

# *Economics of Labor Co-Determination in View of Corporate Governance*

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## **A. Introduction**

The question of co-determination for employees can be regarded under purely economic efficiency aspects as an element of corporate governance. However, co-determination can also be examined under socio-political-economic aspects. The opinion may be held that in its essentials, co-determination is concerned with ethical questions such as social justice and human dignity at work, or, put more generally, with industrial civil rights or industrial democracy. This latter point of view has dominated previous research into co-determination, particularly in Europe and especially in Germany. This is reflected in the relevant empirical studies. These focus in the main on the distribution of power and influence in a company or its committees and not so much on economic efficiency. Only in the last twenty years have analyses of the economic efficiency of co-determination come more to the foreground, and most of them have been purely theoretical. We will focus on these analyses, which stem mainly from the English-speaking world, in Part B of this article. In Part C we

will be examining the empirical studies of the economic effects of co-determination (by supervisory boards). In Part D, co-determination and its future in a European context will be examined and discussed, because national leeway will be reduced in the course of the further Europeanizing of the law. Finally, in Part E, an attempt will be made to explain the heterogeneity of attitudes to co-determination, and also the reversal of the originally planned convergence of co-determination concepts within the European Community.

## **B. Economic Theory and Co-Determination**

In the more recent economic discussions on co-determination, work from neo-institutional economics dominates. In addition, studies from the labor market theory and from the organization theory and business strategy can also be used fruitfully in the discussion on co-determination.

### **I. Co-Determination in the Light of Neo-Institutional Economics**

#### **1. Property Rights and Co-Determination**

Alchian/Demsetz (1972) reconstructed the company and its corporate governance as a system of constantly dissolvable individual contracts (contractual model of the firm).

The reason for these contracts lies in the advantages of team production—in other words specialization—and the resulting synergy effects. The problem here is determining the marginal product and thus the rewards for individual team members, which support the tendency to shirk in the team. Insofar it is necessary to have working behavior monitored by a specialist. To make sure that this person does not shirk as well, he is rewarded with the residual income. Along with the right to appropriate this income, the holder of the controlling position must also have the unqualified right to terminate employment and to amend and conclude contracts in order for him to be able to carry out his coordination function in the team efficiently. This central agent is referred to as the "firm's owner and the employer". Specifying and concentrating property rights in the hands of the owner is also deemed to be allocation-efficient. The classical capitalist firm is therefore always the reference case for the analysis of corporate governance.

Compared with this ideal case, co-determination leads to the attenuation of property rights, because the right of co-ordination is divided between the

shareholders and representatives of the workforce. This type of redistribution of property rights must not necessarily lead to inefficiency of allocation. However, the introduction of statutory co-determination speaks for this inefficiency. The argument runs that if it was in the mutual interests of the owners of capital and the workers, it would take place voluntarily, or would have long since taken place. In other words, according to the property rights theory, voluntarily granted rights of co-determination lead to the presumption of efficiency; in the case of statutory rules (compulsion), the opposite may be assumed (for a criticism of this, cf. Section B.II. below).

However, this position has experienced a differentiation through the contrast between firm-specific and non-specific resources and services (Alchian 1984). The owners of specific resources do not tend to shirk because their input depends on use in a defined firm and the success of this firm. For this reason there is not only no cause for these team members to shirk, but they must especially also have an original interest in the firm's success. The management is therefore made up of those who own the firm-specific means of production.

The consequence of this construction is co-determination for employees in the corporate board, unless the attitude is taken that the knowledge, skills, and capabilities of employees are generally non-firm-specific. Here, Alchian is strangely contradictory, because on the one hand he lists some examples of firm-specific employee investments, but on the other hand describes co-determination as a "wealth confiscation scheme" (Gerum 1988: 26).

The firm-specific character of human resources also leads Furubotn/Wiggins (1984) under specific conditions to plead in favor of co-determination for employees. Their argument states that where human resources take on a firm-specific character during a contract of employment, this opens up to the employer—given the familiar lesser degree of specification with long-term contracts of employment—the opportunity of post-contractual opportunism, in that he appropriates wholly or partly the quasi rents of specialized human capital investments. The probability of the employer's loss of reputation is assessed as being slight, because of the familiar asymmetry of information. This growth in risk on the employee side requires protection and therefore justifies co-determination. However, the specific human capital investments have to be financed wholly or partly by the employees themselves. In spite of this, co-determination is still appropriate even where, with employer financing, these investments would lead to an increase in risks on the employee side.

