Employee Participation in Corporate Governance and Corporate Social Responsibility

Law Working Paper N° 322/2016
July 2016

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ECGI Working Paper Series in Law

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Abstract

The chapter investigates the impact of employee participation on the board of directors or supervisory board (particularly codetermination) on corporate social responsibility (CSR). Conceptually, it is important to distinguish between "internal" and "external" CSR. Internal CSR relates to practices of the firm regarding groups with which it is in a long-term contractual relationship such as employees. Employee participation systems serve to protect employees from shareholder opportunism and shift the balance in the distribution of corporate rents in favor of employees, which is why they clearly have an impact on internal CSR. The situation is much less clear for external CSR, which is concerned with effects of corporate activities that are externalities, for example pollution. I argue that there may sometimes be a tradeoff between internal and external CSR: If a firm is more profitable because it scores badly in terms of external CSR (e.g. because it habitually pollutes), employees may benefit similarly as shareholders. In fact, the interests of shareholders and employees may be largely aligned in this respect, with both either benefiting or being harmed concurrently.

Keywords: Codetermination, Corporate Social Responsibility, CSR, Corporate Governance, Volkswagen Emissions Scandal, Ownership Strucute, Varieties of Capitalism
JEL Classifications: K22, J50

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June 2016

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WORKING PAPER

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To be published in:

Handbook on the Economics of Social Responsibility: Individuals, Corporations and Institutions (Lorenzo Sacconi and Giacomo Degli Antoni eds.)

The chapter investigates the impact of employee participation on the board of directors or supervisory board (particularly codetermination) on corporate social responsibility (CSR). Conceptually, it is important to distinguish between "internal" and "external" CSR. Internal CSR relates to practices of the firm regarding groups with which it is in a long-term contractual relationship such as employees. Employee participation systems serve to protect employees from shareholder opportunism and shift the balance in the distribution of corporate rents in favor of employees, which is why they clearly have an impact on internal CSR. The situation is much less clear for external CSR, which is concerned with effects of corporate activities that are externalities, for example pollution. I argue that there may sometimes be a tradeoff between internal and external CSR: If a firm is more profitable because it scores badly in terms of external CSR (e.g. because it habitually pollutes), employees may benefit similarly as shareholders. In fact, the interests of shareholders and employees may be largely aligned in this respect, with both either benefiting or being harmed concurrently.

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1. Introduction

A large number of countries around Europe, mostly in the center and north, require some form of employee participation on the board of directors or supervisory board. The most prominent case is of course Germany, which has required half of the seats of the supervisory board of the largest firms to be taken by employees or union representatives in the largest corporations. Over the decades, employee participation systems have been a major point of controversy in European corporate governance and an obstacle to EU company law harmonization. While employee participation systems lost their allure in the “convergence in corporate governance” period of the 1990s and 2000s, the idea made a significant gain in 2013 when France introduced a requirement for the largest firms to have employee representatives on the board.

This chapter investigates the possible impact of employee participation systems on Corporate Social Responsibility (CSR), based on theory as well as anecdotal and empirical evidence.

There are a number of ways in which CSR can be understood, but based on the theory of the firm I suggest that we need to distinguish between "internal" and "external" CSR. Internal CSR relates to practices of the firm regarding groups with which it is in a long-term contractual relationship such as employees (sometimes called its stakeholders), whose specific investment in the relationship may generate an interest in the firm's long term profitability akin to that of shareholders. External CSR addresses externalities produced by the firm, such as effects on the environment or consumers.

Based on this distinction, this chapter seeks to make two points. First, scholars have sometimes suggested that informal CSR (typically associated with US corporate governance) and formal stakeholder representation (such as German codetermination) are often substitutes. This literature does not usually engage with debates about corporate ownership structures in international comparison and their implications for employees. In an ownership structure with powerful blockholders, mere informal labor-related CSR would likely not signal a sufficient level of commitment to workers to foster human capital development. Informal practices should rather be seen as an aspect of the balancing act of boards in a dispersed ownership firm. Formal representation of employees, by contrast, is a necessary counterweight to the power of large blockholders in concentrated ownership corporations.

Second, distinguishing between internal and external CSR highlights a possible tradeoff between the two. Employees, as the main example for beneficiaries of internal CSR, can at times benefit from a corporation *not* being a good corporate citizen regarding external CSR. For example, employees' jobs and career prospects may at times be enhanced if the corporation is profitable due to its disregard of the environment.

This chapter proceeds as follows. Section 2 defines what is meant by employee participation systems and codetermination, and briefly discusses its historical origins. Section 3 discusses what is meant by CSR and puts it into the context of the theory of the firm. It emphasizes that employees often have a long-term interest in the well-being of the corporation by virtue of their human capital investment, and discusses strategies used by different legal systems to deal with it. Section 4 studies the consequences of employee participation systems for CSR and I distinguish between internal and external CSR, highlighting the effects of codetermination on labor relations. I also use the Volkswagen emission scandal to illustrate the trade-off between internal and external CSR.

