. 9-19.

95	HR 76	National Employment Priorities Act	1977-01-04	William D. Ford	X (2 years)			X	Referred to House Committee on Education and Labor
96	HR 5040	National Employment Priorities Act	1979-07-31	William D. Ford	X (6 months ~2 years)		X (52 weeks)		Referred to House Committee on Education and Labor
98	HR 2847	National Employment Priorities Act	1983-05-02	William D. Ford	X (1 year)		X (1 year)		Subcommittee Hearings and Subcommittee Mark-up Session Held
99	HR 1616	Labor-Management Notification & Consultation Act	1985-03-20	William D. Ford	X (90 days)	Removed by amendment			Failed of Passage in House by Ye-Nay Vote: 203 -208
100	HR 1122	Economic Dislocation & Worker Adjustment Assistance Act	1987-02-18	William D. Ford	X (90~180 days)	X			Reported to House
	HR 3	Omnibus Trade Act	1987-01-06	Richard A. Gephardt	X (60 days)				Failed of passage in Senate over veto by Ye-Nay Vote: 61-37

Source: The Library of Congress. THOMAS.

**Table 7** Major Plant Closing Bills Introduced in the Senate

Congress	Bill number	Bill title	Date introduced	Sponsor	Employer requirements at time of last legislative action				Result
					Advance notice	Consultation with unions	Severance pay	Justifiable dislocation	
93	S 2809	National Employment Priorities Act	1973-12-13	Walter F. Mondale	X (2 years)			X	Referred to Senate Committee on Labor and Public Welfare
96	S 1608	National Employment Priorities Act	1979-07-31	Donald W. Riegle, Jr.	X (6 months ~2 years)		X(1 year)		Referred to Senate Committee on Labor and Human Resources

100	S 538	Economic Dislocation & Worker Adjustment Assistance Act	1987-02-19	Howard M. Metzenbaum	X (90~180 days)	X			Senate incorporated this measure into S 1420
	S 1420	Omnibus Trade Act	1987-06-24	Robert C. Byrd	X (60 days)				Senate incorporated this measure into HR 3
	S 2527	Worker Adjustment & Retraining Notification Act	1988-06-16	Howard M. Metzenbaum	X (60 days)				Became Public Law No. 100-379

Source: The Library of Congress. THOMAS

### 4.3 THE ROLE OF COURTS

#### 4.3.1 The managerial prerogative

The fundamental right of management to shut down or relocate plants must be viewed in the context of the employment-at-will doctrine. As shown in the previous chapter, this doctrine states that employees without written employment contracts can be fired without for good cause, bad cause, or no cause at all. It follows that there are no employer obligations to provide advance notice or compensation for dismissed workers. This has been a long-standing rule governing the termination of employment in the United States since the last half of the nineteenth century (Shapiro and Tunc 1974; DeGiuseppe 1981; Jacoby 1982). It has limited the ability of politicians with serious fear of losing elections to launch legislation restricting the management right to layoff because it was enshrined in the decisions of high courts at both federal and state levels. In the early twentieth century, the U.S. Supreme Court overrode federal

legislation that prohibited discharges for union activities based on the notion of employer's freedom of enterprise.<sup>50</sup> Although this ruling was overridden by the post-New Deal decisions,<sup>51</sup> the rise of organized labor the New Deal produced did not mean an end to the employment-at-will doctrine. The decision to lay off employees remained a managerial prerogative.

During the heyday of American capitalism, organized labor did not attack this managerial prerogative. Instead, it focused on extracting raises in wage and benefit. Since the late 1970s, however, organized labor began to challenge this managerial prerogative, drawing upon unions' right to bargaining in good faith under the National Labor Relations Act. This law requires employers to negotiate with labor unions on conditions of work such as wages, hours, and benefits. Labor unions argued that employer's plant-closing decision was a mandatory bargaining subject under the National Labor Relations Act, drawing upon the U.S. Supreme Court decision in *Fibreboard Paper Products Corp. v. NLRB* that required bargaining on a decision to subcontract under certain conditions.<sup>52</sup>

To labor's chagrin, however, the U.S. Supreme Court ruled in 1981 that employers had no obligation to bargain with unions over the decision to close part of its business, unless labor costs were an important factor in the decision.<sup>53</sup> The Court limited the application of the National Labor Relations Act to plant-closing situations, based upon the theory that management decision fundamental to the basic direction of a corporate enterprise should be excluded from collective bargaining (Irving 2000).

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<sup>50</sup> *Adair v. U.S.*, 208 U.S. 161 (1908).

<sup>51</sup> *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937); *Phelps Dodge Corp. v. NLRB*, 313 U.S. 177, 187 (1941).

<sup>52</sup> *Fireboard Paper Products Corp. v. N.L.R.B.*, 379 U.S. 203 (1964).

<sup>53</sup> *First National Maintenance Corp. v. N.L.R.B.*, 452 U.S. 666 (1981).

This Supreme Court decision undermined organized labor's new strategy for the 1980s. It weakened the union drive to gain control over plant closures through collective bargaining. To make matters worse to unions, the National Labor Relations Board reversed itself in 1984, finding no duty to bargain over operational changes.<sup>54</sup> Organized labor and its allied politicians then sought to legalize the mandatory consultation with unions prior to plant-closures in the 1985 Labor-Management Notification and Consultation Act. Many legislators were reluctant to pass the consultation requirement because they saw this proposed measure as overhauling the American industrial relations system established by the National Labor Relations Act and the Supreme Court decision in *First National Maintenance*. Republican Representative Jim Jeffords testified to this:

I think it is important to point out that, under existing labor law, bargaining or consulting in this area would be limited to issues involving labor costs. That is the law as I understand it, and I do not believe that there is any substantial disagreement on this. Nor do I believe there is any disagreement with the fact that this bill intends to change that basic labor law and to overrule some NLRB decisions by broadening the scope of consultation or bargaining in this context, to also include the broader issues involved. \*\*\* That is where the real problems and the differences are between these; and the real reasons why I know it was difficult for many to support this legislation.<sup>55</sup>

The provision on consultation was removed by amendment during the House floor debate. The final bill with 90-day notice requirement was rejected by 203-208.

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<sup>54</sup> *Otis Elevator Company*, 269 N.L.R.B. 891 (1984). Recited from Kovach and Millsbaugh (1987).

<sup>55</sup> U.S. Congress. House. 99<sup>th</sup> Cong., 1<sup>st</sup> sess. 2131. Cong Rec H 9992. November 12, 1985. Washington D.C.: Government Printing Office.

### 4.3.2 A new development in state courts

While the U.S. Supreme Court kept unions out of the decision to close plants, state courts were eroding the employment-at-will doctrine by providing common-law protections against wrongful discharge during the 1980s. These common-law protections prevent terminations of employment for reasons that violate a State's public policy, terminations after an implied contract of continuous employment has been established, and terminations made in bad faith or malice intended (Muhl 2001). Figure 10 demonstrates the proliferation of these three exceptions to the employment at will between 1979 and 1987. The number of States that adopted the public-policy exception increased rapidly from 8 to 33. The implied-contract exception was recognized in only 2 States before 1980, but it was adopted in 37 out of 50 States by 1987. The expansion of the covenant-of-good-faith exception was rather gradual. This exception was recognized in only 8 States as of 1987.

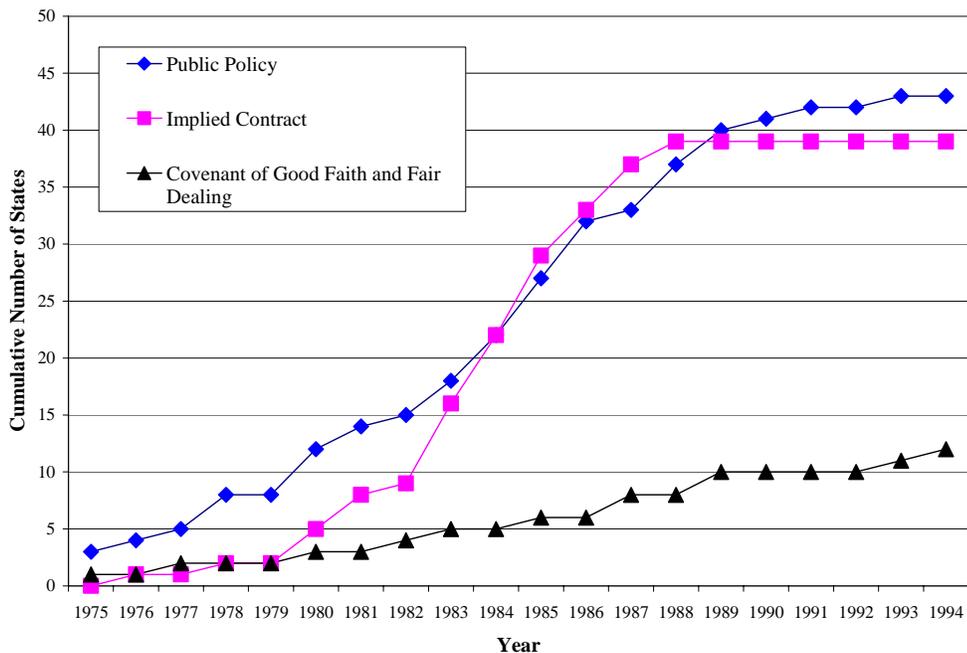


Figure 10 Timing of Judicial Adoption of Wrongful Discharge Doctrines

Source: Walsh and Schwarz (1996)

Among the three wrongful discharge doctrines, implied-contract and covenant-of-good-faith-and-fair-dealing doctrines had important implications for plant closings because they represented the emerging idea that workers had property rights to the jobs they held.<sup>56</sup> Even if employers have the fundamental right to make decisions over the basic allocation of capital, workers' job rights might give rise to financial liability for the employees' loss of jobs. The *Atari* case was a notable example in which these wrongful discharge doctrines were applied to plant-closing situations. In 1983, some 600 Atari employees in California were abruptly informed that they were being terminated due to the company's move to Hong Kong and Taiwan and they were required to quit on the same day.<sup>57</sup> The discharged workers filed a suit against their former employer, alleging that their discharges with no advance notice constituted wrongful discharge based on breach of contract, breach of the duty of good faith and fair dealing (O'Connell, Jr. 1986: 114). Wrongful discharge doctrines were a central feature of the Atari case, because there was no union contract on that situation nor plant-closing legislation in California. This class action suit settled for an amount equal to four weeks wages for each of the 537 employees who were members of the class, plus \$390,000 in attorneys' fees (Rhine 1986: 362n).

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<sup>56</sup> Senator Metzenbaum, sponsor of the WARN Act, provided justification for the legislation based on the principle of fair dealing as follows:

I have heard of instance after instance after instance where the management has walked in and said to the employees: "Pack up your tools, pack up your lunchbox, clean out your lockers, you are through, now." What kind of fairness, what kind of equity, what kind of decency, what kind of compassion would cause an employer to do that? (U.S. Congress. Senate. 100th Cong., 2<sup>nd</sup> sess. 134 Cong Rec S 8449. June 23, 1988).

<sup>57</sup> Santa Clara Cty. Super. Ct. filed Aug. 15, 1983. Rep. William D. Ford mentioned the Atari layoff in his letter to other members of the Congress. See William D. Ford to Colleague, 14 April 1983, Box 36, William D. Ford Papers, Bentley Historical Library, University of Michigan.

The role of courts in shaping employment protection during the 1980s explains why the United States did not adopt the German-style worker-participation model to regulate plant closures and mass layoff. The U.S. Supreme Court forestalled the union drive to control the decision to close plants, holding that a decision on plant closures is a part of employer's fundamental right to enterprise. However, a notion of workers' job rights based on wrongful discharge doctrines expanded the public sentiment that employees should be given advance notice of plant closures. In the next section, I will examine how the political impact of this public concern for job security was limited by the role of competitive federalism.

## **4.4 POLITICS OF PLANT-CLOSING LEGISLATION**

### **4.4.1 Interstate competition for investment**

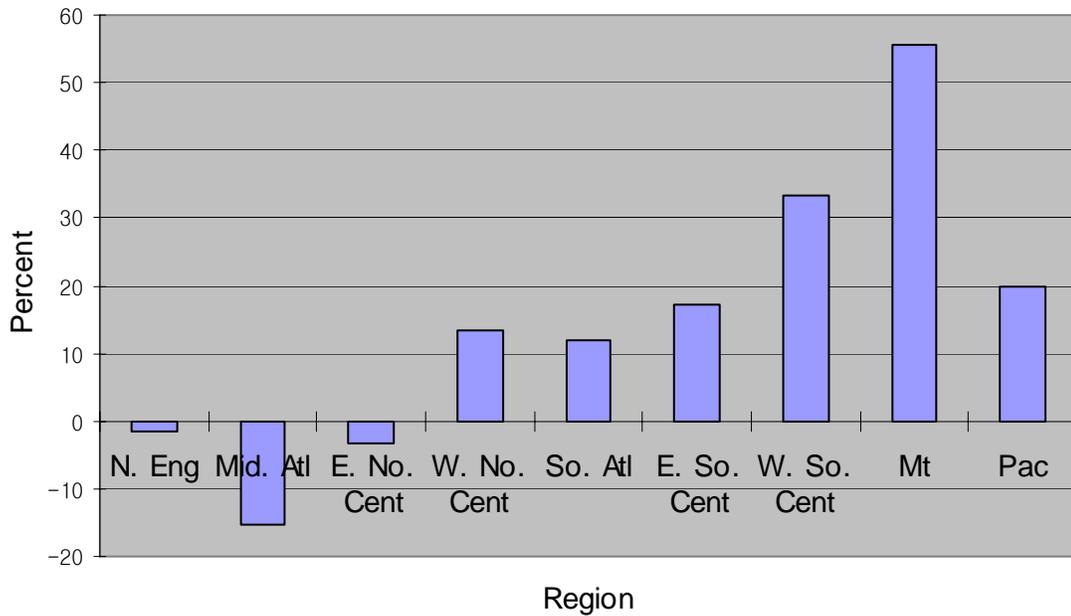
Before the 1988 WARN Act, there were only three states that required advance notice of plant closings. As competition between states and municipalities for business and jobs impeded state action, labor unions and state legislatures called for comprehensive federal legislation to cope with the problem of plant closings.<sup>58</sup> However, inter-jurisdictional competition inherent in the American federal system also turned out to be a stumbling block for federal plant-closing legislation.

As Figure 11 shows, changes in manufacturing jobs during the 1970s divided regions in the United States into two groups. While states in the Mid-Atlantic region suffered from the

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<sup>58</sup> See Statement of Marc Stepp, vice president of UAW, and enclosed Senate Resolution of the State of Connecticut in U.S. Congress. Hearing before the House Committee on Education and Labor on H.R. 76, 95<sup>th</sup> Cong., 2<sup>nd</sup> sess. August 15, 1978. Washington D.C.: Government Printing Office.

severest job loss, all other regions except for New England, Mid-Atlantic, and East-North Central regions experienced job growth. Thus, regulating plant closures became a political issue between two different regions: the Frost Belt comprising traditionally industrial states in the North and the other group of states called the Sun Belt.



**Figure 11** Changes in Manufacturing Employment by Region, 1969-1979

Source: U.S. Department of Commerce. *Statistical Abstract of the United States*. Various years.  
 Note: The nine regions presented here are New England, Mid-Atlantic, East-North Central, West-North Central, South Atlantic, East-South Central, West-South Central, Mountain, and Pacific regions.

Economically less developed states in the Sun Belt sought to attract business investment by using the competitive leverages of low labor costs and weak labor unions against the Frost Belt. In 1970, the state labor cost in North Carolina was merely 32 percent of that in Michigan

(Hansen 2004).<sup>59</sup> Despite the lack of statutory requirement of notice, differentials in union power accounted for the varying degree of contractual obligation of employers to provide layoff notice between the Frost Belt and the Sun Belt. For example, the average American blue-collar worker received only seven days' notice and nonunion workers received only two days' notice in 1986 (Ford 1987: 54). Meanwhile, states in the Frost Belt, which were industrial bases for many big unionized manufacturers such as steel and auto industries, tended to have union contracts that required more than a few months' advance notice in case of plant closures.<sup>60</sup>

Plant closures and mass layoffs had serious impacts on the state economy because they meant the decline of tax bases and the rising pressure for greater state social expenditures such as unemployment benefits. Therefore, proponents of plant-closing legislation sought to stem the movement of jobs from the Frost Belt to the Sun Belt by making plant closures more difficult. Rep. William D. Ford, a long-time sponsor of plant-closing bills, revealed the motive behind his pursuit of federal plant-closing legislation in a letter he wrote to a local economic director in his district:

This section [the National Employment Priorities Act] provides for incentives designed to retain industry in states such as Michigan with higher labor costs, and to discourage industries from relocating to states, particularly in the South, with low wage rates.<sup>61</sup>

Not surprisingly, this legislative initiative faced a fierce opposition from the states that benefited from interstate capital mobility. They criticized legislative actions to enact federal

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<sup>59</sup> Hansen calculated relative labor costs across states based on average workmen's compensation benefits, percent union members, average unemployment benefits, average manufacturing wages, and presence or absence of right to work laws.

<sup>60</sup> Major union contracts in the electrical machinery, automobile, rubber, and meatpacking industries stipulated a 6-month advance notice requirement in 1984 (Craft 1984: 50). The labor contract between the steel industry and the United Steelworkers of America included a 90-day notice provision in 1987. See Statement of J. Bruce Johnston, Executive Vice-President of USX Corporation on behalf of the National Association of Manufacturers in U.S. Congress. Hearing before the House Committee on Education and Labor. 100<sup>th</sup> Cong., 1<sup>st</sup> sess. March 17, 1987. Washington D.C.: Government Printing Office.

<sup>61</sup> William D. Ford to Ernest H. Maddock, 17 March 1975, Box 90, William D. Ford Papers, Bentley Historical Library, University of Michigan.

plant-closing legislation as a conspiracy of Northern states to prevent corporate migration from the Rust Belt to the Sun Belt. Rep. William D. Ford confessed:

This traditionally industrial region finds itself trying to compete with other states which, in their anxiety to build up their own industrial base, started this legalized bribery to induce the location of new industry in their areas. Of course, we cannot complain about anybody doing that. I guess you are aware that the Alabama Industrial Development Commission has selected out this piece of legislation [National Employment Priorities Act] as a Communist plot to keep Alabama from developing to its full potential. They have devoted attacks on the legislation, its sponsors and the whole "plot."<sup>62</sup>

When I first introduced plant-closing legislation in 1974, it was perceived as an attempt to keep jobs from relocating to the South from Michigan and other Northern States. Plant closings were seen as a "Frost Belt" problem.<sup>63</sup>

Facing the opposition from states that benefited from corporate migration, proponents of plant-closing legislation struggled to muster majority support for their bills in both Houses of the Congress. But legislative actions in the Senate were considerably weaker than in the House. Only 15 out of 50 states lost manufacturing jobs during the 1970s, clearly outnumbered in the U.S. Senate.<sup>64</sup> For 1974-1979, plant-closing bills were introduced to the Senate only in two Congresses, while the House held congressional hearings on plant-closing bills in every Congress. The number of cosponsors in the House gradually increased from 13 in 1974 to 63 in 1979. However, only two Senators cosponsored the 1979 National Employment Priorities Act, although Democrats controlled the Senate in that year.

Between 1979 and 1986, job dislocations increasingly became a national problem. As a result, manufacturing job growth was recorded in only 13 states for this period. Sponsors of plant-closing bills expected the Congress to pass them, pointing out the proliferation of worker

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<sup>62</sup> U.S. Congress. Hearings before the House Committee on Education and Labor on H.R. 76. August 15, 1978. 95<sup>th</sup> Cong., 2<sup>nd</sup> sess. Washington D.C.: Government Printing Office.

<sup>63</sup> U.S. Congress. House. 134 Cong Rec H 3533. 100<sup>th</sup> Cong. 2<sup>nd</sup> sess. May 24, 1988. Washington D.C.: Government Printing Office.

<sup>64</sup> U.S. Bureau of Census. *Statistical Abstract of the United States*. Various years.

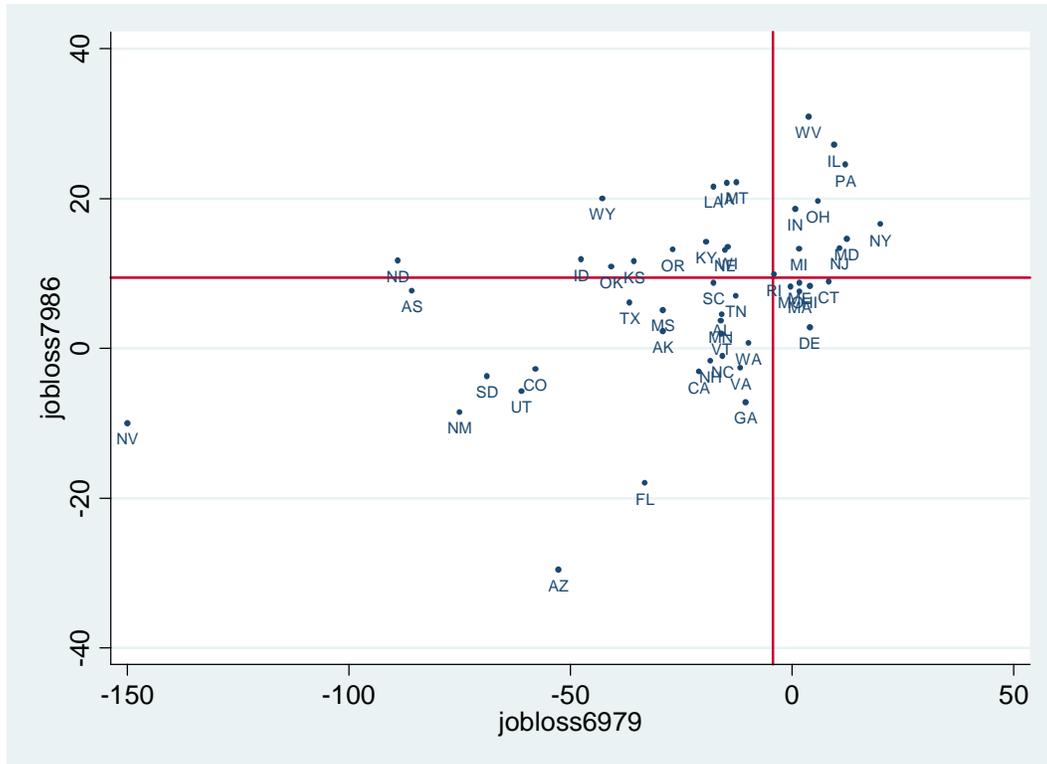
dislocation.<sup>65</sup> Despite the proliferation of plant closures and mass layoffs, there were not a single plant-closing bill introduced to the Senate between 1979 and 1987.<sup>66</sup>

The Republican-controlled Senate may be the partial reason for why the plant-closing bills were not even proposed in the Senate during 1981-1986. However, proponents of plant-closing bills suffered from the lack of political support from relatively well-performing states in terms of job creation as the divergence of manufacturing job performances remained significant among states. Figure 12 compares the changes in manufacturing job loss of each state for different time periods. For the first period of 1969-1979, 33 states outperformed the national average. For the second period of 1979-1986, the number of states whose job loss rates were below the national average decreased to 27. However, there were still 21 states that had consistently outperformed the national average since 1969, compared with 10 states whose job loss rates had been greater than the national average throughout the periods. These 21 states represented the greatest beneficiaries from the problem of economic dislocation that inflicted heavy job losses on the Frost Belt states.

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<sup>65</sup> U.S. Congress. Hearings before the House Committee on Education and Labor on H.R. 2847. July 25, 1983. 99<sup>th</sup> Cong., 1<sup>st</sup> sess. Washington D.C.: Government Printing Office. See the statements of Representatives William Clay and William Ford on pages 1-3.

<sup>66</sup> Bills fared better in the House Democrats controlled, although not successful. In 1985, the Labor-Management Notification and Consultation Act reached the House floor but it was narrowly defeated by a vote of 203-208. This bill required employers of at least 50 full-time employees to give workers 90 days' notice of any plant shutdown or layoff involving at least 100 employees or 30 percent of the workforce. 49 Southern Democrats voted against this bill (CQ Almanac 1985, 120-H).



**Figure 12** Changes in Job Loss in Manufacturing Industries by State

Source: U.S. Department of Commerce. *Statistical Abstract of the United States*. Various years.

Notes:

1. The x-axis denotes the percentage loss of manufacturing employment for 1969-1979, while the y-axis for 1979-1986.
2. The higher score along the x and y axes means a greater job-loss rate.
3. The red crossed lines represent national averages for each period.

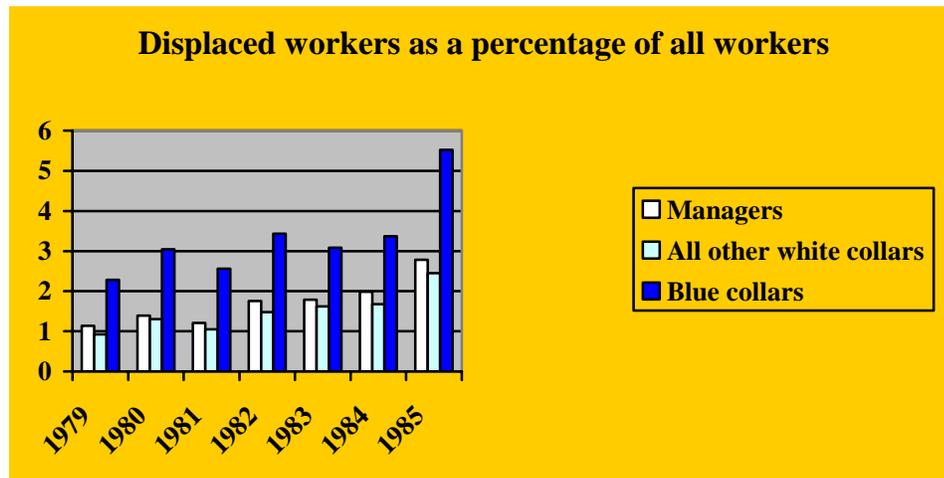
It is interesting to see that the positive relationship between state labor costs and net job loss became stronger during the 1980s despite the proliferation of worker dislocation over the 1980s. Using Hansen's state-labor-cost scores, net job losses between 1970 and 1979 were marginally related to state labor costs in 1970 (Pearson's  $r = 0.25$ ). However, net job losses between 1979 and 1986 were quite strongly related to state labor costs in 1979 (Pearson's  $r = 0.53$ ). This indicates that the problem of worker dislocation affected most states but with a varying degree: states with higher labor costs were hit harder. States vying for jobs and investment still had the incentive to use lower labor costs to lure business. Therefore, as Table 6

and 7 indicates, proponents of plant-closing legislation were forced to make compromise over the 1980s if they were to have any chance to see the legislation.

#### 4.4.2 Trade deficits and election

The year of 1987 saw new developments. First, now it became clear to the public that white-collar workers were no longer immune to job displacements. During the then-President Reagan term in office, American firms began to resort to deep corporate restructuring as a way to reduce large corporate debts and to maximize their shareholder values (Lazonick and O’Sullivan 2000). This led to a gradual increase of white-collar job loss between 1979 and 1985 as shown in Table 8. The strong public sentiment against free layoffs resonated in a 1987 opinion poll, where 86 percent of Americans supported mandatory advance notice.<sup>67</sup>

**Table 8** Increasing Risk of White-Collar Job Loss



Source: U.S. Census Bureau, Current Population Survey, various years.

<sup>67</sup> “Happy days may be here again for labor legislation.” *Business Week*. June 22, 1987. p. 57.

Second, Democrats gained control over both Houses in 1987. Early in that year, Democrats renewed their legislative campaign to pass plant-closing legislation as Rep. William Ford and Sen. Howard Metzenbaum respectively introduced to the House and the Senate the Economic Dislocation and Worker Adjustment Assistance Act, which required employers to give 180 days' notice before closing down or laying off a large number of workers.

Despite the Democratic control over the Congress, the success of this bill did not loom large in either House. Therefore, Democrats maneuvered to muster congressional support for notice requirement. Democratic Senators Edward Kennedy, Howard Metzenbaum, and Robert Byrd softened the language by reducing the notice period to 60 days and raising the small business exemption from firms with 50 employees to 100 employees. Then, they incorporated this new language into the Omnibus Trade Act.

Although President Reagan and many Republican legislators criticized that plant-closing legislation had little to do with the Trade Act, linking plant closings with trade proved to be an effective tactic. The U.S. trade deficits had been exploding since the early 1980s (U.S. Department of Commerce), which was the chief impetus for the trade legislation. Early in 1987, Democrats made passage of a trade bill a top priority for the new, Democratic-controlled Congress.<sup>68</sup> Besides the notice requirement, the Senate bill included provisions requiring the federal government to provide relief for domestic industries affected by imports and to assist U.S. farmers who were victims of unfair foreign trading practices. It also had a provision repealing the seven-year-old "windfall" tax on oil revenues that exceeded a statutory base price. Although Southern Democrats were generally cool to plant-closing legislation, they favored the

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<sup>68</sup> House Speaker Jim Wright of Texas said, "The first imperative in the 100<sup>th</sup> Congress will be to come to grips with the steady decline in American competitiveness and the corollary increase in the trade deficit." See CQ Almanac (1987: 640).

provisions on trade and the windfall tax on oil revenues. The combination of the soft statutory language and trade linkages worked effectively for the proponents of notice requirement. The Omnibus Trade Act was passed by the Senate in July 1987. All of the seventeen Southern Democrats voted for the bill.

The conference report on the Omnibus Trade Act was passed by both Houses in April 1988 and sent to President Reagan. The conference report added a provision on protecting U.S. textile industries, which weakened anti-labor sentiments among Southeastern Democrats, as did repealing the windfall tax on oil revenues did among Southwestern Democrats (CQ Almanac 1988, 12-B). However, President Reagan vetoed the bill on May 24, pointing to mandatory advance notice of plant closings as a major reason.<sup>69</sup> While the House passed the bill again over Reagan's veto, the Senate failed to override the presidential veto partly because of two Republican Senators of Alaska opposing the control over Alaskan oil export inserted to the conference report. Democrats in the Senate needed more support from the other side of the aisle to muster the necessary two-thirds majority.

After the Senate was unable to override the President's veto, Democratic leaders removed the notice requirement from the trade bill and introduced it as a separate bill on June 16, while another version of the trade bill was introduced without the plant-closing notice requirement. The Senate overwhelmingly passed the new plant-closing bill (WARN Act) by 72 to 23, sending a message to Reagan that his veto would not be sustained. Republican Presidential candidate George Bush and Republican leaders in the Congress urged Reagan not to veto the WARN Act

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<sup>69</sup> Reagan wrote in his message sent to the Congress, "The issue receiving the most attention in this bill is the mandatory requirement for business to give advance notice of closings or layoffs. I support voluntarily giving workers and communities as much advance warning as possible when a layoff or closing becomes necessary. It allows the workers, the employer, the community, time to adjust to the dislocation. It is the humane thing to do. But I object to the idea that the Federal Government would arbitrarily mandate, for all conditions and under all circumstances, exactly when and in what form that notification should take place." See CQ Almanac (1988: 15-C).

because they feared that Reagan's veto would reinforce the voters' perception that Republicans were not interested in working people and therefore could damage Republican candidates in the upcoming fall election.<sup>70</sup> Reagan withheld his veto this time and allowed the WARN Act to be enacted.

