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Efficiency Arguments for the Collective Representation of Workers: A Sketch

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Abstract

The dominant agency-cost paradigm for the analysis of corporate law is based on the proposition that the welfare of society is best met by rules which minimise the costs of production through the corporate form. This is typically interpreted to mean that the agency costs of shareholders should be minimised, so as to reduce the company's cost of capital. However, it is clear that the agency cost analysis admits of the theoretical possibility that a company's overall costs of production might be minimised even in the presence of sub-optimal rules relating to the cost of capital if those additional capital costs were outweighed by a greater reduction in the costs of contracting for other inputs necessary for the company's productive activities.

It has often been asserted that this situation obtains in relation to labour inputs. This essay seeks to establish the basis on which this argument might be formulated, dealing in particular with the proposition that employees can obtain full protection for their exchange relationship through contracting with the company. It then considers what empirical evidence is available about the production costs of companies in systems with high levels of mandatory employee involvement in decision-making. It focuses in particular on the tripartite system of employee representation in Germany – board representation, works councils and collective bargaining. Finally, it speculates about the conditions under which high levels of employee involvement might reduce a company's overall costs of production or, by contrast, might increase those costs.

Keywords: Employee involvement, codetermination, consultation, labour contracting costs

JEL Classifications: J24, J51, J53, K12, K22, K31, L14, M12, M14, M54

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Efficiency Arguments for the Collective Representation of Workers: A Sketch

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Abstract

The dominant agency-cost paradigm for the analysis of corporate law is based on the proposition that the welfare of society is best met by rules which minimise the costs of production through the corporate form. This is typically interpreted to mean that the agency costs of shareholders should be minimised, so as to reduce the company's cost of capital. However, it is clear that the agency cost analysis admits of the theoretical possibility that a company's overall costs of production might be minimised even in the presence of sub-optimal rules relating to the cost of capital if those additional capital costs were outweighed by a greater reduction in the costs of contracting for other inputs necessary for the company's productive activities.

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I. Why worry about the question?

The classic works in the UK relating to the collective representation of workers as against the employer (in the UK tradition, predominantly via collective bargaining) have rarely given much attention to the efficiency impacts of the mechanisms for giving employees collective voice. In *The System of Industrial Relations in Great Britain*, edited by Hugh Clegg and Alan Flanders in 1954,[1] the editors analyse both collective bargaining and joint consultation. The chapter by Flanders on collective bargaining presents that method of providing employee voice as something which, from the middle of the nineteenth century onwards, was imposed upon employers, either by trade unions acting alone or by trade unions and pro-worker governments acting together. The main benefit to employers from collective bargaining is seen to be industrial peace. Recognising and doing deals with the union removes the threat of industrial action and so removes one of the threats to undisturbed productive activity – just as a minimum level of political stability at country level can be seen as a pre-condition for successful production. However, there are only hints at possible benefits to the employer of recognising and doing deals with the union, as compared with the situation where there is no collective representation of workers via trade unions and, thus, no demand for collective bargaining.[2]

The chapter by Hugh Clegg and Norman Chester on consultation committees is more open to the potential benefits to employers from collective representation, but the story there presented is, at best, of promise unfulfilled. Collective consultation was crushed because of the inability of those involved to find a way of making it compatible with collective bargaining. The Joint Production Committees, which government and unions fostered during the Second World War, did not make an effective transition into the post-war world of resurgent collective bargaining but rather sank under the weight of the 'suspicions and ignorance' of managers, trade unionists and workers.[3] In the later version of *The System*, written by Clegg alone in 1970, Clegg explained the decline of consultation committees and their absorption into workplace bargaining as the triumph of the pluralist frame of reference.[4] Employers and unions, both committed to maximising their own welfare through collective bargaining, were unable sustain cooperation in consultative committees. The establishment and enterprise level space for collective employee voice had been effectively occupied by collective bargaining and consultation mechanisms were squeezed out.

Turning to the more important question of the societal benefits of collective employee voice, the traditional arguments have not turned on efficiency either. Those arguments (again

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[1] Basil Blackwell, Oxford, 1954, ch V (collective bargaining), ch VI (joint consultation).

[2] There are undeveloped suggestions that employers benefit from taking piece work rates out of competition among employers (via multi-employer collective bargaining) and that unions can assist employers by becoming, in the modern phrase, managers of discontent. Ibid pp 268-272.

[3] Ibid 344.

[4] H Clegg, *The System of Industrial Relations in Great Britain* (Basil Blackwell, Oxford, 1972) p 185ff.

predominantly voice through collective bargaining) have been either distributional or democratic. So, collective bargaining is often presented as achieving a larger share of the firm's revenues for the workers (through the union wage premium),[5] implicitly at the cost of a reduction in the proportion going to the firm's owners (though the analysis is sometimes rather vague as to whether it is the firm's owners or the consumers of its products who carry the bulk of the costs of collective bargaining). More attractively, collective bargaining is not presented simply as a collective version of individual bargaining (in which the employees do better because they have managed to exclude competing offers of service), but as an extension of the democratic imperative from the political sphere into the industrial. One of the crucial benefits of collective bargaining, on this approach, is that it gives the workers the opportunity to participate in the setting of the rules which govern the workplace, irrespective of the size of the financial benefit that collective bargaining confers on them.[6] On this view, collective representation is as important as a protection against abuse of power as it is as a generator of higher rewards.[7] Of course, these two rationales are not incompatible with one another.

The purpose of this piece is not to question either of the rationales given in the previous paragraph, but to explore the question of whether a case can be made for collective employee voice on efficiency grounds. The first step is to stipulate what is meant by 'efficiency' in this argument. Efficiency is defined for the purposes of this chapter as arranging governance rights in the company so as to minimise its costs of production.[8] The proposition is that a company's contribution to society is maximised if, for whatever level of production the market or regulation determines is desirable, the resources consumed by the company to produce that output are minimised. Other possible definitions of 'efficiency' are available, but this is the one stipulated for. The company is a legal construct aimed at facilitating the acquisition and coordination of inputs (financial, material and human) which a business needs to produce outputs. It is suggested, therefore, that the proposed definition of efficiency is an appropriate test to apply to the institutional mechanisms which govern the acquisition by the company of the inputs it needs for production. The applicable rules and institutions may facilitate or hinder acquisition and coordination, and thus raise or lower the company's costs of production. As it has been put, good corporate law 'reduces the ongoing costs of

[5] For (relatively) recent estimates of this see D Blanchflower and A Bryson, 'Union Relative Wage Effects in the United States and the United Kingdom', *Proceedings of the 56th Annual Meeting of the Industrial Relations Research Association*, 2004, 133.

[6] The classic expression of this analysis is A Flanders, 'Collective Bargaining: A Theoretical Analysis' in A Flanders, *Management and Unions* (London, Faber, 1970) 213, a paper first published in 1968. This criticises the Webbs for seeing collective bargaining simply as a mechanism whereby the coordination costs of employees in individual bargaining are overcome..

[7] See for a powerful articulation of this rationale Hugh Collins, 'Market Power, Bureaucratic Power, and the Contract of Employment' (1986) 15 ILJ 1.

[8] Readers will have noticed the shift from 'firm' to 'company'. For the rest of the chapter I will assume the employer is a company. The same issues arise in relation to non-corporate employers but, so as not to complicate the argument and because most of the relevant employers are corporations, will confine myself to companies.

organising through the corporate form by facilitating coordination among participants in corporate enterprise and constraining value-reducing forms of opportunism among the constituencies of the corporate enterprise.'[9]

It is further suggested that government and managers (and possibly shareholders) may today be more interested in the efficiency implications of different governance arrangements for companies than in their distributional outcomes, and this means that workers and unions have an interest in efficiency (as defined) as well. Why has this situation come about? In large part it is because the secular decline in union membership and collective bargaining coverage has reduced the capacity of the union movement to secure the extension of collective bargaining via self-help and has reduced the political incentives for government to take vigorous steps to promote collective bargaining.[10] Thus, both of the main drivers of the expansion of collective bargaining identified by Flanders in the 1950s can already be seen to be operating more weakly than in the heyday of that institution and this situation seems likely to continue in the future.[11] In addition, and partly a cause of the development just mentioned, global competition has sharpened companies' interests in efficiency as the areas of national economies sheltered from competition (especially from outside the jurisdiction) have been substantially reduced. An efficiency rationale, if one could be established, might operate so as both to reduce employer caution in relation to the mechanisms of collective worker voice and encourage government to be more proactive in introducing support for the mechanisms of voice. Employers might be thought to have a natural interest in reducing the costs of production, whilst government has an interest in increasing the competitiveness of productive enterprises, because it benefits in terms of tax revenues and the political dividend from job creation.