2. The prevalence and origin of employee participation systems

While corporate law scholarship often focuses on the German example, employee participation systems exist and are legally mandated in a number of European countries. Germany, which requires one-third of directors to be employee representatives in firms with a workforce between 500 and 2000, and half of directors above that threshold,[1] is only the most extreme example. Austria, Slovenia, Slovakia and Hungary have implemented a "one-third" participation rule on supervisory boards, whereas Luxembourg, Sweden, Denmark, Finland and Norway mandate employee representatives on single-tier boards (e.g. Raiser, 2006, p. 42; Gelter & Helleringer 2015, pp. 1077-1079). Since abandoning its even stronger structure regime in 2004, the Nether-

[1] § 1 MitbestG; § 1 Drittelbeteiligungsgesetz.

lands permit the nomination of one-third of directors by the works council, which are subsequently elected by shareholders (e.g. Groenewald 2005, p. 295; de Jong & Roëll, 2005, p. 473). France, that previously mandated employee representation only in firms with considerable employee share ownership, extended the requirement to firms with more than 5000 workers in France in June 2013.[2] Even the UK considered employee representation in the 1970s, but the proposal submitted in the "Bullock Report" (Department of Trade, 1977) was not supported by unions and ultimately failed (Marsh & Locksley 1983, at 50).

Historically, Germany pioneered labor participation in corporate governance. A law of the early Weimar Republic created works councils in 1920 and enabled inchoate labor representation in the supervisory board in 1922 (for a discussion of the debate during the late monarchy and the early republic, see McGaughey 2015, pp. 18-22). After the Nazis eliminated these mechanisms during the 1930s, employee participation was reintroduced in the Federal Republic after World War II with the toleration of the Western allies, who hoped partial employee control would make a repetition of industry's collaboration with the war effort impossible. In light of British skepticism, codetermination was introduced in collective bargaining agreements (McGaughey 2015, pp. 33-34). Legislative development that began with *Montanmitbestimmung* in the coal and steel industries in 1951, was subsequently expanded to all large firms, and culminated in 1976 with the introduction of quasi-parity codetermination in the largest German firms (Pistor 1999, pp. 165-175). Other European countries followed the German example with various modifications, and in

[2] Code de Commerce, art. L225–27–1.

the early 1990s the model spread eastwards beyond the former Iron Curtain into central European countries with close ties to Germany.

In terms of intellectual history, employee participation was linked to a number theoretical and practical ideas about corporations. First, one major historical idea was that codetermination would help overcome the workers' alienation from the fruit of their labor inherent in capitalism (Pistor 1999, p. 164). As early as the period following the 1848 revolutions, the idea rose that workers should not only participate in political, but also economic governance (McGaughey 2015, pp. 13-14).

Second, the idea of the *Unternehmen an sich* or business as such traceable to the writings of Walther Rathenau (1917) (actually a term coined by its opponents in the discussion of the Weimar Republic), was conducive to or at least tolerated employee participation. Rathenau was concerned about infighting between shareholders and volatile majorities that would make it impossible for corporations to fulfil their public or semi-public purpose (Gelter 2011, p. 683). Based on this, some theorists of the 1970s began to view the corporation exclusively as an association of contributors of capital, but as a self-contained entity operating within a certain social context (Gelter 2011, p. 697-698). Consequently, it was only logical that employees, who formed the core social of the corporation's real social entity, be represented on the board, thus hopefully exercising a mitigating effect on whatever profit-oriented decisions the majority shareholder would take.

Third, with workers being economically dependent on the firm, in part because of unfunded pension obligations, they were also financial contributors of sorts to the corporation, and thus in a similar position as shareholders (e.g. Tyrell & Schmidt 2001, p. 492 n.47, where the significance for assessment of codetermination by the German constitutional court is discussed).

Fourth, center-left views at times emphasized the "democratization" of all levels of society, which included the workplace. This can be seen most clearly in the English debate of the 1970s, which centered around the Labour-commissioned report on "Industrial Democracy." (Department of Trade, 1977).

3. CSR, the theory of the firm, and employees' specific human capital

3.1. Dimensions of CSR

A brief survey of the CSR literature reveals that the meaning of the term is surprisingly opaque. Generally, the literature appears to distinguish along two dimensions, considering the form of commitment on one hand, and the objective of commitment on the other.