#### 4.4.3 Statistical analysis

The theory of competitive federalism predicts that states performing well in creating jobs will resist federal-plant closing legislation, while states losing jobs will support the legislation. I test this theory for the U.S. Senate in the 100<sup>th</sup> Congress, assuming that senators would vote on plant-closing bills for the interests of the states they represent. The dependent variable is individual senators' binary choices between yes or no on the Omnibus Trade Act and the WARN Act. *Congressional Quarterly Almanac* provided the roll call data.

JOBLOSS is my key explanatory variable linking interstate competition with senators' votes. It means the percentage change of net job loss in manufacturing sectors in each state between 1979 and 1986 (for the 1987 Omnibus Trade Act) or between 1979 and 1987 (for the 1988 WARN Act). My prediction is that a senator is more likely to vote for a plant-closing bill, if his state experienced a greater job loss rate over the period. The level of U.S. manufacturing employment reached a peak in 1979 and then began to decline. In this trend, plant closings increasingly became a nation-wide problem affecting some states in the Sun-Belt region. By choosing 1979 as a base year, I seek to test if the geographical expansion of job dislocations diminished the logic of interstate economic competition.

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<sup>70</sup> "Reagan Is Pressed on Plant Closings." *New York Times*. July 27, 1988. A1.

The other independent variables are IDEOLOGY, UNION, and WAGE. IDEOLOGY is senator's ideology, ranging from -1 (most liberal) to 1 (most conservative). My hypothesis is that more conservative Senators are less likely to vote for plant-closing bills because they oppose government intervention in the economy. The ideology data come from Keith Poole's first dimension of DW-NOMINATE scores.<sup>71</sup> UNION represents labor union's power in each state. My prediction is that senators from strong union states will be more likely to support plant-closing bills because of labor unions' pressures. The power of labor unions is measured by the percentage of union membership in total employment. The state union membership data come from Barry Hirsch and David Macpherson's database compiled from the Current Population Survey.<sup>72</sup>

Finally, I specify WAGE to account for the effect of state skill profiles on the employer preference about long-term employment. There is political economy literature that industries dependent on high-skilled labor would be more cautious to implement cutbacks because of high labor turnover costs (Estevez-Abe, Iversen, and Soskice 2001). Then, states abundant with plants using high-skilled workers will be less sensitive to the labor-cost effect of plant-closing bills than states abundant with plants using low-skilled workers.<sup>73</sup> Drawing from the economics literature that wages are returns to skill (Juhn, Murphy, and Pierce 1993), I use state average hourly earnings of production workers in manufacturing sectors to measure state skill profiles. My hypothesis is that states in which workers are paid higher wages per hour are more likely to support plant-closing bills. I use hourly earning data for 1986, which come from the U.S. Census Bureau's *Statistical Abstract of the United States*.

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<sup>71</sup> The Poole database can be accessed at <http://voteview.com>

<sup>72</sup> The Hirsch and Macpherson database can be reached at <http://www.unionstats.com>.

<sup>73</sup> Notice that the requirement of advance notice in the Omnibus Trade Act and the WARN Act applied to large-scale cutbacks as well as pure plant-shutdowns.

Table 9 summarizes regression results of the Senate vote on the Omnibus Trade Act and the WARN Act. What is common to both models is that IDEOLOGY is the most powerful and statistically significant predictor of the Senate vote on plant-closing bills. For a standard deviation increase in IDEOLOGY, the odds of the senator voting for the bill decrease 92 percent for Model I and 99.6 percent for Model II. UNION and WAGE do not have statistically significant effects on the voting behaviors of senators. It seems that neither labor unions supporting plant-closing legislation nor low-skilled industries hostile to restrictions on layoff were not important factors in the passage of plant-closing bills.

However, these two regressions produce quite different results in more details, although the notice requirements in the two bills are alike in principles and details and voted on in the same Congress. In Model I, JOBLOSS has a positive effect on the probability of voting for the bill as expected and it is almost significant at the 5 percent level. For a standard deviation increase in JOBLOSS, the odds of the senator voting for the Omnibus Trade Act increase 78 percent. The sign of UNION is consistent with the hypothesized effect, while the sign of WAGE is not. The negative effect of WAGE seems to be the consequence of senators from lower-wage, southern states who supported the bill because of import relief and repeal of the oil windfall profit tax.

In Model II, however, JOBLOSS is not statistically significant at the 10 percent level. This might reflect the effect of election-year politics as an exogenous factor because all independent variables are either constant or have very strong temporal correlations between 1987 and 1988. It seems that the need to woo working-class voters was far greater to Southern senators than the potential effect of plant-closing legislation on the business decision to move to the South, now that proponents of the pending bill had already softened the language

significantly. The explanatory power of IDEOLOGY is even stronger than Model I, which shows that the ideological opposition to the bill by a group of Republican senators became highly visible in 1988. The sign of WAGE is consistent with the hypothesized effect, probably because as the notice requirement was detached from the trade bill the effect of trade linkages became attenuated and state skill structures of industrial employment became more effective. The negative effect of UNION is surprising. Greater union support from his home state made the senator less likely to vote for the WARN Act, although the impact was not statistically significant.

**Table 9** Logit Regressions for the Senate Votes on Plant-Closing Bills

	<b>Model I: Omnibus Trade Act</b> (Passed 71-27 on July 21, 1987)		<b>Model II: WARN Act</b> (Passed 72-23 on July 6, 1988)	
Independent Variable	Coefficient (z score)	Standard Factor Change	Coefficient (z score)	Standard Factor Change
IDEOLOGY	-6.880 (-6.27)***	0.08	-15.932 (-4.62)***	0.004
JOBLOSS	0.050 (1.93)*	1.78	0.017 (0.22)	1.23
UNION	0.004 (0.06)	1.03	-0.096 (-0.88)	0.54
WAGE	-0.615 (-1.45)	0.49	0.518 (0.84)	1.82
CONSTANT	7.26 (1.94)*		0.04 (0.96)	
Observations	100		95	
Pseudo-R <sup>2</sup>	0.52		0.72	
Chi-square	43.04		26.54	
Percent correctly predicted	84		94	

Notes:

1. Dependent variable = 1 if a senator voted for plant-closing bills, 0 otherwise. The 100 observations of Model I include two senators who did not vote but announced for the bill.

2. \* = significant at the 10 percent level; \*\*\* = significant at the 1 percent level.
3. I used robust estimation to get correct standard errors.
4. I checked multicollinearity using the variance inflation factor (VIF). A rule of thumb is that a VIF larger than 10 is an indication that multicollinearity may be causing a problem (Chatterjee and Price 1991: 182). None of the regressors above had VIFs in excess of 2.

## 4.5 CONCLUSION

The case of U.S. plant-closing legislation shows the extent to which the government regulation of layoff can be established in a political system where the strong judiciary has traditionally defended the managerial right to layoff and where states and municipalities are forced to compete with each other for business and jobs. The 1988 WARN Act was the first federal legislation regulating termination of employment for economic reasons. Considering the employment-at-will doctrine had been the basic rule of employment relationships in the United States, this legislation was apparently a victory for organized labor.

However, the WARN Act was a very limited piece of legislation and has so far had only a marginal impact on the employer's decision to close plants or implement a large scale layoff. The long-standing judicial view of managerial prerogatives restricted the scope of intrusion by the government and labor unions in the decision to close plants or implement a large-scale layoff. Although the notice requirement was a judicially viable option, interstate competition for business and jobs forestalled a swift adoption of federal legislation stipulating a longer notice period. During the legislative process in the U.S. Congress, a majority of states opposed the introduction of any serious notice requirement because they thought it would straitjacket the economic development of their states. To alleviate this concern, proponents of plant-closing legislation were forced to significantly water down their bills.

The WARN Act so enacted requires employers to provide affected workers with 60 days' advance notice regardless of their length of service, which is one of the shortest among OECD countries. Even this modest notice requirement is exempted for employers who are planning to lay off less than a third of total workforce and whose decision to close plants or lay off workers was unforeseeable. According to a study of 11 states by U.S. General Accounting Office (GAO), more than half of employers employing more than 100 employees and planning to lay off 50 employees or more were excluded from the notice requirement under the WARN Act.<sup>74</sup>

The WARN Act also lacked effective tools for enforcement. Lawsuits are the only remedy available to workers or local communities under the WARN Act. The GAO study shows that even when plant closures/layoffs appeared to meet WARN requirements, fewer than half of the employers provided advance notice and only 29 percent of employers providing notification gave the required 60 days' notice. Despite the possible violations of the WARN Act, few lawsuits were filed since the law was enacted. The GAO study pointed out the costs associated with a lawsuit, the limited incentives, and the uncertainty about outcomes as major reasons why workers and local governments were hesitant about filing lawsuits.<sup>75</sup>

Since the New Deal era, collective bargaining has been the major tool for organized labor to raise the standard of living of workers and to ensure their job security. The introduction of the WARN Act formally marked an end to the laissez faire regime of employment protection. However, the WARN Act represents only minimal intervention by the government in the realm of employment protection. This legislation stands consistent with the long-standing

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<sup>74</sup> Statement of Linda G. Morra. "Dislocated Workers: Implementation of the Worker Adjustment and Retraining Notification Act (WARN)." Testimony Before the Subcommittee on Labor, Committee on Labor and Human Resources. U.S. Senate. 103<sup>th</sup> Cong., 1<sup>st</sup> sess. February 23, 1993. Gaithersburg, MD: U. S. General Accounting Office.

<sup>75</sup> Several local officials the GAO interviewed stated that they would run the risk of being viewed as anti-business, which could hamper efforts to lure new business investment. *Ibid.*, p. 5.

characteristic of American labor policy since the early twentieth century in that the statutory protection of workers against layoff provided by the WARN Act is awfully inadequate.

## **5.0 THE ORIGIN OF EMPLOYMENT PROTECTION LEGISLATION IN GERMANY, 1871-1976**

### **5.1 INTRODUCTION**

Germany provides the *prima facie* example of employment protection legislation among industrialized countries. It has the strongest legal protection of workers against dismissal among the three countries under the present study. Germany's protection of regular employment is higher than the average of fifteen European Union countries prior to the 2004 enlargement (OECD 2004). It is not only the degree of protection it provides that renders it worthwhile to study Germany's employment protection legislation. Germany has also been a pioneer in the area of employment protection legislation. The current legal system regulating employment protection was formed circa 1950 with an important precedent from the Weimar period on the basis of the Works Council Act of 1920 (Dose-Digenopoulos and Holand 1985). Over the second half of the twentieth century, German employment protection laws – the Protection Against Dismissal Act of 1951, the German Civil Code as revised in 1964, and the Works Constitution Acts of 1952 and 1972 – have provided legal standards in the areas of unfair dismissal, advance notice, and worker participation in layoff decisions. In particular, distinguished from the French system of dirigiste control over employment relations, Germany's

employment protection legislation features institutional frameworks emphasizing negotiations between business and labor, which has been the hallmark of Germany's social market economy.

How could German labor have these legal shields against arbitrary layoffs by employers? Recently, it has become a conventional view that employment protection legislation is embedded in a cluster of economic institutions comprising national capitalist systems, which differentiate the business preferences for employment protection (Hall and Soskice 2001). This varieties-of-capitalism literature tends to draw upon different economic institutions to explain the strong employment protection in Germany (See Chapter 2). In this chapter, I will demonstrate that the passage of historic legislation about employment protection in Germany was a product of the rise of organized labor after the collapse of dictatorship regimes and the weakness of countermajoritarian political institutions in the new democratic political environments. Strong employment protection in Germany did not originate from employers' support as the varieties-of-capitalism literature argues. Although German employers were interested in retaining skilled workers during economic recessions, they equally disliked the intrusion by labor into managerial decisions of layoffs. However, German employers were forced to make concessions to labor's demand for greater job security, when they faced either Social Democrats in power (e.g. the 1920 Works Council Act, the 1972 Works Constitution Act, the 1976 Codetermination Act) or political opportunism to woo working-class voters (e.g. the Protection against Dismissal Act and the Codetermination Act of 1951).

Before I enter main discussions, it seems proper to answer here whether codetermination as a prominent character of the German corporate governance system should be considered as part of employment protection. The conventional definition of codetermination is workers' representation on the management and/or supervisory boards of a company to balance

employees' and shareholders' interests.<sup>76</sup> Following this line, the OECD measurement of employment protection (OECD 2004) excludes codetermination à la board-level employee representation because the management and supervisory boards are company organs through which decision-making over conducting business takes place and as such neither poses *external* constraints on company's decision over dismissal.

However, I argue that codetermination at the company level is an indistinguishable part of German employment protection. The OECD's measurement ignores that board-level codetermination has played an important role in preventing large-scale layoffs resulting from corporate restructuring under increasing global business competition. Houseman (1991)'s research shows that the German codetermination made German steel employers resort to other methods of workforce reduction than straightforward layoffs in reaction to excess steel capacity during the 1970s and 1980s. German workers have held the legal right to take half of the seats on the supervisory board of coal and steel companies since 1951 and of large companies in other industries since 1976. In addition, the German corporate governance law requires major corporate decisions that “fundamentally change the asset, financial or earnings situations of the enterprise” to be approved by the supervisory board (Commission of the German Corporate Governance Code 2005: 4). Today these regulations prop up job security of workers living under the shadow of layoffs that have become increasingly associated major changes in production such as plant closings or relocations. They extend labor participation beyond the plant level to the company level and strengthen the institutional foundation of employment relations that induce German employers to adopt competitive strategies based on “negotiated

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<sup>76</sup> Meanwhile, Streeck (1984) presented two dimensions of codetermination: the codetermination at the company level that corresponds exactly to the conventional idea of codetermination and the codetermination at the workplace level that refers to workers' participation through works councils in individual plants.

adjustment” instead of the American-style “employer unilateralism.”<sup>77</sup> Therefore, I will include codetermination in my historical analysis of German employment protection legislation.

## **5.2 THE HISTORICAL DEVELOPMENT OF GERMAN CAPITALISM**

The goal of this section is to show when the capitalist institutions of Germany as the variety of capitalism literature emphasizes began to rise. Drawing upon the classification of economic institutions by the variety of capitalism literature, I briefly track down the historical development of financial systems, inter-firm relations, and vocational training and skill formation systems in Germany.

### **5.2.1 Corporate finance**

The marriage between large commercial banks and big businesses became a major characteristic of the German corporate finance system at the turn of the twentieth century (Gershenkron 1962). Large commercial banks such as the Schaaffhausensche Bankverein, the Disconto-Gesellschaft, the Darmstadt Bank für Handel und Industrie, the Berliner Handelsgesellschaft, the Deutsche Bank, and the Dresdner Bank played a central role in financing of big businesses through long-term credits and the issue of industrial shares (Kocka 1978: 565). These banks were not simply financial intermediaries but they were also active players in the daily management of their client corporations. One German economic historian commented on the banks and industries of Imperial Germany that were bonded with each other:

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<sup>77</sup> I borrowed the terms, negotiated adjustment and employer unilateralism, from Wever (1995).

Possessed of such voting power [in shareholder meetings] and relying on their influence as underwriters, the banks themselves were active in industrial management, delegating their own officers to the board of directors of industrial corporations. Conversely, the large industrial concerns were represented on the boards of the banks with which they had business connections (Stolper 1967: 28-29).

The close interrelations between banks and industries had a self-enforcing character as both parties were reluctant to terminate business connections once established. Banks rarely switched to other industrial clients to maximize short-term profits because, as Stolper (1967: 28) noted, there was a keen competition among large banks for establishing intimate contacts with major industries. Therefore, the large banks were prepared to accept short-term losses and did not withdraw their investment from industrial corporations even during the depression of 1900-1902 to maintain the long-term relationships with their clients (Kocka 1978: 566). Firms also preferred this long-term relationship with banks because of the informational advantage brought by insider banks well-informed of the client company's management.

The development during the first half of the twentieth century consolidated the original pattern in the bank-firm relationship. Mergers between large banks led to concentration in banking, increasing the financial influence of Berlin-based large commercial banks (Stolper 1967: 28-29). The experience of the 1931 bank crisis discredited securities as a means of corporate finance and the government policy shifted to discouraging the development of stock markets as a source of long-term capital for industry (Vitols 2001: 186-187). Banks remained the most important player in the provision of corporate finance during the postwar era, while the development of securities markets was very limited. For example, the proportion of securitized liabilities in total liabilities of non-financial companies of Germany was limited to 21.1 percent in 1995, while that of the United States reached 61 percent (Vitols 2005: 388).

### **5.2.2 Corporate governance**

Frick and Lehmann (2005) present two major characteristics of the German corporate governance system. First, the managers of the German firms are accountable to “stakeholders” including employees, shareholders, banks, and sometimes even the government, while the separation of ownership and control in the United States led to the system focusing on protecting shareholders’ interests. Second, due to the bank-based financial system, Germany’s big, universal banks influence the management of their client firms. Compared to American firms, German firms concentrate ownership in a few block-shareholders such as other non-financial firms, banks, and the government. Here the percentage of shareholding by the universal banks might be small, but the actual voting power they exercise is enlarged via the proxy voting practice.

Of these two traits of the German corporate system, the role of banks is originated from the late nineteenth century as discussed above. By contrast, the participation of employees in the management or codetermination is more recent institutional development. Before World War II, large German firms did not accept codetermination. It was by the Occupation Allies that codetermination was first institutionalized albeit in limited geographical areas and industries. Because I consider codetermination to be an important part of German employment protection legislation, I will deal with this issue in more detail in the subsequent sections.

### **5.2.3 Inter-firm relations**

The second economic characteristic that was potentially favorable to employment protection in the Imperial Germany was the tendency toward cartelization, organized cooperation among

independent firms with an aim to control prices and quantity. Modern cartels in Germany were first established in coal and steel industries during the great depression following the crisis of 1873 and the German cartel system became a dominant feature of the German economy in the ensuing period. There were only four cartels in 1875 but the number of cartels reached 385 in 1905 (Kocka 1978: 563).<sup>78</sup> Cartels among leading firms were found in almost every industry before the outbreak of the war in 1914 (Stolper 1967: 48). The labor market effect of limited competition in product markets is that it protects the monopoly rents that can be shared between business and labor (Blanchard and Giavazzi 2003). If limited competition fosters employers' willingness to provide job protection because employers are able to exploit monopoly rents, we should see more support from German industries for making layoff difficult.

The cartelization of German economy persisted throughout the Weimar Republic and reached a climax during the Nazi period. When Germany was defeated in World War II, the Occupied Allies sought to sever cartels, which they thought had contributed to the rise of the Nazis. They also aimed to prevent re-militarization of Germany by decentralizing Germany's industrial production. When the Federal Republic of Germany was established in 1949, Economic Minister Ludwig Erhard and his Chancellor Konrad Adenauer basically opposed cartels. And yet, they also opposed Allied measures of deconcentration because it might weaken the productive capacity of the German economy (Nicholls 1994: 328-329). Although cartels were formally banned in the FRG when the Anti-cartel Act was finally passed in 1957, this law was not a German-version of American antitrust law because it made too many exceptions and

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<sup>78</sup> The prevalence of cartels in the German economy at the turn of the century was a product of political economic factors. The political coalition between the authoritarian government and big business groups played a central role in the growth of cartels in Germany. The politically dependent German judiciary unable to resist the tendency toward cartelization delivered a decision that affirmed the legality of cartels in 1897 (Windolf and Beyer 1996: 205-206). In addition, Gerschenkron (1962) suggests that the bank-based financial system reinforced cartelization of industrial corporations because large banks did not want to see their clients compete against each other.

was too weak to prevent collaborative practices aimed at reducing competition (Nicholls 1994: 360). As Windolf (2002) points out, German firms still cherish collaborative relations with other firms within same industries through cross-shareholdings, interlocking directorates, and coordination by industrial associations. In this vein, it appears that the prewar ideal of regulated competition continued to be found in the structure of corporate networks in the postwar Germany.

#### **5.2.4 Production and skill formation systems**

The diversified production strategy based on firm-specific skills began to develop in Germany at the turn of the twentieth century. During industrialization, the process of deskilling labor that was found extensively in the United States was very limited in case of Germany. Although the gradual shift from the handicraft to factory production increased unskilled workers, the numerical dominance of skilled workers in manufacturing persisted during Imperial Germany. In 1895 there were 1.5 times more skilled and semi-skilled workers than unskilled workers in manufacturing (Nolan 1986: 366). This skill composition of labor force remained fundamentally true in the twentieth century. In 1933 skilled workers accounted for 48.6 percent of male workers in manufacturing and the share of unskilled male workers as distinguished from semi-skilled workers was limited to 30.1 percent (Lee 1978: 447).

Traditionally in Germany, the handicraft sector (Handwerk) comprising highly specialized small- and medium-sized firms had played a central role in the vocational training to produce skilled labor. As industrialization proceeded, Handwerk became vulnerable to the market penetration and poaching of skilled workers by big businesses. Although the conservative elites of Imperial Germany favored big, heavy industrialists in the areas of foreign trade and cartels, they were concerned about the possibility of unregulated industrialization to

produce a great number of proletariats out of failing Handwerker, which they saw would be a serious threat to their political regime (Streeck 1992: 112). Therefore, Imperial Germany enacted the Handicraft Protection Law in 1897 to protect Handwerk as a conservative shield against socialist labor movement (Thelen 2004). This law endowed regional handicraft chambers with the exclusive power to certify skills legally required in artisanal trades. German industrialists were forced to contend with the handicraft sector over the production and certification of skills and to establish firm-based training system in cooperation with Handwerk chambers because German workers increasingly preferred to obtain skill certifications for their own careers and employers also wanted to hire more skilled workers.<sup>79</sup> The current system of skill formation has been governed by the 1969 Vocational Training Act.that formally provided Handwerk chambers with the rights to approve and monitor in-plant training (Thelen 2004).

In conclusion, the main features characterizing the German capitalism today are not a recent invention. The bank-based financial system, collaborative intra-sectoral network, and relatively high density of skilled workers of the German economy dated back to the era of Imperial Germany. The next question is when and how employment protection began in Germany.

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<sup>79</sup> Very interestingly, as pointed out by Thelen (2004), this institutional development unexpectedly strengthened organized labor as skilled workers so trained joined labor unions and influenced works councils.

## 5.3 IMPERIAL GERMANY, 1871-1918

### 5.3.1 Employment protection enacted during the period

German social insurance schemes put into place under Chancellor Bismarck are considered as pioneering before other industrialized countries in terms of the origin of welfare states. During the 1880s, Bismarck introduced historic legislation on three areas of social security: Health Insurance for Workers Act in 1883, Accident Insurance Act in 1884, and Invalidity and Old Age Insurance for Workers Act in 1889.<sup>80</sup> The political motivation behind making these laws is well known. Having introduced the Anti-Socialist Law in 1878 to repress Social Democratic Party and free labor unions, Bismarck wanted to dampen the socialist appeal to the working class by improving the well-being of workers and making it dependent upon the state (Ritter 1983: 33-34; Leisering 2001: 114).<sup>81</sup>

Compared to the areas of social security, however, the role of state in the area of employment protection was virtually absent during the period of Imperial Germany, in which there was no legislation that seriously limited the freedom of employers to dismiss workers (Berghahn 2005, 21). Although in the 1890s employers began to establish works councils, a pivotal institution for workers' participation on the shop floor in the twentieth-century Germany, their intention was to co-opt labor movement and therefore the voice of works councils was very limited (Dore, Lazonick, and O'Sullivan 1999: 105). For example, the imperial government introduced the Act for the Protection of Labor (*Arbeiterschutzgesetz*) in 1891 which permitted

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<sup>80</sup> Unemployment insurance was not introduced until 1927.

<sup>81</sup> In the Imperial Message of February 15, 1881 to the Reichstag, it was stated that "A remedy [of social ills] cannot alone be sought in the repression of Socialistic excess; there must be simultaneously the positive advancement of the welfare of the working classes" (Dawson 1890, 110).

the establishment of works councils in almost all plants employing twenty or more workers, but it provided that employers had only to consult with workers on *social* matters such as health, safety, welfare, discipline and morale of workers, not being required to conform to workers' wishes (Schuchman 1957: 17-18). It was not until the enactment of the Works Council Act of 1920 during the Weimar Republic that the establishment of works councils became mandatory and works councils played a significant role as checks on dismissals (Lorch 1943: 128).

Employers in Imperial Germany were able to fire workers freely if they provided notice as the German Civil Code required (Guillebaud 1928: 161). Section 621 of the 1896 Civil Code required that employers provide advance notice to terminate indefinite employment relations except certain circumstances that could precipitate instant dismissal. The legal term of notice depended upon the mode of remuneration of the employee. If he was paid by the day, one day's notice was required; if he was paid by the week, one week's notice was required; and if he was paid by the month, fifteen days' notice was required (Loewy 1909: 153). This notice requirement was not excessively encumbering businesses compared to the situations in Britain and the United States. By the time when the German Civil Code was enacted, the English common law required reasonable notice although the length of notice not specified (DeGiuseppe 1981: 4-6). In the United States, where the employment-at-will doctrine became the governing rule of employment relationships, there was no legal obligation for employers to provide advance notice of layoff. However, one study of the U.S. cotton-textile industry in 1934 shows that slightly more than 40 percent of 188 employers who were surveyed provided at least one week for advance notification of layoff as a personnel policy (U.S. Department of Labor 1936: 1484). Since the cotton-textile industry tends to suffer frequent and violent changes in employment due

to seasonal factors, heavy industries whose employment was relatively stable were likely to provide more generous notice periods.

### **5.3.2 Employers' attitudes toward employment protection**

Many experts on the German history agree that big, heavy industrial interests concentrated in the Ruhr of western Prussia supported Bismarck's social welfare policy because they calculated it would serve their interests (Spencer 1979; Ullman 1981; Steinmetz 1996). Facing the upheavals of revolutionary labor movements, they shared the authoritarian conviction that effective social control would require the combination of material benefits and repression of labor activism (Spencer 1979: 48). It is even said that they provided for models of Bismarck's social legislation what they had already implemented to their own employees since the mid-nineteenth century. McCreary (1968: 27) argued that Bismarck's programs simply took employers' corporate welfare programs such as Krupp's, made them compulsory, and extended them to the national level.

Despite the economic conditions the varieties-of-capitalism literature would see as favorable for employment protection, the vocal support from the Ruhr heavy industry for Bismarck's social insurance laws seems completely absent when it comes to the question of establishing legal protection of workers against dismissal. While heavy industries in the Ruhr were interested in protecting skilled workers and therefore cautiously dealt with their employment security through retention schemes and reduced work hours responding to recessions (McCreary 1968; Huberman 1997), they also desired to preserve their managerial prerogatives in the area of personnel policy in the face of organized labor's pressures to regulate employment decisions. German heavy industry generally displayed authoritarian labor-

management relations based on the “Herr-im-Haus” position, i.e. employers’ claim to absolute rule over their employees (Jaeger 1967; Winkler 1976: 5; Eley 1989: 332).

During Imperial Germany, German workers failed to achieve rights to participate in making decisions over dismissals let alone the basic right to bargain collectively with employers on wages and working conditions. German employers in heavy industries opposed giving labor unions recognition and allowing joint regulation with workers’ representatives on employment, which they saw as a “political challenge to their overall power and authority in society” (Lewis and Clark 1981: 22).<sup>82</sup> They were so recalcitrant that even major strikes in 1896-97 and 1905 failed to bring employers’ concessions to militant workers (Barkin 1982). Large employers such as Krupp and Siemens used every arsenal to break strikes and to avoid collective negotiation with unions. They resisted any form of independent workers organizations, whether trade unions or works councils. Instead, they created company-controlled unions to strengthen company loyalty and to weak the appeal of the trade unions (Hickey 1985: 245). During the final years of Imperial Germany between 1900 and 1914, the spread of these so-called ‘yellow’ unions was extensively found in large business interests in the Ruhr.

In contrast to German heavy industry’s harsh hostility toward labor unions, light and processing industries tended to prefer compromises and negotiations with labor unions (Jäger 1967: 236; Steinmetz 1996: 296). Geographically concentrated in Baden, Württemberg, and the Kingdom of Saxony, these industries comprised small- and medium-sized firms producing a variety of consumer goods based on the amalgamation of traditional handicraft and modern technology (Herrigel 1996). These industries typically hired only a handful of, very skilled

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<sup>82</sup> In 1890 Henry. A. Bueck, General Secretary of the Central Association of German Industrialists (CVDI), said: “German employers will never be prepared to negotiate with workers’ organizations on an equal footing” (Lewis and Clark 1981: 22)

workers, which made them vulnerable to workers' demands (Abraham 1980: 91). Because of their production strategy focusing on specialization and export orientation, their interests were against cartels and protectionism of heavy industry and agrarian interests. As heavy industry dominated the CVDI, they withdrew their membership to establish the Federation of Industrialists (BDI) as a representative organization of their interests in 1895 (Abraham 1980: 92). To answer whether this segment of employers and the states where they were harboring were able to influence national legislation, we need to examine the political system of Imperial Germany.

### **5.3.3 A federation of undemocratic states**

Why did Imperial Germany not act to ensure social stability by providing greater job security for workers as it sought social insurance systems to respond to the rise of labor movement and class conflicts? As previously discussed, it is in part because the German heavy industry fiercely resisted workers' intrusion into managerial prerogatives. However, despite German employers' harshness toward labor unions, independent labor movements grew rapidly after the repeal of anti-Socialist Act and the resignation of Bismarck from the Chancellor of Imperial Germany in 1890. The number of total union membership was about 230,000 in 1890, but then it surged to one million in 1904 and 4.5 million in 1913 (Paque 1993: 210). The vast majority of union members had strong ties to the Social Democratic Party whose electoral power grew in parallel with the rise of union membership. The political system of Imperial Germany was not an autocratic regime in which popular participation was prohibited. The political system created in 1871 was a soft authoritarian regime based on a compromise between monarchism and parliamentarism (Berman 2001: 438). The franchise of Imperial Germany – universal suffrage

for males twenty-five or over – was the widest in Europe and the ballot system was effectively secret. Although the executive branch comprising the Kaiser, his chancellor and staffs was insulated from democratic control, the imperial legislature had a supreme power in making laws in domestic issues. After 1890 the SPD became a fast-growing party in the Reichstag, parliament of the imperial legislature. It gained the largest share of votes in every Reichstag election between 1890 and 1912 (Fairbairn 1997: 30). The SPD won the largest seats in the Reichstag first in 1912 because the Reichstag was elected by a plurality system in contrast to a proportional representation system. And yet, right-wing parties were not able to muster the majority in the Reichstag between 1890 and World War First. Their combined share of votes declined rapidly from 47 percent in 1887 to 25.7 percent in 1912 (Fairbairn 1992: 24).