However, the credibility of the efficiency argument can by no means be taken for granted. It needs to be explored in some detail. What is the theory behind the claims that worker voice reduces companies' costs of production? Is there any empirical evidence to back up the theoretical claims? This chapter will explore the empirical evidence mainly through an analysis of the German system of worker voice, which contains three main elements: board level employee representation, works councils and collective bargaining. It will be argued that there is some empirical evidence to support the efficiency claims for the German system.

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[9] R Kraakman et al, *The Anatomy of Corporate Law*, 2nd ed, OUP, 2009, p 2. This approach is, of course, in the tradition established by Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

[10] The union recognition procedure in Schedule 1A of the Trade Union and Labour Relations (Consolidation) Act 1992 inserted by the Employment Relations Act 1999 demonstrates both that governmental support has not completely disappeared but also the limited nature of that support. See A. Bogg, *The Democratic Aspects of Trade Union Recognition* (Hart, 2009).

[11] The force of this argument was recognised some years ago by Richard Hyman ('Is there a Case for Statutory Works Councils in Britain?' in A McColgan (ed) *The Future of Labour Law* (London, Pinter 1996) – with a response by John Kelly. The latest WERS survey shows a continuing decline in union density and collective bargaining coverage, but at a much slower rate than in earlier surveys (Workplace Employment Relations Study, *The 2011 Workplace Employment Relations Study: First Findings*, 2013, URN 13/1010).

An attempt will be made to isolate the conditions under which in Germany those efficiency results obtain. This gives rise to the final, and perhaps crucial, question. In a system where those conditions do not obtain, what would be costs of establishing those conditions so as to capture the efficiency gains which are currently foregone? Are the costs of change likely to be greater than the efficiency gains and, even if they are not, are the necessary changes likely to be opposed successfully by the incumbents in the current system?

How does this chapter related to the notion of the 'autonomy' of labour law? In so far as autonomy means that labour law struggled against and at least partially succeeded in escaping from the legal concepts of the common (or civil) law, such as freedom of contract and restraint of trade, this chapter has nothing to contribute, because it is not about legal concepts but rather institutional design. In so far as autonomy means that the rationales underlying labour law were unique to that body of law, then this chapter is at odds with such a notion of autonomy. However, in terms of underlying policies, the claim of labour law to autonomous status was closely linked to the idea that the predominant purpose of labour law was to promote collective bargaining.[12] This is clearly no longer a sustainable notion of the function of labour law.[13] By contrast, older views of the drivers of labour law polices (such as industrial democracy) or newer ones (such as protection of human rights) did not present claims which were unique to labour law. They represented rather the extension into the field of work of ideas of general social value.[14] So, also with efficiency, the notion around which this chapter revolves.

The chapter proceeds as follows. Section II deals with worker voice in corporate law and so focuses on the form of governance known to corporate law scholars as control rights. The claims of law and economics scholarship to show that employees are in most cases efficiently excluded from control rights are shown not to be as conclusive as is generally taken to be the case. Section III analyses the open-ended nature of the contract of employment and analyses the potential value to both employees and employers of allocating governance rights to employees. Section IV takes the notion of governance rights beyond the control rights known to corporate law and discusses the potential role of sub-board participation mechanisms, such as works councils and collective bargaining. Section V describes the German system of codetermination as a case-study of a governance system containing board representation, works councils and collective bargaining. Section VI considers the empirical evidence about the efficiency of the German system. Section VII considers the extent to which the German system is capable of generalisation. Section VIII concludes

[12] O Kahn-Freund, 'Labour Law' in O Kahn-Freund, *Selected Writings* (London, Stevens & Sons, 1978), a paper first published in 1959.
[13] P Davies and M Freedland, *Labour Legislation and Public Policy* (OUP, 1993).
[14] For a general survey of the goals of labour law see G Davidov, 'The Goals of Regulating Work: Between Universalism and Selectivity' (2014) 64 *University of Toronto L J* 1.

II Worker voice and the law and economics of corporation law

Over the past three decades or so, the economic analysis of law has transformed the study of corporate law – and indeed many other fields of legal research. By and large labour or employment law has remained resistant to this trend.[15] Work has either continued within the existing paradigms or, where advances have been made, they have focussed on distributional questions. Fairness rather than efficiency has been the acid test.

Whatever the explanations for this lack of this engagement with economic concepts, some opportunities to open up old questions in novel ways were in danger of being lost to labour lawyers. Take, for example, the idea of the company as a 'nexus of contracts', one of the foundational ideas of the law and economics school.[16] This idea seeks to explain the function of separate corporate personality in the following way. As a separate legal person, the company facilitates contracting among all the providers of inputs to the corporation (and indeed the purchasers of outputs). By contracting with the company, which acts, so to speak, as a central counterparty, the suppliers and purchasers are enabled, functionally, to contract with each other.[17]

For labour lawyers the important implication is that, by itself, the nexus of contracts theory tells one nothing about where control rights should be allocated in the company. (For the purposes of this essay I take control rights to be the rights to appoint or remove directors or to give them instructions as to how to conduct the management of the business.) Indeed, it undermines one of the historically potent rationales for the allocation of control rights to shareholders, ie that they are the owners of the company. There is no obvious basis in this contracting theory upon which control rights are allocated (either wholly or in part) to shareholders. Shareholders are just one among several groups of people whose inputs are necessary for production (at least in most cases).[18] Shareholders are contractors with, not owners of, the corporation. Control rights cannot be claimed by the shareholders because they are owners of the company: the nexus of contracts theory does not need to assign

[15] See Michael L Wachter, 'Neoclassical Labor Economics: Its Implications for Labor and Employment Law', in C Estlund and M Wachter (eds), *Research Handbook on the Economics of Labor and Employment Law*, Edward Elgar, Cheltenham, 2013, ch 2. For notable exceptions in the UK see A C L Davies, *Perspectives on Labour Law* (1st ed 2004); much of the *oeuvre* of Simon Deakin ; and Hugh Collins, 'Regulating the Employment Relationship for Competitiveness' (2001) 31 ILJ 17 and 'Justifications and Techniques of Legal Regulation of the Employment Relation', in Hugh Collins, Paul Davies & Roger Rideout, eds, *Legal Regulation of the Employment Relation* (The Hague: Kluwer, 2000).

[16] M Jensen and W Meckling, 'Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Law and Economics* 305.

[17] Separate legal personality, together with limited liability, also functions so as to separate business assets from shareholders' personal assets and to focus business creditors on the corporate assets and personal creditors on the shareholders' assets – but that is not an argument relevant to the present discussion. See H Hansmann and R Kraakman, 'The Essential Role of Organizational Law' (2000-1) 110 *Yale L J* 390.

[18] Under certain, rather rare,, conditions a business could be financed wholly be debt and internal cash flows, and so not need shareholders and risk capital.

ownership of the company to anyone – though it does need to do something about control rights.[19]

In order to decide on the allocation of control rights (and thus to decide whether shareholders should have them exclusively, be required to share them with other contracting groups or be entirely excluded from control rights), some additional level of theorising is required. It is true that the mainstream of law and economics theory as applied to corporations does have a rationale for allocating control rights exclusively to shareholders. This is that shareholders, by contrast with any other contracting group, are in the worst position to protect their interests by contract and have the best incentives to exercise their control rights efficiently. So, if the objective is to minimise the sum of the company's costs of contracting and costs of governance, the shareholders get exclusive control rights in most situations.[20] Shareholders are residual claimants because they earn remuneration on their investment only after other groups (who have fixed contractual claims on the company) have been paid off. Ordinary shareholders, at any rate, do not normally have a contractual (or any other) right to a return on their investment (short of a winding up of the company), but receive one only to the extent that the company earns profits and the directors decide to make a distribution to them.[21] The rule that shareholders are remunerated out of profits means that the claims of other groups have to be met before a profit is struck and a potential for distribution created. It is clear enough that the shareholders come last in the liquidation of the company and it is broadly true when the company is a going concern, because of 'no distribution except out of profits' rule.[22] Because of their lack of a fixed claim and residual status, shareholders have the strongest incentives to drive down the company's costs of production. Every pound of net cost saved is a pound of profit earned, which will inure to the benefit of the shareholders via either a distribution or the share price. Nor can shareholders contract for rights of return, without changing the function they perform in corporate finance, ie the provision of risk capital.[23]

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[19] English doctrine, in any event, abandoned the idea that the shareholders own the company (as opposed to their shares) more than half a century ago in *Short v Treasury Commissioners* [1948] A C 534. The real objection to the nationalisation statute in that case was that the state obtained control of the company without paying a control premium.