As to the first dimension, a number of authors see CSR as some kind of voluntary commitment to some social goal, as opposed to pursuing this goal only because of legal or regulatory requirements (e.g. Davis 1973, p. 312; European Commission 2011, p. 3; Cherry 2014, p. 283; Bevivino 2014, p. 926). In other words, socially responsible corporations pursue public or eleemosynary goals voluntarily, possibly to the detriment of profits, without being forced to do so. Others authors include mandated social responsibility into the definition and focus on the content of the obligation or commitment (e.g. De Schutter 2008, p. 203-204; Sjåfjell 2012, pp. 118-119). Soft law, such as OECD Guidelines on CSR, are also said to play a role (e.g. Scheltema 2014, pp. 384-388, Afsharipour & Rana 2014, p. 185). It is of course possible to make CSR mandatory for corporations, although it is questionable to what extent a general requirement to spend a certain proportion of profits on CSR is enforceable.[3]

There are of course good reasons why firms may decide to be "socially responsible." Most of all, CSR may at times enhance the reputation of the firm, thus rendering it more profitable in the long run, e.g. because customers are more likely to purchase the products of a "social responsible" firm (Davis 1973, p. 313). Moreover, CSR may lower the risk of intrusive public regulation on certain issues, thus maintaining the firm's flexibility in making certain types of business decisions (Davis 1973, p. 314). For example, environmental regulation is not particularly likely if firms are not polluting. CSR disclosure requirements, such as the ones in s. 417(5)(b) of the UK Companies Act 2006 or the Amended EU Accounting Directive's provisions regarding "non-financial disclosures"[4] are intended to strengthen the incentives for voluntary disclosure because they raise the reputational stakes for firms (for more examples, see Williams 2015, pp. 14-16).

The second dimension in which there is no unanimity in the CSR concept is what issues are included. Most statements, including those from many academic authors, seem to ignore the theory of the firm and provide rather careless definitions such as the European Commission (2011, p. 3), according to which CSR is "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis." The term "stakeholders" is of course hard to define, and is sometimes criti-

[3] Besides a range of other requirements, Indian law requires that firms spend 2% of their profits on CSR (Afsharipour & Rana 2014, pp. 217-219).

[4] EU Accounting Directive 2013/34/EU, art. 19a and 29a, as amended by Directive 2014/95/EU.

cized as being hospitable to encompassing virtually everyone, including “terrorists and competitors, vegetation, nameless sea creatures, and generations yet unborn” (Sternberg 1997, p. 4).

3.2. Specific human capital and the theory of the firm

The theory of the firm has taught us that a corporation can be seen as a nexus of contracts, in which many of the firm’s stakeholders stand in a relationship with the firm that can be seen as a long-term contract, most obviously long-term lenders (e.g. Easterbrook & Fischel 1991, pp. 12-13). Shareholders provide equity and do not have a long-term contract, but as a group they cannot withdraw, thus exposing them to risk of loss of their investment (Williamson, 1985, pp. 304-305). Shareholders’ particularly vulnerable position is usually thought to be the reason why they have residual control rights.

Looking beyond shareholders, some employees may also be residual claimants of the firm. In certain industries or firms, it is beneficial if employees create specific human capital, a term referring to skills and training that ultimately translate into a better productive process and consequently benefits for whoever makes a profit from the firm. Becker (1964, pp. 11-36) famously distinguished between general human capital, industry-specific human capital, and firm-specific human capital, depending on the areas in which the respective skills can be used (see generally Hansmann, 1996, p. 26; Malcolmson 1999, p. 2311-2337; Fauver & Fuest 2006, p. 679). The firm-specific variety is of particular interest for corporate governance, as it invests workers in specific jobs, and consequently creates an economic interest in the corporation for them, provided that the acquisition of the skills is costly for the worker. This might be the case if the worker pays for the training, but more realistically, because she has to put up a higher effort in an early period of the employment relationship, or because she will have an opportunity to cost from not taking another job where this type of investment is not necessary.

While the standard example as to the type of skills would be training e.g. to use specific machinery that may enable workers to perform jobs more efficiently and to produce better quality products; particular idiosyncratic combinations of packages of skills may be more realistic (see Lazear, p. 342, who cites the example of work in a tax software company requiring knowledge of computer programming, economics, and tax law). Firm-specific skills may also be of an organizational nature, e.g. how to work in a particular group or environment (e.g. Ippolito 2004, p. 1254; Franck et al. 2011, pp. 377-381). Moreover, human capital may be effectively made firm-specific if it is costly for employees to switch to another employer. One instrument that may immobilize human capital are pension benefits. Unfunded or underfunded pension claims are or were historically often not transferable, and employees risked losing part of their claim by switching to another employer (Gelter 2013, pp. 939-940).

Firm-specific skills are present if the entire package of skills cannot be transferred to another job without losses. If the cost of creating such skills is borne by the corporation, it may be exposed to holdup by employees, who might threaten to leave in order to secure higher wages or other benefits. If, however, the acquisition of these skills is costly to employees, they may be "held up" by the employer, who might attempt in an ex-post renegotiation to extract the return employees may be expecting from their investment (e.g. Eger 2004, p. 384). Rational employees will only make a costly firm-specific investment in human capital if they expect a return on it, such as expectations of wage growth, benefits and career opportunities (e.g. Shleifer & Summers 1988, p. 37; Charny 1996, p. 1613). If these advantages can be taken away by the employer by hold-up and ex-post renegotiation (e.g. to extract higher profits for shareholders), employees will not make a specific human capital investment ex-ante, which may reduce the overall amount of rents produced by the firm for both employees and shareholders.