Then, why did the political struggle of labor not result in any significant legislative victory over employers in the area of employment control? The answer lies in the political system of Imperial Germany in which highly undemocratic Prussia acted as a center of political gravity in the federal politics by means of its influence on the Bundesrat. In the United States, competitive federalism – competition on the one hand between different levels of government over jurisdictions and on the other among states for capital – and a strong judiciary committed to defend constitutionally guaranteed states' rights constrained the rise of employment protection at both federal and state levels. By contrast, the German federalism discouraged the adoption of imperial legislation on employment protection as well, but in quite different ways than the operation of American federalism. The Bismarck constitution vested legislative powers in the imperial government in an extensive range of areas including labor, which clearly distinguished Imperial Germany from the United States of the same period although both countries apparently took a federal form of government (Gierke 1910: 285). Since then, the strong federal legislative

power has always been a major feature of the German-style federalism (Merkl 1959: 733). Therefore, the imperial jurisdiction over labor laws was rarely problematic since the formation of Imperial Germany. The other features of American federalism were also not present or less prominent in Germany. Although important taxes on income and property remained under the jurisdiction of states (Renzsch 1989: 21), weak imperial regulations over employment cannot be seen as a result of the race to the bottom among states craving for capital as the hegemonic power of Prussia in Imperial Germany brought about the upward harmonization of state tax rates on capital (Hallerberg 1996). While the Reichsgericht, the imperial court, was as hostile to labor as the U.S. Supreme Court of the same era, the impact of the Reichsgericht on the weakness of employment protection is dubious because it was not an independent actor. The Reichsgericht was subordinate to the Kaiser and the imperial legislature, lacking the right to review the constitutionality of imperial statutes (Heun 2003: 1999).

What mattered in the German federalism was a mix of undemocratic political regimes of constituent states, especially of Prussia, and the role of the Bundesrat, the federal chamber of the imperial legislature. The main feature of the Bismarck constitution was that it effectively ensured the *direct* participation of constituent states in making imperial laws by means of the Bundesrat that was a federal council comprising delegates appointed by state governments (Lehmbruch 2000). The Bundesrat had the absolute veto power in the passage of legislation; even a majority in the Reichstag was not able to push through its legislative agenda unless it secured the consent from the Bundesrat.

The Bismarckian constitution of 1871 was designed to be federal because Bismarck aimed to preserve the feudalistic political structures within individual states against liberal and socialist pressures in the Reichstag (Brecht 1945: 4). Imperial Germany was not a federation of

republics but a federation of monarchs and princes as the preamble of the Bismarck constitution indicates.<sup>83</sup> As Fairbairn (1997: 15) noted, the universal male suffrage for the Reichstag existed alongside restricted state suffrages meant to protect those privileged within individual states. However, there was a variation of political openness among German states ranging from relatively liberal Baden, Bavaria, and Württemberg in southern Germany to highly undemocratic Prussia and Saxony (Ziblatt 2006: 113-114). For example, the electoral system of Prussia was neither direct, nor equal, nor secret (Suval 1985: 233). It retained a three-class voting system which divided Prussian male aged over 24 into three classes calculated by how much tax one paid. This system was fundamentally plutocratic because the first class that paid the highest tax but comprised a handful of voters elected as many electors as the third class that paid little or no tax but made up of massive voters. Although the southern states had limited suffrages as well, they more resembled the Reichstag suffrage system (Niehuss 1990).

The historical literature confirms that government reactions to the rise of free labor movements varied according to this political institutional difference between Prussia and southern states. While labor unions suffered malicious police harassment in Prussia, they met with relatively liberal policies in southern states (Saul 1985: 338).<sup>84</sup> The influence of the conservative elites in Prussia based on the alliance between heavy industry and agrarian interests was funneled

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<sup>83</sup> The preamble of the Bismarck constitution begins: “His Majesty, the King of Prussia on behalf of the North-German Federation; His Majesty, the King of Bavaria; His Majesty, the King of Württemberg; His royal Highness, the Grand-Duke of Baden; and His Royal Highness, the Grand-Duke of Hessen and of the Rhein – the latter for the section of the Grand-Duchy situated south of the river Main – conclude an eternal federation to protect the federal territory and the law of the land as well as to promote the welfare of the German people. This federation shall be known by the name of German Reich and shall have the following Constitution” (Brecht 1945: 4).

<sup>84</sup> Spencer emphasized the close tie between heavy industrialists in the Ruhr and the Prussian government. He noted, “Government officials did on occasion, especially during the Ruhr coal strike of 1905, criticize the excessive rigidity and harshness of employer policies, which threatened to alienate workers and drive them into the arms of the socialists. But on the whole, throughout the existence of the Empire, there was overwhelming agreement between Ruhr industrialists and Prussian officials about the nature of the employers’ role and the authority that attached to it. And there was further agreement between the two groups that the defense of the employers’ authority constituted a central element in the defense of authority as such (Spencer 1979: 49).

into the realm of federal politics by means of the Bundesrat. Prussia accounting for a three-fifth of the imperial population controlled seventeen votes out of the fifty-eight votes in the Bundesrat. The predominance of Prussia in the Bundesrat enabled her to block proposed federal legislation that was against its interests (Berman 2001: 439). For example, the Reichstag proposals to guarantee workers' right to organize and bargain collectively were turned down because of oppositions from Prussia and the Bundesrat (Saul 1985: 350).

## **5.4 THE WEIMAR REPUBLIC, 1919-1933**

### **5.4.1 The 1920 Works Council Act**

The Works Council Act was introduced in February 1920 under the National Assembly that had delivered the Weimar constitution. It was the first legislation in the history of Germany that mandated institutions of workers representation with significant powers in the shop floor. It required the establishment of works councils composed of elected workers in plants with at least twenty workers. The power of works councils in the area of employment protection was so substantial that the works councils during the Weimar Republic were clearly differentiated from the shop committees of Imperial Germany, basically established by employers as a check against labor movement. About this law Lorch (1943: 127) noted:

By far the most important duties of the works councils related to the engagement and dismissal of employees. It is to be noted, however, that the powers of the works councils were considerably wider with respect to dismissals than to engagements.

The protection against dismissals introduced by the Works Council Act can be summarized in terms of individual and collective dismissals.<sup>85</sup> In case of the dismissal of an individual employee, the employee could appeal to works councils within five days after the date of dismissal. If the works council considered the protest justified, it must first seek to reach an agreement by negotiation with the employer. Failing to conclude an agreement within a week, the works council or the employee could appeal to the labor court.<sup>86</sup> In case of the dismissal of a large number of employees, the employer had to notify the works council as far in advance as possible concerning the nature and scope of the dismissals and to discuss the means for avoiding hardship.<sup>87</sup>

#### **5.4.2 War, revolution and labor**

How could this legislative change to protect workers against dismissals happen? The collapse of Imperial Germany and the ensuing regime change to the Weimar Republic played a crucial role to force employers' acceptance of compulsory works councils. Although the Anti-Socialist Act was repealed in 1890, employers insisted on not recognizing labor unions. They refused to engage in collective bargaining with labor unions because they saw it as encroaching upon their autocratic position within plants. However, the First World War rendered the repression of labor movement to look increasingly untenable to government officials who needed organized labor's cooperation for the war economy. In 1916 the Imperial German government introduced the

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<sup>85</sup> I drew upon Lorch (1946: 128-129) for the discussion of employment protection provided by the Works Council Act.

<sup>86</sup> Neither protest to the works council nor an appeal to the labor court suspended the effect of the dismissal (Guillebaud 1928: 162).

<sup>87</sup> There were no penalties for the breach of this provision, but German courts held that if the employer disregarded his obligation of notification and consultation, employees affected by the decision of collective dismissal were eligible to appeal individually against their dismissals (Guillebaud 1928: 168).

Auxiliary Service Act, which called for the establishment of shop committees in plants with more than 50 workers. Also, there was a legislative reform to free labor unions from police surveillance and harassment and to allow railroad workers to join unions provided they renounced strikes (Bieber 1987: 76). Nevertheless, the attitude towards labor unions remained virtually unchanged. Employers refused to accept union movement and in many companies union members continued to be persecuted and impeded (Bieber 1987: 76).

The real momentum to end the lack of protection against arbitrary dismissal by employers came with the 1918 Revolution after Imperial Germany was defeated in the First World War. When the German Revolution broke out in November 1918, Workers and Soldiers Councils inspired by the 1917 Bolshevik Revolution in Russia sprang up in major industrial cities and spread rapidly all over Germany. This revolutionary movement aimed to set up a Soviet or Council State, emulating the “Dictatorship of the Proletariat” in Russia (Guillebaud 1928: 7). While the Soldiers and Workers Councils obviously threatened the existence of business groups in Germany, they also posed a serious threat to the mainstream labor union movement led by the Social Democratic Party (SPD) and its affiliated “Free” unions. The mainstream labor movements composed of the Free (Social Democratic), liberal Hirsch-Duncker, and Christian labor unions supported parliamentary democracy to provide social welfare for working classes and to guarantee the collective rights of labor unions against the Bolshevik dictatorship (Moses 1982: 293). They sought to provide for co-determination, parity with management, on the basis of the continued existence of private enterprise. The extreme left-wing of the labor movement, who promoted workers self-government and socialization of the means of production through the Workers and Soldiers Councils, attacked the mainstream of the labor movement as a betrayal of the socialist idea (Shuchman 1957: 60).

In response to this frightening situation after the 1918 Revolution, employers seemed ready to make concessions to the reformist labor groups because of their fear of the radical movement (Thelen 1991: 67). The Stinnes-Legien Agreement of November 1918 was a product of political compromise between business groups and the mainstream labor movements, both of whom wanted to contain communism from Germany. In the Stinnes-Legien Agreement, employers agreed to grant labor unions unrestricted rights of assembly and collective bargaining and to establish mechanisms for conciliation and arbitration comprising an equal number of employers' and workers representatives for resolving industrial disputes (U.S. Bureau of Labor Statistics 1919: 1104-1106).

Strong political and organizational resources buttressed the power of the reformist labor groups in the reconstruction of Germany in the immediate years after the Revolution. First, the membership of the three reformist labor unions increased rapidly from 1,181,211 in 1916 to 3,541,197 in 1918, compared to the slight increase in the membership of radical groups (U.S. Bureau of Labor Statistics 1922: 210). Secondly, the reformist labor groups played a major role in political institutions during the interim government. The Joint Central Committee (ZAG) established to implement the Stinnes-Legien Agreement was composed of an equal number of representatives from the reformist labor groups and employers organizations (Moses 1982: 224). Also, the Council of People's Representatives, the interim government of Germany, favored the reformist labor groups as opposed to radical labor movements, although it was based on a coalition between the reformist Social Democratic Party (SPD) and the radical Independent Social Democratic Party (USPD) (Moses 1982: 292). After the disgruntled USPD representatives withdrew from the coalition in December 1918, there were uprising by

communists. The interim government led by Friedrich Ebert used the army to suppress the uprisings (Miller and Potthoff 1986: 70).

However, the social partnership between labor and capital formed immediately after the Revolution did not last long. As political situations returned to normalcy after the initial threat to private enterprises following the 1918 Revolution, employers reverted to their prewar position of the patriarchal “Herr-im-Haus” plant relations by the time works councils were being debated in the constituent National Assembly. The employers organization attacked works councils for a “ruinous onslaught on the essential conditions of industrial enterprise” (Lorch 1943: 118). The Confederation of German Employers’ Associations (BDA) opposed the passage of the Works Council Act in the form that was adopted in the National Assembly (Thelen 1991: 69). Furthermore, the extreme left bitterly opposed the Works Council Act adopted by the Reichstag for betraying the ideals and hopes brought by the German Revolution.

Despite the oppositions from both industry and radical labor groups, the Works Council Act was adopted in February 4 of 1920. As Thelen (1991: 68) noted, the Works Council Act represented a significant triumph for the reformist labor groups. The reformist unions supported industrial democracy based on works councils, but they opposed the radical idea that works councils should be autonomous from labor unions and eventually supersede the latter. Consequently, while the Works Council Act underlined the independence of works councils from management by describing the purpose of works councils as being “to protect the common interests of the employees as against the employer,” it also made works councils “subsidiary and subordinate organs of the Trade Unions” (Guillebaud 1928: 41).

### 5.4.3 The Weimar federalism

The passage of the 1920 Works Councils Act was not just an outcome of the power of the reformist labor groups, but also reflected the fact that the political system of the Weimar Republic made it easier for the reformist labor groups to have their demands translated into national policy outcomes. In contrast with Imperial Germany, the Weimar Republic was a parliamentary democracy in which the head of the government, Reich Chancellor, was dependent upon the Reichstag majority and the Weimar constitution introduced more centripetal characters in the German federalism. The result was that coalition parties controlling a majority in the Reichstag were able to pass any legislation once they agreed to do.

In January 19 of 1919 there were elections to form the National Assembly that was to provide a constitution for the Weimar Republic. At the elections the Social Democratic Party (SPD) gained a majority of seats leading all other parties, as shown in Table 10. After failing to reach an agreement with the radical left Independent Social Democrats (USPD), the SPD formed a coalition government with two middle-class center parties, the Catholic Centre Party (Zentrum), and the liberal Democratic Party (DDP). These three parties known as the Weimar Coalition represented three fourths of the National Assembly.

**Table 10** The Election Result for the National Assembly

Party	Percentage of Votes	Seats
SPD	37.9	165
Zentrum	19.7	91
DDP	18.6	75
DNVP	10.3	44
USPD	7.6	65
DVP	4.4	19
Others	1.6	7

Source: Miller and Potthoff (1986: 296).

Since the left wing of the SPD defected to form the USPD, the Social Democrats, the Centrists, and the Democrats shared views on major political and social issues. For example, all of them supported a republic as the post-Revolution political regime against a return to a monarchy. Also, despite their different ideological origins, the Social Democrats, Roman Catholics, and Liberals in the Weimar Coalition held up participation by works councils in personnel and social questions.<sup>88</sup> Particularly, the SPD and the Catholic Centre, two big mass membership parties, had common interests in strengthening the material welfare and collective rights of working classes because the Majority Socialist unions and Christian unions respectively accounted for a large chunk of electorates in each party (Manow 2005: 232).

After the National Assembly was formed, the Weimar Coalition appointed Hugo Preuss, DDP Minister of Interior and liberal jurist, to draw a draft constitution. He basically envisioned a decentralized unitary system and a parliamentary democracy in which the government would be made dependent on parliament. Now that the German states themselves were under transition from monarchies to republics, they were willing to accept a parliamentary and democratic constitution. But the relationship between the federal and state governments was a thorny issue. Preuss sought to reduce the German states to administratively autonomous units while the central government should be endowed with more extensive powers. Because state governments diametrically opposed Preuss's unitarist idea, the Weimar Republic had to be a federal state if national unity was to be maintained.

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<sup>88</sup> Spiro (1958) discusses these three distinct ideological origins of co-determination in Germany. The DDP initially opposed a more radical version of the Works Council Act, which would have allowed the more extensive role by works councils in economic matters. However, as its watered-down version limited the economic functions by works councils, the DDP joined the other coalition parties to pass the law.

However, the coalition parties in the National Assembly successfully reduced from the Weimar Constitution much of the strong federalist character of the Imperial Constitution (Manow 2005: 233-235). First, former German *states*, now to be called sovereignty-neutral *Länder*, were weakened considerably in their legislative and executive powers. Most importantly, the power of direct taxation was centralized to the Reich government. After tax revenues being pooled, they were to be shared between the Reich and Land governments. As Manow (2005: 235) noted, this constitutional reform of fiscal power “gave the central government access to its own substantial tax revenues for the first time.” Furthermore, the principal powers reserved to the *Länder* were limited to the administration of the courts, maintenance of law and order, direction of education, concern for religious affairs, and supervision of local government that were of little political significance (Eyke 1962: 74). Meanwhile, the Reich was able to intervene in key policy areas such as labor and social welfare through its extensive right of concurrent legislation for the purpose of enacting nation-wide standards (Manow 2005: 236).

Second, the Weimar Constitution also diminished the power of the Reichsrat, the federal council of the Weimar legislature. The Reichsrat consisted of delegates of Land governments as the Bundesrat of Imperial Germany. However, while the consent of the Bundesrat was required to pass legislation during Imperial Germany, the Reichsrat only assumed a suspending veto power as the Reichstag was able to override the Reichsrat’s veto by a two-thirds majority (Manow 2005: 233). Furthermore, the Reichsrat no longer held the exclusive right to initiate legislation, but it had to share the right to initiate legislation with the Reichstag.

These centralist tendencies in the Weimar Republic made the German federal state very distinct from the American counterpart. First, the Reich government of the Weimar Republic did

not face the degree of political activism for states' rights that obstructed the federal intervention to deal with labor unions and unemployment in the pre-New Deal America. The Reich government had extensive legislative powers over social welfare and labor policy. Second, Länder's fiscal autonomy was significantly compromised because the Reich government gained control of direct taxation. In the United States where constituent jurisdictions have their own tax bases, poorer states have strong incentives to launch economic development policy, which is basically to create local environments favorable to business investment. Therefore, the U.S. states have been very reluctant to introduce higher labor standards that businesses oppose. Contrary to the American federalism, poorer Länder in the Weimar Republic had limited incentives for using policy measures to stimulate an inward flow of capital and labor because their independent tax bases were scant. Consequently the interstate competition that plagued the making of social welfare and labor policy in the United States was not effective in the Weimar Republic.

#### **5.4.4 Constrained judicial power**

While the judges of Imperial Germany were rejected the right to test laws for their constitutionality, there existed tendencies toward the acceptance of judicial control of laws passed by parliament in the Weimar Republic. The National Assembly was evenly split on judicial review and the Weimar Constitution neither formally recognized nor expressly forbid judicial review (Kommers 1976: 57). Right-wing parties, who were suspicious of democratic parliament because they equated parliamentary democracy with left-wing rule, argued in favor of judicial review to deteriorate the Weimar Constitution (Hartmann 2003: 121). The judges of the Reichsgericht, the Federal Supreme Court, were the civil servants of Imperial Germany, were

predominantly conservative, and regarded themselves as a bastion against socialism (Stolleis 2003: 271). Therefore, although the judges avowed to serve the new republic loyally after the Revolution (Stolleis 2003: 272), there was a degree of tension between the Reich government and the Reichsgericht. The Reichsgericht first asserted the right to test the constitutionality of federal laws in 1925 and actually exercised judicial review to void two federal laws until the collapse of the Weimar Republic (Dietze 1957: 545-547; Kommers 1976: 58).

However, the judicial checks against parliament remained limited in Germany compared with the American case. Judicial review was never firmly established during the Weimar Republic as it was hotly debated even after the Reichsgericht openly asserted the right to judicial review in 1925. The judges confined judicial review to test statutes for their compatibility with the Weimar Constitution that could be amended by a two-thirds majority in the Reichstag. In its relationship with the executive branch, the Reichsgericht was not politically strong. The Reich government dwarfed the Reichsgericht in deciding upon disagreements between the Reich government and the Länder, which was a *raison d'être* of the judiciary in the federal system. The most revealing case was the inter-branch conflict that occurred in 1928 between Hermann Müller, Social Democrat Chancellor, and Walter Simons, President of the Reichsgericht (Simons 1929: 767). Four years after the Weimar Republic nationalized railroad systems that had been controlled by Land governments, the Reich government transformed the state-owned national railways into a semi-private railroad company, Deutsche Reichsbahn-Gesellschaft (DRG), in 1924. Initially, the Reich government was engaged in an agreement with the Länder to reserve a seat for every Land in the board of directors of the DRG. However, as the Dawes Plan to implement Germany's war reparations forced to reduce the number of members in the board of directors, the Reich government reneged on its promise because it would have to decrease seats

for the Reich government if the initial agreement was to be fulfilled. Therefore, the Reich government announced that it would appoint its own candidates to all vacant posts. The Länder sued the Reich government before the Reichsgericht. To Walter Simon's chagrin, however, the Reich government disregarded the Reichsgericht and pushed the appointment of its own candidates before the court was convened. Walter Simons resigned in a protest against the Reich government, but this could not lead to revoke their action about the DRG.

## **5.5 DISMISSAL OF EMPLOYEES IN THE FEDERAL REPUBLIC OF GERMANY**

### **5.5.1 The collapse of fascism and the revival of German labor**

After Hitler came to power in 1933, developments in labor protection under the Weimar Republic were completely dismantled by the National Socialists. Hitler severely repressed labor union activities and abolished the Weimar works councils. The National Socialist "Charter of Labor" denied workers all rights of consultation and participation (Thelen 1991: 70). Industrial relations reverted to the earlier state of employers being the masters in their plants that characterized the pre-World War period.

Germany's defeat in the two world wars brought favorable political environment to the German labor. When the country's first defeat resulted in the collapse of Imperial Germany, the possibility of works councils to turn into bastions for a proletariat revolution loomed large. In this circumstance German employers approached to the reformist labor groups in an aim to forestall the deluge of radical left movements. The 1918 Stinnes-Legien Agreement was the outcome of political compromise between capital and labor. However, the shift in employers'

position toward recognition of labor unions was fundamentally strategic. After the threat of extreme-left movements receded, German employers by and large returned to their traditional anti-unionist position.

Germany's defeat in the Second World War also played an important role in empowering German labor. This time the policy of the Allied Control Council critically affected the evolution of laws regarding works councils and codetermination. Immediately after the war works councils voluntarily sprang up to provide basic services to the Germans and restart production in plants (Thelen 1991: 72). The Control Council, the military government comprising Britain, France, the Soviet Russia, and the United States, encouraged the establishment of works councils in individual firms throughout Germany and it eventually sanctioned them by enacting the Control Council Law No. 22 in April 1946.

The Law No. 22 did not make the establishment of works councils compulsory, but merely permitted it. The German labor gained further momentum as the Control Council unveiled its industrial policy for Germany in August 1946. The Allied Control Council had accused major German industrialists of being responsible for the rise of the National Socialists and supporting the Nazi government's war campaign. Therefore, the occupation authorities sought to dissolve cartels in a way of denazifying and demilitarizing the postwar Germany. The threat to dismantle German industries was biggest in the British occupation zone that included the Ruhr coal and steel area, Germany's industrial heartland. The British launched their decartelization program in the steel industry, "Operation Severance," by organizing the North German Iron and Steel Control (NGISC) in August 1946 (Shuchman 1957: 123). Breaking up the organization of their basic industries was not a popular task with the Germans. Therefore, the NGISC sought the support of Hans Böckler, who led the German labor union movement and

eventually became the German Trade Union Federation (DGB), by offering him labor's co-determination in the severed companies. At last, iron and steel companies agreed to introduce parity codetermination that granted works councils an equal number of seats on the supervisory board was established in 1947.

Quite interestingly, even the newly founded Christian Democratic Union (CDU), the then largest political party in Germany, expressed their support of limiting the free enterprise in the Ahlen Program that was adopted in February 1947 (Carr 1987: 193). The Ahlen Program was a product of power struggles between the left- and right-wing groups within the CDU. At the moment the public mood against free capitalism in the immediate postwar years in Germany helped the left-wing group of the party become salient and prevail over the right-wing group. By the time West Germany was established, however, the electoral pendulum swung right. The recovery of German economy under the American tutelage based on anti-communist and pro-free market policies favored the right-wing group of the CDU and as a result increased the ideological distance between the CDU and the SPD. In the next sections I will discuss how political competition between these two major parties in the Bundestag affected the postwar development of employment protection legislation in the distinctively German political institutional setup.

## **5.5.2 The Basic Law and the postwar German federalism**

### **5.5.2.1 The election of the Parliamentary Council**

By March 1948 Britain and the United States made it clear that they would push through the formation of West Germany by integrating their zones. Their commitment forced the participation of France that had initially declined to join them because of the disagreement over

the political organization of West Germany.<sup>89</sup> The Germans objected the Allied powers' decision because they feared it would make the division of Germany permanent. However, they eventually accepted it, provided that the constituent assembly adopted a provisional constitution named Basic Law.

In August 1948 each Landtag - the lower chamber of the Land legislature - elected delegates for the Parliamentary Council that was to draft Basic Law. The Parliamentary Council was composed of 65 members from the Western Länder (Golay 1958: 19). The Christian Democratic/Christian Social Union (CDU/CSU) and the Social Democrats (SPD) equally accounted for twenty-seven representatives. The Free Democrats (FDP) were represented by five and other parties by two each. Konrad Adenauer, the Christian Democratic leader, was elected president of the Parliamentary Council.

### **5.5.2.2 The federal supremacy in legislation**

Political parties in the Parliamentary Council were split over the form of federalism to be adopted.<sup>90</sup> The Christian Democrat Union and its sister party in Bavaria, the Christian Social Union, took the position of strong Land autonomy and equal powers between the popular and the federal chambers. In contrast, the SPD preferred the Weimarian federalism, in which the powers of legislation and taxation were centralized but administration was decentralized, for their vision of a liberal social state. Two small parties, the Centre party and the Free Democratic party

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<sup>89</sup> France preferred a loose association of the Länder to prevent Germany from rising to an aggressive power. Therefore, they argued for extreme decentralization of power in which authority to raise taxes was to exclusively be reserved for Land governments and the federal legislature was to be a unicameral body of a federal chamber. On the other hand, the United States preferred a bicameral legislature to ensure both the democratic and federal characters of the central government and put forward the central government with sufficient powers to cope with problems expected to arise from the postwar economic reconstruction. Britain was close to the American position (Golay 1958: 8-9).

<sup>90</sup> For the positions of political parties, I heavily depended upon Golay (1958: 41-44).

(FDP), were closer to the position of the SPD than that of the CDU/CSU regarding the federalism issue. Although they opposed a centralized state, they approved sufficient central power to ensure national unity against Land particularism.

The Parliamentary Council essentially tilted toward the latter group and as a result the German federal state in the postwar era took the form that was fundamentally different from the American federalism. Beside the exclusive power the federation had to legislate, the Basic Law gave the federal government concurrent legislative powers over a long list of matters including labor and social security. Article 72 of the Basic Law stipulated that in the matters of concurrent legislative powers the federal laws were to preempt Land laws and this clause also broadly defined the legal conditions for the federal intervention. The Allied authorities preferred to limit the case for federation's use of concurrent powers, but the Germans prevailed. The legislative areas under the exclusive Land jurisdiction were limited to education, regional industrial policy, and public infrastructures.

While the Basic Law adopted the supremacy of the federation in legislation, the Länder were able to participate in making federal laws through the Bundesrat, the federal chamber consisting of delegates from the Länder governments. The legislative power of the Bundesrat under the Basic Law was greater than that of the Reichsrat under the Weimar constitution. While the Reichsrat had a suspending veto for all federal laws, the Bundesrat had absolute veto in matters that affected administration by the Länder of federal legislation. Although a majority of delegates in the Parliamentary Council rejected the proposal by CDU/CSU to bring back the Bundesrat under the Bismarckian constitution, the number of matters requiring the consent of the Bundesrat was considerably large, accounting for approximately 55 percent of all federal laws (Manow 2005: 234). Thus, the Basic Law clearly rejected the American ideal of competitive

federalism, in which the federal and state governments claimed their exclusive legislative powers. Instead, the Basic Law in practice set up the Bundesrat as a venue in which the federation and the Länder constantly met to negotiate and compromise over federal legislation. As Watts (1999: 26) pointed out, the interlocked relationship between the federal government and the Länder governments became a notable characteristic of the German federalism.<sup>91</sup>

### **5.5.2.3 Fiscal federalism in Germany**

No other areas would reveal the extensive constitutional and political interlocking of the federal and state governments characterizing the German federalism better than its fiscal federalism, namely, a constitutional principle of how financial resources are collected and allocated to governments at different levels. The German fiscal federalism established in 1949 was distinguished from the U.S. fiscal federalism by the centralization of tax legislation and the fiscal equalization scheme to correct horizontal and vertical imbalances.

Facing the issue of how to financially organize a federal state, the founders of the Basic Law in the Parliamentary Council opposed the American solution that the federal and state governments had financial autonomy and vied for tax sources with each other (Golay 1958: 76). They feared that if the Länder had financial autonomy, the Länder would seek to maximize their narrow interests and the competition between the federation and the Länder and among the Länder would undermine the reconstruction of the national economy at large. The Parliamentary Council saw that the new democratic federation could not afford this. Therefore, the Parliamentary Council put forward a distinctive financial arrangement that concentrated powers to raise taxes to the federation, established a pool of collected taxes subject to a constitutional

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<sup>91</sup> For more treatment of German federalism from the comparative perspective, see Scharpf (1988) and Sbragia (1992).

division between the federation and the Länder, and a redistribution of taxes between rich and poor Länder to equalize living standards throughout West Germany.

The Allied authorities opposed this fiscal arrangement as “insufficiently federalistic” (Golay 1958: 77). They preferred the American-style fiscal federalism in which the federation and the Länder had dual tax powers and federal legislation on taxes were strictly limited to finance federal activities. In the end, there was compromise between the Allied authorities and the Germans that revenues from sales tax belonged to the federation while revenues from income taxes to the Länder. And yet, the Germans essentially prevailed in the question of fiscal federalism. Article 72 of the German Basic Law stipulated that a federal regulation is necessary for the establishment of equal living conditions beyond a territory of a Land. The constitution also listed policy areas where the federal government could engage in the tasks of Länder through concurrent legislation powers to ensure balanced regional development and uniformity of living conditions throughout the federation.

Thus, the Basic Law established national uniformity in the area of fiscal legislation that was lacking in the American case. The U.S. state governments have tax bases autonomous from those of the federal government. States retain the right to levy taxes and to regulate the taxing powers of local governments. Thus, multiple tiers of government can exploit the major revenue sources by tax legislation of each own. For example, both federal and state governments may levy personal and corporate income taxes, and selective sales taxes. In contrast, tax legislation in Germany has been placed under federal government’s exclusive mandate. The federal government decides on all major revenue sources including personal and corporate income taxes and sales taxes while Länder collect these taxes by federal laws (Voigt 1989, 104-105). Once collected, tax revenues are shared by the federal and Land governments. They are distributed

vertically and horizontally in the form of fiscal equalization between states and supplementary federal grants to financially weaker Länder. As a result of these gap-filling financial transfers, the fiscal abilities for all states are ensured to be higher than 99.5 percent of the average.

Table 11 provides evidence for fiscal equalization among the Länder. Without any financial transfers, the gap in terms of public revenue per capita relative to the average of all states amounts to 113.8 percent points between Hamburg and Thuringia. However, after all horizontal and vertical equalization schemes are concluded, Thuringia comes to earn more public revenues than Hamburg by 25.5 percent points. The principle of intergovernmental solidarity is effectively realized by the financial equalization scheme in Germany.

**Table 11** Fiscal Equalization among the German Länder, 1995

Rank before equalization	Federal states	Relative public revenue per capita (average = 100)			
		Before equalization	After interstate equalization	After federal grants	Rank after equalization
1	<b>Hamburg</b>	157.5	102.3	93.4	15
2	<b>Hessen</b>	118.7	103.5	94.6	10
3	<b>Baden-Württemberg</b>	115.7	103.0	94.2	12
4	<b>North Rhine-Westphalia</b>	114.2	102.4	93.7	14
5	<b>Bavaria</b>	113.8	102.5	93.7	13
6	<b>Bremen</b>	111.7	96.4	141.4	1
7	<b>Schleswig-Holstein</b>	106.8	101.3	95.9	9
8	<b>Lower Saxony</b>	96.2	97.8	92.9	16
9	<b>Rhineland-Palatine</b>	95.7	96.8	94.3	11
10	<b>Berlin</b>	93.3	95.0	111.0	8
11	<b>Saarland</b>	83.5	95.0	129.2	2
12	<b>Brandenburg</b>	56.4	95.0	118.6	6
13	<b>Saxony</b>	50.3	95.0	117.4	7

14	<b>Mecklenburg-West Pommerania</b>	47.0	95.0	119.8	3
15	<b>Saxony-Anhalt</b>	44.5	95.0	118.8	5
16	<b>Thuringia</b>	43.7	95.0	118.9	4

Source: Excerpted from Spahn and Fottinger (1997: 239).