[20] See H Hansmann, *The Ownership of Enterprise* (Cambridge, Mass, Harvard University Press, 1996) Part I, who also provides a rationale for the cases where shareholders are excluded from or share control rights.

[21] The prospect of a distribution may cause the company's share price to increase and investors can thus obtain a return by selling part of their holdings before a distribution is made. However, if it were clear that a company would never make a distribution (for example, where it is ineluctably prohibited from doing so), there is no reason to supposed that profits earned by the company would have an impact on the share price.

[22] Given the 'no distribution except out of profits' rule, investors who want a reliable contractual entitlement to a regular return need to provide debt to the company; by the same token, the contractual commitment of the company to the debt-holder impairs the loss-absorbing capacity which attaches to equity.

[23] Of course, shareholders can contract for dividend rights and preference shareholders often do so, but typically preference shares are also non-voting shares, ie their holders have no control rights but rely on their contractual entitlements instead. I

This is an argument which says that control rights are allocated to shareholders because they will make best use of them (by pressing for managerial action which minimises the company's costs of production). The point can also be put negatively. Without control rights the company's cost of ordinary share capital would increase. Investment via the acquisition of ordinary shares consists of handing over a chunk of money in exchange for shares which normally carry no right to a return (short of liquidation) but an expectation of a return, if the company makes profits and the directors decide to pay out part of that profit. Without control rights the power of shareholders to protect their expectations would be much reduced. Consequently, without the ability to choose those who are or who monitor the management and make distribution decisions (the members of the board), shareholders would pay less for the company's shares because the risk of no or an inadequate return would increase. Investors would thus protect themselves against loss of control rights by paying less for their shares, but society would suffer because companies would have a reduced capacity to raise risk capital.

By contrast, standard law and economics theory views employees as able to contract for protection against opportunistic behaviour by others in the nexus of contracts with the company, and for the same reason they have weaker incentives than shareholders to exercise control rights efficiently. This is partly because less turns for them on the efficient exercise of their control right (since they have contractual entitlements which the company is obliged to meet except in extremis) and partly because their incentives are to enhance their contractual entitlements, irrespective of the impact of that enhancement on efficiency.

Overall, the argument is that society will benefit from allocating control rights exclusively to shareholders, because the persons with control rights are then those with the biggest incentives to reduce the company's costs of production. The dominance of this theory amongst law and economic scholars may seem to present a gloomy picture for the labour lawyer. But, like many an economic theory, examining when the theory does not apply proves to be as illuminating as examining when it does. In particular, once one relaxes the assumption that all claimants other than shareholders have fixed contractual claims on the corporation under fully-specified contracts, then some important questions can be asked. How do the arguments for allocating control rights exclusively to shareholders fare when other groups have incomplete contractual protection? Are employees' interests confined to the short-term maximisation of their rents or do they have a long-term interest in the competitive efficiency of the enterprise?

III The open-ended nature of the contract of employment and governance rights

Let us start the process of reverse-engineering the standard law and economics argument by examining whether the contract of employment is a fully specified contract, so that employees do not need control rights to protect themselves against opportunism. The law and

economics school, at least in its early manifestations, tended to treat the contract of employment as a fully specified contract. On the reward side, this appears a plausible argument. Entitlements as to wages, bonuses, hours and holidays are normally spelled out, although, in the case of bonuses, the provisions normally provide for a way of calculating the bonus rather than a commitment to a fixed amount of payment. Even on the reward side, however, the contract rarely seeks to specify more than current entitlements. Commitments to wage increases are uncommon, even more so commitments to promotion. These lie, as far as the employee is concerned, in the realm of expectation, not contract. This may not matter in a short-term employment contact which is expected to be ended before such questions arise. In contracts that are expected to be of long duration, however, the result is that important elements of the reward side of the contract are not fully specified.

On the task side the contract often does not achieve even the level of specification found on the reward side, whilst the provisions as to termination of the contract normally vest a high level of discretion in the employer about the continuity of the employment. It is in the employer's interest that the contract of employment should contain these elements of discretion. The employer wishes control what the employee is required to do in the light of how matters develop in the future. It will be unwilling to tie itself down with a limited and specific job description. Consequently job descriptions tend to be either short and vague or very long and detailed, specifying more tasks than any one person could possibly discharge in a working week, so that the employer retains a discretion as to which items to choose for actual performance from time to time. If the job description is framed as a concise analysis of what the job entails at the point of hiring, the tasks actually performed tend to diverge from those listed quite quickly. Quite apart from the undesirability (from the employer's point of view) of defining the task side of the contract, it is difficult to specify the quality of the employee's performance of the tasks, except in very general terms. Often the quality issue is simply not addressed, beyond some generalities. In short, the contract of employment is a potentially long-term relational contract, whose core features on the reward side can be spelled out at the time of hiring only to a limited extent.[24] This contractual gap was partly filled by implied terms developed at common law, but these terms were necessarily standards rather than rules[25] and so difficult to apply on a self-enforcing basis and unattractive to apply via litigation in the courts, except upon termination of the contract. The implied terms might be formulated in a pro-employer way but low-cost and effective enforcement of those terms was not usually available to the employer, at least in modern times.

Reserving contractual discretion as to how the employee is to discharge the task side of the contract makes abundant good sense from the employer's point of view, and may have some

[24] S Deakin and G Morris, *Labour Law*, (6th ed, Hart, 2012) 4.3.

[25] The central ones bearing on the current discussion were the employee's implied duties to: obey lawful orders, take reasonable care in the performance of the contract, to act loyally towards the interests of the employer and to serve the employer faithfully. See M Freedland and N Kountouris, *The Legal Construction of Personal Work Relations* (OUP, 2011) ch 4.1.B.

advantages for the employee who is not risk-averse. Nevertheless, converting a contractual commitment to work into the effective deployment of labour power is a challenge for the employer. Traditionally, this was done by creating a layer of inferior managers,[26] whose task was to monitor and direct the activities of the large number of bottom-level employees, and by assigning those managers a social status clearly superior to the 'hands' they directed.[27] This proved an unsustainable general solution to the employers' problem, partly because it became expensive to maintain additional layers of management and partly, as jobs became more skilled, and conferred high levels of discretion on employees, low-level managers were often unable to observe how well the worker was performing the assigned tasks until after they had been completed – and perhaps not even then.[28] Alternatively, employers might design financial incentives to induce the level of effort desired, but it was often difficult to identify a measurable payment metric which was both appropriate and not open to manipulation by the employee.[29] Again, this problem became more prominent with the increased technical sophistication of jobs. In modern times, 'human resource management' techniques are a response to this issue, with mixed results.

If, therefore, the reward side of the contract is not fully specified, the claim of employees to governance rights cannot be set aside as superfluous. Equally, if the task side is even more open-ended and the monitoring costs of the employer are high, the employer has an interest in the internalisation by the workforce of effective working practices. These positions give rise to the possibility that the following type of 'deal' could be arrived at between employer and employee. Employees would commit to discharge the task side of the work contract in a way which promoted the employer's needs for productive output, in exchange for the employer's commitment to take into account the interests of the employees in the exercise of its discretions, notably when taking decisions which impact on wage increases, promotion and continuity of employment. Employees would internalise the need to work cooperatively (rather than be monitored or subject to financial inducements related to their work performance) whilst employers would commit to giving employee interests an independent weight when exercising their discretions. This could be referred to as 'the mutual cooperation deal'.

For the reasons given above it is unlikely that this arrangement would be (or even could be) cast into contractual form. Specifying what the exchange of mutual regard undertakings would mean in all future situations which might arise would be beyond the capacity of the

[26] These were the charge-hands and foremen so prominent in nineteenth century factories.
[27] The implied duty to obey lawful orders was clearly central in this context.
[28] As Fox remarked, '[P]erformance of the discretionary content requires, not trained obedience to specific external controls, but the exercise of wisdom, judgement, expertise.' (A Fox, *Beyond Contract: Work, Power and Trust Relations* (London: Faber, 1974), p 19).