3.3. Corporate governance and the protection of specific human capital

An extensive literature – which does not normally overlap with writing about CSR – addresses the question of how the interests of employees are protected. Without any security to receive a compensation ex-post, employees would be strongly incentivized against making a specific investment in human capital ex-ante, as it would expose them to holdup. In order to address the holdup problem, Hart and Moore (1990, p. 1149) suggest that the party whose specific assets are crucial for the creation of a surplus should have control rights. Conceivably, this could be an explanation for residual control by shareholders, whose capital contribution is also specific. Rajan and Zingales (1998, pp. 422-423), in their theory of access to the corporation's assets, propose that the underinvestment problem connected to specific assets could be resolved by assigning control to a neutral third party whose investment is of little importance. While the aforementioned economists imagined that shareholders would be this "mediating hierarch", legal scholars Blair and Stout (1997, 2006) suggest that the party is in fact the board of directors, who are in the position to balance the interests of shareholders and employees (and potentially other groups). Thus, they assert that the board's task is not to maximize shareholder wealth, but aggregate welfare. The premise of this model to work as a description of actual corporate governance, however, is the classic Berle-Means corporation, shareholders suffer from strong collection action problems and their residual powers over management are de facto very attenuated.

With less retail and more institutional share ownership over the past decades, and activist investors increasingly taking a stronger role in US corporate governance, the US may be entering a new "shareholder-centric reality" (Rock 2013), where the "shareholder disempowerment" model applies less than it likely did in the past. In Continental Europe, this model clearly never applied, at least not directly, given the general presence of large shareholders with considerable influence on management. While Continental European laws may on one level appear shareholder-friendly, as they tend to enhance the control rights of large shareholders, they are obviously not shareholder-friendly when we consider the role of labor (Strine 2015). Taking the role of labor into account, we might identify two different strategies of dealing with the holdup problem: While in the US, shareholders are (or were) disempowered, European systems have balanced strong shareholder power with equally strong labor power. These powers not only include codetermination and other employee-participation systems, but also other laws that strengthen the bargaining powers of unions, including works councils and laws that make firing workers or changing workplace conditions more costly (Gelter 2009, pp. 168-173). Besides various other factors, stronger employment and labor laws and enhanced union bargaining powers likely detracted from producing more shareholder value at the expense of employees. Other factors that could have played a role would include non-pecuniary cost on controlling shareholders for harming employees, given the particular social and political context in their respective jurisdictions (for a model of a taxonomy see Ecchia et al. 2012). The protection of employees against holdup may be provided by or backed up with implicit contracts, the breach of which could result in a disappointment of legitimate expectations in the form of ex-post expropriation for the benefit of shareholders (Shleifer & Summers, 1987).

Regardless of whether one considers asset specificity of human capital to be realistic and normatively important, it is likely that some component of the employment agreement is backed up by expectations based on unenforceable promises or merely implicit contacts. For example, given an appreciable individual effort, employees typically can expect higher income or better opportunities for advancement or higher wages in parts of the world where firms do well. Consequently, in reality employees, and not only shareholders, are often also residual claimants of the firm.

Sacconi (2013, p. 303) asserts that the “mediating hierarchy” theory of corporate governance is more receptive to CSR than a pure agency theory view. By contrast, Cespa and Cestone (2007) as well as Surroca and Tribó (2008) have interpreted voluntary CSR as mechanism for unaccountable managers to entrench themselves and extract rents from the firm, which the shareholders sometimes support so as to restrict managerial discretion. Of particular interest for the discussion here is Jackson and Apostolakou’s (2010) finding that explicit CSR policies and activities are negatively correlated with formal stakeholder involvement; in other words, firms in “liberal market economies” make up for the lack of formal stakeholder protections of “coordinated market economies” by implementing CSR policies (including, but not exclusively policies relating to employees). Similarly, Matten and Moon (2008) suggest that American firms – in contrast with European firms – need to make CSR policies explicit because they are not subject to comparable regulatory restraints e.g. in employment law. Preuss’ (2008) qualitative analysis presents CSR as an American development toward which Continental European unions were at first skeptical. While these papers do not discuss or control for ownership structure, all of this is consistent with the above analysis of different strategies of how the shareholder-employee conflict of interest is dealt with in different corporate governance systems, i.e., in a system with relatively disempowered shareholders as the American one, CSR might be an aspect of balancing by the board, whereas in Continental European systems, a balance between shareholders and employees is achieved through formal influence.

3.4. Employee interests, internal and external CSR

Returning to the definition of CSR, one might ask whether the treatment of the firm's employees should also be considered an aspect of the concept. Sacconi, who defines CSR as a model of corporate governance where those running firms owe duties to all the firm's stakeholders (Sacconi 2013, p. 307), provides a helpful distinction between "stakeholders in the strict sense" and "stakeholders in the broad sense." Stakeholders in the strict (or narrow) sense are those who make specific investments in the firm and are therefore affected by a lock-in effect, while stakeholders in the wider sense would be those who are hit with an external effect produced by the firm (Sacconi 2013, p. 308). Arguably, workers could be in both groups, as some of them clearly have no appreciable human capital, e.g. workers hired for low-skill tasks on short-term basis, while others might have considerable amounts, e.g. in the form of specialized skills or non-transferable pension wealth. A typical "stakeholder in the broad sense" might be an individual enjoying an environment potentially affected by pollution generated by the firm.