#### **5.5.2.4 Dampened competition among the Länder**

How did these characteristics of federalism in Germany illustrated so far affect the degree of government regulation over dismissal? During the first three decades of the postwar era the freedom of capital to move beyond the national boundary was significantly constrained. However, the fact that capital was free to choose the optimal location for production within an integrated domestic market was a grave concern for the founders of the Federal Republic of Germany (Golay 1958: 76). If the power to make legislation affecting the business decision over plant location had been reserved to sovereign units comprising the federal state, each unit would have been tempted to lure business by curtailing labor and social standards to make environments more favorable to capital. Now that there was no hegemonic Länder such as Prussia of Imperial Germany who acted as a Stackelberg leader (Hallerberg 1996), the result would have been a ruinous race to the bottom, that is, competitive deregulation of labor and social standards across the Länder.

The political institutional design of the Federal Republic of Germany prevented regulatory competition among the Länder. The centralization of legislative power in the field of labor made it possible to enforce uniform employment protection legislation across the nation.<sup>92</sup>

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<sup>92</sup> Under Article 74 (12) of the Basic Law, the federal government and the Länder governments shared concurrent legislative powers in labor issues, but federal legislation superceded Land legislation.

Furthermore, while most taxes were determined by federal legislation, the extensive equalization of fiscal revenue among the Länder weakened the financial autonomy of individual Länder and thereby distorted the preferences of Länder concerning the need to stimulate the development of Land economy by taking advantage of differential regulations of labor across Länder.<sup>93</sup> Contrary to the United States where States with lower labor costs remained active players in holding down federal regulation of labor after federal legislation in labor relations was accepted as constitutional, economically less developed German Länder found it less appealing to block the passage of employment protection legislation uniformly applied across the nation first due to their lack of financial autonomy and second due to inter-jurisdictional redistribution of revenues. As Scharpf (1997: 24) pointed out, these institutional arrangements were the “most clear-cut solution in the Federal Republic of Germany, where regulatory competition among the Länder in areas that might affect the location choices of capital and firms is almost totally eliminated.”

#### **5.5.2.5 The role of judiciary in the German federalism**

One notable change in political institutions brought to the Federal Republic of Germany was the significant empowerment of the judiciary in its relations with the federal legislature. In case of the United States, the strong judiciary was a stubborn defender of state parochialism against the federal power at least before the New Deal era. However, the German judiciary was more supportive of the supremacy of the federal government over the Länder in legislation.

The Basic Law had provisions to create a special court, the Federal Constitutional Court, and to grant it far-reaching constitutional authority compared with the Federal Supreme Court

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<sup>93</sup> For example, Land works council laws before the 1951 Works Constitution Act differed significantly from each other in the degree of restrictions on employers' freedom of enterprise (Fisher 1951: 4).

under the Weimar constitution (Leibholz 1952: 723).<sup>94</sup> The Basic Law expressively provided the Federal Constitutional Court with the power of determining the constitutionality of federal and Land statutes and even the power of banning political parties that the Court considered unconstitutional. Individual citizens were allowed to appeal directly to the Court when their constitutionally-ensured basic rights were infringed by a public authority. The Federal Constitutional Court Act passed by the legislature in 1951 explicitly stated that it was “separate from, and independent of, all other constitutional organs” (Leibholz 1952: 724). By 1951 judicial checks by politically independent courts against the legislature were firmly established in the Federal Republic of Germany.

Because of this division of powers accustomed to Americans, one might think that the Federal Constitutional Court could restrict the scope of federal legislative power by its interpretation of Article 72 concerning when a need for a federal rule existed just as the U.S. Supreme Court forestalled federal intervention in labor-management relations by giving a narrow interpretation of the interstate commerce clause of the federal constitution. However, this did not happen. Although the Parliamentary Council almost unanimously agreed to give the judiciary the explicit power to examine the constitutionality of laws in drafting the Basic Law (Reich 1963: 204), they sought to put some checks against the possible future interference by the judiciary in federal legislation. Walter Strauss, leader of CDU, espoused that “we [the Parliamentary Council] were unanimous in this small circle that the constitutional court could examine only an abuse of discretion by the federal legislature, but not the question of the need

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94 Regarding the origin of the Supreme Constitutional Court, Reich (1963: 204) wrote, “By 1949 the unfavorable lessons that the writers of a new constitution might have drawn from the record of the Weimar high court had been overlaid by the still less fortunate experience of government under National Socialism. Centralization of governmental power and legislative supremacy had been discredited; that the restoration of constitutional government required, among other things, independent courts and a form of judicial review was a premise not only of the Allied governments of occupation but of the German draftsmen as well.”

for legislation, the decision as to which must be confined exclusively to the Bundestag and Bundesrat” (Golay 1958: 61). Therefore, the draftsmen of the Basic Law inserted Article 74 illustrating a long list of matters for concurrent legislative powers that were never considered as exhaustive. The Federal Constitutional Court followed the will of the Parliamentary Council, taking the position that the decision regarding the need for federal exercise of the concurrent powers was solely within the discretion of the federal parliament and not by its nature a judiciable question (Golay 1958: 61).

### **5.5.3 Government ideology, political competition, and employment protection**

#### **5.5.3.1 The early Federal Republic of Germany**

If the Basic Law had adopted the American type of federalism, the political institutions in West Germany would have provided stronger safeguards against popular pressures to provide employment protection legislation. Since the Basic Law adopted a fundamentally different federalism for the new German state and the countermajoritarian political institutions as found in the American federalism were less developed in Germany, the remaining factor constraining the popular pressures was the ideology of government parties that was in turn dependent upon the result of popular elections.

In August 1949 there was the first parliamentary election under the Basic Law in which the Social Democrats lost to the conservative coalition of CDU/CSU and FDP. The left wing of the anti-socialist camp, represented by the Christian Democratic Labor Minister Anton Storch, comprised members from Christian unions and they insisted making co-determination laws. At the other end of ideological spectrum were members committed to a free market economy represented by the Christian Democratic Economic Minister Ludwig Erhard. These neoliberals

endeavored to introduce an anti-cartel law to end the cartel-abundant economy of the pre-war period. They did not necessarily see the freedom of union activities contradict their neoliberal tenets. However, they criticized co-determination for a serious interference with the management right to enterprise. Thus, they wanted to separate works councils that had mushroomed since the war from unions' influences. As a pragmatist, Chancellor Adenauer was more concerned with his own authority or the future of his cabinet than taking a side with any of the ideological camps within the coalition government (Mierzejewski 2004: 89). In fact, he accepted labor unions' demands when he found their support for his government to be necessary.

The Protection Against Dismissal Act and the Codetermination Act, both enacted in 1951, were the notable examples of Adenauer's pragmatic approach to labor issues. When West Germany became independent in 1949, the public perception of the day was favorable to providing greater protection for workers against employers' negligence of workers' interests in making personnel and economic policies as a general means of denazification because labor was a major victim under the Nazi dictatorship.<sup>95</sup> The Social Democrats had been participating in every Land government in a coalition with the CDU and/or the FDP by the end of 1949 (Cusack and Fuchs 2002). Furthermore, the strength of the German labor significantly increased when the German Federation of Trade Unions (DGB) was established to unite German labor movements in October 1949. This umbrella organization included eighty-seven percent of seven million organized workers. Few politicians were insulated from popular pressures for national legislation limiting employers' Herr-im-Haus attitudes. Fisher (1951: 4) noted:

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<sup>95</sup> Jackson (2005: 240) confirms this point: "After the Nazi period, codetermination reemerged during the postwar democratization. Codetermination found new political legitimacy by being reinterpreted in light of Nazism and postwar reconstruction."

In the latter part of 1949, pressure upon the Federal Government to enact a federal works council and codetermination law became so strong that Labor Minister Storch called for discussions between trade unions and employers' organizations in the hope that these two groups would agree upon a set of principles which could be embodied in law.

When the DGB and employers representatives met in Hattenheim in January 1950 to discuss the future of German industrial relations, the DGB took an initiative in the issue of wrongful dismissal and got the employer representatives to accept the legal restrictions on dismissal expected to help protect unions members against anti-union employers (Seifert and Funken-Hötzel 2004: 490). The Protection Against Dismissal Act of 1951 introduced the requirement of “socially justified causes of dismissal” to prevent dismissals at employer’s will. Dismissals are regarded as lawful strictly for three occasions: dismissals upon lack of capability, misconduct, and redundancy.

Codetermination was a major goal the DGB sought to achieve in Hattenheim. The DGB demanded recognition of workers’ right to participate in the making of economic decisions on the enterprise, industry and state levels (Shuchman 1957: 126-129). Especially at the enterprise level, the DGB submitted to the Bundestag its proposal to fill half the members of the board of directors and the supervisory board in large companies with union or works council representative nominated by the DGB. The DGB and employers representatives failed to reach an agreement on codetermination because employers strongly opposed the codetermination bill as threatening their freedom of enterprise. Erhard was on the business side. He even rejected labor’s request to guarantee by German law parity codetermination the British institutionalized in the steel industry whose ownership had been returned to the Germans (Wachenheim 1956: 118; Shuchman 1957: 130). In reaction, the DGB mobilized unions’ offensive by having ninety-six percent of metal workers and ninety-three percent of mine workers authorize strikes in the event that codetermination was discontinued (Shuchman 1957: 136).

The deadlock between capital and labor was resolved by Adenauer's intervention in January 1951. He made a compromise with Hans Böckler to give parity codetermination in steel companies a statutory ground and to extend it to coal companies. Adenauer accepted labor's demand for equal representation on the supervisory board. Although he declined to worker's direct participation on the management board, he made it obligatory to add to the management board a labor director who was in a sense a labor's representative because he could not be appointed against the majority of the labor representatives on the supervisory board.

As Mierzejewski (2004: 95) noted, Adenauer's concession to the DGB on codetermination was mainly motivated by his "placing political and Christian considerations above economic rationality." His political considerations can be elaborated in terms of domestic and international dimensions. First, Adenauer was intended to buy not only social peace but also some of working-class votes away from the SPD (Wachenheim 1956: 119; Nicholls 1994: 339). For Adenauer, it was important to strengthen the political base of CDU/CSU that won the 1949 election against the SPD by only 1.8 percent of votes (Bundeswahlleiter).

The external factor was related with Robert Schuman, French foreign minister. In May 1950 he presented a proposal to place Franco-German production of coal and steel under a supranational authority, the European Coal and Steel Community (ECSC), which Adenauer endorsed. Schuman's goal was not only to prevent remilitarization of Germany by regulating production by war-making industries but also to promote Germany's role in the reconstruction of European economy. Adenauer supported the Schuman Plan as an opportunity to make Germany an equal partner with other European countries, but he faced strong oppositions from domestic business groups. The Federation of German Industry (BDI), the umbrella organization of German industry favoring large export interests, opposed the sectoral approach of the Schuman

Plan because they preferred more general economic integration including Germany's internationally competitive capital goods (Moravcsik 1998: 97). German coal and steel interests, who initially envisaged the ECSC to be a big cartel-like organization, switched to opposition as the final draft of ECSC's constitution was much more liberal and anti-cartel (Nicholls 1994: 341; Moravcsik 1998: 112).

Furthermore, the German labor was skeptical of the Schuman Plan, although not bitterly opposed to it. The Social Democrats, CDU's main political opposition, criticized the Schuman Plan for a French conspiracy to control core German industries (Bretton 1953: 989). The DGB was worried that the breakup of German trusts the Schuman Plan aimed at would result in mass job loss in coal and steel industries (Warner 1996: 29). In order to secure broad domestic support, Adenauer had few options but to turn to Hans Böckler and to provide workers' codetermination rights in the coal and steel industry as an inducement. Thus, Adenauer yielded to labor's demand for codetermination in coal and steel industries to win labor unions' support for his geopolitical agenda (Warner 1996: 52).<sup>96</sup>

After the Codetermination Act was passed in April 1951, the DGB sought to extend parity codetermination to other German industries and to make works councils subordinate to labor unions. However, political and economic situations were shifting to labor's political disadvantage. The postwar German economy under Erhard's steering recovered rapidly, fueled by the Korean War and Marshall Plan funds. By 1951, West Germany returned to its prewar levels of gross domestic product and of industrial productivity (Carlin 1996: 265). Adenauer concluded the negotiations for the ECSC and got to sign the Treaty of Paris in April 1951, which

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<sup>96</sup> The ECSC Treaty signed on April 18, 1951 in Paris sought to provide for workers in coal and steel industries adequate protection against unemployment and wage increases to the highest level in the Community and to protect the labor interest by granting a certain degree of participation in some of the bodies of the Community in order to gain labor's support for the Schuman Plan (Bebr 1954: 1008).

symbolized the successful rapprochement of Germany with its European neighbors. Adenauer's success in foreign affairs was also demonstrated by the negotiations with the Allies to reach an agreement to end the Allied occupation, which was eventually concluded in the Contractual Agreements in May 1952. These political and economic developments greatly increased the popularity of the conservative government (Shuchman 1957: 138).

The establishment of works councils and their functions were officially restored when the Works Constitution Act was passed in July 1952. The 1952 Works Constitution Act granted works councils the right to participate in employers' decisions regarding dismissals as the 1920 Works Council Act. It obliged employers to inform works councils before they implemented dismissals and to consult with works councils regarding the number and specific workers to be released, the method by which they were to be released, and measures to avoid undue hardship for those to be released (Schuchman 1957: 165). This law also introduced company-level codetermination by giving workers' representatives one third of seats on the supervisory board of companies with at least 500 employees.<sup>97</sup>

In contrast to his negotiation with the DGB on sectoral codetermination in coal and steel industries, this time Adenauer was determined to refuse the DGB's demands on codetermination in broader industries. Compared with its Weimarian predecessor, it was a setback to labor in terms of the power of works councils at the workplace on three accounts. First, while the 1920 Works Council Act left works councils' participatory rights open in the area of collective dismissals, the 1952 Works Constitution Act restricted employers' duty to consult with works

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<sup>97</sup> This provision did not apply to coal and steel industries. Co-determination in coal, iron, and steel industries was governed by the 1951 Codetermination Act, which provided parity representation for workers in the supervisory board. The clauses on workers participation in the supervisory board in the 1952 Works Constitution Act were replaced by the 1976 Codetermination Act, which extended workers' representation to one half of seats in the supervisory board.

councils to cases where “fundamental changes” in plant operations were involved (Schuchman 1957: 165). Second, while works councils under the old law had the right to apply to the labor court on behalf of dismissed employees, the new one did not mention works councils’ right to bring a claim to the labor court (Dose-Digenopoulos and Holand 1985: 543). Third, as Thelen (1991: 75) pointed out, the languages of the 1952 Works Constitution Act stressed the independence of works councils from labor unions. Therefore, labor unions’ power on the shop floor and their ability to control dismissals through works councils were severely weakened.

The 1952 Works Constitution Act provided watered-down version of codetermination rights even compared with the provisions of some progressive Länder it replaced (Thelen 1991: 74; Addison et al. 2004: 394). Between April 1946 when the Allied Powers passed Control Council Law No. 22 that permitted works councils and 1950 six Länder adopted works council laws.<sup>98</sup> Among them, the works council laws of three Länder in the U.S. Zone (Hesse, Württemberg-Baden, and Bremen) significantly extended the rights of works councils from those of the 1920 Works Council Act. The codetermination clauses of Hesse and Württemberg-Baden were the most progressive because they gave labor the right to participate in “economic” decisions of the company beyond codetermination in social and personnel areas. The U.S. Military Government had suspended the works council laws of Hesse and Wuerttember-Baden until national legislation was enacted.

After the Works Constitution Act was passed, the DGB did not choose to step up a national strike protest but to utilize the impending Bundestag election of 1953 to revise the law. However, the DGB could not have an opportunity to bring about a revision of the Works Constitution Act until the mid-1960s as the SPD lost five consecutive Bundestag elections since

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<sup>98</sup> I depended on Fisher (1951: 4) for the survey of Land works council laws.

1949. During this period, the German economy was driven by Erhard's anti-Keynesian, liberal economic philosophy. Organized labor was not considered to be a legitimate partner in the economic policy-making at either national or company levels. Organized labor's hope for codetermination was buried. Instead, unions were getting more interested in distributive issues such as wages and welfare benefits (Scharpf 1991: 118).

### **5.5.3.2 Social Democrats in power**

Labor unions' action for codetermination resumed in 1966 when Social Democrats became a part of the Grand Coalition with Christian Democrats. In 1966 West Germany experienced the first recession in its postwar history that was precipitated by the strongly independent Bundesbank, the FRG's central bank, which had tightened money supply to quell an overheated economy (Scharpf 1991: 118-119). This economic recession led to a breakdown of the coalition government between the CDU/CSU and the FDP that had been formed in 1965 because FDP cabinet members resigned demanding cutbacks in the federal budget (Carr 1987: 198). The CDU/CSU escaped being a minority government by making a coalition with the SPD. However, SPD's first return to power since 1930 was followed by enhanced power resources for labor unions.

In response to unions' pressures for labor relations reform, the Grand Coalition government established in 1968 the Federal Expert Commission to investigate the effect of parity codetermination in the coal and steel industry on corporate profitability and labor militancy (Streeck 1984: 396). The committee concluded that while parity codetermination in the coal and steel industry was associated with industrial peace, there was no indication that parity codetermination in the coal and steel industry was incompatible with a capitalist management. However, Social Democrats' wish to extend parity codetermination to general industries could

not be realized without obtaining its coalition partner's agreement unless it won an absolute majority of Bundestag seats. Neither the Grand Coalition nor the SPD-FDP coalition formed in 1969 reached an agreement to extend parity codetermination to all industries covered by the 1952 Works Constitution Act.

As Free Democrats opposed an extension of parity codetermination to outside of the coal and steel industry, the SPD-FDP government decided to focus on a reform of works councils that was a politically less contentious issue than parity codetermination (Streeck 1984: 400). The rights of works councils were significantly strengthened when the SPD-FDP government completely overhauled the 1952 Works Constitution Act in January 1972. Adams and Rummel (1977) nicely compared works councils' powers under the Works Constitution Acts of 1952 and 1972. The new law endowed works councils with a veto power in individual dismissals only to be superceded by the labor court while works councils' decisions had not been able to suspend the effect of dismissals under the old law. In the area of collective dismissals, although the right of works councils remained consultative regarding layoff decisions, the new law required employers to reach an agreement by negotiation with works councils over measure to protect workers' interests and over compensation schemes or "social plans" for the affected workers before executing mass layoffs. The failure to reach an agreement over the social plan must be resolved by the arbitration committee made up of equal numbers of assessors, appointed by the employer and works council respectively, and an impartial chairperson. In addition, the 1972 Works Constitution Act enhanced the influence of unions over works councils as well. The Act permitted works councilors to hold union offices and granted full-time union officials extensive rights to participate in works council meetings. The formal links between unions and works councils were greatly improved.

In the 1972 election the SPD emerged as the largest party in the Bundestag for the first time in the postwar history, partly owing to the success of Brandt's Ostpolitik. Especially, as a result of the first vote to elect one-half of the Bundestag seats directly by pluralities in single-member districts, the CDU/CSU became southern regional interests as they won more seats than the SPD only in Bavaria and Baden-Württemberg while the SPD became a true people's party winning 152 direct seats over the CDU/CSU's 96 (Laux 1973: 522). After the SPD-FDP coalition was extended because of acrimony between the CDU and the FDP (Laux 1973: 514-516), the two parties began negotiations to reform codetermination in general industries. While the SPD was committed to a general extension of the coal and steel model, the FDP under pressures from business opposition was hostile to it (Streeck 1984: 401). Finally, the coalition parties made a compromise. The 1976 Codetermination Act strengthened workers' representation at the enterprise level outside the coal and steel industry, providing workers equal representation on the supervisory board and the position of a labor director on the managerial board. However, the government rejected labor's demand to give unions the right to appoint representatives on the supervisory board and a labor director on the managerial board (Streeck 1984: 401-402).

Employers Associations bitterly opposed the passage of the passage of the 1976 Codetermination Act (European Foundation for the Improvement of Living and Working Conditions 2006). Even after the passage of the law, they resisted the law by challenging its constitutionality in the Federal Constitutional Court and also by making company by-laws to circumvent it. However, the Codetermination Act of 1976 became an integral part of German industrial relations as the Federal Constitutional Court ruled that the Act was compatible with the constitution and that all company by-laws to circumvent the Act was void (Streeck 1984: 403).

## 5.6 CONCLUSION

This chapter examined the origin and development of employment protection legislation from Imperial Germany to the Federal republic of Germany. The difference of employment protection between Imperial Germany and the Weimar Republic despite their similar economic systems is the major finding of this chapter. This chapter also finds that the German employment protection has been strengthened in the face of employers' opposition since the first national legislation significantly restricting employers' right to fire their employees was enacted in 1920. The varieties-of-capitalism argument is an incomplete explanation for this longitudinal change of employment protection.

While emphasizing the limitation of the varieties-of-capitalism literature in explaining the temporal variation of employment protection of Germany, this study confirms the cross-country differences drawn by the current literature about comparative capitalism. Germany and the United States had a similar level of employment protection before the First World War. Since the formation of the Weimar Republic, however, these two countries have followed completely different paths in reaction to rising democratic pressures to limit managerial prerogatives in employment decisions. Using Stepan (1999: 24)'s terminology, the democratic federalism of Germany that was formed in 1919 was much more "demos-enabling" than that of the United States. As the previous chapter shows, the countermajoritarian political institutions of the United States warded off democratic pressures to increase job security. As a result, the American employment protection legislation was limited to providing a minimal notice period for those to be laid off. In contrast, Germans successfully institutionalized extensive workers' rights in making decisions over individual and collective dismissals at the plant level, which was complemented by workers' participation on the supervisory board over the management of their

company. The German-style federalism featuring interlocked jurisdictions played a permissive role in generating statutory restrictions on dismissal.

## **6.0 CAPITALIST INTERESTS, DEMOCRACY, AND EMPLOYMENT PROTECTION IN SOUTH KOREA**

### **6.1 INTRODUCTION**

Employment protection has become a major political issue in South Korea since the mid-1990s as changing business environment prompted Korean employers to abandon traditional lifetime employment. Korean employers demanding further labor market flexibility have criticized South Korea's employment protection legislation for making industrial adjustment very costly, while organized labor has responded that the freedom of layoff would only aggravate workers' job security.

The key legislation for employment protection is the Labor Standards Act amended in 1998. Rather than take a snapshot view of the 1998 Labor Standards Act, this paper examines employment protection of Korea "in a temporal sequence of events and processes stretching over extended periods" (Pierson 2004: 2). I seek to explain the historical development of employment protection in South Korea from the early 1960s through today.

South Korea is an ideal case to study the question of change in employment protection. During the time period under study, South Korea underwent shifts in industrial strategies, political regime changes, upheavals of radical labor movement and national economic crises. Although this chapter is a one-country case study, it enables to compare different periods within

one country characterized by such varied historical experiences.

South Korea experienced the rise of employment protection through democratization as Germany. Before the 1987 democratization, the government protection of workers against dismissal was very limited: workers were fired for union activities and workers in light industries mostly comprising small and medium firms were subject to abrupt layoffs at best with minimal severance pay when their plants were shut down as a result of decreasing demand from export markets. On the other hand, workers in chaebols enjoyed considerable job security as the heavy-chemical industrialization based on chaebols during the 1970s increased demand for skilled labor and tightened labor markets. Further, because the government guaranteed the survival of chaebols by providing policy loans and emergency bailouts, chaebols could use expansion-oriented business strategies that made workforce reduction unnecessary.

In the early 1990s, chaebols began to perceive lifetime employment to be a liability rather than an asset, responding to challenges from international market competition and rising domestic labor costs. And the 1997 financial crisis was decisive in turning chaebols against lifetime employment. Since the crisis, chaebols have become increasingly in favor of flexible use of labor. However, South Korea's employment protection legislation remains resilient because of electoral constraints on its reform in the democratized country.

This chapter is organized in the following order. First, I provide a sketch of South Korea's employment protection and a comparative assessment of its strictness. Secondly, I critically review existing explanations for the traditional business practice of lifetime employment with focus on the varieties-of-capitalism perspective. The varieties-of-capitalism model is appropriate to explain the Korean chaebols' business practice of lifetime employment, but it is unable to explain the absence of employment protection *as government regulation*

during the dictatorship regimes and its rise and continuity after democratization. Thirdly, I historically trace the rise of employment protection after 1987 and how it survived the conflict-ridden 1996 labor law reform politics and the neoliberal economic reform after the 1997 financial crisis. Finally, I discuss how the 1997 financial crisis affected the business preference for lifetime employment and whether the cutback of employment protection will be possible in the near future.

## **6.2 HISTORICAL DEVELOPMENT OF EMPLOYMENT PROTECTION IN SOUTH KOREA**

Employment protection legislation in South Korea dates back to 1953 when President Syngman Rhee enacted the Labor Standards Act during the Korean War. President Rhee wanted to show that the South was a better place for workers to live than the communist North. Thus, he stipulated in the Labor Standards Act too idealistic labor protections for a poor agrarian economy such as 48 hours' work per week, restrictions on employing minors, and minimum wages. Regarding employment protection, the Labor Standards Act forbade an employer to dismiss a worker without justifiable causes but it did not specify what "justifiable causes" meant.<sup>99</sup> The statutory protection of workers against dismissal was apparently reinforced under the Park Chung-hee's military government. Immediately after the military coup in 1961, he revised the Labor Standards Act to introduce one month's advance notice as a procedural requirement for dismissals.

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<sup>99</sup> The 1953 Labor Standards Act also required employers to provide one month's average pay per every year of service as severance pay. Yet this severance pay should not be seen as an employment protection because it was given to those who left companies voluntarily as well as to those who were dismissed.

However, the employment protections in the Labor Standards Act were very limited throughout the dictatorship regimes. First of all, the government did not enforce the law in the face of frequent violations on the employer's side.<sup>100</sup> Combined with the problem of weak enforcement, the employment protection provided by the law was largely decorative because the definition of "justifiable causes" for dismissal was left to administrative decrees but there were no government actions on this. Employers fired or threatened to fire workers if they joined labor unions despite the "justifiable causes" provision in the Labor Standards Act (KCTU 2001). Finally, contrary to the argument that layoffs or dismissals for managerial reasons had been prohibited during the dictatorships (Kim 1998; Yoon 1998), layoffs due to plant shutdowns were commonplace even during the period of rapid economic growth (Song 2000; KCTU 2001).<sup>101</sup> South Korea's small and medium firms were predominantly labor-intensive and light industry, exposed to strong competition in world markets. Therefore, when they entered temporary or permanent plant closings during downturns, this precipitated mass layoffs in those firms.<sup>102</sup> Workers in chaebols were better off than their colleagues in small and medium firms. Although there were no formal regulations prohibiting layoffs, the government sought to protect their job security by helping chaebols in deep financial trouble when the oil crises made mass unemployment loom large during the 1970s.

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<sup>100</sup> In November 1970 Jeon Tai-il, an apparel worker and labor union activist, killed himself by fire in protest of the disregard of the Labor Standards Act by his employer and the government (Cho 2003).

<sup>101</sup> In 1975 the Federation of Korean Trade Unions, a moderate umbrella union, demanded the government to enforce the Labor Standards Act, to eradicate mass layoffs due to plant shutdowns, and to launch anti-unemployment measures (Song 2000: 224-225).

<sup>102</sup> The incident at Y.H. Trading Company, a wig firm, illustrates the job insecurity of low-wage workers during the 1970s. When the company announced to close as a result of the decline of wig industry and managerial corruption, more than 500 workers lost their jobs. Unionists of the company entered a sit-down strike in protest of the closing of the company. But the police raided the strikers, killing one union worker (Park 2006).

But it was only in the late 1980s that South Korea had a general rule concerning layoffs. In the 1989 decision, the Supreme Court provided the following four conditions for layoffs to be lawful<sup>103</sup>:

- There must be urgent managerial needs for workforce reduction.
- Employers must make every effort to avoid layoff. The Supreme Court held that employers must seek to reduce workforces first through natural attrition and early retirement;<sup>104</sup>
- Employers must select workers to be laid off by establishing reasonable and fair standards; and
- Employers must have sincere consultation regarding measures to avoid layoff and standards of the selection of workers to be laid off with employees' representatives.

Since this ruling was rendered, the meaning of “urgent managerial needs” has been hotly debated and accordingly the position of the Supreme Court has changed. The 1989 Supreme Court ruling interpreted this term very narrowly in a way that layoffs must be allowed only to prevent bankruptcy. Since then, the Supreme Court has expanded the scope of managerial needs (Kim 2004: 545). For example, it held in 1991 that managerial needs were acknowledged if workforce reduction was not only necessary to prevent bankruptcy but it had “objectively reasonable reasons” such as an improvement in productivity, a change in work organization to make the business more competitive, and a change of industrial structure due to technological innovation.<sup>105</sup>

These four judicial principles were first codified in the Labor Standards Act in March 1997, but their implementation was delayed for two years. The Labor Standards Act was put into effect in February 1998. It required at least 60-day’s prior consultation with workers and

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<sup>103</sup> Ruling No. 87DaKa2445 (S. Korea Sup. Ct. May 23, 1989).

<sup>104</sup> Ruling No. 92Da14779 (S. Korea Sup. Ct. Dec. 22, 1992).

<sup>105</sup> Ruling No. 91Da8647 (S. Korea Sup. Ct. Dec. 10, 1991); Ruling No.92Nu3076 (S. Korea. Sup. Ct. Jan. 26, 1993).

acknowledged that transfers, mergers, acquisitions of business due to its continued deterioration constituted a urgent managerial need. The layoff regulations in the 1998 Labor Standards Act are fairly strict compared to other OECD countries. The OECD Employment Outlook of 1999 ranked South Korea as most difficult to dismiss full-time, permanent employees except for Portugal. The OECD Employment Outlook 2004 revised the strictness of South Korea's regulations on layoff it originally measured in 1999. It ranked South Korea as tenth most difficult to dismiss full-time, permanent employees among twenty-eight OECD countries, pointing to the information that what was called "severance" pay was in fact a payment made to every worker who left the firm, voluntarily or involuntarily, and judicial practices had been relatively permissible.

### **6.3 LABOR POWER VERSUS CAPITALIST INTERESTS**

What theory best explains both the level and the change of employment protection in South Korea? Is the rise of employment protection after 1987 a result of strong labor power or employers' self-interested behaviors? According to power resources theory (Korpi 1983; Huber and Stephens 2001), strong labor groups are necessary to bring employment protection because capitalists generally oppose it. However, the South Korean case does not support this antagonistic theory of capital-labor relations. South Korea lacks traditionally important labor factors such as union density, bargaining structures and electoral strength of left parties. Its union membership has reduced to eleven percent of total private employment as of 2004 (Korea Labor Institute), major unions are organized at company levels similarly to American labor (Park 2001), and no social democratic parties in South Korea won seats in the National Assembly

before 2004.