[29] 'Payment by results' reward systems, at one time popular in industrial production, for example, tended to allow work groups to capture all the efficiency gains from technical innovation, thus disinenctivising companies from making such investments: Clegg, above n 4, 178-180.

parties to imagine and expensive to translate into contractual language, even if possible.[30] Indeed, it is likely that the terms of the arrangement would not be set out explicitly at all, but would be discernible only from repeated interactions amongst the parties involved, giving rise to what economists call 'implicit contracts'.[31] This type of deal might be particularly valuable in industries or occupations where the employer needed to induce employees to make investment in firm-specific skills ('firm specific human capital investment' – FSHCI). A firm specific skill has either no, or much less, value when deployed on behalf of another employer, because the most extensive exercise of the skill depends upon its use in conjunction with the particular physical assets or routines which the current employer has established. Loss of a job thus means loss of the opportunity to deploy the skill, either at all or as effectively as in the previous employment, and thus future employment at a lower wage. An employee is more likely to expend time or resources in FSHCI if there is some concomitant commitment on the part of the employer to increase wages to reflect the skills acquired and to maintain the employment.[32]

From an enforcement point of view, an obvious difficulty with the mutual cooperation deal that is not enforceable as a contract is that the exchanges under it are not synchronous. The parties cannot enforce the arrangement through self-help, ie by refusing to perform if the other party is not ready to perform, because simultaneous exchanges are not expected to occur. In particular, whilst the employee commitment is more-or-less continuous – cooperation is required in principle in all working periods – the employer's commitments are episodic, ie they are triggered mainly when managerial decisions bearing on wages or continuity of employment fall to be taken. Some sort of control arrangement is thus needed to protect the party who performs first, and this builds an argument for a governance arrangement. Governance rights are particularly important for the employees, for verification purposes. The employer may not be able to observe accurately the effort of individual employees but it is probably well placed to gauge the productivity of the workforce as a whole through its management information systems. For employees the matter is more complex. The employer's commitment is not likely to consist of an undertaking never to dismiss employees for economic reasons or always to promote employees or raise their wages whenever asked to do so. Rather, it is a promise to exercise its discretions in a way

[30] The standard impediments to specifying completely long-term contracts – bounded rationality and transaction costs – apply strongly in this situation. See O. Williamson, 'Transaction-Cost Economics: the Governance of Contractual Relations' (1979) 22 *Journal of Law and Economics* 233.

[31] See, for example, A Shleifer and R Summers, 'Breach of Trust in Hostile Takeovers' in A Auerbach (ed), *Corporate Takeovers: Causes and Consequences*, National Bureau of Economic Research, 1988. The term 'implicit contract', like its bed-fellow 'agency costs', is apt to cause misunderstanding between lawyers and economists because the term means different things in each discipline. Lawyers tend to think of implicit contracts as contracts the terms of which have to be deduced by the court from the behaviour of the parties, whereas for an economist an implicit contract is an agreement the terms of which are not observable by third parties (with any accuracy), including by a court. So, for a lawyer, an implicit contract is not a contract at all.

[32] M Blair and L Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia L Rev* 24.

which takes appropriate account of the interests of employees in continued employment or wage increases in return for cooperative working or FSHCI. Whenever the employer wishes to take decisions in these areas which do not fully comply with the employees' wishes, it will normally have plausible reasons for so deciding – often relating to the economic state of the company. However, given the asymmetry of information between employees and managers, it may well be very difficult for the employees to judge whether the employer is acting opportunistically or has arrived at a defensible decision after fully considering the employees' interests. Governance rights may provide the employees with reliable information to make that judgement. In addition, governance rights not only protect employees ex post (after they have performed) against employer opportunism but they will also have the ex ante effect of helping to set the conditions under which the employees are willing to make their initial commitments. For example, an employee is more likely to engage in FSHCI, in the expectation of higher wages in the future, if she knows there is in place some governance mechanism which can scrutinise the employer's subsequent wage decisions.

However, verification is only one, perhaps a secondary, function of governance institutions. The governance institution may constitute part of the process through which the mutual cooperation commitments are expressed. Thus, in their classic theoretical analysis of works councils, Freeman and Lazear show that the information rights of works councils can not only operate as a verification tool for employees (incidentally also reducing the level of strategic industrial action), but also encourage the communication of information from employees to management, which gives rise to better-informed management decisions. Equally, consultation rights for employees may lead to the emergence in the consultation process of new solutions to problems facing the firm or the improvement of existing solutions, whilst also assuring employees that their interests are being taken into account in managerial decision-making.[33]

The above has been addressed at disposing of the argument that employees have complete contracts with the company and so can protect themselves through the contracting mechanism and do not need recourse to governance rights. However, even at a theoretical level, this is not enough to make out the case for allocating governance rights to employees. Employees might be very poor monitors of management, so that introducing them onto the board might reduce the overall quality of the supervision of management. Or employees might be equally good monitors but allocating control rights to them and to shareholders jointly might produce a very high level of conflict between the two groups on the board, again reducing the quality of the board's supervision of management. The most efficient allocation is one which minimises the combined costs of contracting and of governance:[34] if

[33] R B Freeman and E P Lazear, 'An Economic Analysis of Works Councils' in J Rogers and W Streek (eds), *Works Councils* (Chicago, National Bureau of Economic Research, 1995).
[34] H Hansmann, *The Ownership of Enterprise* (Harvard University Press, 1996) Part I.

the governance costs of allocating employees control rights are very high, then it might be less costly for the company to exclude employees from control rights even at the cost of less efficient working practices. We will return to this point in section VI, since it is essentially an empirical point.

IV Governance mechanisms in corporate and labour law

One potential conclusion from the argument in the previous section is that allocating employees governance rights might reduce the company's costs of contracting for labour inputs, because it could be part of an overall deal in which employees work more effectively to deliver the output the employer is seeking. The next question is: what sort of governance rights are we thinking of? The corporate law debate revolves around what we have termed control rights, ie the right to appoint and remove and instruct the board of the company.[35] Governance rights, however, need not be so narrowly conceived when the employment relationship is considered. Labour lawyers tend to have a broader concept of governance rights. Employee representation at board level is included, to be sure, but so also are collective bargaining and works councils. All three can be thought of as institutions of joint regulation, but potentially operating at different levels of decision-making within the company and covering different subject-matters. As we shall see in our case-study of Germany, it is the interrelationships among these various institutions that give the overall governance arrangements their particular character.

The institutional value of the board, from the point of view of employee governance, is that it captures the high-level strategic decision making within the company.[36] As the UK Corporate Governance Code puts it,

> "The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met."[37]

To be sure, not all boards work in this way. Some may be captured by the company's management or by a controlling shareholder. Nevertheless, the board has formal power to

[35] The corporate lawyers' concept of governance strategies might also embrace situations where the employees have rights to take decisions directly (rather than through representatives) and systems in which (some of) the board members are made sensitive to the employee interests through mechanisms other than their being appointed by the employees. (R Kraakman et al, above n 9, 39). For simplicity, however, we will concentrate on the core appointment, removal and instruction rights.

[36] Most corporate decisions are taken solely by the board. In the case of a small number of 'fundamental' decisions shareholder approval is required as well, but even then the right to initiate the decision is, de jure or de facto, with the board.

[37] Financial Reporting Council, *UK Corporate Governance Code*, 2012, A.1 Supporting Principle.

approve the company's strategy and there is no other institution within the corporate structure with the potential to enable employees to have an input into corporate strategic decisions. Those decisions will certainly include some decisions of significance to employees under a mutual cooperation arrangement. In particular, high level decisions about the location of investment might well impact in due course on the competitiveness of particular establishments operated by the company and thus on the availability of continued employment or promotion opportunities in those establishments.[38] However, many decisions salient to employees will never reach board level. The board meets episodically, perhaps for one day each month, and has time only for matters of overall importance for the company (or the group of companies it controls). The size of wage increases in a particular establishment or enterprise, for example, is likely to be left with lower-level management in the normal run of things, as are many other matters relating to terms and conditions of employment or which impact upon terms and conditions of employment. These are matters more likely to be captured by the governance mechanisms which labour lawyers have studied, namely collective bargaining and works councils.

It thus seems plausible to assert that a fully developed system of employee governance rights forming part of a deal in which the employees commit to cooperative forms of working might involve participation at both board and sub-board levels and the involvement at sub-board level might focus on works councils or collective bargaining or both. Employee governance rights which operate only at sub-board or only at board level are unlikely to provide sufficient support for a fully effective cooperation arrangement, but each is arguably a necessary ingredient in a complete structure.