This bifurcation suggested could be used as the basis for a distinction between types of CSR that involve two separate analytical issues. First, *internal CSR* refers to the firm's interaction with "stakeholders" that are not purely external to the firm, but in a long-term relationship possibly characterized by asset specificity, such as some types of employees. Second, *external CSR* should be understood as referring to the firm's conduct in respect of its stakeholders in the wider sense and other social and public interests. The question in this case is how voluntary commitment and regulatory requirements interact to internalize these externalities. The distinction is analytically important because of the effects of CSR on employees might differ. A firm might perform very different on both dimensions. The following section will consider both internal and external CSR as defined in the previous section.

4. Employee participation and CSR

4.1. Internal CSR

4.1.1. Employee relations as internal CSR

As discussed in section 2, the purpose of employee participation certainly has a link to some form of social responsibility, although maybe not narrowly conceived. Historical justifications addressed the firm's relationship with its workers, but emphasized various aspects of that relationship, namely their political and economic situation and a larger concern about governance within and outside the firm.

From the perspective of corporate governance theory focusing on the agency cost paradigm in the shareholder-manager relationship, employee participation is mainly another rent-seeking device for workers and unions that detract from shareholder wealth. If employees are sufficiently protected by contract, increasing managers' discretion to take employee interests into account only increases agency cost (for a critique see e.g. Stout 2005, p. 1445). Hostile takeovers provide a good example, since they are typically opposed by managers and employees but favored by outside shareholders (e.g. Orts 1992, p. 24-25).

There are, however, a number of theories explaining why employee participation systems may be socially beneficial. On the micro level, firms may benefit. A first possibility could be enhanced information flow from the shop floor to the board (Hertig 2005). However, it has also often been argued that employee directors inhibit information flow to the board from management because the latter is eager to keep unions in the dark (Fitzroy & Kraft 2005, p. 236). The second possibility (already discussed in section 2) is for firms to benefit if workers are shielded from shareholder rent-seeking or short-term shocks. Employees may be more willing to specialize their human capital if they are protected from losing the quasi-rents on their investment by employee directors and other legal mechanisms that restrain shareholder power. Some evidence suggests that in particular industries employee participation systems enhance productivity (Fitzroy & Kraft 2005), which may be linked to the employees' specialized human capital. More recently, the German labor market may have weathered the financial crisis with better than those of than some other countries (e.g. Rinne & Zimmermann 2012) because firms were not as easily able to lay off workers after an exogenously driven demand shock.

4.1.2. Explaining codetermination

An alternative interpretation of employee participation systems is the lens of political economy. An influential theory in the legal literature by Mark Roe suggests that codetermination is an aspect of a broader political current of social democracy that took different forms in various jurisdictions after World War II in reaction to the destruction of assets brought upon Europe by wars and the Depression in the first half of the 20th century (Roe 2006). In this view, social democratic policies, including codetermination, are essentially an exogenous influence on corporate governance. Rendering pro-shareholder mechanisms aimed at reducing agency costs ineffective, e.g. by putting employee representatives on the board, it induced European blockholders to stay in control and hindered capital market development (Roe 2000, 2003). In order become productive, societies thus had to strike a political bargain securing labor peace that ultimately undermined the development of dispersed ownership structures and liberal market institutions centering, with the board of directors unable to bring agency cost under control.

Similarly, political scientists have proposed explanations for codetermination. Gourevitch and Shinn (2005) suggest that corporate governance outcome are the result of political struggles between three interest groups that might form various coalitions, namely managers, owners and workers. In this view, codetermination is part of a corporatist bargain between (concentrated) owners on the one side, and labor on the other, with managers remaining weak (Gourevitch & Shinn 2005, pp. 157-160). Cioffi (2005, p. 19) describes it as a "…'microcorporatist' institution to facilitate negotiation between the conflicting interests of management, finance and labor" (see also McGaughey 2015, p. 42: "social consensus"). While Cioffi (2005, pp. 74-75, 238-239) suggests that codetermination has had few actual affects (in contrast to works councils), he suggests that it has not come on the bargaining table when the center-left sought to accommodate investor interests. On the macro level, employee participation systems may help to explain why some economies tend to experience more peaceful labor relations than others. Davies (2015, p. 22) points out the interaction between board-level codetermination, shop-floor works councils, and national collective bargaining. Arguably, the fact that macroeconomic distributive decisions are left to sectoral bargaining on the national level, it leaves it to the works councils and codetermined boards to resolve firm-level issues in a conciliatory manner. Codetermination thus forms an element of industrial relations characterized by cooperation rather than hostility, which may also be linked to macroeconomic and productivity gains.