A more sophisticated power-of-labor argument is that Korean labor can exercise significant bargaining power by using a threat to strike in chaebols, South Korea's family-owned business conglomerates, because union membership is concentrated in those big corporations, which account for much of export in the export-oriented economy (Mo 1996; Kim 2003: 62). Individual labor unions in chaebol sectors, unions of standard workers, have been quite successful in extracting wage concessions from their employers using the threat of strikes. However, South Korean labor unions lack the ability to initiate progressive welfare state reforms because of a weak social democratic party, comparatively low union membership, and divided labor movements.

Contrary to the power-of-labor resource model, the employer-centered explanation focuses on the business interest in social protection. First, there is an argument that large, monopoly firms are generally more favorable to social policy than small firms. Swenson (2002: 22-23) argues that capitalists are more likely to support progressive relations with their employees when they face less competition in sales markets. In her comparative analysis of social insurances, Mares (2000, 2003) suggests that since large firms have power to set their prices, they can more easily shift the cost of social insurance onto consumers.

Traditionally, the high degree of economic concentration in chaebols was a major characteristic of the South Korean economy (Gereffi 1990: 96). In 1973 the fifty largest chaebols accounted for 32 percent of GDP and in 1980 they accounted for 49 percent of GDP (Haggard and Moon 1990: 218). However, this argument does not explain why employment protection was weak in the period before South Korea was democratized in 1987 despite the overwhelming economic power of chaebols and severely distorted market competition.

Although chaebols were interested in lifetime employment as an implicit business practice over the period, they did not support the introduction of employment protection as public policy.

Another school of the employer-centered approach is the varieties-of-capitalism perspective (Hall and Soskice 2001) that emphasizes national differences rather than sectoral differences of business interests in social policy. It suggests that employment protection is embedded in complementary economic institutions: employment protection will be strong (or weak) if the entire capitalist economic system where it belongs rewards (punish) long-term employment relations. To test this argument in the Korean context, we need to examine the kind of capitalist model that prevailed in Korea in the time between the early 1960s and the 1997 financial crisis.

#### **6.4 THE KOREAN ECONOMIC MODEL, 1961-1997**

The political economy of South Korea has been widely known as a follower of the Japanese model, a prime example of a “coordinated market economy” along with Germany, mainly thanks to the developmental state literature (Johnson 1987; Kohli 1994; Kim 1997). From the autonomy of penetrating state over the society underpinned by efficient bureaucracy, state control over finance, government-business risk partnership, to group-oriented business networks every major character of the Korean economic model seems to display the Japanese influence. However, a closer look at the Korean capitalism during the period of high economic growth runs counter to this commonly held idea. The Korean capitalism is not a copy of the Japanese model as opposed to the Anglo-American liberal market economy, but it has a more complicated nature.

I will examine the characteristics of the Korean economic model before the 1997 financial crisis from the varieties-of-capitalism perspective.

#### **6.4.1 Institutions of skill formation**

Empirical research about the skill formation in Korea shows that firm-specific training has been very limited as in the United States (Park 1992; Yoon 1996). Even the engineering industry that required the most skilled labor determined the skill level not by tenure but by years of schooling at the point of entrance (Yoon 1996). Except for the shipbuilding industry where employers introduced in-plant training programs in the early stage of industrial development during the 1970s (See Noh 2004), most firms resorted to external labor markets in which they imported skills from advanced countries and poached skilled workers from other firms rather than creating internal labor markets for skill formation.

While small and medium firms were not interested in firm-based training because of the low skill requirement and high potential cost (Kang et al. 2001), even large employers in heavy industry did not seriously invest in the formation of firm-specific skill.<sup>106</sup> The major domestic source of skills needed for industry was technical high schools, junior colleges, and university engineering schools that dictatorship governments promoted with vigor (Lee et al. 1999; Cho et al. 2002). These three education levels reflected segmented career paths: graduates of technical schools would become factory workers, graduates of junior colleges technicians, and university graduates professional workers. As years of schooling of a worker increased, so did the level of his skill and pay. As in Japan, Korean firms had seniority-based wage systems. However, the

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<sup>106</sup> Park (1992)'s survey of an engine manufacturer's plant employing more than 2,000 workers revealed that this company spent only 0.2 percent of its total sales for training workers.

crucial difference was that in Korea the wage system was *rigidly* seniority-based: individual worker's wage was not linked to his training and skill development. As in the United States, manual workers were rarely advanced to white-collar positions. Therefore, talented youths were more attracted to university-bound school education with great encouragement, or pressures in many cases, from their parents than to vocational training.

#### **6.4.2 Inter-firm relations**

As in Germany before the postwar period, South Korea did not have competition policy during the period before the early 1980s. Chaebols expanded their businesses through cross-shareholdings and cross-debt guarantees among affiliated firms that were often monopolists or oligopolists (Chang and Jung 2005). Cartels mushroomed to maintain prices during downturns. Therefore, Park Chung-hee controlled prices between 1975 and 1979 because he attributed rampant inflation to the anti-competitive behaviors of chaebols. However, his attempt to control chaebols' behaviors only aggravated market distortions (Lee 2002: 67-68).

The Monopoly Regulation and Fair Trade Act (Fair Trade Act) enacted in 1980 was a watershed in the competition policy of South Korea. Chun Doo-hwan, who seized power through a military coup, introduced this law as a way to gain regime support from the media and consumer organizations who were critical of the economic concentration in chaebols. This law does not regulate firms for the fact that they had dominant market shares but it focuses on the abuse of their market-dominant positions. In that respect this law follows the European model rather than the U.S. anti-trust law (Chang and Jung 2005: 174).

The Fair Trade Act prohibited formal cartels and cartel-like concerted activities to substantially restrict market competition. However, it provided several exemptions for cartels

that were conducted for the purposes of industrial rationalization, research and technology development, overcoming economic depression, industrial restructuring, rationalization of trade terms and conditions, and enhancement of competitiveness of small and medium enterprises.<sup>107</sup> In view of these exemptions, the Fair Trade Act resembled the German competition law of 1957 that outlawed cartels in principle but left many exemptions (See Giersch, Schmieding, and Paqué 1992: 85).

However, there is a notable difference in business networks between Germany and South Korea. While industry-level business networks played a central role in joint research, product development, and the diffusion of new technologies in Germany, Korean firms lacked close inter-firm collaboration for R&D. Kim (1999)'s study shows that in South Korea purchasing technology licenses and poaching professionals from abroad were the major vehicles used to acquire new technologies needed to start up light industry in the 1960s and also heavy industry in the 1970s. His study finds that the transfer of more innovative technologies such as semiconductor since the 1980s have come through enhanced research efforts by academic universities, government research institutes, and individual firms. In case of Korea, business networks were based on chaebols in which affiliated firms were interconnected through cross-shareholdings and cross-debt guarantees across different industries. Except for chaebol networks, inter-firm relations in Korea were driven by competition.

### **6.4.3 Financial system**

In sharp contrast to the market-based financial system of the United States, the Korean financial

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<sup>107</sup> Monopoly Regulation and Fair Trade Act. <[ftc.go.kr/data/hwp/monopoly.doc](http://ftc.go.kr/data/hwp/monopoly.doc)>.

system was predominantly bank-based as in Germany. However, German banks were very powerful actors autonomous from the state. By contrast, the government-controlled banking sector was an essential tool of state-led industrialization in South Korea. As Woo-Cumings pointed out, the state control of finance was the “most important aspect of state intervention in economic development” (Woo-Cumings 1999: 11). Banks were used to funnel financial resources to selected industries and to bail them out when they were in financial trouble.

The state control over finance in South Korea was established during the early period of Park Chung-Hee’s rule (Cho and Kim 1995: 30-31). After General Park Chung-Hee seized power in 1961, the military government nationalized commercial banks in an attempt to confiscate illicitly accumulated wealth by industrialists linked to former dictator Rhee Syng-Man. In 1962 the military government revised the Bank of Korea Act to transfer monetary policy authority from the Bank to the Ministry of Finance. Therefore, this revision deeply weakened central bank independence, making the Bank of Korea subordinate to state-led development finance.

Although the military government introduced state control over finance during the first two years after the coup, it failed to formalize plans on how to use this state-controlled financial system as a conduit for export-driven economic development. Until 1963 South Korea was still dependent upon primary import substitution based on basic consumer goods and foreign aid was the biggest source of finance in importing production goods (Haggard and Cheng 1987: 87). President Park amended the first Five-Year Economic Development Plan (1962-1966) to shift national economic development strategies toward export-promotion based on labor-intensive goods (Oh 1998). This shift in development strategies was backed by the state intervention in finance. First of all, the Park government directed state-owned banks to provide credits to

exporters according to their export performances (Lim 2003: 44). Although export credit programs had existed in South Korea before 1963, the Park government streamlined and expanded those programs between 1963 and 1965. Furthermore, lower interest rates on export loans were introduced in 1965, which as Amsden put it was “getting the price wrong” to create an incentive structure for exporters. The government also supported exporters wishing to borrow from foreign lenders by guaranteeing repayment (Haggard and Cheng 1987: 112).

The risk partnership between government and business worked well and successfully increased the volume of economy during the second half of the 1960s. As can be seen from Table 12, gross domestic product expanded by average 10 percent per year, exports increased by average 37.3 percent per year, and gross fixed capital formation increased by average 34.4 percent per year.

**Table 12** The Success of Korean Economic Development Model Before 1970

Variables	GDP growth	Export growth	Gross fixed capital formation
Unit	annual %	annual %	annual %
1965	5.2	35.8	27.2
1966	12.7	42.3	59.6
1967	6.1	32.7	22.6
1968	11.7	39.5	37.4
1969	14.1	36.2	24.8
1970	8.3	13.8	1.0
1971	8.6	15.1	3.0

Source: World Bank. *World Development Indicators*. 2003.

This rapid economic growth was mainly financed through debt, which made the Korean financial system vulnerable to external shocks. As Table 13 shows, the rapid growth in output came with high inflation reaching average 13.4 percent a year. The overshooting of economy also led to the financial disarray in corporate and banking institutions. Bank loans increased to 41.5 percent of GDP and total foreign debt snowballed to 24.4 percent of GDP by 1969. The

debt-equity ratio of manufacturing firms increased rapidly from 92.7 percent in 1965 to 270 percent in 1969.

**Table 13** South Korea's Debt-Laden Economy

Variables	Inflation	Domestic credit provided by banking sector	Total foreign debt	Debt-equity ratio, manufacturing firms
Unit	annual %	as % of GDP	as % of GDP	%
1965	6.4	19.9	6.9	92.7
1966	14.0	20.0	10.5	117.7
1967	16.1	25.4	13.9	151.2
1968	16.0	34.1	20.4	201.3
1969	14.6	41.5	24.4	270.0
1970	18.4	42.1	25.6	328.4
1971	14.2	43.1	30.0	394.2

Source: World Bank. *World Development Indicators*. 2003; Bank of Korea. Economic Statistics System.

These economic ramifications of rapid growth developed into a financial crisis as the Korean economy experienced a major economic slowdown in 1970 following the economic recession in industrial economies. As Table 12 show, GDP growth dropped from 14.1 percent to 8.3 percent and export growth plunged from 36.2 percent to 13.8 percent in 1970. The Korean government sought to halt on the deterioration of export growth by devaluating its national currency by 7.7 percent in 1970 and 11.9 percent in 1971 (Bank of Korea). However, this devaluation brought many firms into deeper financial trouble, because their burden of debt grew heavier. As of 1971, total foreign debt reached 30 percent of GDP and manufacturing firms' debt ratio became 394.2 percent.

Since banking sectors already held large non-performing loans, many firms turned to the informal curb market to meet their short-term financial needs, although firms had to pay higher

interest rates to curb lenders than interest rates on bank loans.<sup>108</sup> As of August 1972, total 345.6 billion won in curb loans were reported, equivalent to 42 percent of total bank loans (Kim 1994: 72). Curb lenders often withdrew their loans abruptly when there were signs of borrowers having a credit crunch, which forced many firms to go bankrupt. According to a survey by a Korean newspaper in August 1971, 20-30 percent of textile and clothing producers, South Korea's major exporters at the time, were being closed.<sup>109</sup> South Korea fell to the second financial crisis in its modern history.

The Federation of Korean Industries comprising big businesses supplicated the government to relieve their financial distress (Kim 1994: 67). In August 1972 Park Chung-Hee chose to bail out the debt-laden companies by issuing the Emergency Decree for Economic Stability and Growth. This Decree placed an immediate moratorium on the payment of all corporate debts to curb lenders, and called for an extensive rescheduling of bank loans at a reduced interest rate.<sup>110</sup> In details, the Decree stipulated that after three years' moratorium debts from curb lenders would become five-year loans at an annual interest rate of 16.2 percent while the prevailing annual interest rate on curb loans was 39 percent in 1972.

As Lim (2001) argues, the August 3 Decree of 1972 was a critical decision that established the precedent for the government intervening in the financial sector to relieve corporate debt when deemed necessary. By making the bailout decision, the government did not just signal businesses its willingness to prevent their bankruptcy. The government also made the owners of large firms believe that they would not be held responsible for their mismanagement

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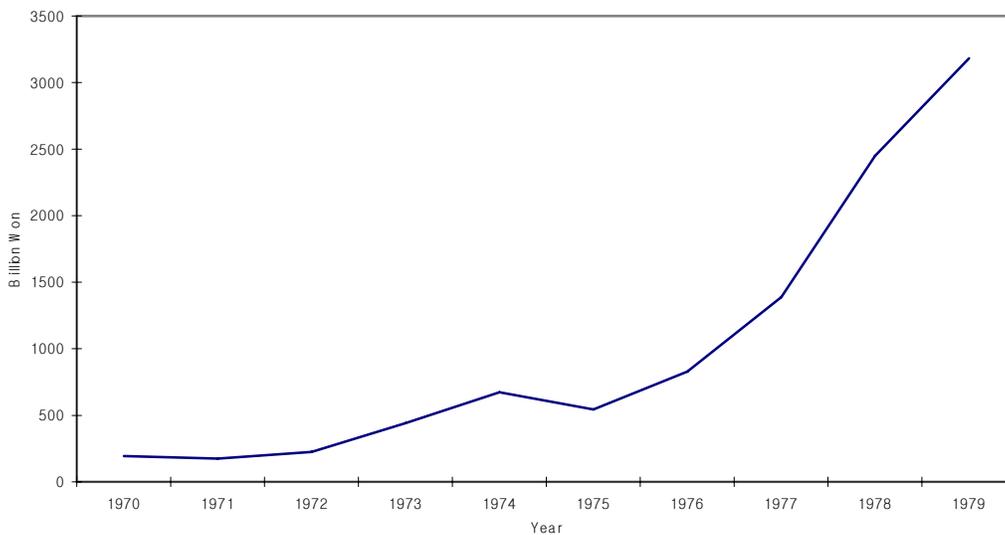
<sup>108</sup> In 1970 annual interest rate on bank loans was 24 percent while annual interest rate on curb loans was 50.16 percent (Lim 2001: 12).

<sup>109</sup> *Daily Hankook*. August 17, 1971. p. 3.

<sup>110</sup> *Daily Hankook*. August 3, 1972. p. 1.

of debt. Therefore, the moral hazard for chaebols came to take root in the debt-laden Korean economy.

The ensuing heavy chemical industrialization (HCI) that was officially implemented in 1973 further distorted South Korea's financial system. The government provided policy loans at a negative real interest rate for the six key industries – nonferrous metal, steel, machinery, shipbuilding, chemicals, and electronics – selected for rapid growth. Since 1967 government corporations had undertaken the construction of Pohang Integrated Steel Mill and Ulsan Petrochemical Complex. And yet, the HCI based on state-owned enterprises was not acceptable to Park Chung-Hee because of his anti-communist ideology. He preferred the familiar development model that seemed to work well with the export drive based on labor-intensive industries: government controlled finance and private firms produced goods. Thus, sector-oriented preferential policy loans were used to induce chaebols to enter these new businesses requiring greater fixed capital investment and longer waiting period for return on investment than labor intensive industries. As Figure 13 shows, bank loans to manufacturing firms expanded by more than 500 percent between 1973 and 1979.



**Figure 13** Bank Loans to Manufacturing Sectors

Source: Bank of Korea. Economic Statistics System.

Wary of chaebols' heavy reliance on debt finance, the government sought to control debt growth in chaebols by introducing three measures. First, the government passed the Law on Facilitating the Opening of Closed Corporations in December 1972 (Kim 1994: 73). Its purpose was to force corporations to increase their equity relative to debt by raising more funds through stock markets. The government also introduced a credit control system to limit bank loans to chaebols and improve financial structures of chaebols in July 1974 (Nam and Kim 1994: 453). The credit control system consisted of the designation of business groups whose total credit from banks exceeded a certain amount and their principal transactions banks.<sup>111</sup> The main function of

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<sup>111</sup> Nam and Kim (1994: 485-486) nicely compares the Korean principal transactions bank system with the Japanese main bank system. Both systems have the government intervention in financial markets to provide credits to preferred industries at lower interest rates. Where they differ is the bank-business relationship. The Japanese main bank system emerged with the historical formation of keiretzu, Japan's business conglomerates. As a major component of keiretzu, a main bank established a long-term, committed relationship with their client firms within keiretzu. It played a crucial role in maintaining keiretzu through mutual equity ownership with client corporations and helped protect their ownership against hostile mergers and acquisitions. In contrast, principal transactions banks of Korea were not within *chaebols'* corporate governance structure. It was the creature by government to control

a principal transactions bank was to supervise the overall credit to its client chaebols and to make sure the observance of credit ceilings. The credit control was enforced through agreements among banks with the administrative guidance from the government during the 1970s, but it was officially incorporated into the Banking Act in 1982. Finally, the Chun Doo-Hwan government privatized commercial banks by selling government-owned shares of the banks during 1981-1983 (Hahm: 2003: 81). This measure aimed to reduce government control of banks while keeping chaebols from the ownership of newly privatized banks.

Neither of these measures led to the fundamental change of government-controlled financial system. Although the law on opening corporations successfully increased the number of listed companies from 66 firms in 1972 to more than 300 firms in 1979 (Kim 1994: 73), it had little impact on chaebols' financial structure. These family-owners of chaebols were not willing to share ownership and control with shareholders outside the family (Lim 2003: 46). Rather than reduce a reliance on debt, the opening of firms strengthened chaebols' existing ownership structures.

The credit control over chaebols could not end the government control of banks. Principal transactions banks lacked the autonomy of loan-making decisions on chaebols' investment projects (Nam and Kim 1994: 475-476). The government continued to intervene in rationing credits, making principal transaction banks mere administrative agencies controlling credit supply and gathering and reporting information on chaebols' financial situations.

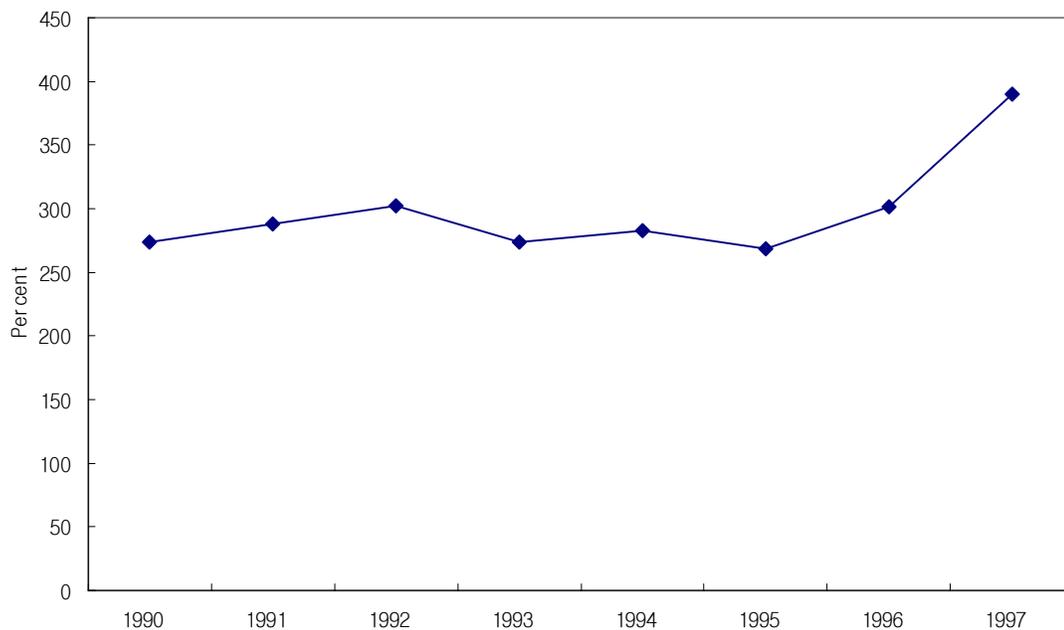
Furthermore, while chaebols' ownership of banks was prohibited, Chun Doo-Hwan allowed chaebols to own non-bank financial institutions (NBFIs) such as insurance companies and investment and finance companies. Chaebols used these NBFIs as financial intermediaries

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credits to *chaebols* from outside. Because of their lack of autonomy, principal transactions banks rarely took responsibility of rescuing and liquidating financially troubled *chaebols*.

mobilizing domestic capital and borrowing from foreign financial institutions and lending them to chaebols. Between 1980 and 1990, the share of loans from NBFIs in total loans to private firms increased from 38.7 percent to 58.3 percent (Bank of Korea).

In conclusion, there were only timid efforts to bring chaebols in a market-oriented financial system. The dilemma of government was that the collapse of a large chaebol might cause the downfall of the entire financial system because of huge non-performing loans. Therefore, the government was obliged to provide an implicit guarantee of the survival of chaebols, which induced them to undertake risky investment (Lim 2004: 156). This state control over finance continued until the 1997 financial crisis. As a result, chaebols' debt snowballed to a dangerous level. As Figure 14 shows, the debt-equity ratio of large manufacturing firms reached 390 percent in 1997. In that year, the average debt-equity ratio of the top thirty chaebols was 519 percent (Lim 2004: 158).



**Figure 14** Debt-Equity Ratios of Large Manufacturing Firms, 1990-1997

Source: Bank of Korea. Economic Statistics System.

#### **6.4.4 Corporate governance**

Large firms in the United States disperse corporate ownership but concentrate corporate control in the executive; large firms in Germany are owned by large block-shareholders and corporate control is exerted jointly by the executive and supervisory boards. The traditional corporate governance structure of chaebols was characterized by the high concentration of control in family-owners, the lack of protection of minority shareholders, and the insulation of the management from takeovers. Chaebols were typically controlled by their founding families that were also the largest shareholders of their companies. The corporate governance system was so concentrated that it was called “imperial management” (Lee 2003). The unconstrained managerial power in chaebols played an important role in the acquisition of new assets as a way to expand the business groups and to spread risks across affiliated firms. However, because financially strong subsidiaries were forced to bail out their sister companies in trouble through cross-shareholdings and cross-debt guarantees, this strategy usually ran counter to minority shareholders’ interests (Claessens and Fan 2002: 81).

The government-controlled financial system encouraged this internal structure of chaebols. Because firms relied on banks as a main conduit of corporate finance, domestic financial markets were not developed. Shareholdings by foreigners were prohibited during the period before the 1990s and remained under government restrictions until the 1997 financial crisis. Chaebols’ owner/managers were not monitored by outsiders in securities markets as in the United States or by insiders representing client banks and employees via the supervisory board as in Germany. In South Korea government played a more important role in monitoring chaebols’ performances. And yet, this monitoring by government was not done in a strictly

performance-based way except for during the 1960s, but it was often linked to money politics between business leaders and the governing political party.

#### **6.4.5 Lifetime employment as a business practice**

Lifetime employment has both efficiency and cost to employers. Lifetime employment is economically efficient in a sense that guaranteeing job security may decrease turnover costs, bring employees' loyalty, encourage employees to invest in firm-specific skills, and eventually increase labor productivity (Lazear 1979). On the other hand, lifetime employment raises labor costs because employer's commitment not to lay off workers makes difficult the flexible use of labor in response to business cycles.

South Korea's big businesses heavily reliant upon debt finance used expansion-oriented strategies. The number of chaebol subsidiaries increased rapidly during the 1970s. The expansion of chaebols continued during the 1980s and the 1990s (Lim 2003: 39-41), although Korean manufacturing firms earned less profit than the opportunity cost of capital during much of the period from 1967 to 1997 (Lim, Haggard and Kim 2003: 14-15).

The continued expansion of chaebols made layoffs virtually unnecessary and even undesirable because the labor market situation was tight. Employers found it increasingly difficult to replace workers and thus they considered the advantage of lifetime employment to outweigh its cost. The willingness of employers to establish lifetime employment is revealed in the fact that a majority of them voluntarily established mandatory retirement system based on age in their employment contracts. A mandatory retirement system is double-edged (Cho and Kim 2005). By guaranteeing employment until the worker reaches a fixed retirement age, the mandatory retirement system can promote job security and generate worker loyalty toward the

company. On the other hand, this system can be used as a means of workforce reduction by retiring the aged labor force.

Empirical evidence shows that the mandatory retirement system became prevalent when the Korean economy was growing so fast that mass layoffs were rare and large firms did not experience considerable personnel bottlenecks. According to a survey conducted by the Korea Employers Federation during 1987-1988, 93 percent of 622 firms implemented mandatory retirement at age 55 (Bahng et al. 2005: 88). This survey also shows that 43.3 percent of the companies with a mandatory retirement system introduced this system during the 1970s and 34.6 percent between 1980 and 1988.<sup>112</sup> This indicates that Korean employers might have adopted the mandatory retirement system mainly to promote lifetime employment rather than to reduce workforces.

However, it should be noted that the implicit employment contract in which a company offers lifetime employment and receives worker loyalty was not prevalent throughout all occupations and all firms. It seems lifetime employment contracts were limited to large firms and they mainly applied to white-collar employees rather than blue-collar workers. A former CEO of LG Electronics said:

*Chaebols* guaranteed lifetime employment for managerial workers. They did not guaranteed lifetime employment for production workers but they refrained from laying them off. The rapid economic growth of Korea would not have been possible without the loyalty of employees, especially white collars, who identified themselves with their companies.<sup>113</sup>

There is an argument that South Korea has never developed the Japanese-style lifetime employment system, where employers and employees established a mutual commitment to permanent employment relationship (Kim 1981; Lindauer 1984). This line of argument points to

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<sup>112</sup> Firms with fewer than 100 employees accounted for 15.4 percent of the sampled 622 firms.

<sup>113</sup> I interviewed him in Seoul on July 26, 2005.

the data showing that the average monthly quit ratio of Korean workers in manufacturing firms during the 1970s was 5.2, which was higher than Japan's 1.8 and even the United States' 4.1 (Kim 1981: 68). The gap of quit ratio between Japan and Korea continued in the 1980s, although it narrowed (Yoon 2005: 223). Lindauer concludes, "A commitment to maintain skilled workers is likely to be a feature of many Korean firms but the absence of worker commitment to the firm signals the limited role of lifetime contracts currently in use in Korean enterprises" (Lindauer 1984: 60).

However, Lindauer's argument that worker commitment to the firm was absent is misleading for a couple of reasons. First, it is hardly meaningful to make cross-sectional comparisons between Korea, Japan, and the United States, because of the different level of economic development in Korea. During the 1970s and the 1980s when Korea experienced rapid economic growth, industrial changes were so dynamic that very few small- and medium-sized firms had stable labor-management relations. It would make more sense to compare Korea in the 1970s with Japan during the interwar period. Japan's quit ratio between 1924 and 1931 was actually as high as that of Korea in the 1970s (Kim 1981: 68).

Second, other quit ratio data that reflect occupational differences show that blue-collar workers tended to quit more frequently than white-collar workers before the 1997 financial crisis (Eoh 1993; Cheon 2002). For example, the monthly quit ratio of blue-collar workers in manufacturing industry was 2.88 in 1990, more than twice higher than white-collar workers' 1.38 in the same industry (Eoh 1993: 42). In Korea white-collar workers tended to be more loyal to their employers than blue-collar workers, while in Japan blue-collar workers usually had a longer tenure than white-collar workers (Park 1992: 61-62). Low wages and poor working conditions prompted less skilled workers to leave companies occasionally (Park 1994).

Authoritarian industrial labor relations ruled out these workers making voices on wages and working conditions within the company. In addition, rapid industrialization made skilled labor very scarce. Especially the heavy-chemical industrialization drive during the 1970s increased demand for skilled manual workers and labor mobility became a credible option for them. Employers of heavy-chemical industries often poached skilled manual workers from other firms (Kim 1994: 195).

However, the blossoming of labor movement after 1987 and the stabilization of industrial structure resulted in a significant drop of labor turnover. For manufacturing companies with more than 500 employees, the average monthly quit ratio decreased from 4.5 in 1980 to 2.4 in 1990 (Yoon 2005: 223). Although the 1990 quit ratio was still twice as high as that of Japan for the same year, the trend clearly shows that the overall employment relationship including all occupations had been considerably stabilized over the 1980s.

#### **6.4.6 Conclusion**

The conventional wisdom has portrayed South Korea as a developmental capitalist state very similar to Japan. However, our investigation of the pre-1998 Korean economic model leads to conclude that heterogeneous elements from liberal, coordinated, and state-centered market economies were mixed in the institutional arrangements of the Korean capitalism. To sum up:

- As in the United States, the skill formation in Korea depended on school-based training which emphasizes general school education, not tenure, as the most important factor in determining the level of skill. Generally, even large firms did not invest much in firm-based training to upgrade the skill of their own workers.
- The business network in Korea was historically cartel-ridden as in Germany, but since the Fair Trade Act was established in 1980 there has been sharp competition among different firms in the same industry. Korea resembled the Japanese model based on keiretzu.

- Although Korean firms relied on bank-based financing and therefore they had high debt ratios as German firms, Korea had a fundamentally state-centered financial system. Financial institutions were merely administrative arms of the state-led industrialization policy.
- The internal structure of chaebols was highly concentrated in family owners. While markets for corporate control were not developed, chaebols' owner-manager system was not subject to effective monitoring by insiders, that is, representatives of principal-transaction banks and employees.

These heterogeneous parts produced contradictory effects on the business preference for lifetime employment. The weakness of firm-based training and inter-firm collaboration could have encouraged labor turnover, but it seems to me the labor market effect of state-controlled financial system was overwhelming. Although labor protection might not have been a factor government considered in establishing the state control of finance, the national structure of finance had an important ramification for workers' job security in two ways. First, the state control of industrial finance freed employers from the pressures of stockholders or securities analysts to cut jobs in the period of decreasing demand. Second, state-controlled financial system induced firms to maximize expansion rather than profits because it socialized the risk engaged in capital investment. Since employers at large wanted their employees to be loyal and productive, employers using this expansion-oriented business strategy were likely to engage in long-term employment relations with their employees without having to worry about the labor cost effect of such commitment.

However, although the varieties-of-capitalism perspective provides a useful account for the business preference about lifetime employment, it does not explain the change in the stringency of legal protection of workers against dismissals. The first real employment protection in South Korea was established in 1989 by the Supreme Court following democratization and rising labor activism. And yet the Korean capitalism remained constant

during the period of turbulent political and legal changes. Now I will examine historical events that led to the adoption of rules governing dismissals.