However, this reason for co-determination is questioned (Michaelis/Picot 1987: 112). The argument runs that risk for firm-specific capital assets and

human resources is not really equal. In fact, there would often be analogous employment opportunities for employee skills with the competition. In addition, the problem of the specific nature of human capital is less significant the simpler and less problematic the processes of imitation in an economy are. It is exactly with administrators and managers that general skills are of considerable significance, and on the whole this is why competition policy is of central importance for this set of problems. However, in relation to capital assets, the question must be asked whether and to what extent "specialized assets" would be formed in companies in the same sector given the appropriate imitation processes (Gerum 1989: 51). In other words, the risk position of capital assets and human capital does not seem to be so dissimilar that it can be used to reject co-determination (in general). Independently of this, a statutory protection of employee investments continues not to appear logical to the property rights theory, because this means that insufficient differentiation between firm-specific and non-firm-specific human resources can be made on an individual company basis.

## 2. Co-Determination as a Reduction in Transaction Costs?

According to Coase (1937) and Williamson (1975), the organization of economic activities depends primarily on the transaction costs involved. Under competitive conditions, the institutional arrangement with the lowest transaction costs will prevail, or rather has to be the objective for shaping the organization. Whether and to what extent transaction costs are generated depends basically on the opportunistic behavior of individuals, the intensity of the competition, the complexity and uncertainty of the decision situation, and the limited information-processing capacity of the individuals involved.

Prima facie, statutory co-determination is inefficient for the transaction costs theory as well, because it restricts freedom of contract and therefore obstructs the search for the most favorable organization form regarding costs in each respective case. In addition, distribution of disposal rights to employees is dysfunctional because there is a wide gap between the planning horizon and the willingness of shareholders and employees to take risk in investment and financing decisions (von Weizsäcker 1984: 146 et seq.). There is a danger that for opportunistic considerations, employees will aim for a short-term utility maximization. This leads to sub-optimum results, because the required long-term-oriented allocation decisions by the risk capital owners are obstructed or even prevented. In addition, the costs of coordination would increase, not only in

the decision-making phase, but also in the implementation phase under co-determination conditions.

Cost advantages of statutory internalization of employee interests in operating and entrepreneurial decision-making processes, however, are put forward as arguments against the inefficiency of co-determination based on the economics of transaction costs (Brinkmann/Kübler 1981: 685 et seq.). These advantages are in the range of current transaction costs and, in particular, in the establishment of the co-determination institutions themselves. Compared with solutions based on collective agreement or even with the arrangement of individual regulations, statutory co-determination saves negotiations running and repeating at very different levels. These negotiations are very cost-intensive because they are not just a matter of the recognition of co-determination rights, but are at the same time concerned with their use in individual cases. It is also said that in these negotiations, the participants tend to produce conflicts in other negotiation fields for "strategic reasons". These behavioral patterns in fact endanger the productivity of economic systems with a high division of labor, which are very susceptible to sectional disturbances. The usefulness of statutorily controlled co-determination can therefore be explained with the logic of the transaction costs approach.

These divergent assessments of co-determination are based as well on the deficient operationalizing of and lack of a closer definition for the transaction costs. Insofar, a broad scope of discretion opens up for the arguments both *ex ante* and *ex post* where there is a comparison of the efficiency of capitalist corporate governance and with co-determination.<sup>1</sup>

### 3. Co-Determination as a Principal-Agent Problem

The agency theory links up with the principal-agent relationships created in the contractual model for the firm. It analyzes the problems of incentives and controls based on the asymmetrical distribution of information in the principal-agent relationship. The most efficient institutional arrangement is the one with the lowest agency costs. Jensen/Meckling (1976) differentiate here between (1)

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<sup>1</sup> A further, more fundamental problem is included in the paradigm of the transaction cost approach: "Corporate governance follows costs." The opposite is correct: the paradigm has to be turned around. What are supposed to be costs and benefits of economic action are the result of a decision about corporate governance. Corporate governance determines the objective function of the firm and therewith the relevant cost and benefit categories. It prevails: "Costs follow corporate governance."; Gerum/Steinmann (1984: 97).

monitoring costs for the principal, (2) the bonding costs which accrue to the agent through controls and self-engagement, and (3) the residual loss arising in contrast to the case of ideal cooperation.