Chronologically, it seems unequivocal that in Continental Europe concentrated ownership came first and pro-labor policies developed only later (Gelter 2009, pp. 181-184). The explanation of codetermination as a reaction to shareholder power can also be interpreted within an economic theory framework. If shareholders both have an influence on the firm and could potentially have the incentive to behave opportunistically toward employees, employees will be reluctant to invest in a long-term relationship with the firm, particularly in human capital. Because of the adverse selection problem, a corporate governance system "as a whole" may therefore have to switch to pro-employee rules, without giving firms the option to opt-out (Gelter, 2009, pp. 168-176). Similarly, Belloc and Pagano (2009, p. 108) suggest a link between a more egalitarian society in the US early on, whereas class divisions persisted in Continental Europe when large firms were formed after industrialization. "Social democratic" corporate governance policies, including codetermination, should thus be seen as a reaction to the power of (certain) shareholders. Chronologically, this explanation matches history better than some political accounts, given that corporate governance systems generally started out with concentrated ownership – which put shareholders in the position just described. In line with Pagano's aforementioned explanation of "aristocratic" families, this means that concentrated ownership came first, and labor power later.

Representatives of the varieties of capitalism literature throw another variable into the mix, namely, the degree of human capital investment. Some economic systems rely on highly skilled trained workers, which require a higher level of human capital investment, whereas in other jurisdictions, workers will be less often required to apply high skills, but discretion will be more often removed from them in a highly planned production process. Consequently, only high-skill capitalist systems require a high level of coordination, for which employee participation systems may be a precondition (e.g. Estevez-Abe et al. 2001; Carney 2010, p. 127).

Regardless of whether we think that the degree of significance of firm-specific human capital differs between corporate governance systems, in summary it is important to emphasize that labor relationships, as an element of internal CSR, cannot be analyzed without taking different ownership structures into account. As previously mentioned, some of the CSR literature suggests that formal CSR (such as codetermination) replaces and crowds out the voluntary CSR policies, which is why they are more common in the US than in Continental Europe. Analyzed in light of the typical structures of ownership and control, voluntary internal CSR policies in the US appear to be an aspect of the balancing act of a board not strongly linked to any particular shareholders, which generates some flexibility in giving certain benefits to labor. US corporate governance is (or has historically been) characterized by both weak shareholders *and* weak labor (putting it in box A in the taxonomy in Table 1), whereas German corporate governance has been characterized by strong shareholders *and* strong labor (putting it in box D) (Gelter 2009, pp 177-181).

A	weak shareholders weak labor	**B**	strong shareholders weak labor
C	weak shareholders strong labor	**D**	strong shareholders strong labor

Table 1: Balancing shareholder influence and labor power

Strengthening formal labor involvement in the US would most likely favor labor too much by reducing the flexibility of management e.g. to reduce the workforce in times of low demand.

In Germany (or Continental Europe), weakening labor would expose workers to idiosyncratic decisions by strong blockholders and possibly impede human capital development. Mere informal CSR would thus most likely be inadequate because it does not provide the level of commitment enshrined in formal legislation.

4.2. External CSR

4.2.1. Ownership structure and external CSR

Moving beyond the relationship between the firm and labor, we now look at external CSR, defined as the relationship with groups not characterized by a long-term relationship and specific investment (section 3.4). External CSR thus refers to impact of the firm's decisions outside of the nexus of contracts of the firm, i.e. the impact of firm conduct on third parties through purely externalities. Larger public purposes can also been seen as an aspect of this, and it can be found even in Rathenau's World-War-I era booklet *Vom Aktienwesen*, whose author was concerned that managers too beholding to the whims of the shareholder interest would neglect public purposes, including national defense (Rathenau 1917, p. 60). Almost the opposite public political purpose can be seen in the rediscovery of codetermination in West Germany after World War II, where one goal was to position labor as a counterweight to private capital that had put heavy industry in service of national armed mobilization (Pistor 1999, p. 167). Conceivably, codetermination's effect could go in either direction. Neither of these two possibilities was ever put to a practical test, and neither appears particularly relevant today, as opposed to e.g. environmental issues or corporate conduct vis-à-vis third parties such as consumers.

The impact of codetermination on external CSR raises a number of interesting and new questions, but requires a deeper analysis of what external CSR preferences shareholders are likely to have before we add employee directors into the mix. Without employee powers, the firm's conduct relating to external CSR would seem to depend on the pressures influencing the firm's corporate governance in general. In a concentrated ownership structure, the social responsibility of a firm would likely depend on the individual shareholders in question. If a firm is controlled by a particularly socially responsible family, for example, it might forego extra profit-making opportunities in order to behave in a socially responsible way. If the controlling shareholder is the caricature of a stereotypically greedy hedge fund, the firm might not act on a socially responsible way at all. These are, however, arbitrarily chosen examples in the absence of a general rule. The level of external CSR chosen by corporations will depend on the preferences of the controlling shareholder, and the various market forces and social pressures to which it is subject. A controlling family might prefer a reputation for philanthropy, a government entity might focus on political goals, and a financial investment might favor profits. In fact, in Ferrell et al.'s (2014) empirical study the effect of the level of ownership concentration on CSR is non-monotonic, indicating that various effects are in play in choosing the level of CSR.