## **6.5 REPRESSION AND COOPTATION UNDER DICTATORSHIPS**

During the period between 1961 and 1987 South Korea was ruled by right-wing dictatorships. Park Chung-hee (1961-1979) and Chun Doo-hwan (1980-1987) oppressed labor's collective actions to prevent labor unions from becoming powerful interest groups and to contain the wage growth in export industries. Between 1961 and 1963, Park Chung-hee outlawed other unions than the Federation of Korean Trade Unions (FKTU), prohibited political activities of labor unions, and required local unions to get approvals from both FKTU and government before entering strikes (KCTU 2001: 43-44). In October 1972, Park Chung-hee declared martial law, removed free election ballots from the political scene, and introduced the *Yushin* Constitution to stay in power permanently. Under the *Yushin* regime government labor policy became more repressive as Park Chung-hee's emergency decrees rendered virtually every strike unlawful. Meanwhile, Figure 2 shows that labor unions gained more membership throughout the 1970s as the heavy chemical industrialization gave rise to large-scale factories.

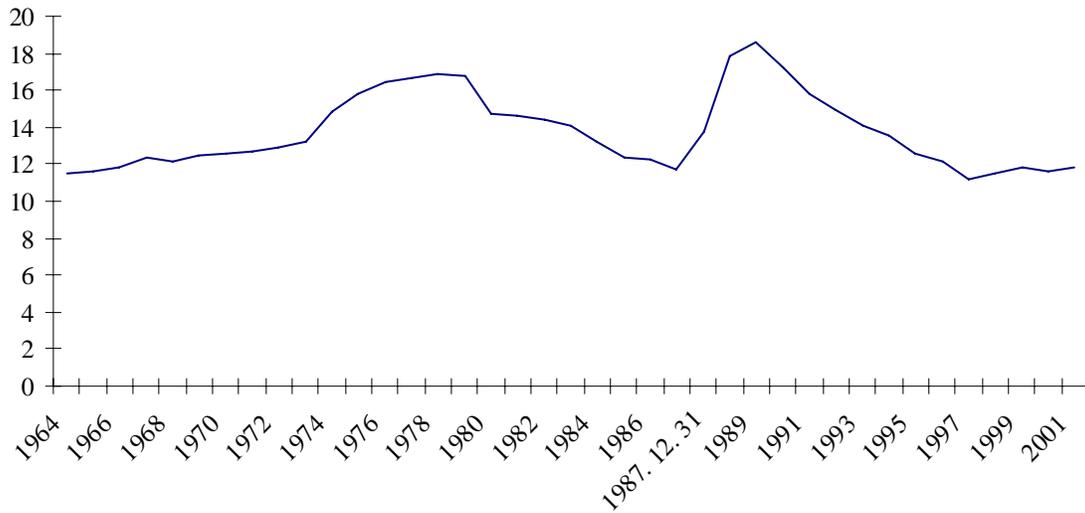
Park Chung-hee's *Yushin* regime ended in Park's assassination by the head of national intelligence agency in October 1979. After his assassination, General Chun Doo-hwan seized power through a military coup in December 1979 and was elected President by a government-appointed electoral college in August 1980. He was the sole candidate running for the

election.<sup>114</sup>

Repressive labor policy was continued during Chun's government. Figure 3 shows that union membership increased rapidly since the beginning of heavy chemical industrialization in 1973. However, Chun revised labor laws to further control labor unions in December 1980. The new Labor Union Law prohibited unions at the industrial level to prevent the Federation of Korean Trade Unions (FKTU) from becoming a stronghold for labor movements. Unions must be established only at the company level and they could be disbanded by government orders. The new Labor Dispute Law prohibited any third-party intervention in labor disputes in an attempt to block the intervention by the FKTU. The new Labor Dispute Law also made government approval mandatory for labor unions to initiate collective bargaining. Chun Doo-hwan enacted the Labor-Management Council Law, which required the establishment of labor-management councils in individual companies to eventually replace unions. Accordingly, the Korean labor substantially lost its organizational power under the Chun regime as the union membership decreased from 16.8 percent in 1979 to 11.7 percent in June 1987 as can be shown in Figure 15.

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<sup>114</sup> *Daily Donga*, August 27, 1980. p. 1.



**Figure 15** Labor Unions Membership (percentage of total employment)

Source: Korea Labor Institute. KLI Labor Statistics. 2005.

The state corporatism literature argues that dictatorships use seemingly contradictory measures of constraints and inducements to gain control over labor groups (Collier and Collier 1979). According to this argument, dictatorships might provide individual workers with a degree of social protection, which is deemed necessary to maintain social stability, while they repress collective rights of labor. We know from the Bismarckian social legislation of Germany that dictatorships do make some efforts to provide social protection. To what extent did the two Korean dictators from the military display benevolence toward workers?

The dictatorships conducted social policy fundamentally as a way to divide and rule workers. They sought to stabilize their political regimes by appeasing high-skilled workers in chaebols at the expense of low-skilled workers in smaller companies. For example, mandatory health insurance for employees and their dependents was introduced first in firms with more than 500 employees in 1977, firms with more than 300 employees in 1979, and firms with more than

100 employees in 1981 (Lee 2003). Park Chung-hee also cared about the job security of workers in chaebols. When oil price shocks hit the Korean economy in 1973-74 and 1979-80, the government urged leaders of big business to make efforts to avoid mass layoff and to stabilize employment.<sup>115</sup> In contrast, social protections for lower-class workers were weak during dictatorships. The Minimum Wage Act was put into effect in 1989. Public pension for workers other than teachers, soldiers and public servants was first introduced in 1988. Unemployment insurance did not exist during the period before 1995.

Even the employment protection for workers in chaebols would not have been effective if business had lacked the capacity and willingness to retain redundant workers. In this vein, the employment protection policy under Park and Chun regimes should be seen as the product of the interplay between the state seeking to buy the consent of middle-class workers and the big businesses willing to provide lifetime employment. It seems that business leaders were not forced to retain excess workers by government so much as they were willing to keep them. For example, the Federation of Korean Industries, a business association consisting mostly of chaebols, declared in 1974 that its members would not implement mass layoffs but reduce hiring in response to the economic recession following the first Oil Shock (FKI 1975).

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<sup>115</sup> *Maeil Business Newspaper*. December 13, 1974. p. 7; *Daily Chosun*. July 13, 1979. p. 1; *Daily Chosun*. September 8, 1979. p. 1; *Kyunghyang Newspaper*. July 26, 1980. p. 1.

## **6.6 DEMOCRATIZATION AND POLITICS OF LABOR LAW REFORM (1987-1997)**

### **6.6.1 Democratization and the return of the old cadre**

After a quarter of century in which only two figures reined the government, South Korea embarked on its shift to democracy on June 29 in 1987 when President Chun Doo-hwan accepted the demand of citizens and opposition groups for the constitutional amendment as to the election of president. The new constitution of October 1987 introduced a direct popular election of president without a runoff system. The term of president must be one-time 5 years and a change to this shall not affect the incumbent. The constitutional rule banning reelections was established to prevent presidents from seeking prolonged assuming of power.

Also, there was a change in legislative election rules. Since the beginning of the *Yushin* regime, the government had been using two-member district plurality to guarantee the ruling party a majority in the National Assembly. For instance, in the National Assembly election of 1985, the ruling Democratic Justice Party won only 35.3 percent of the popular vote, but its share of seats in the National Assembly was 53.6 percent (Brady and Mo 1992: 412). In 1987, this rule gave way to single-member district plurality. The single-member district plurality rule was advantageous to two opposition leaders, Kim Young-sam and Kim Dae-jung, each of whom had strong regional bases.

In the December presidential election of 1987, Kim Young-sam and Kim Dae-jung ran for the presidency after they failed to unify the candidacy representing democratic opposition groups. This division within the pro-democracy group led to the election of Rho Tae-woo, Chun Doo-hwan's military cohort, who won only 36.6 percent of total votes. However, the April legislative election of 1988 cost Rho's Democratic Justice Party (DJP) a majority in the National

Assembly, as single-member district plurality translated opposition party leaders' strong regional support to their electoral success. The ruling DJP gained only 125 seats among 299 seats in the National Assembly. Thus, newly democratized Korea began with a divided government and a multi-party system.

### **6.6.2 The majoritarian state under the conservative mood**

South Korea has the most centralized political system among the three countries under study. Between 1961 and 1987 South Korea followed an authoritarian-capitalist developmental strategy based export-promotion in which the executive of the central government controlled the commanding height. This long-term pattern of centralized fiscal and legislative powers did not change even after Korea was democratized in 1987. The 1987 Constitution provides a unitary political system. Article 117 of the Constitution reads, "Local governments shall deal with matters pertaining to the welfare of local residents, manage properties, and may establish *within the purview of the laws and decrees, rules and regulations regarding local autonomy*" [Italics by author].<sup>116</sup> The Korean people have elected governors of provinces and mayors directly since 1995. However, subnational governments in South Korea are still subject to strong fiscal and legislative control by the central government. The Local Autonomy Act stipulates in the Articles 15 and 16 that local governments and councils are allowed to make local ordinances only "within the scope of the national laws and presidential (administrative) orders." Local governments can operate in areas only explicitly permitted by the national laws or delegated by the central government (Seong 2000). Besides the legislative constraints, weak fiscal autonomy severely

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<sup>116</sup> Here "local" represents both provincial and city/county levels, although the normal usage of the term in the American context applies to city or county levels.

constrains the competence of local governments. Currently all income taxes and value-added taxes are classified as the national taxes, while local government can raise property taxes and several special taxes. This leads to a serious fiscal imbalance between the central and local governments: the central government accounted for 71.7 percent of total tax revenues in 2001 (Ministry of Government Administration and Home Affairs).

Judicial independence was restricted under dictatorships, although the constitution had recognized judicial review of constitutionality of laws since 1961. Between 1961 and 1972 the Supreme Court held legislation unconstitutional in only one instance, which resulted in the dismissal of all the judges who had agreed on the unconstitutionality of the law after the *Yushin* regime was established in 1972 (Yang 1993: 1-2). Between 1972 and 1987 judicial review was nominally maintained under the jurisdiction of the Constitutional Committee without a single case being referred to it (Yang 1993: 2).

There have been significant improvements in judicial independence after democratization. The 1987 Constitution introduced a dual structure in which the Constitutional Court was to decide on the constitutionality of laws, while putting the judicial review of presidential decrees under the Supreme Court's jurisdiction. Between 1988 and April 1990 the Constitutional Court ruled on the constitutionality of legislation in 37 cases, in which it held unconstitutional in fourteen (Yang 1993: 3).

Although institutionally independent, the Korean courts have tended to make rulings that reflected the majority public opinion of the time on politically sensitive cases. During the immediate years after democratization, middle-class workers who played a decisive role during the civil demonstrations against the authoritarian regime in June 1987 were generally sympathetic to labor unions' demands for the increase of wages and the prohibition of unfair

dismissals. A January 1989 survey shows that 67 percent of the public thought those demands were appropriate (KLI 1990, Table 2-11). At this backdrop, the Supreme Court delivered the famous ruling on the four conditions of redundancy dismissals in May 1989. It was a clearly pro-labor decision, compared to what the Labor Standards Act had provided.

However, as the middle classes increasingly became wary of violent tactics of labor unions, the public opinion had already begun to turn around. The same January 1989 survey reports that 81.7 percent of the public thought labor unions' current behaviors were radical (KLI 1990, Table 2-13). The dissident labor unions deliberately violated labor laws that restricted collective rights of labor as a tactic to force legislative changes, but the government did not enforce the laws in the time before June 1989. However, after an opposition legislator was arrested in June 1989 for his illegal traveling to North Korea to meet Kim Il-sung, the public opinion increasingly became conservative and critical of labor unions' strikes and illegal practices. The conservative turnaround of the middle classes culminated in a National Assembly re-election held in August 1989 in which the ruling party solidly won a heavily middle-class district (Koo 1991: 498).

As the government began to prosecute union activists involved in illegal labor disputes, the Supreme Court upheld the government hard-line policy toward dissident unions in most cases (Mo 1996: 298). The Constitutional Court held constitutional the ban on third-party intervention in 1990 and declared the Teachers' Union as illegal in 1992. During the early 1990s, the Supreme Court subsequently changed its interpretation of the requirement of "urgent managerial need" to a more permissive view. If those judicial conditions had not been codified in 1997, the regulation of layoffs could have been much less restrictive than present, considering the liberalizing trend in the Supreme Court's interpretation of lawful layoffs.

### **6.6.3 Labor's discontent**

The relaxation of political control following June 1987 led to the upheaval of hitherto repressed labor movement. As can be shown in Figure 15, union membership increased by more than 50 percent in two years after June 1987. While there were 1,433 labor disputes between 1980 and 1986, there occurred as many as 3,749 labor disputes in the year of 1987, most of which happened after June (Kim 1994: 638-639).

During the interim period after June 1987, there was limited improvement of collective labor rights. The 1987 amendment of labor relations laws lifted the ban on unions at the industrial level and some other restrictions on union organizations (Lee and Yoo 2000: 46). However, there remained substantial limitations on labor unions such as the bans on multiple unionism, third party intervention in union activities, unions of public employees including teachers, and unions' political activities.

Many workers were discontent with the monopoly of representation by the Federation of Korean Trade Unions (FKTU). Criticizing the FKTU for being corporatist, they sought to build new left-wing labor organizations. The democratic union movement led to the formation of the Korean Trade Union Congress in 1990, which developed into the Korean Council of Trade Union Representatives in 1993. The democratic labor movement ended with a singly nationwide organization, Korean Confederation of Trade Unions (KCTU) in 1995.

Those democratic labor unions were unlawful and therefore the labor disputes they initiated were also unlawful. And yet, the Rho Tae-woo government could not enforce laws because democratic labor movements became nation-wide and uncontrollable by government. After the legislative election of 1988, two opposition leaders, Kim Young-sam and Kim Dae-

jung, sought to amend labor relations laws using their majority in the National Assembly.<sup>117</sup> The ruling party and business groups resisted any policy changes to strengthen labor unions. The Federation of Korean Trade Unions demanded further liberalization of labor activities but it opposed the recognition of multiple unions. In March 1989, the National Assembly passed a set of bills that freed multiple unions, third-party intervention, public employee unions, and union's political activities. However, none of these bills were enacted because President Rho vetoed against them.

In January 1990, there was a major change in the political landscape of Korea. The ruling Democratic Justice Party merged with two opposition parties led by Kim Young-sam and Kim Jong-pil, excluding Kim Dae-jung's party. The new Liberal Democratic Party assumed more than two-thirds of seats in the National Assembly, which meant it could initiate constitutional amendment. The 1990 Interparty Merger dampened political debates on the labor law reform.

#### **6.6.4 Declining business support for lifetime employment**

It was not only organized labor that was discontent, but business was also dissatisfied with the status quo. In the late 1980s, South Korea experienced a sharp slowdown in export growth as it faced growing international market competition. The annual average growth rate of export was 13.6 percent between 1980 and 1987, but it was only 4 percent during the next three years

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<sup>117</sup> Labor groups generally opposed the banning of third party intervention because it prohibited any help from outside the company regarding union organization, collective bargaining, and strikes. However, labor groups were divided on the issue of multiple unionism. The democratic union groups that ended up with the formation of the Korean Confederation of Trade Unions in 1995 were most strongly concerned about the recognition of multiple unions because otherwise they would remain outlawed organizations. In contrast, the Federation of Korean Trade Unions was less sanguine about multiple unionism.

(World Bank). Two factors deserve mentioning here: the rise of Chinese export and real wage growth. The Chinese manufacturing industry was making inroads into the share of Korean products in the U.S. market. Between 1989 and 1996, the U.S. market share of Korean manufactured goods decreased from 5.3 percent to 3.5 percent, while the U.S. market share of Chinese manufactured goods increased from 2.6 percent to 6.7 percent (Kwon 1999: 13-14). The Chinese competition had greater impact on labor-intensive goods such as toys, shoes and garments, where the U.S. market share of China increased from 9.4 percent to 23.2 percent but that of South Korea plunged from 10.7 percent to 2.7 percent. The other factor was the rise of labor cost after 1987. The real wage in manufacturing firms rose by average 7.5 percent per year between 1985 and 1987, while it increased to 13.5 percent per year between 1988 and 1990. This sharp increase in real wage undermined the international competitiveness of Korean exports. South Korea was experiencing a demographic change as well. The post-Korean War baby boomers, who were born between 1955 and 1961, began to enter labor markets during the 1980s. Chaebols had absorbed the large influx of these new entrants because they continued to expand but later they came to face overstaffing and personnel congestion problems. According to the Korea Employers Federation's survey of 1997, 22.1 percent of 233 firms that responded answered that they had a serious redundancy problem (KEF 1997: 40-43).<sup>118</sup> The redundancy ratio was highest in white-collar jobs in large firms. 37.5 percent of large firms with more than 1,000 employees answered that they employed excess workforce. Almost three times more companies felt the excess workforce to be in managerial and clerical positions than production lines.

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<sup>118</sup> This survey was conducted on randomly chosen 1,000 firms with more than 100 employees during February to March in 1997, which was before the financial crisis.

In respond to the change in the social and economic environment, Korean employers began to consider lifetime employment to be a liability. They did not seek to sever redundant employment relationships unilaterally but they used early retirement as a means of employment adjustment.<sup>119</sup> In the forementioned Korean Federation of Employers' survey, the companies that had introduced early retirement amounted to 18.1 percent of total respondents and most of them first adopted early retirement in the 1990s.

However, chaebols were still timid in reducing abundant employees. Many of the early retirement plans undertaken before 1997 were limited to banks and state-owned companies (Kim 1996: 8). Major chaebols such as Daewoo, Hyundai, LG, and Samsung pledged that they would not introduce early retirement for fear of the deterioration in employee morale and their corporate reputation.<sup>120</sup>

### **6.6.5 The Labor Law Review Committee, 1992-1994**

South Korea became a member of the International Labor Organization in December 1991. The ILO conventions and recommendations were in conflict with the government policy prohibiting multiple unionism, third party intervention in union organization and collective bargaining, and unions' political activities (Yoo and Choi 2000: 151-152). Thus, South Korea's entry into the ILO rekindled the political debates on labor law reform. In April 1992 the Ministry of Labor established the Labor Law Review Committee (LLRC), whose aim was to produce a draft on the

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<sup>119</sup> Most of OECD countries have also experienced the development of early retirement in recent decades as a result of the strengthening of social security systems (Blöndal and Scarpetta 1997). However, such a use of early retirement by employees as seeking leisure at older ages makes a striking difference from the use of early retirement by employers as a means of workforce reduction in Korea.

<sup>120</sup> *Daily Donga*. September 25, 1996. p. 19; *Seoul Newspaper*. September 26, 1996. p. 8; *Kyunghyang Newspaper*. September 26, 1996. p. 9.

direction of labor law reform for the government. The LLRC was the first social dialogue committee in Korea that officially included business and labor to discuss labor policy issues. The eighteen committee members consisted of twelve experts on labor relations, three business representatives, and three officials from the Federation of Korean Trade Unions.<sup>121</sup> The outlawed Korean Trade Union Congress were excluded from this committee. Therefore, it actively used non-institutional channels such as petitions to the ILO (Yoo and Choi 2000: 158-161).

While business previously tended to avoid being engaged in any political debates over labor law reform, this time it began to demand policy changes in a bid to promote labor market flexibility. Employers found the labor law provided excessive protection with individual regular employees, which they considered to forestall industrial adaptation to rapidly changing business environment. Since the Labor Standards Act discouraged the use of non-regular employment to protect regular employees, employers demanded the government to legalize the use of dispatched workers by manpower supply agencies and to relax the restrictions on hiring part-time workers. They also urged the government to permit the use of a flexible work hour system in which if a worker agreed, a company could have him or her work in excess of legal working hours (8 hours a day and 44 hours a week) on the condition that the average work hours did not exceed the legal working hours (KFE 1993: 158-167).

However, there is little evidence that chaebols demanded government to tackle restrictions on layoff at that time. Although the Labor Standards Act had been silent about whether employers might legally dismiss workers for managerial reasons, it was not impossible to lay off workers. The Supreme Court decision of 1989 already set the conditions for layoffs to

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<sup>121</sup> *Seoul Newspaper*. April 25, 1992. p. 2.

be lawful. Moreover, judicial practices on layoff became more permissible in the early 1990s. The Supreme Court ruled that urgent managerial needs were not limited to the circumstances where layoffs were necessary to avoid bankruptcy but that they included broader situations such as employers seeking to improve productivity, to introduce new production technologies, and to implement business rationalization.<sup>122</sup> The Ministry of Labor changed its guideline for layoff in accordance with this new court decision.<sup>123</sup> It was labor that demanded to tighten restrictions on layoffs. Labor groups urged government to require unions' approval of layoff and to extend advance notice periods from 30 days to 90 days.<sup>124</sup>

In December 1992 Kim Young-Sam, who joined the interparty merger in 1990, was elected President. For the first two years of his term, the LLRC labored through conflicts between business and labor and failed to produce an agreement except for the law on the National Labor Relations Commission. Finally, it went adrift at the end of 1994. The failure of LLRC reflected the longstanding confrontation between business and labor in South Korea. During dictatorship regimes, normal labor-management relations were replaced by state control over labor. Therefore, business did not consider labor unions to be their partners except for a few enlightened managers. This lack of mutual trust between business and labor made labor unions more militant, which in turn made labor relations more confrontational. As a result, as Table 14 shows, South Korea suffered deep labor unrest during the first half of the 1990s, which caused considerable economic losses compared to advanced democracies.

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<sup>122</sup> The Supreme Court ruling, 91 Da 8647. December 10, 1991; 90 Nu 9421. May 12, 1992.

<sup>123</sup> *Daily Chosun*. January 13, 1992. p. 22.

<sup>124</sup> *Hankyoreh Newspaper*. June 10, 1992. p. 12.

**Table 14** Workdays Lost due to Strikes and Lockouts per 1,000 Employees

	Korea	Japan	Germany	United States
1990	409.8	3.0	14.2	54.7
1991	279.6	1.9	4.6	42.8
1992	128.3	4.5	47.2	36.9
1993	109.5	2.2	18.4	36.3
1994	118.9	1.6	7.2	44.7
1995	30.4	1.4	7.7	50.5
1996	67.7	0.8	3.1	42.1

Source: Korea Labor Institute (KLI). *Foreign Labor Statistics*. 2004. p. 93.

#### **6.6.6 The Labor Relations Reform Commission, 1996-1998**

In May 1996 President Kim Young-sam established the Commission for Labor Relations Reform (CLRR) to expedite the labor law reform process. Kim Young-sam considered labor reform to be the most important part of his overall reform drive, saying “We must boldly break away from the backwardness in labor-management relations if we want to make Korea an advanced nation in the world.”<sup>125</sup> He desired to see the labor law reform complete by the end of 1996 because the next year was a presidential election year.

The CLRR was not an apparatus under the Ministry of Labor like the LLRC, but it was under the immediate control of the President. Other than that, there was much continuity between the LLRC and the CLRR. The CLRR followed the social dialogue framework of the LLRC, comprising ten social figures, ten from the academic circle, five from management and

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<sup>125</sup> “Kim Calls for End to Backward Labor-Management Relations.” *Korea Times*. May 10, 1996. p. 2.

business associations, and five from labor groups.<sup>126</sup> Park Se-II, former LLRC member, had been appointed Senior Secretary to the President for Social Policy in December 1995 and he led the formation and operation of the CLRR. Four other former LLRC members were appointed public interest members in the CLRR to chair subcommittees (Yoo and Choi 2000: 200).

The major issues over which business and labor conflicted can be summarized as Table 15. Business insisted that the stringent protection of individual worker be lifted but restrictions on labor union activities be maintained. In contrast, labor urged government to upgrade collective rights of labor to international standards, while they opposed reducing individual worker protection for fear of employers' abuse (Park 2000: 13-14).

**Table 15** Major Issues That Divided the Commission for Labor Relations Reform

Three Least Protected Areas	Three Most Protected Areas
Multiple unionism	Dismissal for managerial reasons
Third party intervention	Flexible working hour system
Unions' political activities	Manpower supply business

Source: Park (2000: 13-14)

It was a new development that the CLRR discussed the legalization of dismissal for managerial reasons. This redundancy dismissal was not clearly stipulated in the Labor Standards Act, although it had been allowed by judicial decisions. Table 16 shows how the CLRR was divided as to redundancy dismissal. Labor groups did not oppose codifying it but they demanded to put substantial restrictions to prevent abuse by employers. The Korea Federation of

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<sup>126</sup> *Daily Chosun*. May 9, 1996. p. 2. The twenty social figures and scholars were called “public interest members” as opposed to business and labor interest members. Two of the five labor members belonged to the outlawed Korean Confederation of Trade Unions.

Employers (KFE) insisted on incorporating the more permissive conditions set by the 1991 decision of the Supreme Court and leaving procedural regulations to judicial judgment.

**Table 16** Different Views on Lawful Layoffs within the CLRR

	FKTU	KCTU	KFE	Public Interest Members
Definition of “urgent managerial need”	Same as present	Limited to prevent bankruptcy [the Supreme Court ruling of 1989]	Objectively reasonable reasons; not limited to economic losses [the Supreme Court ruling of 1991]	No further specifications
Procedural conditions	Extended advance notice; Efforts to avoid layoffs; Consultation with unions; Provision of layoff compensation	Extended advance notice; Efforts to avoid layoffs; Agreement with unions; Government approval	No statutory requirements specified	60-days’ advance notice; Efforts to avoid layoffs; Consultation with unions

Source: CLRR. *The Present Situation of Discussion on Labor Laws and Institutions*. August 1996.

The CLRR failed to conclude formal agreements in any of the six contended issue areas in Table 15. However, business and labor had been converging to the idea of public interest members on the two major questions of multiple unionism and layoffs. Although multiple unionism was bitter to business, business groups except for more anti-union companies such as Samsung were aware that the spread of democratic labor unions under the umbrella of KCTU had become a reality and at any rate employers would be forced to recognize the KCTU.<sup>127</sup>

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<sup>127</sup> An interview with a former public interest CLRR member. This interview was conducted in Seoul on June 15, 2005.

Regarding employment protection, the public interest members' idea was to codify the "urgent managerial needs" requirement but to leave it unspecified as in Table 16. Business supported the codification of layoff as a way to bring legal clarity about when and how layoffs could be executed, to prevent unnecessary disputes over layoffs between business and labor, and to see the managerial right to layoff publicly declared by the law.<sup>128</sup> It was their misjudgment that they were content with this symbolic effect and did not negotiate harder for more permissive statutory conditions for layoff. A former public interest CLRR member commented on the employers' position about layoff regulations:

At first, business demanded to ease the condition of urgent managerial need. However, public interest members suggested that business focus on the symbolic meaning of the codification of layoff rather than seeking the relaxation of legal requirements. Business also found it significant that the state officially recognized the managerial right to layoff. It seemed to me the business demand for the codification of layoff was less driven by the immediate need to implement mass layoffs than by the leverage that the codification of layoff would give to employers in labor-management relations.<sup>129</sup>

In November 1996, after the CLRR presented a final report to President Kim Young-Sam, the government embarked on making draft labor bills. Jin Nyum, Minister of Labor, and Park Se-II, Senior Secretary to the President for Social Policy, advocated the labor law reform within the administration. However, they faced strong opposition from the conservative group comprising Minister of Finance and Economy, Minister of Commerce and Industry, and Senior Secretary to the President for Economic Affairs, who were strongly business-oriented and critical against new labor relations (Park 2000: 41). As can be seen in Table 17, the government bill was a considerable retreat from the CLRR proposal in the labor's view because it delayed the recognition of multiple unions at firm levels for five years. The government bill underwent

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<sup>128</sup> Statement of Cho Nam-hong, Vice-president of FKI, The National Assembly of the Republic of Korea Committee on Environment and Labor Record. February 20, 1997. p. 30.

<sup>129</sup> Same interview as in note 128.

another major revision during the consultation period between the administration and the ruling party. In the final bills delivered to the National Assembly, the recognition of multiple unions was not only delayed at the firm level but also at the industry level for three years, which echoed the voice of conservatives in the administration.

**Table 17** Making Laws on Multiple Unionism and Layoff

		CLRR Draft (Public Interest Members)	Government Bill	Final Act Passed December 26, 1996
Multiple Unionism		Immediate and full liberalization on condition of unitary collective bargaining channels	Immediate liberalization at industry level; Postponed for 5 years at firm level	Postponed 3 years at industry level & 5 years at firm level
Layoff	Definition of “urgent managerial need”	No further specifications	Continued deterioration of business, business restructuring to improve productivity, technological innovation, change of business, transfer/merger/acquisition due to continued deterioration of business	Same as government bill
	Procedural conditions	60-days’ advance notice; Efforts to avoid layoffs; Consultation with unions	Same as CLRR	Added mandatory approval by the Labor Relations Commission for certain layoffs

Source: Yoo (2000: 291, 312)

In contrast to multiple unionism, the layoff provisions in the government bill was not a setback to labor. It accepted all the procedural conditions for layoffs established by the 1989 Supreme Court ruling. The government bill specified what constituted “urgent managerial needs” as presented in Table 17. Although it rejected the bankruptcy-prevention view of the

1989 Supreme Court ruling on the interpretation of “urgent managerial need,” it also left out the expression of “objectively reasonable cutback” that was a major theoretical development adopted by the 1991 Supreme Court ruling. Further, the National Assembly passed a motion that required approval by the Labor Relations Commission, a quasi-judicial government body in which members for workers and employers had an equal number. There were even concerns within the business community that the new layoff-related clauses under this revision was more prohibitive than permissive.<sup>130</sup> The final outcome of 7-month-long tug-of-war over labor law reform was a virtual replication of the old regime.

The ruling party forced the passage of the labor bills through the National Assembly in a surprise, predawn session on December 26, 1996. The passage of labor bills led to the fierce protest by labor groups. The KCTU was especially enraged at the legislative outcome because they were forced to remain an outlawed organization for the next three years. Both the FKTU and the KCTU entered general strikes in protest against the new labor laws on the day the labor bills were passed. The general strike rapidly spread to 652 unions of 310,000 workers in two days.<sup>131</sup>

To the government’s dismay, the general strike gained strong popular support because the passage of labor bills aroused middle-class workers’ concern about their job security because of the legalization of layoff. On January 6, 1997 white-collar unions including banking and financial industry unions, journalist unions, and government research institute unions joined the

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<sup>130</sup> Statement of Cho Nam-hong, Vice-president of FKI, The National Assembly of the Republic of Korea Committee on Environment and Labor Record. February 20, 1997. p. 30. Another FKI official also commented that the revised Labor Standards Act provided stricter conditions for layoffs than the judicial precedents. See “Interview: Lee Dong-ung, International Director of FKI.” *Hankyorhe* 21. January 30, 1997.

<sup>131</sup> *Daily Chosun*. December 28, 1996. p. 3.

general strike.<sup>132</sup> According to an opinion poll, a majority of workers regardless of occupations supported the general strike.<sup>133</sup> In this poll, almost 70 percent of the workers answered that they were more concerned about the impact of the codification of layoff on job security than any other issues in the labor bills. The participation of white-collar workers in the general strikes was parallel to the mass rallies of June 1987 that led to the retreat of dictatorship regime.

Why were there massive labor protests in reaction to the revised labor law even if the final act passed by the National Assembly largely followed the judicial precedents and some FKI officials held that it was a revision for the worse? First, the economic situation during the mid-1990s was underlying the public resentment linked to the revised labor law. Many Koreans had perceived the early retirements of white-collar workers in their middle ages as signaling the demise of lifetime employment. At this backdrop the new provisions on layoff exacerbated the public concern about the deterioration of job insecurity although their real impact on job security remained doubtful. Many Korean workers feared that the codification of layoff would bring mass layoff and job insecurity – later labor groups took advantage of this public fear as a tactic to force down the revised labor law. They tended to believe that the legalization of layoff was to make possible layoff that had been previously prohibited. But this general perception of the public over the codification of layoff was largely unfounded because layoff had been possible by judicial decisions and the statutory conditions for layoff were stricter than judicial precedents.