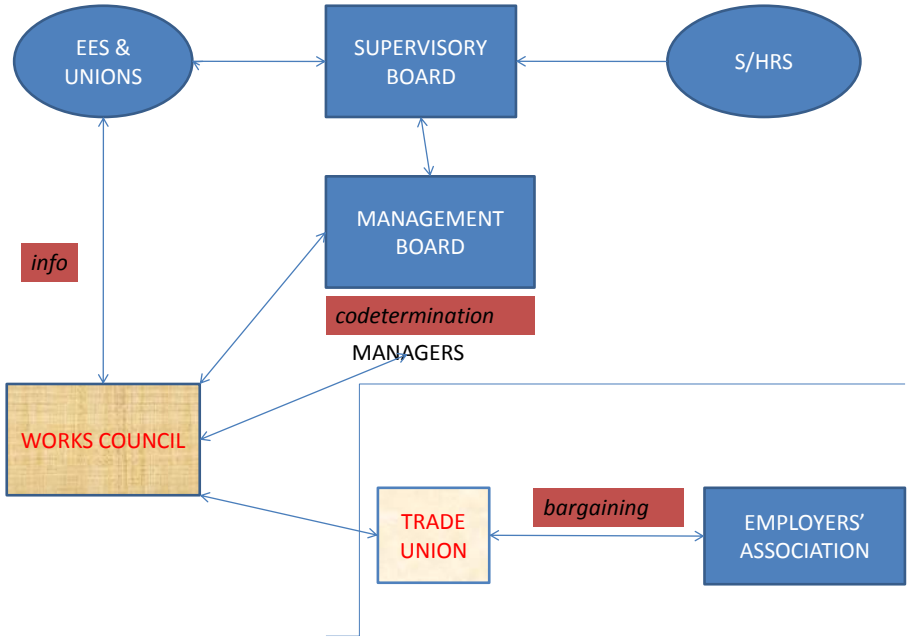
The next section will analyse employee governance rights in Germany. There are three main reasons for choosing Germany as the country to examine more closely. First, it has an employee governance system which displays all three elements (board, works council and collective bargaining) which seem relevant – though it is not unique in that respect. Second, Germany has the strongest system of governance rights for employees of all the EU countries. It is unique in having near-parity representation at board level in companies with more than 2000 employees, and its works councils have a particularly impressive set of information, consultation and co-decision rights. Finally, and most important for this chapter, there is now a growing body of empirical evidence about the efficiency effects of the German system. This will be examined in the section VI.

V The German system of employee participation

Figure 1

[38] Wedderburn and P Davies, 'The Land of Industrial Democracy' (1977) 6 ILJ 197.

GERMAN CODETERMINATION



The three elements of German codetermination show clearly in this chart, as do the complexities of their interrelationships. The first element is the appointment of employee representatives to the supervisory board.[39] In companies with more than two thousand employees (outside the iron, steel and coal industries)[40] the employee representatives constitute one half of the supervisory board and the shareholder representatives the other half, but the shareholder representatives can insist on their choice of the chair of the board, who has the casting vote in cases of deadlock.[41] All employee representatives are elected by the workforce of the company (either directly or indirectly via delegates), and so a crucial issue becomes the allocation of nomination rights. The union has nomination rights over a minority of the employee representatives (the larger the board the smaller the de facto proportion of

[39] In Germany a two-tier board is mandatory. Employee representation is on the upper – or supervisory – board. The supervisory board appoints the members of the management board. The division of function between supervisory and management boards in a two-tier system is not bound to take a particular form. The German company law of 1937 (which influenced the post-war legislation) took a noticeably constrained view of the functions of the supervisory board. In 2002, however, the rules were amended so that what the supervisory board of a listed German company is now expected to do vis-à-vis the management board is not markedly different from how a UK one-tier board functions vis-à-vis the management of a UK listed company – except that the UK management is not formally organised in a separate board but are members of the one-tier board along with the non-executive directors. Even this difference is attenuated by the fact that members of the management board often attend meetings of the German supervisory board, even if they are not members of it. See M Roth, 'Corporate Boards in Germany' in P Davies et al (eds), *Corporate Boards in Law and Practice* (OUP, 2013), 276-8, 282-3.

[40] To reduce length I leave on one side those three industries' (even stronger) provisions as well as those weaker ones applying to companies with fewer than 2000 employees.

[41] Codetermination Act 1976, §27. Hence the term 'quasi-parity' codetermination, in contrast to the full parity operating in the iron, coal and steel industries.

union nominees)[42] but the union must give the workforce a choice of nominees for election (ie there must be more union nominees than union places). Nomination rights for the remainder of the board lie with the employees ($1/5^{th}$ of the workforce or 100 employees), though in practice the works council will have substantial influence over the selection of those nominated. The union nominated representatives need not be employees of the company (and normally are not) but the other employee representatives are required to be employees.[43]

The formal role of the supervisory board is not altered where quasi-parity codetermination applies (but see below) and the formal legal duties of the employee representatives are no different from those of the shareholder representatives.[44] The supervisory board appoints the members of the managing board. To constrain the shareholder representatives' powers of appointment (when coupled with the chair's casting vote), appointments to the managing board require (on a first vote) two thirds support (ie some element of support from the employee representatives) from the supervisory board. This is an important mechanism for making the senior executives of the company sensitive to the interests of the employees and the trade union in the company. If the two-thirds level of support is not achieved, a later vote can be held after a further month, at which only simple majority support is required. However, the nomination power for this later election is confined to a supervisory board sub-committee consisting of equal numbers of employee and shareholder representatives. The institutional pressures are thus towards appointments to the managing board on which both shareholder and employee representatives agree.[45]

The second element is the works council. This operates within the company but at sub-board level.[46] The members of the works council are elected by the employees with more than six months' seniority, must be employees of the company and any employee may nominate a candidate. However, the union represented within the plant also has nomination rights.[47]

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[42] Two union nominees out of 6 or 8 employee representatives in the case of 12 or 16 member boards and 3 out of 10 in the case of 20 member boards. (Codetermination Act §7) The size of the board is determined by the number of employees in the company and the formula can lead to large and unwieldy boards. The average board size across Europe as a whole is no more than the smallest board permitted under quasi-parity codetermination. See P Davies, K Hopt, R Nowak and G van Solinge 'General Report' in Davies et al (eds), above n 39, 15.

[43] Codetermination Act 1976, §§ 15-16.

[44] However, those board member duties are owed to the 'company', which is not traditionally conceived of as being identical with the shareholders but as embracing a range of other groups as well, so that the board formally has power to balance all group interests in the way it considers appropriate. (Roth, above, n 39, 262-3)

[45] Codetermination Act §31. The fact that the employee representatives must include one member of the 'executive staff' (§15(2)) – in effect the leading white-collar workers – may help the shareholders build support for proposed member of the management board.

[46] Works Constitution Act. In fact, there is a hierarchy of works councils, operating establishment, enterprise and group level, but this account will ignore that complication.

[47] §§8 and 14.

Most works councillors, at least in large companies, are union members,[48] and, since most employee board representatives are also works council members, union influence carries through to that level as well. It is mandatory for a works council to be set up in establishments with five or more employees, upon request by three or more employees or a trade union represented within the establishment.[49] The powers of the works council are legally defined and wide ranging but exclude the core subjects of collective bargaining (basic wages, hours and holidays). Those powers range, in ascending order, rights to information about the financial affairs of the company; rights to consultation over personnel planning (including works processes and job allocation); and consent rights to 'social matters' such as payment methods, performance-related pay, allocation of working hours (unless these are covered by collective agreement); and veto rights over dismissals. Since these powers are legally granted, they are legally sanctioned and in fact the works council is forbidden to use industrial action to enforce its rights (or to any other end).[50] Where the works council has a consent or veto right, a failure to agree can be resolved or a veto removed by a third party, such as an arbitration board or the labour court.

Collective bargaining in Germany deals with the usual core subjects of bargaining in any country, but its crucial characteristic for present purposes is that it is conducted outside the enterprise on a multi-employer basis and thus with an employers' association. Typically, the bargaining covers a particular industry in a particular region of the country.

Figure 2

[48] Overall, about three-quarters of works council members were union members in 1990: W. Müller-Jentsch, 'Germany: From Collective Voice to Co-Management' in Rogers and Streek (above n 33), Table 3.2.
[49] §§1 and 17. In fact works councils are ubiquitous in larger companies but only about 35% of the total number of eligible companies have one (Muller-Jentsch, previous note, at 56).
[50] §74.