In a firm with dispersed ownership, by contrast, the management and board of the firm seem crucial for whether a firm is socially responsible. Taking the traditional Berle-Means firm in the US, corporate policies are essentially set by the board, which historically tended to be dominated by a self-perpetuating and self-replacing managerial elite. With a board of directors that was not historically under a lot of pressure to produce results for shareholders, to the extent that it was good enough to keep the corporation in business, it could decide to pursue a socially responsible course of action or not. Arguably, with certain types of shareholders increasingly being able to exercise direct influence on management in the US, managerial capitalism in the US seems to be gradually giving way to shareholder capitalism. Consequently, managers would seem to have less discretion to decide about overall goals of the firm distracting from the profit-making enterprise, thus leaving less space for CSR activities if they were not in a colorable way connected to profits for shareholders. By contrast, if there is a strong business case for CSR, particularly for reputational reasons, even third-party financial investors would be interested in the firm conducting itself responsibly. Arguably, British firms tend to be more oriented towards CSR than American firms because of the strong influence of institutional investors, who have both financial and reputational reasons to support CSR (Aguilera et al. 2006, p. 154). Generally, pension funds with a long-term investment strategy have been found to be associated with higher levels of CSR (Williams 2015, p. 30).

However, this is not true if there is a short-termism effect, and long-term reputational gains are outweighed by short-term profit. In the end, whether managers will choose the optimal level of CSR on their own accord, whether they will do so only if properly incentivized to do so by shareholder-oriented mechanisms such as executive compensation, or whether shareholder pressure will result in a suboptimal level of CSR will depend on the relative merits of shareholder and manager control in corporate governance, which is a perennial debate in the US. While the debate about whether the new American ownership structure is conducive to corporate short-termism is far from settled, it is sometimes thought that the traditional autonomy of the board would enable it to “slow down” short-term pressures and consider the impact on other constituencies (i.e., including the best interest of all stakeholders) (e.g. Thompson 2015, p. 446). If short-termism is indeed a problem, directors facing short-term pressures from shareholders might choose an amount of CSR below the optimal point, e.g. by choosing short-term profits at the expense of consumers and sacrificing long-term reputational concerns that may theoretically be in the interest of shareholders (Williams 2015, p. 23).

Social norms and pressures are also likely to play a role. Elhauge (2005, pp. 796-805) suggests that social and moral sanctions (which operate on a large shareholder or sole entrepreneur) generally do not operate on dispersed, financially oriented shareholders given their status as an amorphous, anonymous mass of individual investors and intermediaries. The disempowerment of shareholders in the US in turn allows these social norms to influence managerial conduct, thus inducing firms to behave in a socially responsible way more or less in line with the preferences of society as a whole. In this view, binding boards and managers too strictly to shareholder wealth maximization would eviscerate socially desirable corporate behavior.[5]

4.2.2. Employee representatives and external CSR

Whatever the external CSR conduct of shareholders and managers, whether employee representatives on the board influence external CSR one way or the other is even less clear. Conceivably, if shareholders put pressure on firms to ruthlessly produce financial gains for shareholders, firms might begin to exploit the environment or consumers for financial gain, employee representatives could provide a counterweight. One could speculate that their preferences might be more in line with the general social norms of society than directors representing certain profit-oriented investors, and thus provide a buffer against executive compensation that is widely per-

[5] Note that the most recent empirical study on CSR in the US actually suggests that firms with fewer agency problems spend more on CSR, indicating that CSR is in fact in the interest of shareholders (Ferrell et al. 2014).

ceived as excessive, or against profit-maximizing corporate policies benefiting financial investors to the detriment of the environment or consumers.

Employee representation on the board tilts decision-making of the board somewhat toward worker interests, but it is not clear at all that worker interests should align with external CSR goals. As previously discussed in section 3.3, shareholder may sometimes share residual claims on the firm’s rents with workers: if the firm is more successful, employees are likely to get more income, from bonuses or otherwise, and tend to have better career prospects. Even more so, if the company has an employee stock ownership plan in place, or if workers are essentially creditors of the firm because of underfunded pension obligations of the firm, in each case employees stand to gain from the financial well-being of the corporation.

Consequently, the interests of shareholders and employees may in fact be largely aligned concerning external CSR. For example, if the firm is enable to produce at a lower cost by polluting more, both shareholders and workers will benefit. If the firm takes a reputational hit for being sufficiently socially responsible, again both shareholders and workers are harmed. Thus, overall there is no reason to believe that employee representation as such will make corporations behave more – or less – in a socially responsible way.[6]

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[6] One could also speculate that union-appointed directors will on average have different objectives than labor representatives who are actually employees of the firm. The former might be more interested in larger political CSR goals, while the latter might be more focused on securing opportunities for workers (possibly at the expense of external CSR).