Second, the long-standing lack of trust between business and labor aggravated the labor's fear of potential mass layoffs. Although there were substantive and procedural restrictions on layoffs in the revised labor law, labor groups did not trust that employers would sincerely

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<sup>132</sup> An official of Professional Workers Union said, "This general strike is being led by employees at their forties. They are worried that the introduction of layoff could cost their jobs without receiving severance pay." *Daily Segye*. January 6, 1997. p. 20.

<sup>133</sup> *Hankyoreh Newspaper*. January 13, 1997. p. 4.

observe the rules. They saw that employers would circumvent the rules to abuse layoffs.

The development of the general strike shaped the strategies of opposition leaders and the KCTU. Kim Dae-jung's National Congress for New Politics and Kim Jong-pil's United Liberal Democrats, had not been active players during the legislative period. Their dilemma was that they needed both business and labor support in the 1997 presidential election. Thus, they simply reiterated the principle that the government and the ruling party should do the labor law reform on the basis of dialogue and compromise.<sup>134</sup> After the general strike expanded to white-collar workers, Kim Dae-jung and Kim Jong-pil expressed support for the general strike on January 15, 1997 and began to organize mass rallies against new labor laws, which was a dramatic turnaround from their ambiguous positions.<sup>135</sup> The KCTU strategically adjusted its focus to attacking the legalization of layoff to continue to hold public support for labor groups when it announced that it was willing to accept the delayed recognition of multiple unions if the government renounced the legalization of layoff.<sup>136</sup> At that point, the KCTU was seen to represent broader interests rather than act like a special interest group.

President Kim Young-sam finally yielded to democratic pressures as public opinions turned against him.<sup>137</sup> On January 21, 1997 he said to opposition leaders he wished the labor laws would be revised through negotiations in the National Assembly.<sup>138</sup> In March 1997 the ruling party agreed to accept multiple unionism at the industry level without delay while postponing multiple unions at the firm level until 2002. Instead, the ruling party also agreed to make the justifying reasons of layoff as strict as the Supreme Court decision of 1989, although

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<sup>134</sup> *Daily Hankook*. December 28, 1996. p. 4.

<sup>135</sup> *Daily Hankook*. January 16, 1997. p. 2.

<sup>136</sup> *Daily Hankook*. February 23, 1997. p. 2.

<sup>137</sup> Total 3,206 labor unions and 3,597,011 workers were reported to participate in the general strike that had continued until the end of January 1997 (Park 2004).

<sup>138</sup> *Daily Hankook*. January 22, 1997. p. 2.

the Supreme Court decision of 1990 had a more permissive view on when business could dismiss workers for managerial reasons, and to postpone the implement of layoff until March 1999.<sup>139</sup>

From the business view, this compromise on layoff was a retreat even from the proposal by the CLRR's public interest members. However, the biggest loser in the politics of labor law reform was President Kim Young-sam. The success of the general strike was the reversal of policy decisions he made. At least until the end of 1996, President Kim Young-sam had exercised command of government and politics. And yet, only in a few months, he became a lame duck president.

To sum up, the 1997 general strike became a success to labor groups because the legalization of layoff was at stake. Labor groups could muster broader popular support for the general strike by taking issue with the legalization of layoff and its potential impact on job security. Although the new labor bill only accommodated the pre-existing judicial practices established since 1989, the government was compelled to put off the implementation of layoff for two years. The legalization of layoff threatened workers who had been accustomed to lifetime employment relationships as these workers were acutely concerned about their job security. Vote-maximizing politicians were not able to ignore the opposition from the constituents of employment protection.

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<sup>139</sup> *Daily Chosun*. March 9, 1997. p. 3.

## 6.7 THE IMPACT OF THE 1997 FINANCIAL CRISIS

### 6.7.1 The evolution of the crisis

After currency turmoil erupted in the Southeast Asian region between July and October 1997, foreign investors wary of the debt situation of South Korea withdrew from the Korean financial market and several decades' outstanding economic performance of Korea finally ended up with the third major financial crisis in the Korean history.<sup>140</sup> Table 18 suggests the depth of the financial crisis Koreans suffered. The massive outflow of foreign capital caused the freefall of the value of the Korean won against the U.S. dollar. Foreign lenders' rush to demand repayment pressed domestic intermediaries to tighten credits, which led to a sharp increase of market interest rates. And the ensuing credit crunch forced many firms to go bankrupt. Thus, the financial crisis became an industrial and economic crisis. Between 1997 and 1998 the real GDP growth plunged from 4.7 percent to -6.9 percent and unemployment rates increased from 2.6 percent to 7 percent.

**Table 18** The Macroeconomic Consequences of the 1997 Financial Crisis

Variables	Exchange Rates, Average	Market Interest Rates, Overnight	Bankruptcy Ratio, Nation-wide
Unit	Won/Dollar	Percent	Percent

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<sup>140</sup> I will not discuss the causes of the Korean financial crisis here. Readers might find the following literature useful. IMF Staff (1998) provides a nice, general review of the causes of East Asian financial crisis with more emphasis on domestic factors. Lim, Haggard, and Kim (2003) focus on the *chaebol* problem of Korea. Wade (1998) attributed the financial crisis to the global financial system lacking adequate regulatory regimes over global investors.

August 1997	896.55	12.39	0.21
September 1997	910.15	13.17	0.31
October 1997	926.19	13.56	0.43
November 1997	1033.23	14.00	0.38
December 1997	1499.38	21.29	1.49
January 1998	1701.53	25.34	0.53
Variables	Real GDP Growth, Annual	Unemployment Rates, Annual	
Unit	Percent	Percent	
1997	4.7	2.6	
1998	-6.9	7.0	

Source: Bank of Korea. Economics Statistics System.

The Kim Young-sam government asked the International Monetary Fund for bailing out its troubled economy on November 21, 1997. On December 4, 1997, the IMF approved Korea's request for a three-year stand-by credit equivalent to about 21 billion US dollars in support of the government's economic reform program as can be shown in Table 19.

**Table 19** The Structural Reform Program Concluded between South Korea and the IMF (except for trade liberalization)

Financial Restructuring	Corporate Restructuring	Capital Market Liberalization	Labor Market Reform
Enhanced central bank independence & financial supervision	Improvement of transparency of corporate balance sheets	Liberalization of foreign direct investment	Strengthening of employment insurance system
Exit or re-capitalization of troubled financial institutions	Reduction of dependence on debt-financing	Liberalization of foreign ownership of stocks & bonds	Improvement of labor market flexibility
Bank requirement of the BIS capital ratio (8%)	No government subsidies to bail out individual corporations		
Elimination of government intervention in bank management & lending decisions			

Source: Republic of Korea. IMF Stand-By Arrangement. December 5, 1997.

## 6.7.2 Structural reform under the Kim Dae-Jung government

On December 18, 1997 the opposition leader Kim Dae-jung was elected President. Most of structural reform measures were undertaken by Kim Dae-jung's transition team and his administration.<sup>141</sup> The reform program focused on reconstructing Korea's financial system.<sup>142</sup> The government-controlled financial system had left corporations and banks in a deep debt trouble. At the end of 1997, the debt-equity ratio of large firms reached almost 400 percent (Bank of Korea) and non-performing loans of commercial banks accounted for 22.6 percent of total loans (Kataoka 2000: 267).

Kim Dae-jung pursued the reconstruction of the financial industry by using a twin-pronged approach. On the one hand, he sought to resolve the enormous debt. Approximately 82.9 billion dollars of public funds were injected into the financial system through the Korea Asset Management Corporation established in November 1997 (Kataoka 2000: 268-271). This money from the government budget was used for repaying deposits of failed or exited banks, recapitalizing fragile banks, and purchasing non-performing bank loans. On the other hand, he opened capital markets to foreigners and encouraged a wave of exits and mergers of commercial banks and other financial institutions in a bid to make the Korean financial industry competitive. By the end of 1998, 135 financial institutions including 5 commercial banks were closed and 20 were merged (Ahn 2001: 456). Three commercial banks, Koram Bank, Korea First Bank, and Korea Exchange Bank, were sold to foreign investment companies. The cap on foreign stock ownership was raised from 20 percent to 50 percent in December 1997 and it was finally

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<sup>141</sup> For the reform legislation passed during 1997-1998, see Haggard (2000: 102-103).

<sup>142</sup> At a press conference on December 5, 1997, First Deputy Managing Director of IMF Stanley Fischer said, "The heart of the program is in the area of financial restructuring... I don't think this restructuring would be possible within the Korean model." [Available at <http://www.imf.org/external/np/tr/1997/tr971205.htm>].

removed in May 1998.

The government enhanced central bank independence by revising the Bank of Korea Act. Previously, the Bank of Korea (BOK) lacked political independence under the government-controlled financial system because its main function was less price stability than money creation and credit allocation to finance rapid economic development. The Monetary Board, BOK's decision-making body, had been composed of nine members, six of which had been from the government. In December 1997, the Bank of Korea Act was revised such that central bank independence was officially confirmed, price stability took the first priority, and the number of government seats in the Monetary Board was reduced.

For the corporate sector restructuring, the government used different approaches, depending on firm size (Park 2003: 181). For the largest five chaebols, the government adopted the so-called Big Deals program, in which the government called on them to exchange subsidiaries and to concentrate on fewer business activities. For the sixth through sixty-fourth chaebols and other independent firms, the government applied workout programs, in which creditor banks rescheduled or reduced debt in return for corporate restructuring. Firms were let go bankrupt if they failed to implement restructuring programs.

### **6.7.3 Implementing layoffs**

In March 1997 layoff was legalized but the implementation of the clause permitting layoffs was delayed for two years. The IMF saw that the lack of flexibility in the Korean labor market was a problem obstructing financial and corporate sector restructuring. Therefore, the Korean government agreed to ease restrictions on dismissals for mergers and acquisitions and corporate

restructuring to receive the stand-by credit.<sup>143</sup> The Korea Federation of Employers also asked the government to implement the provisions on layoff early and to ease the restrictions on the conditions of lawful layoff.<sup>144</sup>

To implement the IMF agreement on layoff the government had to revise the Labor Standards Act enacted only nine months ago. Before elected President, Kim Dae-Jung opposed early implementation of the provisions on layoff.<sup>145</sup> Instead, he promised a six-month moratorium on layoffs.<sup>146</sup> But soon after his election, he admitted layoffs were inevitable and pledged to implement the agreement on layoff as concluded with the IMF.<sup>147</sup> On December 27, 1997 President-elect Kim Dae-jung proposed to establish a tripartite committee to discuss broad reform issues including layoff. Han Kwang-ok, vice-chairman of the ruling party and Kim Dae-jung's lifetime confidant, was appointed to be the chairman of the committee.

Facing Kim Dae-jung's proposal, both the FKTU and the KCTU openly opposed any meetings offered to discuss the introduction of layoff. Considering that rank-and-files were highly concerned about their job security under the IMF restructuring programs, FKTU and KCTU leaders were hesitant about participating in the tripartite committee. However, union leaders implicitly acknowledged that layoffs were inevitable to overcome the economic crisis, but they wanted to ensure that labor did not make all of the sacrifices.<sup>148</sup> Meanwhile, Kim Dae-jung elevated this committee to a high-level commission composed of leaders from business and

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<sup>143</sup> "IMF Approves SDR 15.5 Billion Stand-by Credit for Korea." Press Release Number 97/55. December 4, 1997. Washington D.C.: International Monetary Fund [Available at <http://www.imf.org/external/np/sec/pr/1997/pr9755.htm>].

<sup>144</sup> *Hankyorhe Newspaper*. November 27, 1997. p. 1.

<sup>145</sup> *Hankyorhe Newspaper*. November 28, 1997. p. 6.

<sup>146</sup> *Hankyorhe Newspaper*. December 6, 1997. p. 9.

<sup>147</sup> *Daily Chosun*. December 23, 1997. p. 1.

<sup>148</sup> "Korea Braces for Layoffs Despite Labor Impasse." *Wall Street Journal*. December 31, 1997. p.1.

labor associations and political parties as well as economic and labor ministers.<sup>149</sup> This decision helped to reduce labor groups' suspicion that the government sought to utilize the committee to force labor to sacrifice. Finally, labor chose to fight for workers' interests within the Korea Tripartite Commission.

On February 6, 1998 labor agreed to the immediate implementation of provisions for layoff. The revised Labor Standards Act followed all the procedural restraints of layoff except for the requirement of approval by the Labor Relations Commission that business opposed. Instead, the "urgent managerial need" term was left unspecified as labor groups demanded – giving the impression that the theory of bankruptcy prevention could be invoked again by judges – although transfer, mergers, and acquisitions of business due to its continued deterioration were still recognized as lawful. In its attempt to appease labor, the government promised to expand unemployment insurance to all firms regardless of their size. Labor's collective rights were also strengthened. Public employees and teachers unions became lawful and the restrictions on unions' political activities were also lifted.

Despite the legal clarity that this revision was aimed at, however, implementing layoff turned out to be less straightforward because political concerns confounded the exercise of management right to layoff. Shortly after the Labor Standards Law was revised, Hyundai Motors attempted to reduce its workforce. The case of Hyundai Motors was a test for the new provisions permitting employers to lay off. Before Hyundai Motors acted, thirty-three companies had made announcement of layoff since the revision of the Labor Standards Act but there were only three minor subsidiaries of the top-30 chaebols.<sup>150</sup> Other big corporations were hesitating because they were concerned about labor unions tenaciously opposed to layoff and the

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<sup>149</sup> *Hankyoreh Newspaper*. January 7, 1998. p. 5.

<sup>150</sup> *Daily Hankook*. May 21, 1998. p. 29.

government policy of layoff as the last resort.

Before implementing layoff, Hyundai Motors offered an early retirement scheme to managerial employees and later extended it to all employees. However, as the Hyundai Motors union declined the offer, the company announced on May 29 to lay off 8,189 employees, which amounted to 18 percent of the entire workforce.<sup>151</sup> The Korean Confederation of Trade Unions (KCTU) organized two-day's general strikes in protest against the Hyundai Motors layoff plan. Upon the labor protest, Hyundai Motors extended the application of early retirement schemes. However, it finally submitted a formal notice to the Ministry of Labor on June 29 that it would dismiss 4,800 employees.<sup>152</sup>

The Hyundai Motors union and the KCTU launched a series of strikes in July, demanding the company to renounce its layoff plan and to use work sharing in place of job cut as a means of employment adjustment. Hyundai Motors responded to the strikes by shutting down factories on July 21. The Tripartite Commission fell into disarray as both labor and business parties deserted the organization. The Ministry of Labor held the view that the labor dispute at Hyundai Motors should be resolved through the negotiation between labor and management, which came to a deadlock by mid-October. At last, politicians were impelled to intervene in the dispute. Leaders of the ruling party conducted political arbitration and settled the dispute in four days dispute after they came in.<sup>153</sup> The struggle by labor unions was not fruitless. The final layoff plan agreed on August 23 limited the number of dismissals to 277 employees, significantly watered down from the company's initial target.

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<sup>151</sup> *Daily Chosun*. May 20, 1998. p. 1.

<sup>152</sup> *Hankyorhe Newspaper*. June 30, 1998. p.1

<sup>153</sup> *Hankyorhe Newspaper*. August 24, 1998. p. 1.

#### 6.7.4 Changes to the traditional financial system

The structural reform after the 1997 financial crisis ended the government-controlled financial system established in the early 1960s. It is important to examine whether South Korea adopted the market-based financial system characterizing the United States or the bank-based financial system as can be found in Germany through the structural reform program.

The standard political economy literature suggests that national financial systems can be distinguished by how corporations raise business funds (Demirguc-Kunt and Levine 1999; Vitols 2001, 2005). As Table 20 shows, Japan and Germany are considered to have bank-based systems because firms tend to raise funds mainly through loans from banks (indirect finance), while the United States is classified as a market-based system country because of firms' heavy dependence on financing through securities markets (direct finance).

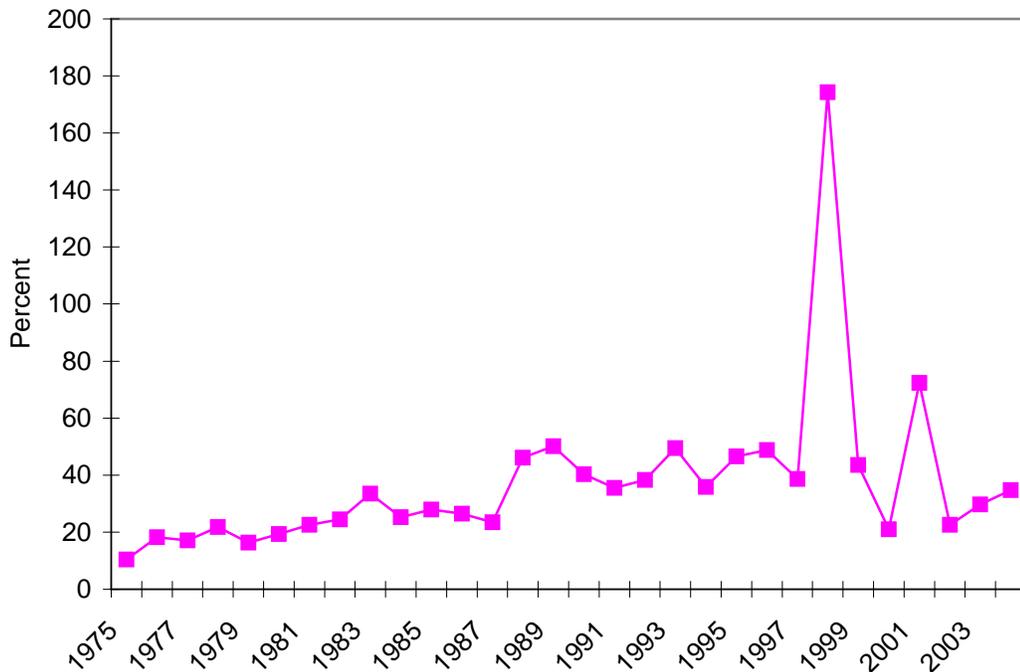
**Table 20** Percentage of Securitized Liabilities in Total Financial Liabilities of Nonfinancial Enterprises, 1995

Japan	Germany	United States
15.4	21.1	61

Source: Vitols (2005: 388)

However, comparable data do not explain well the type of financial system in South Korea. Figure 16 presents the securitized liabilities of Korean nonfinancial corporations since 1975. I have argued that South Korea had a government-controlled financial system before the 1997 financial crisis. For the period after the crisis, the data clearly show that the share of securitized liabilities in total corporate liabilities decreased from the pre-crisis level except for 1998 and 2001 when bank loans plunged because of credit crunches. One might want to interpret this trend as a sign of rising German- or Japanese-style bank-based system. However,

the data in Figure 16 do not account for the changing nature of the relationship between banks and corporations after the crisis. It is that South Korea has experienced the proliferation of transaction-oriented banking as opposed to relationship banking (Kim 2002; Kang 2005a, 2005b).



**Figure 16** The Share of Securitized Liabilities in Total Liabilities of Non-financial Corporations, 1975-2004

Note: Securitized liabilities comprise commercial paper, corporate bonds, and stocks.  
 Source: Bank of Korea. Economic Statistics System.

According to Boot and Schmeits (1998), relationship banking focuses on lending to corporations based on the insider information about the client firms they obtain through dense networks linking banks and corporate managers. In this case, the bank-borrower relationship is likely to be rigid and intimate because it is costly to switch to other banks or borrowers. In contrast, transaction-oriented banking is characterized by the diversification of business activities to maximize profits. Banks divert funds to lending to households and investing in securities and

other financial derivatives. Banks do lend to corporations but their decisions to make loans are based on public information about the client firms such as balance sheets. In this case, the bank-borrower relationship is likely to be liquid and arm's length.

Kim (2002) demonstrates the proliferation of transaction-oriented banking in Korea by using a couple of indicators. First, bank's holding of securities gradually increased from 6.3 percent of total bank portfolios in 1981 to 12.4 percent in 1996 and jumped to 26.5 percent in 2001, while the share of loans in total bank portfolios was stagnant over the same period. Second, there is a growing importance of non-corporate loans in the composition of bank loans. The share of corporate loans decreased from 82.6 percent in 1985 to 75 percent in 1996, and then it fell to 48.7 percent in 2001. Meanwhile, the combination of household and mortgage loans increased from 8.6 percent in 1985, 22.1 percent in 1996, to 49.5 percent in 2001. The 1997 financial crisis clearly accelerated the existing trends except for the stagnant share of bank loans in total bank portfolios.

The economic literature maintains that the concentration and globalization of the Korean banking sector has been structural causes driving the trend toward transaction-oriented banking (Kang 2005a, 2005b). After a series of mergers and acquisitions among banks, the Korean banking industry has become more concentrated in a few giant banks.<sup>154</sup> It has been argued that giant banks prefer standardized procedures of lending review to reduce agency cost and therefore relationship banking is unlikely with larger banks (Berger and Udell 1996). Also, as a result of financial liberalization, foreign stock ownership in commercial banks increased to 59.74 percent on average by September 2004 (Kang and Kim 2005: 7). The huge influx of foreign capital into

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<sup>154</sup> In June 2002 the four largest banks accounted for 64.5 percent of total assets, 67.2 percent of total loans, and 63.8 percent of total deposits. "Banks Are Giant, But Not Strong Enough" [in Korean]. *Monthly Shin-Donga*. January 2003. pp. 286-299.

the Korean banking sector exposed banks to globally accepted operation standards of management and financial investment.

However, the agency cost of a giant bank regarding lending review will be less severe if the bank deals with a giant corporations or large chaebols such as Hyundai, LG, and Samsung. Thus, the concentration argument does not explain why big banks and chaebols did not engage in a relationship based on financial commitment. Furthermore, although the concentration and globalization of banking sector is a cross-country phenomenon, national responses are varied. While Germany and Japan have introduced elements of transaction-oriented banking without changing their traditional relationship banking systems, South Korea has undergone a revolutionary process or big bang in the banking industry. Why is Germany (or Japan) so different from Korea?

South Korea never had the German-type relationship banking under a state-controlled financial system and because of this lack of prior experiences banks and chaebols chose transaction-oriented banking when they faced the concentration and globalization of banking industry. The state control over finance deprived banks of lending autonomy. Banks were merely regulatory agencies of the government implementing government's credit allocation policy. While the main actors consisting of risk partnership in Germany and Japan were banks and firms, they were government and firms in South Korea. While bank managers sat in the supervisory boards of their client firms and this invited employee representation to establish horizontal networks among stakeholders of the firms in Germany and Japan, the corporate governance of chaebols was hierarchical and solely concentrated in the hands of family owners, the largest shareholders, in South Korea.

Therefore, the reason why South Korea failed to institutionalize relationship banking

after the 1997 crisis seems less because of the attributes of banks than because of the historical pattern in which the bank-chaebol relationship developed. In this vein, the institutionalization of transaction-oriented banking in South Korea seems to be a case for path dependency.

### **6.7.5 The retreat of business support for lifetime employment**

One pundit was pointing to a business reality when he said: “Corporations can’t provide their workers with economic security if the companies’ own future is highly insecure.”<sup>155</sup> Chaebols’ support for lifetime employment was conditional on the stability of the government-controlled financial system, which guaranteed their survival. Despite their high leverage, top-30 major chaebols were not let go bankrupt before 1997 thanks to the state-controlled financial system.<sup>156</sup>

As the 1997 financial crisis and the IMF program forced the Korean government to adopt market-oriented principles to deal with debt-laden firms, chaebols were obliged to work out their own survival. South Korea’s corporate restructuring was very successful. The debt-equity ratio of large firms sharply decreased from 390 percent in 1997 to 91.7 percent in 2004 (Bank of Korea 2005). In terms of debt-equity ratio, the financial soundness of Korean corporations surpassed that of the United States (141.2 percent), Germany (241 percent), and Japan (145.4 percent). In the process, more than twenty chaebols have been bankrupt and dissolved. With the exit of those chaebols also vanished the belief that chaebols were too big to fail.<sup>157</sup>

As the Korean economy was getting restructured, macroeconomic indicators improved,

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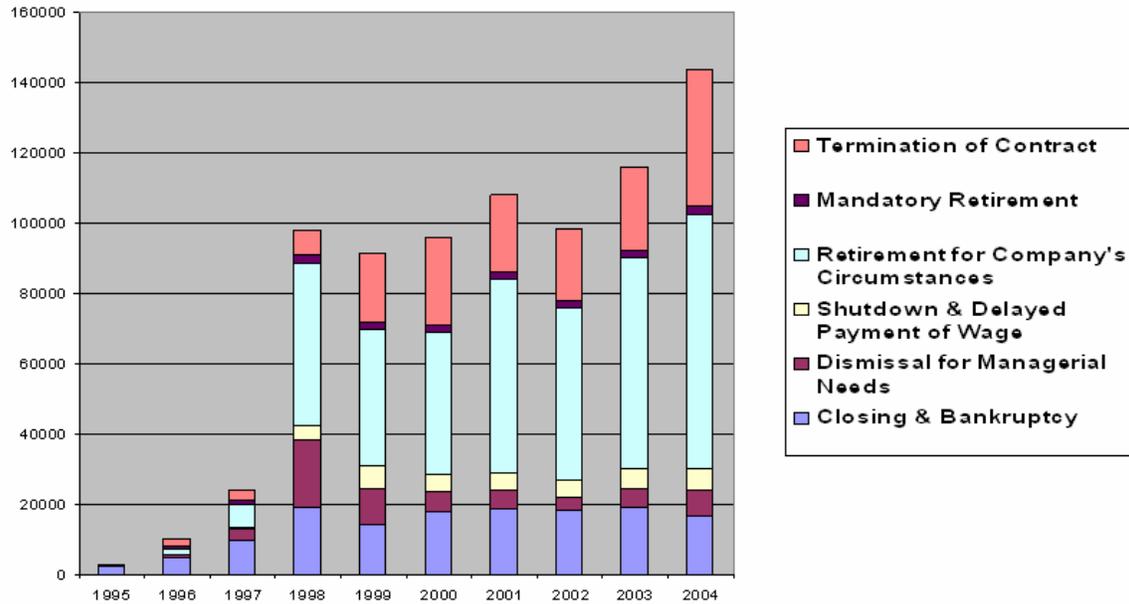
<sup>155</sup> Paul Krugman. “Age of Anxiety.” *New York Times*. November 28, 2005. p. 19.

<sup>156</sup> Kookje and Woosung are exceptions. Kookje, bankrupt in 1985, was the seventh largest *chaebol*. However, it is well known that the exit of Kookje was politically motivated by Chun Doo-Hwan who wanted to establish a showcase of his power to punish *chaebols*. Therefore, Woosung was the only top-30 *chaebol* bankrupt before 1997 for economic reasons. Woosung was the twenty-seventh largest *chaebol* when it was collapsed in January 1996.

<sup>157</sup> A notable example was the collapse of Daewoo, the second largest *chaebol*, in 1999.

compared to the situation in 1998. Between 2000 and 2004, the annual average GDP growth was 5.4 percent and the annual average unemployment rate was 3.6 percent (Bank of Korea). In addition, the rise of returns to investors was remarkable. For example, the annual average dividend ratio of large manufacturing firms was 5.18 percent for the period between 1990 and 1997, but it increased to 7.7 percent between 1998 and 2004 (Bank of Korea).

However, ordinary workers were not the beneficiaries of this development. After the financial crisis, Korean firms have sought to raise shareholder value while jettisoning job security for their employees. As can be seen from Figure 17, the number of involuntary job separations sharply increased in 1998 and has been increasing ever since. In other words, more workers have been forced to leave their companies year after year. Although economic growth recovered from the deep depression of 1998, the impact of the financial crisis on workforce reduction has not disappeared. This shows that employment adjustment by firms has become a usual business practice quite independent of business cycles. The impact of the financial crisis was not simply about economic contraction but it was also structural in that it shaped business preferences against lifetime employment.



**Figure 17** Trend of Involuntary Job Separators, monthly averages

Note: Early retirement as a means to workforce reduction belongs to the category of Retirement for Company's Circumstances.

Source: Korea Work Information Center, *Monthly Statistics of Employment Insurance*, Various Issues.

There are two interesting facts linked to Figure 17. First, Figure 17 shows that Korean employers have been heavily dependent on early retirement for employment adjustment rather than redundancy dismissal of the Labor Standards Act (LSA). The proliferation of early retirement can be attributed to the stringent provision of layoff in the LSA, because the LSA requires employers to make every effort to avoid layoff and courts have interpreted this effort as including early retirement. Also, large employers tend to see early retirement as attractive because they expect to buy unions' consent on workforce reduction through early retirement schemes.<sup>158</sup>

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<sup>158</sup> KT Corp, South Korea's largest fixed-line telecom provider, cut its workforce by some 5,500 through early retirement in October 2003. KT Corp offered early retirees 45 months' wages plus other financial benefits in

Second, according to a Korea Labor Institute survey of 300 nonagricultural private firms, white-collar workers accounted for the sharp increase of job displacements between 1997 and 1998. Table 21 shows that while all occupation groups experienced an increase of the number of job displacements except for upper-blue-collar early retirees, the share of white-collar job displacements increased from 49.7 percent to 76.4 percent for early retirees and from 49.3 percent to 71.7 percent for those laid off. Although large firms were overrepresented in the sample of the survey, the result appears to reflect the overall trend of declining white-collar job security.

**Table 21** Job displacements by occupation

Units: persons (percent)

		Early retirements		Redundancy dismissals	
		Jan. - Nov. 1997	Dec. 1997 - Mar. 1998	Jan. - Nov. 1997	Dec. 1997 - Mar. 1998
White-collar	Clerical and managerial workers	589 (34.3)	2,324 (60.6)	256 (32.6)	1,234 (44.7)
	Professional & technical workers	71 (4.1)	371 (9.7)	83 (10.6)	460 (16.7)
	Sales workers	193 (11.3)	232 (6.1)	48 (6.1)	284 (10.3)
	White-collar total	853 (49.7)	2,927 (76.4)	387 (49.3)	1,978 (71.7)
Blue-collar	Technicians, equipment operators & assemblers	635 (37.0)	433 (11.3)	398 (50.7)	644 (23.3)

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addition to their legal severance pay (“Korean Telco KT Corp to Cut Workforce by 5,500.” *Asia Pulse*. October 1, 2003). A middle manager at Doosan, top-20 *chaebol*, said, “Korea has a very rigid labor market, so unilateral dismissal results in a strong rejection by employees and unions. But such an early retirement system with job-transfer and special bonuses causes not so much opposition” (“Korean Firms Use Early Retirement as Tool Against Recession.” *Yonhap News*. October 3, 2003).

Simple laborers	227 (13.2)	474 (12.4)	0	140 (5.1)
Blue-collar total	862 (50.2)	907 (23.7)	398 (50.7)	784 (28.4)

Notes: The figure inside each parenthesis denotes the percent of early retirees (or those dismissed) in the general occupations for a specific period.