INTERRELATIONSHIPS

- Ee reps on SB ⟺ Shr reps/top management
- Supervisory board ⟺ works council
- Works council ⟺ plant management
- Works council ⟺ trade union & collective bargaining
- Trade unions ⟺ SB/top management & ers association

2

From the above short account of the elements of German codetermination it appears that it creates a complex set of interrelationships among the employee representatives in the three governance institutions and between different levels of management and those representatives. The potential for these relationships to support long-term cooperative deals can be identified along the following lines. The size of the employee representation on the supervisory board and that board's appointment rights over the management board give the employees the power to influence corporate strategy so that it does not cut across implicit contracts between workers and employer (the details of which are probably settled at lower levels within the company). Information obtained at supervisory board level is fed to the works council and this reduces the information asymmetry between works council and plant or company management. That lower level management is less likely to behave opportunistically in dealing with the works council (whether in relation to the council's information, consultation or decision rights) for two reasons. Plant or company management statements may verifiable by the council through the information it has received via the supervisory board, so that lower management has an incentive not to exaggerate. The top management of the company will wish to maintain at least a minimum level of support from the employee representatives at board level in order to secure the continuation of their own jobs and those representatives may influenced by the views of the works council about how it has been treated by lower-level managemnt. The legal rights of the works council thus provide a platform from which the cooperative deal could be fashioned.

Nevertheless, there is nothing in the above which guarantees that the works council and lower level management will work cooperatively rather than antagonistically. For example, the works council might perceive the best interests of the employees to be served by its adopting an obstructive attitude towards the exercise of its legal rights, in exchange for concessions in areas not covered by their statutory powers. However, there is one feature of the German arrangements which reduces this risk. This is that the high-powered distributional conflicts are allocated to collective bargaining, which takes place outside the plant on a multi-employer basis. Whilst the works council has decision or consultation rights over a number of wages and hours issues, these matters are framed within the context provided by collective bargaining (assuming the employer is a member of the employers' association). So, whilst council/management relations display a mixture of cooperative and conflictual elements, the risk is reduced that conflict will become the dominant characteristic of that relationship and stymie cooperative initiatives.

On the other hand, the design of the arrangement is clearly not that union and works council be put in hermetically sealed boxes.[51] In addition to the union's formal rights to initiate the establishment of a works council, to enter the plant and to attend works council meetings if one quarter of the members of the council so request,[52] we have seen that there is substantial overlap between union and works council membership. Nevertheless, there is a risk inherent in these arrangements that the union will seek to make the works council its puppet or, alternatively, set up a rival in-plant institution for the representation of the workers' interests. In either case, the high-powered distributional conflicts, instead of being resolved through multi-employer bargaining, might enter the plant and undermine the cooperative elements in the works council's relationship with management. Yet, the works council and the union have strong incentives not to allow either of these developments to occur, because each will maximise its influence if they work together in separate, but linked, spheres. The works council may need expertise which only the union can provide (or provide at reasonable cost), whilst the union needs representation within the plant to build membership. At times the works council and the union have been in danger of becoming rivals for employee support within the enterprise, but by and large unions have adopted the strategy or working through, rather than against, the works council.[53] Equally, the union has an interest in the works council not venturing into the field of high-powered distributional conflict but leaving that to collective bargaining, for otherwise the role on the union might be significantly undermined.

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[51] For a contrast between Germany and France in this respect see R Gumbrall-McCormick and Richard Hyman, "Embedded Collectivism? Workplace Representation in France and Germany" (2006) 37 *Industrial Relations Journal* 473.

[52] §§2(2), 17(3) and 31.

[53] Müller-Jentsch, above n 48, 64. Section 2 of the Works Constitution Act in fact imposes an obligation on the works council to work cooperatively with the union for the good of the employees and the enterprise. There is no corresponding obligation on the union.

Neither is it guaranteed that the presence of employee representatives on the board will not generate a high degree of conflict. Whilst the shareholder representatives can always break deadlock in their favour and this may encourage the employee representatives to seek agreement, it is easily conceivable that those representatives might think that their prestige with their electorate would be enhanced by pushing matters to a deadlock rather than in seeking consensus. So, it is conceivable that quasi-parity codetermination will lead to high levels of conflict between shareholder and employee representatives at board level and that the quality of board decisions on corporate strategy will suffer.

VI Empirical studies of the German system

It is thus possible to construct a plausible argument in favour of an efficiency view of the German codetermination system. It is equally clear that the design of the system does not guarantee an outcome which reduces the company's costs of production. Employee representatives, both at board and lower levels, might use their powers so as to raise, rather than reduce, the company's costs of contracting for labour. Higher wages might be compounded by lower levels of effort rather than off-set by higher levels of productivity.[54] Board level employees might slow down the process of formulating and implementing revised corporate strategies as the business environment changes. Even if labour codetermination reduces the company's costs of contacting for labour, it may increase its costs of contracting for capital, and the net balance of those cost movements may be negative. It is therefore of the utmost significance to look at the empirical evidence which might cast light on these questions.

Let us look first at the board level evidence. There is a long tradition in Germany of qualitative, observational studies of the operation of boards under quasi-parity co-determination. These studies are not that useful from our point of view, partly because observational work on boards (whether in Germany or elsewhere) is hard to do, given the difficulties of obtaining sufficient access. Nevertheless, these studies do rebut one hypothesis about the functioning of boards under codetermination. One might think that codetermined boards would discharge the same functions as before they were codetermined but display high levels of conflict between employee and shareholder representatives. In fact, overt conflict, involving the use of the chair's casting vote is rare and consensus reached after perhaps hard bargaining between the two groups is the norm. On the other hand, the functions of the board do change, in that more time under codetermination is spent on strategic issues

[54] Brian Cheffins has a game-theoretic model in which it is shown that, whilst the joint surplus of employers and employees is maximised by sticking to the cooperative deal, the welfare of either party is maximised by defecting from the deal, provided that the other party does not defect. (B. Cheffins, *Company Law: Theory Structure and Operation* (OUP, 1997) 578-580. Consequently, the constant risk of defection needs to be addressed through governance arrangements which provide that defection will be quickly identified and appropriately punished.

which impinge rather directly on the interests of the employees and less time on strategic issues which lack this quality.

In Katharina Pistor's perceptive analysis of these studies, codetermination is a 'socio-political model with governance externalities'.[55] By this she means that the studies show that quasi-parity codetermination has functioned as an effective way of handling the conflicts between capital and labour, but has operated less effectively as a mechanism for reducing the agency costs[56] of shareholders as against the management of the company. The codetermined board is a less effective way of making managers responsive to the interests of the sh areholders, because, in general, the shareholder influence on the supervisory board is diluted and, in particular, because managers can build coalitions with the employee representatives against the shareholder representatives in some situations.[57] However, the codetermined board has operated so as to reduce the agency costs of the employees as against the shareholders and managers of the firm. This analysis nicely frames the issue, but does not tell us whether overall the sum of the employees' and the shareholders' agency costs is reduced.

More recent statistical studies have focussed, not on observation of board behaviour, but on seeking to demonstrate associations between the elements of the codetermination system and positive or negative indicators of firm performance. This work has become possible as the range and quality of data sets has improved, but it is not without its own problems, notably the problem of endogeneity.[58] Even taking these studies at face value, a survey of them by Frick and Lehman published in 2006 concluded that no positive or negative association between codetermined boards and the overall value of the firm had been shown.[59] Although disappointing for the advocates of codetermined boards, this conclusion can be read as providing no grounds for arguing that Germany should change is current board level arrangements.

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[55] This is the title of her chapter in M Blair and M Roe (eds), *Employees and Corporate Governance* (Brookings Institution, Washington, DC, 1999.

[56] In this context an agency costs arise because shareholders, especially dispersed shareholders, run the risk that the management of the company will not loyally pursue the shareholders' interests but rather management's own interests or the interests of some other stakeholder group. To combat this, shareholders may incur costs in the monitoring of management action. The agency costs of shareholders are thus the sum of the post-monitoring 'disloyalty' costs (assuming the monitoring is not wholly successful) plus the costs of the monitoring. The same analysis can be applied to the employees, especially where there is an implicit contract in place which exposes employees to managerial opportunism.