4.2.3. The Volkswagen emissions scandal as a recent example

The recent Volkswagen (VW) emissions scandal provides a timely illustration. Since late 2015, evidence has come to light that VW has systematically used a so-called “defeat device” to deceive regulators around the world, particularly the American EPA, about the level of pollutant emissions produced by a number of their models (e.g. Elson et al. 2015, p. 36). The scandal, once it emerged, was very expensive for VW. The firm had to recall millions of automobiles and was exposed both to regulatory action and lawsuits by consumers and investors in various jurisdictions, thus exposing it to a cost ranging in the billions of dollars as the scandal progresses. At this point in time, it is not entirely clear how many people knew about the – technologically highly sophisticated – defeat devices, particularly not if members of top management or the supervisory board were informed, which might expose them to criminal charges. However, it appears that a relatively large number of employees must have been aware of the scheme, which was eventually exposed because an outside research team tried to understand VW’s emissions figures. Only two months into the scandal, a whistleblower forced VW to admit broader wrongdoing (e.g. Nelson 2016, p. 11). The board appears not to have been aware of the scheme, and top executives have been called “willingly blind” (Nelson 2016, p. 14).

VW is notable for the structure of its supervisory board. Being subject to German codetermination, half of its board members are union and employee representatives. Historically, the firm was under government control, and when it was privatized a special “Volkswagen Act” was put into place that gave the federal government and the state government of Lower Saxony, as long as they held any shares, the right to appoint to board members each on the shareholder bench. Moreover, the law implemented a voting cap of 20% for shareholders and subjected important decisions to an 80% approval requirement for large shareholders, effectively giving the government a veto. The purpose of the law was to protect the firm's employees from a large new shareholder (Ringe 2010, p. 385). This law was found to be in violation of the EU free movement of capital by the ECJ in 2007.[7] Following the decision and the subsequent amendment of the law, VW amended its articles of incorporation to retain the appointment rights of the state of Lower Saxony (Ringe 2010, p. 407). Consequently, today the "shareholder bench" of the firm's supervisory board comprises two political officials next to representatives of the major shareholder groups (including two wealthy families closely associated with the company, and the Emirate of Qatar), and hardly any directors that can be realistically called independent (e.g. Elson et al. 2015, p. 41). In fact, with ten labor representatives and two members of the (at the time of writing) left-wing state government on the supervisory board, one could argue that labor and groups close to it currently have a majority.

Looking at VW's governance structure, it clearly has excellent internal CSR as far as employees are concerned (e.g. Elson et al. 2015, p. 42 ["Piëch …it was misleading regulators, was long an ideal company leader from labor's perspective"]). The firm has shop-floor employee participation on all levels, and has learned to deal with it so well that it has implemented it in most foreign establishments as well. As recently as 2014, VW was in the news in the US when there was a debate about whether the plant in Tennessee should officially recognize a union in order to create a local works council (e.g. Greenhouse 2014). While US labor law required workers to

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[7] Case C-112/05 Commission v. Germany [2007] E.C.R. I-8995.

vote whether to establish a union, it was widely understood that management would have welcomed it, given how it interacted with works council system throughout its establishments around the world (for a discussion of the legal context, see e.g. Drutchas 2015, pp. 34-39).

VW's apparently excellent internal CSR was not linked to good external CSR. VW did inflicted serious harm on its customers and the environment, even though it had a more stakeholder-oriented board than any other company. In fact, a number of observers have blamed codetermination and the strong role of labor as a contributing factor (e.g. Elson et al. 2015; Stewart 2015). At present, we do not know of the involvement of any significant shareholder or top managers, while a significant number of employees must have known.

The point is not, however, that codetermination undermines effective oversight by the board, as American observers of corporate governance have argued for decades. It is rather that workers, just like shareholders, benefit when the company does well, and are harmed when the company does not do well. Consequently, as long as VW was doing very well as a result of the emission cheating, its employees probably benefited from the wrongdoing just as much (or even more so) than shareholders did, resulting in high income, professional success and more secure jobs. VW mentioned to strengthen its position in the market and even increase its market share relative to its competitors. Of course, after the scandal was uncovered, VW shareholders were harmed. Arguably, VW employees will likely suffer as well, for reasons inverse to the benefits they received from VW's improved market position before the discovery of the defeat device. The reputational or long-term reasons that are considered a "good business case" for CSR have similar effects on shareholders and employees. Thus, whether a firm is a good "corporate citizen" does not depend so much on whether board members are elected by shareholders or employees, but rather on the effectiveness of legal compliance systems.

5. Summary and conclusion

We have seen that it is important to look at CSR from the perspective of the theory of the firm, and to distinguish carefully between the firm's different "stakeholder" groups. The reasons for and against CSR, and the consequences for various groups will at times conflict. It is particularly important to distinguish between internal and external CSR, where the former concerns stakeholders with long-term relationship with the firm, and the latter concerns externalities produced by the firm. As the VW scandal shows, the two goals may at times conflict. Employees, an important example of an internal stakeholder group can potentially benefit from violations of "good CSR" regarding externalities, such as the emission problems created by VW in the course of the scandal. It appears that the literature so far has not considered this important distinction to the full extent. As always, more research is needed.

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