Source: Choi and Lee (1998: 25, 28)

## 6.8 CONCLUSION

The 1997 financial crisis heralded an era in which the government would not be able to bail out chaebols through its control over the financial sector. This had a profound impact on chaebol's behaviors. As the restructured banking sector is proliferating transaction-oriented banking and being driven by short-termism, the bank-firm relationship is becoming increasingly arm's length. Instead, exposed to investors' pressures to maintain dividends and high credit evaluation, chaebols have switched their business strategies from expansion to profit maximization. In this vein, South Korea can be said to approach the Anglo-Saxon model of capitalism. Chaebols turning against lifetime employment is a product of this great transformation after the 1997 financial crisis.

However, the shift of chaebols' interests in lifetime employment has not led to the removal of employment protection yet. Although business associations have asked the government to ease the legal restrictions on layoff and economic ministries are supportive of their request, politicians are not willing to accept the proposed reform because layoff is a politically sensitive issue. A recent poll shows that a great majority of Korean lawmakers

oppose making layoffs easier.<sup>159</sup> 155 out of 299 lawmakers responded to the survey and 67.7 percent of the 155 lawmakers disagreed to ease legal restrictions on layoff. Even lawmakers from the center-right Grand National Party were almost evenly split between 27 that agreed and 26 that disagreed. More recently, the Ministry of Commerce, Industry, and Energy sought to erase the urgent managerial need condition for layoff and to reduce the 60-days' consultation period with employees.<sup>160</sup> However, this proposal has been significantly watered down in later discussions. The government is currently negotiating with labor over the reduction of mandatory consultation period from 60 to 30 days.<sup>161</sup>

All in all, there is obviously a growing pressure from capitalists to reduce layoff costs in Korea. Firms have used more extensively non-regular workers comprising part-time, temporary, and casual workers partly because of the layoff costs related to employing full-time, permanent workers.<sup>162</sup> However, the lesson from the process of labor law reform during the 1990s is that easing dismissal regulation will require extraordinary political resources in a country where the public concern about job security is immense.

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<sup>159</sup> "Survey for the Seventeenth National Assemblymen on Labor Law Issues." *Labor Today*. June 8, 2004.

<sup>160</sup> *Hankyorhe Newspaper*. February 1, 2005. p. 2.

<sup>161</sup> *Kyunghyang Newspaper*, November 12, 2005. p. 3.

<sup>162</sup> The share of non-regular workers in total employment increased from 27.3 percent in 2001 to 37 percent in 2004. National Statistical Office, *Economically Active Population Survey*. Various issues.

## **7.0 CONCLUDING REMARKS**

### **7.1 BEYOND THE VARIETIES OF CAPITALISM PERSPECTIVE**

The so-called “new institutionalist approach” to welfare capitalism is in vogue (See Hall and Soskice 2001). This approach places the welfare state in the web of economic institutions making up the production regime. The nature of skill formation, corporate finance, and inter-firm relations determines the kind of welfare state that employers would support: if firms invest in training their own employees, building intimate, long-term relationships not only with banks as main financiers but also with other firms in the same industry, then they are more likely to support the German-style welfare state characterized by layoff restraint and generous social security. Conversely, if firms invest little in training their own employees, have at-arm’s-length relationships with their main financiers, and play in the very competitive product market, they are more likely to support the American-style welfare state characterized by flexible layoffs and lean social security. This theory’s implication for globalization and capitalism is clear: because employers in each model find their national model to be economically rewarding, the convergence between different capitalist models will not occur.

This varieties-of-capitalism approach has been presented as a strong alternative explanation for the welfare state against the power resource theory. As an institution-based model that stresses the role of economic institutions in shaping employers’ self-interest about

labor protection, it is diametrically differentiated from the interest-based, class-conflict model of the power resource theory. Along with the model focusing on the cross-class alliance between capital and labor (Swenson 2002; Mares 2003) the varieties-of-capitalism model has formed a firm-oriented approach to the welfare state.

However, this dissertation reveals that employers tend to oppose employment protection legislation even if long-term employment benefits their production regime. As Chapter 4 on Germany demonstrates, while German big business expected works councils to play as a shield against radical labor movement, they disliked them to have substantial power in personnel and economic issues. They subverted the new industrial relations based on the role of works councils during the Weimar Republic in favor of Nazism. In the postwar period, they were forced to abandon the traditional Herr-im-Haus position in labor-management relations under the Occupied Allies that recognized collective rights of labor as a part of the de-nazification plan. However, they were reluctant to give works councils and workers' representatives on the company board greater power to limit the management right to dismissals.

This dissertation also shows that the institutional complementarity thesis of the varieties-of-capitalism model does not explain the change of employment protection within individual cases. The investigation of the German case reveals that employment protection under dictatorships was very weak although the then-German economy was characterized by the kinds of economic institutions supposedly favorable to employment protection such as the dominant role of big commercial banks in corporate finance, the prevalence of cartels in major sectors of the economy, and strong business interests in plant-based training. Imperial Germany required employers to give only 15-days' advance notice to workers if they were paid by month. The Weimar Republic mandated works councils to serve as important vehicles to check dismissals,

but all the progressive achievements in labor-management relations during the Weimar Republic were wiped out under the Nazi Germany. Rather than complementary economic institutions, the hegemonic power of Prussia governed by a right-wing dictatorship in the federal politics of Imperial Germany and the more extreme right-wing dictatorship under Hitler explains the low level of employment protection during these two periods. Therefore, the transition to democracy that took place in 1919 and 1945 brought important effects on employment protection, but these impacts relied upon the nature of political institutional arrangements under the new democracies.

## 7.2 BRINGING POLITICS BACK IN

The varieties-of-capitalism theorists claim that their major theoretical strength consists in the account for why employment protection varies across nations and why the cross-national difference continues to hold although markets are increasingly being integrated. However, for them politics do not play a role, as can be seen in their assertion that each capitalist model pursues a distinct path of institutional development and the logic of institutional development is basically functionalist: Germany has stronger employment protection than the United States because employment protection is economically efficient in the German capitalism but not in the American capitalism. But, is strong employment protection purely a product of favorable economic institutions?

This functionalist account has difficulty in explaining employment protection as *government regulation*. Business preferences shaped by economic institutions should be closely related with business decisions on lifetime employment. By contrast, employment protection as a political decision is not a mirror of business preferences, but it is an outcome of political

struggles between coalitions of actors with divergent preferences. This dissertation suggests an alternative explanation accounting for the role of politics. While economic institutions shape the interests of employers who make decisions on employment and production by taking economic institutions as external constraints, their effects on political actors might not be equal to those on economic actors. Politicians whose prime goal is to win elections rather than to maximize profits would perceive political institutions rather than economic institutions as fundamental constraints on their decisions. If politicians find that the introduction of employment protection will help win elections, they are likely to support employment protection even when it is not deemed as economically efficient in their capitalist system.

My investigation of the U.S. case shows that business opposition to employment protection was not a crucial factor that frustrated pro-employment protection politicians. They lost political struggles over employment protection mainly because of strong counter-majoritarian political institutions. The popular pressure for employment protection followed a distinct pattern in the United States. While in Germany the SPD and the DGB launched and steered the public campaign toward codetermination, the popular pressure for employment protection in the United States existed without similar organizations to serve as strategic strongholds for employment protection. The electoral insignificance of social democratic parties led to the prevalence of business unionism that directed labor groups to focus on collective agreements rather than legislation as a vehicle to protect workers' job security. Opposed to Germany, white-collar unions were dwarfed. The rising risk of job displacements after the 1970s played a more important role in the formation of popular pressures in the United States. When the tidal wave of plant closings led to an across-the-board deterioration of workers' job insecurity, politicians sought to respond to the demand for employment protection.

This study observes two major periods when unemployment shocks hit both blue-collar and white-collar workers. The Great Depression provided a first opportunity for introducing employment protection. In the face of fierce opposition, Franklin D. Roosevelt and his Democratic colleagues instituted the New Deal programs, which constituted a watershed in the history of U.S. social policy. However, they failed to curb employers' freedom of layoff because the federal regulation of employment contracts was deemed unconstitutional. The Wisconsin idea of dismissal compensation was rejected in the course of congressional debates that ended up with the adoption of unemployment insurance program in 1935.

A second opportunity for introducing employment protection came in the 1970s and '80s. These two decades were a period of intense industrial restructuring in American firms. The tidal wave of plant closings due to relocations, mergers-and-acquisitions, and recession spawned massive job dislocations unmatched by any time in the U.S. history. The growth of federal power since the New Deal era made federal intervention to regulate layoffs constitutionally acceptable. However, inter-state competition for investment made it extremely difficult for states in diverse economic conditions to consent to higher standards on layoffs. While politicians from job-losing states strived to limit mass layoffs, they faced strong oppositions from job-gaining states that criticized plant-closing bills for the plot of industrially-developed, high-labor-cost states to keep jobs from moving to less-developed, low-labor-cost states. Thus, sponsors of employment protection were forced to water down their bills remarkably in order to secure a majority in the Congress before making it legislation.

Although the adoption of employment protection in Germany was partly linked to unemployment shocks as during 1948-50 and 1975-76, the rise of political power of labor

profoundly influenced the establishment of employment protection laws.<sup>163</sup> The popular pressure for employment protection in Germany was not only better organized but it was also steadier than that in the United States because it was propelled by the SPD and the DGB (or formerly Socialist unions) that presented the idea of codetermination in the form of an ideological program to bring industrial democracy rather than ad-hoc solutions to economic crises. The German federalism played an important role in channeling this popular pressure for employment protection into the political system and making it the law of the land. Germany represents a distinct model of federalism where labor legislation is centralized and subnational governments rely on extensive measures of fiscal equalization. In this type of federalism voters can readily attribute the responsibility of providing job security to the central government. Therefore, the German federalism has not provided effective checks on the popular pressure for employment protection.

Similar to Germany, South Korea experienced the rise of employment protection as a result of democratization. Dictatorships' approach to workers job security was politically expedient and discriminating against workers in small-medium firms. Park Chung-hee did not introduce formal regulations of layoff but he induced chaebols to restrain layoffs by providing informal administrative guidance when the oil crises caused liquidity problems during the 1970s. He did not ban or limit dismissals of workers. Unfair dismissals for union activities were commonplace. Employers could lay off workers freely when there was a permanent or temporary shutdown of a plant. Job security became a political issue only when national economic crises forewarned mass layoffs in chaebols, and then Park Chung-hee promised to bail out chaebols to ward off the need for slashing payroll. Therefore, it would be misleading to

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<sup>163</sup> The 1920 Works Council Act is a notable case where the passage of employment protection legislation was less linked to unemployment shocks than motivated by the ideology of the Weimar coalition.

assert that his dictatorship regime provided strong employment protection without considering the structured relationship between the government and big business linked by the state control over financial institutions.

The Supreme Court of Korea established four conditions for lawful layoffs in 1989, which were the first employment protection law regulating layoffs. As the strong expansion of the Korean economy ended in the early 1990s, Korean firms suffered overstaffing problems, especially with white-collar workers. The Supreme Court began to interpret the condition of “urgent managerial need” for redundancy dismissals in a more permissive term from 1992. During this period, commercial banks and big business began to reduce their white-collar workers through early retirement plans. Although the overall unemployment rate was still low, Korean middle-class workers who had believed their jobs were permanent came to realize they might be forced to leave their companies for lump sum compensations. The year of 1996 was a critical moment for employment protection because the Kim Young-sam government brought labor law reform to the fore. The Korean bureaucracy was divided on employment protection. The market-oriented group fought for a significant liberalization of legal conditions for layoffs, while the other group advocated the wholesome codification of the 1989 judicial principles.

South Korea in 1996 was similar to the United States with respect to the structure of labor movement and the electoral power of left party. Union membership had declined to 12 percent and there was no social democratic party that had elected representatives in the legislature. While the political power of Korean labor was very limited, the public perception of declining middle-class job security became a major source of popular pressure for employment protection as in the United States.

On the other hand, South Korea had a very important difference from the United States: it was a strongly unitary political system with the executive branch superior to the others. Therefore, although there was a group of bureaucrats in favor of reducing employment protection, the Korean government was responsive to the public concern about rising white-collar job insecurity. Labor groups took advantage of this political circumstance and won a significant concession from the government on employment protection. The outcome of the politically contentious labor law reform was that the 1989 judicial principles of layoffs were codified into the Labor Standards Act with major provisions virtually intact, and moreover the implementation of those provisions was suspended for two years. Although the financial crisis forced the early implementation of layoff provisions, the impact of this legislation on the business practice of workforce reduction has been very limited. Table 22 summarizes the comparisons among the United States, Germany, and South Korea on key variables.

**Table 22** Comparing the United States, Germany, and South Korea

	United States	Germany	South Korea
Power resources of labor	Weak	Strong	Weak (some strong unions at firm-level)
Middle-class job loss	1929-32; since the 1970s	1929-1932; recent years	Since 1996
Counter-majoritarian political institutions	Strong	Weak	Weak
Employment protection for regular workers, current	Weak (28 <sup>th</sup> of OECD)	Strong (6 <sup>th</sup> of OECD)	Moderately strong (10 <sup>th</sup> of OECD)
Key legislation	Worker Adjustment and Retraining Notification Act (1988)	Works Council Act (1920), Codetermination Act (1951, 1976), Protection Against Dismissal Act (1951), Works Constitution Act (1952, 1972)	Labor Standards Act (1997; enforced in 1998)

### 7.3 EMPLOYMENT PROTECTION UNDER DICTATORSHIPS

The varieties-of-capitalism literature ignores other political economic systems than advanced industrial democracies. This dissertation unveiled how dictators dealt with workers' job security by examining two right-wing authoritarian regimes in Germany and South Korea. Dictators' essentially conservative motive explains the early development of the welfare state in Imperial Germany and South Korea under dictatorships. Just as Bismarck instituted social security to dampen the socialist zeal among workers, so did Park Chung-hee introduced laws on national health care and national pension schemes during the 1970s because he was concerned that economic and social inequality might cause many workers to feel more sympathetic toward the communist regime in North Korea. But these two right-wing dictatorships acted somewhat differently on the issue of employment protection. While Imperial Germany enacted very inadequate employment protection provision in the German Civil Code, the Park regime induced big business to restrain layoffs by administrative guidance when the Korean economy suffered foreign currency crises in 1973 and 1979.

Measuring the level of employment protection during the Park regime is not straightforward because the government used an informal pressure on big business rather than enacting legislation. But it should be noted that the informal pressure by the government to keep redundant workers could not have been successful without providing a huge government patronage for big business as a way to prevent mass layoffs. Korean dictatorships controlling the banking sector guaranteed the financial survival of big business during intermittent crises, which led to the bailout expectation on the business end. When big business realized they were too big to fail, there was no need to cut back labor force even during economic downturns. Rather, Korean big business pursued operational expansion and diversification. It would be misleading

to assert that his dictatorship regime provided strong employment protection without considering this structured relationship between the government and big business linked by the state control over financial institutions.

This state-controlled financial system makes a stark difference from Germany's bank-based financial system. Although banks were important vehicles to provide corporate finance in both systems, Korean banks were merely administrative arms of state-led industrialization whereas it was German big banks that led industrialization through the merger between financial capital and industrial capital and gave rise to a myriad of cartels in the German economy. Bismarck could have done more to protect workers' job security if he had possessed the financial instrument that was available to Park Chung-hee.

#### **7.4 A FUTURE PROSPECT FOR KOREA IN THE VARIETIES-OF-CAPITALISM PERSPECTIVE**

I have shown that the varieties-of-capitalism perspective is limited in explaining the rise of employment protection *as government regulation*. However, the institutional arrangements comprising a specific type of capitalism are still a powerful predictor of the business preference for self-restraint of layoffs *as a corporate practice*, which is well-addressed in Hall and Soskice (2001). However, the existing varieties-of-capitalism literature focuses on advanced capitalist systems, and it does not answer the question of whether the varieties-of-capitalism perspective could be used to account for capitalist systems in less-developed countries. Although the main goal of this study is to criticize the varieties-of-capitalism argument by demonstrating that its lack of political theory makes it impossible to make causal inference about employment

protection *as government regulation*, this study also seeks to complement the varieties-of-capitalism perspective as a descriptive framework of economic systems by extending it to a less-developed country, South Korea.

During the 1970s and '80s, South Korea was fundamentally a developmental capitalist state characterized by the active role of state in organizing industries and allocating financial resources. As Chapter 7 indicates, the Kim Dae-jung government adopted liberal market reforms as a way to crack the state-centered capitalism to which many experts attributed the 1997 financial crisis. In particular, the restructuring of financial system was a crucial part of the reform program. In response to the IMF recommendations attached to its bailout program, the Korean government liberalized domestic financial markets rapidly, including the removal of the longstanding administrative control over commercial banks and restrictions on foreign ownership of financial and non-financial corporations. In the process the Anglo-American capitalist model has strongly influenced the Korean economy in the following ways.

First, what replaced the government-administered financial system that broke down amid the financial crisis was transaction banking with foreign capital dominating the banking sector. Consolidated banks after the financial crisis have sought to maximize short-term profits out of consumer lending rather than building close relationships with industrial clients to ameliorate their liquidity constraints (Chang and Shin 2003). Second, the current corporate governance system of big business is under mounting attack from foreign investors. As the previous chapter presents, the traditional corporate governance structure of chaebols is characterized by the high concentration of control, the lack of protection of minority shareholders, and the insulation of the management from takeovers (Lee 2003). Chaebols were controlled by their founding families that were also the largest shareholders of their companies. The corporate governance system was

so concentrated that it was called “imperial management” (Lee 2003). This unconstrained managerial power was exercised in a way to benefit affiliated firms on average at the expense of minority shareholders (Claessens and Fan 2002: 81). However, as the foreign ownership of major Korean corporations increases, they face unprecedented challenges from foreign investors.<sup>164</sup> Currently, foreign investors account for greater than 50 percent of shareholding in major chaebols such as Samsung and Hyundai.

Some commentators have argued that South Korea rushed into Americanizing its economy after the 1997 economic crisis at the risk of systemic disorder. For example, Myers warns that “most optimistic analysts are ignoring the extent to which the IMF-Kim Dae-jung ‘free market’ solution is at odds with the Korean economic traditions of mercantilism and the chaebol” (Myers 1998). However, as Table 23 shows, the Korean capitalism before the crisis had already much resembled the American model except for the financial system. First, South Korea lacked the tradition of stakeholder capitalism in which workers’ participation in management gained legitimacy. Although the separation of ownership and management as in the United States was rare in South Korea, family-owners as largest shareholders kept strong grip on the management of their firms without being monitored by their employees or client banks. Second, as in the United States, South Korea lacked employers’ associations with strong competencies at industrial level. Thus, the inter-firm relations in the same industry have been competitive and poaching skilled workers was a prevailing practice in Korean businesses, while inter-firm collaboration was easily found across different industries in the same chaebol.

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<sup>164</sup> Two recent incidents are worth being mentioned. Between 2003 and 2005 Sovereign Asset Management, the largest shareholder of SK Corporation, sought to oust the chairman of the company because of his conviction for accounting offences. Carl Icahn’s attempt to control KT&G in 2006 was the first hostile takeover bid for a major Korean company. Although both were unsuccessful, they were emblematic of rising shareholder activism in South Korea (Financial Times 2006).

Third, the Korean education system has stigmatized vocational training as in the United States. Considering the level of economic development, the preference for higher education among Korean people has been outstandingly strong. As shown in Table 23, the gross enrollment ratio at tertiary level in South Korea in 1996 was 60 percent, which is higher than that of Germany in 2003. The gross enrollment ratio at tertiary level in the United States reached 60 percent only in 1985 (UNESCO). Traditionally, as in the United States, vocational education tracks were shunned from most talented youths in South Korea. But this pattern was reinforced by a change in education policy during the mid-1990s. The-then Kim Young-sam government liberalized regulations of establishing tertiary schools, which led to an increase of colleges and universities. This policy change brought more middle-school graduates to enter university-bound high schools and also induced more technical high school students to opt for academic careers instead of industrial careers (Lee et al. 1999). As a result, the gross enrollment ratio increased rapidly from 39 percent in 1990 to 60 percent in 1996 (UNESCO). Currently, the gross enrollment ratio in tertiary education in South Korea is 89 percent, higher than that of the United States.

Firm-based skill formation has been also limited. Hong and Ryoo (1999)'s study of Hyundai Motors' Ulsan plant find that the production system of this company is based on the Taylorist principle of rationalization. In Hyundai Motors, skill formation has depended on "on-the-job training" combined with job circulation, in which the company does not bear training costs. "Off-the-job training" has been concentrated in ethic education rather than skill formation (Jo 2004).

Thus, it appears that the government-directed financial system was the decisive, but the sole factor that differentiated the Korean capitalism from the Anglo-American liberal market

capitalism. In coordinated market economies different kinds of social fabrics have constrained the economic dependence on the free market for coordination. In Germany they were strong peak associations representing business and labor. In Japan they were bonded relationships between employers and workers as expressed in lifetime employment. By contrast, the development of these non-market coordination mechanisms in South Korea was extremely limited except for corporate finance. Now that the government-directed financial system has been replaced by market-based one, it is natural the Korean economy is being increasingly Americanized.

This economic transformation leads us to predict that Korean employers will become more reluctant to provide long-term employment to their employees and will increasingly substitute non-regular workers for regular workers whose employment is protected by law. As suggested in Figure 17, this is exactly what has happened in South Korea since the financial crisis. In particular, the growing number of non-regular workers has recently become a political issue. Between 2001 and 2004 the proportion of non-regular workers in total employment increased rapidly from 26.8 percent to 37 percent.<sup>165</sup> Those non-regular workers' pay is on average 60-65 percent of that of regular workers. Considering the weak firm-based skill-formation system and the production system based on the rationalization of process that prevail in the current Korean economy, it is not surprising that more Korean employers would seek the price-efficient strategy of replacing regular workers by non-regular workers on same jobs.

How will this booming non-regular employment affect the political support for employment protection in South Korea? Non-regular workers would demand to improve

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<sup>165</sup> The proportion of non-regular employment slightly decreased to 36.6 percent in 2005 and 35.5 percent in 2006. The relevant data can be retrieved from the website of the Republic of Korea Ministry of Labor at: [http://www.molab.go.kr/issue/issue00/sub01\\_02.jsp](http://www.molab.go.kr/issue/issue00/sub01_02.jsp).

employment protection for themselves, which helps the cross-class alliance between non-regular and regular workers, or between periphery and core workers, to continue. But at the same time non-regular workers might criticize stringent employment protection for regular workers for a major institutional source of the economic differentials of wages and working conditions between regular and non-regular workers. Thus, the increasing non-regular employment associated with the attrition of middle-class workers could destabilize the cross-class coalition for employment protection. Dolado, Garcia-Serrano, and Jimeno's study of surging temporary jobs in Spain since 1984 (2002) shows that non-regular workers disgruntled with the high level of employment protection for regular workers favored the employment protection legislation reform during the 1990s. A lesson from the Spanish case is that the cross-class coalition within labor for employment protection is not set in stone. When the excessive dualism between protected insiders and vulnerable outsiders in labor markets turns most non-regular workers and the unemployed against regular workers, someday we might observe that low-class workers and employers become allied to retrench employment protection for regular workers.

**Table 23** A Glance at the Varieties of Capitalism

		United States (2005)	Germany (2005)	South Korea (1996)	South Korea (2005)
Financial System	Type	market-based	bank-based	government-directed	market-based
	Stock market capitalization, percentage of GDP <sup>1)</sup>	135	43.7	29	72.9
	Financial assets of institutional investors, percentage of GDP <sup>2)</sup>	191	81	57.3	77.2

	Debt/equity ratios <sup>3)</sup>	141.2	241	317.1	100.9
	Proportion of securitized liabilities in total financial liabilities of nonfinancial firms <sup>4)</sup>	61	21.1	35.2	34.9
Corporate Governance <sup>5)</sup>		outsider system	insider system	imperial management	burgeoning outsider system
Inter-firm Relations within Industry		competitive	collaborative	competitive	competitive
Production System		mass production	diversified quality production	mass production	same as before
Education System	Key Institutions of Training for Skilled Manual Workers	ordinary high schools and community colleges	firms and public training schools	technical high schools and junior colleges	same as before
	Enrollment Ratios at Tertiary Level <sup>6)</sup>	82	51	60	89

Notes:

1) Data are from World Bank (2007).

2) Figures as of 2001 except for South Korea in the fourth column. Data are from OECD (2004).

3) Figures for the United States and Germany are as of 1995 and provided by Schroeder and Schrader (1998). The Korean data are from the Bank of Korea's Economic Statistics System.

4) Figures for the United States and Germany are as of 1995 and are provided by Vitols (2001). The Korean data are from the Bank of Korea's Economic Statistics System.

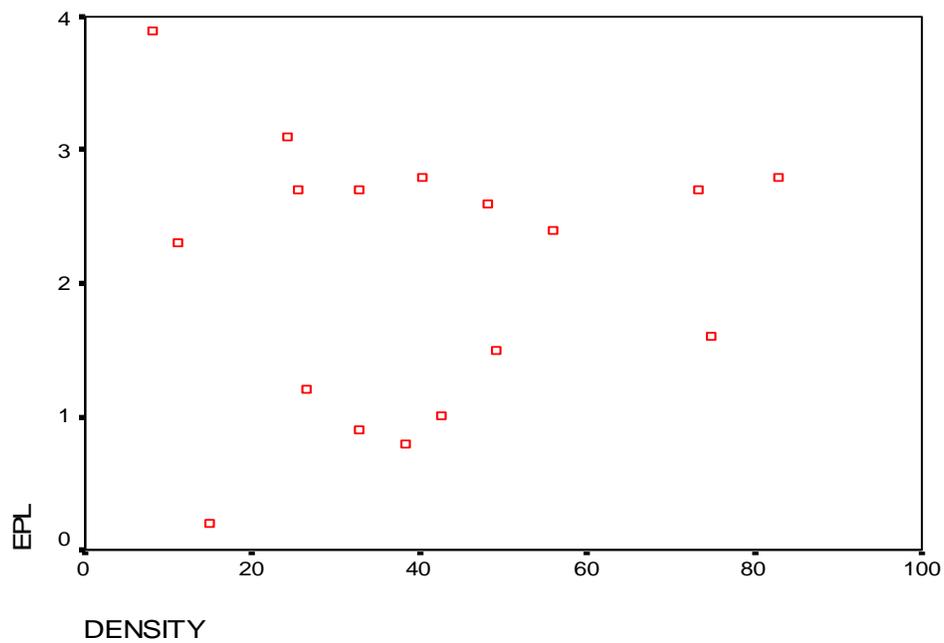
5) The descriptions for the United States and Germany are from Schroeder and Schrader (1998).

6) The gross enrollment ratio in tertiary education is the total enrolment in tertiary education regardless of age, expressed as a percentage of the population in the five-year age group following on from the secondary school leaving age. The U.S. figure is as of 2004, the German figure as of 2003, and the Korean figure in the last column as of 2004. Data are from UNESCO Institute for Statistics, Global Education Digest, various years.

## APPENDIX

### LABOR POWER AND EMPLOYMENT PROTECTION

#### A.1 UNION DENSITY AND EMPLOYMENT PROTECTION



#### Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.035	.001	-.065	1.03331

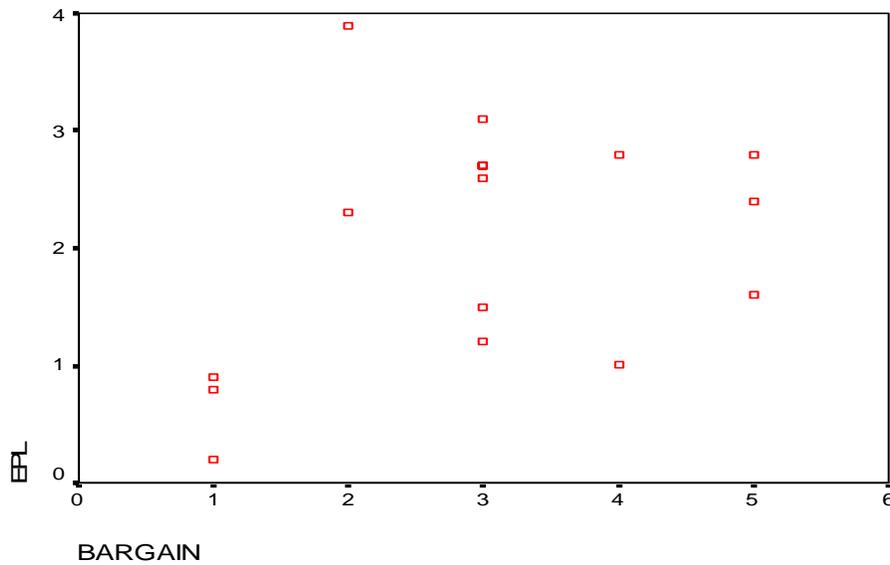
Predictors: (Constant), DENSITY

### Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.008	.531		3.783	.002
	DENSITY	.002	.012	.035	.134	.895

Dependent Variable: EPL

### A.2 BARGAINING LEVEL AND EMPLOYMENT PROTECTION



### Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.349	.122	.063	.96883

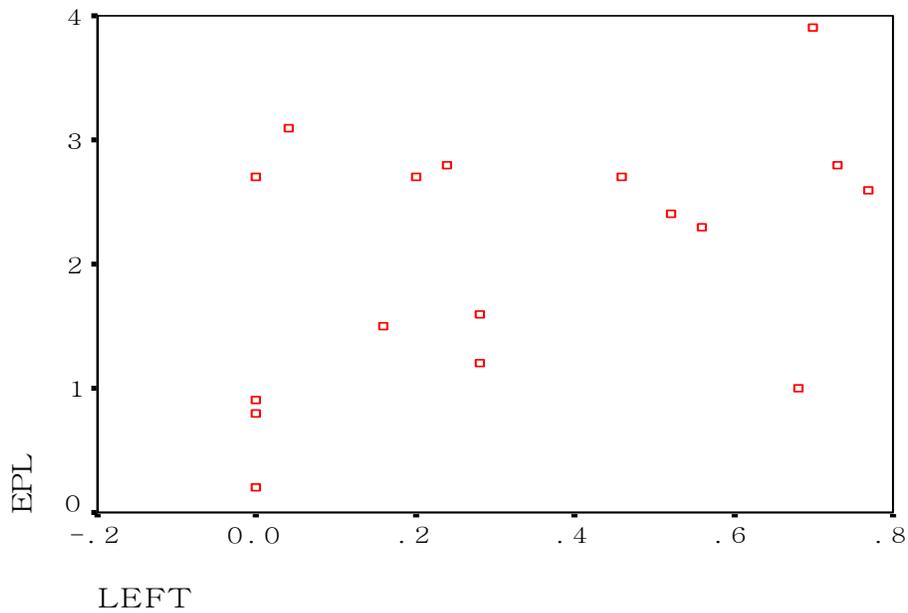
Predictors: (Constant), BARGAIN

### Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.278	.597		2.139	.049
	BARGAIN	.264	.183	.349	1.443	.169

Dependent Variable: EPL

### A.3 POLITICAL POWER OF LEFT PARTIES AND EMPLOYMENT PROTECTION



#### Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.429	.184	.130	.93391

Predictors: (Constant), LEFT

### Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.572	.353		4.450	.000
	LEFT	1.509	.820	.429	1.840	.086

Dependent Variable: EPL

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