[57] It is sometimes suggested that, for this reason, concentrated shareholding is associated with strong forms of employee representation on the board. Controlling shareholders have less need for a board to protect their interests because they have the capacity and incentive to deal with management directly. See M Gelter, 'The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance' (2009) 50 *Harvard Journal of International Law* 129.

[58] R Adams et al, 'The Role of Boards of Directors in Corporate Governance' (2010) 48 *Journal of Economic Literature* 58.

[59] B Frick and E Lehman, 'Corporate Governance in Germany: Ownership, Codetermination and Firm Performance in a Stakeholder Economy' in H Gospel and A Pendleton (eds), *Corporate Governance and Labour Management* (OUP, 2006).

More recently, Maug and colleagues[60] have shown an association between quasi-parity boards, on the one hand, and wage levels and job security among white-collar and skilled blue-collar workers, on the other. As compared with similar companies without quasi-parity codetermination, such workers were associated with lower wages levels (by some 3%) but higher levels of employment (some 15%) in periods after the company in question had suffered an economic shock. They interpret these findings as evidence of an 'implicit contract' between these groups of workers and the management of the firms under which lower wages were traded for higher job security. More important for our purposes, they explain the absence of such as association in firms without parity codetermination as evidence that parity codetermination gives the employees a method of verifying and enforcing ex post management's adherence to the 'contract'. This is therefore a study which supports the view that board level representation at parity facilitates the conclusion of long-term deals between management and workers because it controls ex post opportunism on the part of the management. What these authors have demonstrated is not, of course, a classic example of a deal based on cooperative working or FSHCI. That argument usually assumes that employee cooperation or investment will show itself in higher wages, whereas the opposite is true in this study. Whilst it is conceivable that workers under the classical model will wish to take out the value of their cooperation in the form of increased job security, rather than higher wages, it is difficult to explain why workers should enter into a deal which reduces their wages from the level that would otherwise obtain.[61] To establish this, it would be necessary to show that the benefit to the employer of cooperative working did not cover the cost to the company of the job security commitment and that the balance of the cost was covered by the reduction in wages. However, the data for the study in question did not permit this hypothesis to be tested.

Turning to works councils, the results of the statistical analyses are richer, but still not conclusive on the overall balance of costs and benefits to the firm. There is substantial support for the propositions that works councils are associated with higher wages, higher productivity, the same level of investment and lower profitability than in firms without works councils.[62] At first sight such findings are strongly in favour of the efficiency of works councils. Lower profitability is not necessarily a finding against the efficiency impact of works councils. It might be a purely distributional point, ie works councils have an impact on the distribution of the company's revenues as between shareholders and workers (in favour of workers) *at the same time* as they lower the company's costs of contracting for labour. In other words, works councils might both raise the joint surplus and divide the resulting surplus

[60] E Maug et al, *Labor Representation in Governance as an Insurance Mechanism*, Working Paper 2013.
[61] The authors explain the lack of the insurance arrangement in relation to blue-collar workers on grounds of their de facto under-representation at board level.
[62] Frick and Lehman, above n 59; J Addison et al, 'Works councils in Germany: their effects on establishment performance' (2001) 53 *Oxford Economic Papers* 659.

between workers and shareholders in a pro-worker way. From the point of view of the efficiency test adopted in this piece, however, the distributional effect of works councils is irrelevant and only the productivity effect is important.

However, it is possible that the adverse distributional impact on the shareholders has efficiency implications for the company. If lower profitability means less by way of distributions to the shareholders (as the lack of impact of works councils on the level of investment suggests), then the amount of equity capital the company will be able to remunerate at an appropriate level will be less than at higher levels of profitability. Shareholders will have an expected rate of return on their equity investment, depending on the riskiness of the company's activities, and so lower distributions may mean a constrained ability to remunerate equity capital. This may not matter if the company can substitute debt[63] for equity or has a highly cash generative business so that it can finance investment from internal sources. However, where recourse to these substitutes is constrained, the company may find that its ability to finance future positive-value projects is also constrained. This distributional finding may be linked to the traditionally smaller part played in corporate finance by equity and the correspondingly large part played by debt and retained earnings in the funding of German companies as compared with UK companies.[64] Unfortunately, the works councils studies did not have access to the data necessary to make the assessment whether the distributional impact on shareholders of works councils generated costs for companies in terms of high financing costs and, if so, whether those costs outweighed the productivity gains.

The third important element in the German system is the location of collective bargaining outside the company at multi-employer level. Not all companies which have works councils[65] are covered by collective bargaining arrangements. Taking advantage of this fact, Hübler and Jirjahn[66] compared wage levels and productivity arrangements in companies with works councils which were and were not covered by collective bargaining. They found that in covered companies the level of wages was lower and productivity was higher than in uncovered companies. They interpret this result as showing that, where high-conflict distributional issues are not dealt with through collective bargaining and where they

[63] Though increased leverage may raise the company's risk profile and thus its cost of equity capital, so that the amount of equity capital the company can remunerate is further reduced. Finance theory predicts precisely this consequence, though at moderate levels of debt (ie low bankruptcy risk) the tax shield for interest payments on debt may mean that more debt reduces the company's overall cost of capital.

[64] C. Mayer and I Alexander, 'Banks and Securities Markets: Corporate Financing in Germany and the UK' (1990) 4 *Journal of the Japanese and International Economies*, 450

[65] And not all companies eligible to have them do (above n 49).

[66] O Hübler and U Jirjahn, 'Works Councils and Collective Bargaining in Germany: the Impact of Productivity on Wages' (2003) 50 *Scottish Journal of Political Economy* 471.

necessarily have to be dealt with through works agreements concluded with the works councils, the works council focuses on those high-conflict issues, to the detriment of its ability to reach cooperative deals with the employer on the task side of the contract. This study is thus strong support for the Freeman and Lazear conclusion from their theoretical model that firm-level collective bargaining is likely to hinder the conclusion of cooperative deals.[67]

VII Can the German system be generalised?

The empirical evidence about the German system suggests, overall, that it is a system in which the employees' governance rights over the corporation facilitate long-term implicit contracts between employees and managers[68] and that the impact of the system on the production costs of German companies is not negative and may well be positive. Should other countries seek to emulate the German arrangements? Even if the empirical studies had come up with a more ringing endorsement of the German system, the question of transposition raises many difficult questions. Just because a particular set of arrangements may well be functional in Germany, it does not follow that it will be functional in another country with different background institutions. On the other hand, just to state the banality that an institution from country A may operate very differently in country B hardly provides great insight into the factors which might affect the transferability of the institution in question. The institution may not be functional in country B, but maybe it will. How can one assess which is the more likely outcome?[69]

It is sometimes suggested that there is a market answer to this question, which removes the need for developed institutional analysis. It has been pointed out, that it is rare (though not unknown) for employees to be allocated control rights in the corporation in the absence of mandatory law requiring this. If, it is said, control sharing were functional, we would see it more frequently. More to the point, shareholders would wish to assign employees a share of control rights in order to reduce the company's costs of production. However, a moment's thought shows that this argument is unconvincing. We have already noted that, although employee sharing may lower the company's costs of production, it also has a distributional effect which is adverse to shareholders. In other words, shareholders may be better off with a larger slice of a smaller pie than with a smaller share of a larger pie. If they judge that to be

[67] Above n 33 at

[68] This evidence may be thought to be stronger in relation to works councils than in relation to quasi-parity codetermination, but, given the interrelationships identified in section V, it would be unwise to conclude that works councils would have the same effects if quasi-parity representation at board level were reduced.

[69] See on comparative law as a tool of law reform the masterly piece by Otto Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 *Modern Law Review* 1.

the case, they will oppose moves on the part of the managers to introduce control sharing.[70] Consequently, mandatory law may be necessary to achieve the introduction of control sharing over shareholder opposition for the benefit of society as a whole.

In addition, it is far from clear that the steps necessary to introduce effective control sharing lie wholly within the powers of the company. To be sure, the company can alter its internal governance and propose the establishment of works councils to the employees, but it may be beyond its powers to shape the level of collective bargaining or the attitude of trade unions towards the introduction of works councils. The Freeman and Lazear model suggests that, left to themselves, management will want a works council with too little power and trade unions a works council with too much. Management beholden to shareholders will want to reduce the power of the council to a level below the optimum (because of its distributional impact), whilst the union will want to maximise its institutional power, even though an over-powerful works council may fail to promote cooperative deals.[71] Finally the 'varieties of capitalism' literature[72] suggests that there are complementarities not only between corporate governance arrangements in a company and its labour governance institutions, but also with other coordination mechanism in society at large in the case of 'coordinated market' economies, like Germany. Those larger societal institutions include employers' associations and the system of education and training a society has put in place. But these societal institutions will be outside the reach of individual companies. For all these reasons, an appropriately calibrated market solution is unlikely to emerge.

Although a legislature has the formal power to overcome sectional shareholder opposition and excessive union demands by introducing, and calibrating, mandatory control sharing, it too (and the government controlling the legislature) will need to have a convincing answer to the ex ante question, ie will the benefits of the reform exceed its costs? Government may worry about the distributional impact on shareholders, if shareholders are a politically powerful group,[73] but, even where government's sole concern is with efficiency, it will need to conclude that the efficiency gains of the new arrangements will be substantial before it expends political capital and scarce legislative time introducing them. The expected opposition may be high and expected benefits of the new system may be uncertain. Take, for example, a jurisdiction with existing institutions not unlike those in the UK. In such a jurisdiction, the intra-plant representation space has been occupied by adversarial collective bargaining; there is no history of work-place based works councils elected by the employees as a whole; and no significant history of worker representation on the board, even on a

[70] Shareholders are likely to be in a strong position to oppose such voluntary moves since they would inevitably require amendment to the articles of association which, in most countries, requires a shareholder resolution, normally on a supermajority basis.
[71] Above n 33 at 29.
[72] P Hall and D Soskice 'An Introduction to Varieties of Capitalism' in P Hall and D Soskice (eds), *Varieties of Capitalism* (OUP, 2001).
[73] Institutional shareholders; families

voluntary basis; and a history of generally adversarial union/employer relations. In such a case, the degree of institutional upheaval involved in moving to the German system may appear to be high and benefits of such a shift distinctly uncertain. How is collective bargaining not only to be moved to a multi-employer level but the unions induced to vacate a space in which they are already established in exchange for the new role of acting in conjunction with an employee-based works council?[74] How are shareholders to be convinced that parity representation on the board for employees will not entail a significant dilution of their control rights over the company without any corresponding efficiency gains? And so on.

Understanding the development of the German system will provide little help in answering these questions. What is now referred to as the German 'system' was not designed as a coherent whole. Its three constituent parts – board level representation, works councils and multi-employer collective bargaining – have come together over the years into their current configuration and, arguably, operate so as to reduce the costs of production of German companies. However, no-one started with a grand design which was the current configuration.[75] Only after a long and turbulent history did the current system emerge from its disparate elements. Defeat in two world wars, a period of totalitarian rule, and significant social discontent in the late 1960s have all contributed to the 'system' as we now see it. And there is no reason to think that today's configuration is necessarily the end-point of its development.[76] Whilst the current German system could conceivably be regarded as a good point to aim it, its history provides no clues as to how to get there from the starting points at which other countries are likely to be located.

On the other hand, it is easy to underestimate the possibilities of change in societies with a more stable history over the past century. Even though victorious in both world wars, the UK suffered the strains of war and post-war reconstruction and those strains induced significant change. However, that change tended to work with the grain of existing institutions and to ratify their centrality. After both world wars the position of collective bargaining as the

[74] In the UK even the policy of supplementing in-plant collective bargaining with works councils with information and consultation rights has proved daunting to implement and the results so far are far from encouraging for the proponents of such a move: Hall & Purcell.

[75] This is not to say that, when major reforms in the system were put in place at different times, the authors did not have grand visions of what they would achieve – simply that those grand visions were not what the current system appears to achieve. See, for example, Ruth Dukes' analysis of the ideas of Sinzheimer in relation to the reforms of the 1920s: R Dukes, 'Hugo Sinzheimer and the Constitutional Function of Labour Law' in G Davidov and B Langille (eds), *The Idea of Labour Law* (OUP, 2011).

[76] See W. Streek, "The study of organized interests: before 'The Century' and after" in C Crouch and W Streeck (eds) *The Diversity of Democracy* (Edward Elgar, 2006) Ch 1, stressing the contingent nature of German employers' commitment to corporatist institutions and the shift in role of the works councils in recent decades from 'market constraining' institutions to institutions which provide employers with a cooperative labour force. In addition, the power of the union may have lessened as against the works council. But he acknowledges the potential for German codetermination to provide an effective, high-value, competitive strategy in a globalised world). See also by the same author, *Re-forming Capitalism* (OUP, 2009), ch 6 ('Corporate Governance: the Decline of Germany Inc').

primary method of providing employee voice was reinforced.[77] When in the 1980s the governments of Mrs Thatcher sought to destroy the post-Second World War settlement, that occurred only after political support for it had been undermined by its association with high levels of industrial conflict, high inflation and low productivity. Even this significant policy shift took the form of undermining the dominance of collective bargaining in favour of individual 'bargaining' rather than the creation of alternative collective representation mechanisms.[78] Thus, it was easier for a major shift in perception about the value of collective bargaining to lead only to the legislative undermining of that institution rather than to the creation of a new, potentially more efficient, set of replacement institutions.

The above simply reinforces one of the simpler lessons to be drawn from 'path dependency theory'.[79] The chances of a reform taking place turn not on the expected benefits of the reform but on the balance between the expected benefits and expected costs. Even if the expected benefits of a proposed reform are the same in two countries A and B, the country with the lower expected costs of reform (A) is more likely to implement than the country with the higher expected costs (B). B may be expected to continue without the reform until the expected benefits exceed the expected costs, for example, as the existing system becomes increasingly dysfunctional for B. In the meantime, the competitive advantages of A over B will be strengthened. Even this puts the cost/benefit analysis in too simple a form and if countries do choose sometimes to take significant immediate losses for longer term gains (partly because the size of those losses may not be clear ex ante),[80] nevertheless it must be unlikely that a country will embark on wholesale introduction of new institutions whose successful operation depends on the adoption of behaviours and attitudes on the part of trade unions, workers and manager which are at odds with those generated in the system which is being replaced. The history of the war-time joint production committees, recounted at the beginning of this piece, and the more recent failure of workplace institutions mandated by EU law to take root in UK workplaces[81] are pieces of evidence which show the difficulties of comprehensive institutional change in industrial relations.

VIII Conclusion

This chapter has suggested that that labour lawyers should not hold back from engagement with law and economics scholarship. Although that scholarship, at least as applied to the corporation, has shown little interest in engaging with distributional questions, which might be thought to be at the heart of labour law, the efficiency argument is not one that labour

[77] Davies and Freedland, above n 13, ch 1.
[78] Ibid. ch 9.
[79] L Bebchuk and M Roe 'A Theory of Path Dependency in Corporate Ownership and Governance' (1999) 52 *Stanford Law Review* 126.
[80] See C. Crouch, *Capitalist Diversity and Change* (OUP, 2005), putting a powerful case for the role of 'institutional entrepreneurs' in producing radical change in societies.
[81] M Hall and J Purcell, *Consultation at Work* (OUP, 2012).

lawyers are bound to 'lose'. As efficiency considerations obtain more and more prominence in policy debate, labour lawyers need to be able to engage with these arguments. Quite apart from policy-making, there is something intellectually limiting about a refusal to analyse the implications for one's discipline of a major intellectual development, no matter how unpalatable it may seem at first sight. Even distributional arguments might be more persuasive if coupled with arguments from positive economics, designed to demonstrate the likely outcomes proposed reforms, which do not always coincide with the predictions of the reformers or those opposed to the reforms. That, however, is a debate for another day. What this chapter has sought to show is, first, that the law and economics analysis of the corporation does not exclude an efficiency argument in favour of governance rights for employees and, second, it has sought to take a first step towards identifying the conditions under which such efficiencies might be realised. As to the second point, it has been show that it is unlikely the market will cause employee governance to emerge where it would be efficient, but also that the efficiency of employee governance is highly sensitive to both the overall configuration of the mechanisms for employee voice in the company and, probably, to societal coordination mechanism existing outside the company. This makes it more than usually uncertain whether the transposition of a governance system from one jurisdiction to another will generate the efficiencies associated with that system in the jurisdiction in which it is embedded.[82]

[82] From an efficiency perspective it is therefore a matter of relief that the European Union failed in its attempts to impose an unsophisticated and uniform system of board level employee representation on companies through the draft Fifth Company Law Directive (now abandoned) or the European Company, where employee board level representation is a conditional and default rather than a mandatory rule, but equally that the 'board neutrality' rule in the Takeover Directive was made optional.

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