In the language of the agency theory, a contract of employment is a principal-agent relationship. As the principal, the employer has to pay control costs, because he has to reckon with all forms of withholding of performance and information by employees. On the other hand, as agents, the employees must reckon with post-contractual opportunism on the part of the employer arising from the specific structure of long-term contracts of employment. The search is therefore for the institutional arrangement with the lowest welfare losses.

Co-determination can make a positive contribution here in many ways. An improvement in the supply of information to workers' representatives in decision-making committees can restrict the opportunities for the employer side to post-contractual opportunism. At the same time, it increases the readiness of employees to participate in firm-specific investments. The improved supply of information for employees is accompanied by the risk for the principal of being caught in opportunist behavior and therefore losing face. The tendency towards this type of behavior will therefore be reduced. In addition, co-determination is suitable for increasing coordination efficiency by reducing the creation of expectation errors (Furubotn/Wiggins 1984: 176 et seq.).

However, according to neo-institutional economics, these positive effects of co-determination do not provide grounds for accepting co-determination as the right to take part in making decisions. Labor market immobility with the corresponding misallocation of resources, or slowing down of technical progress, are deemed to be possible dangers of co-determination. For this reason, only a "strict minority representation on corporate boards" is regarded as being reasonable to restrict a possible loss of steering and control efficiency (Furubotn/Wiggins 1984: 186). A counter-argument might be that the tendency of the agents to shirk and withhold information would disappear if they were able to influence their working conditions. This would then mean that the necessity for and intensity of monitoring would be reduced, and monitoring costs would fall.

## II. Key Aspect: Statutory versus Voluntary Co-Determination

It is interesting that co-determination, insofar as it is institutionalized, has very rarely been privately organized; instead it has usually come into effect as a result of statutes. The conclusion often drawn from this is that co-determination, in

contrast to the claims made by its advocates, is not really efficient at all. Jensen/Meckling (1979: 474) express this as follows: "If co-determination is beneficial to both stockholders and labor, why do we need laws which force firms to engage in it? Surely, they would do so voluntarily. The fact that stockholders must be forced by law to accept co-determination is the best evidence we have that they are adversely affected by it".

This argument has been attacked by Levine/Tyson (1990) and Freeman/Lazear (1995), among others. They argue, as do Keynesians with new-classical economists in the field of macroeconomics, that because of the existence of externalities and coordination problems (prisoner's dilemmas), the state may be forced or called upon to prescribe institutional extensions to the private market economy in order to maximize social welfare. It may well be that the total revenue of a firm would be increased by the introduction of co-determination, and all participants may be aware of this. However, uncertainty over the distribution of the larger overall earnings may be so great for both sides because of the changing conditions that there is no incentive for the private introduction of this efficient institution. (To prevent the introduction, it is enough that the uncertainty referred to is too high for one side.) As Levine/Tyson (1990) stress, for a firm which introduces co-determination voluntarily, there is the danger that pressure will grow for erosion of pay differentials and greater protection against dismissals. This is why these firms must be afraid that the introduction of co-determination will mean that they will suffer disadvantages compared to firms without co-determination, namely in the form of "adverse selection" (they will attract the less motivated labor suppliers) and negative externality (their best workers will be poached by firms without co-determination and with less equalized pay structures). This means that no single firm will have an incentive to start the introduction of co-determination. Only if all firms were to introduce co-determination simultaneously would individual firms have an incentive to realize the perceived opportunities for increasing earnings through this institutional innovation. However, because there is no reliable coordination mechanism with regard to the introduction of this type of institution—which does basically increase efficiency—we cannot expect the introduction on a private level. Therefore, if the state is assumed to be oriented towards maximizing social welfare, it is now called upon.<sup>2</sup>

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<sup>2</sup> The same argument is used by advocates of a "share economy" (profit or revenue sharing), which is also supposed to be socially desirable or superior but privately not introduceable; Wagner (1989, 1998). The most prominent objection to a share economy is, interestingly, that it would only be accepted by the workers or unions if it were combined with co-determination

Freeman/Lazear (1995) take the same line. They are convinced that firms' total earnings would increase through the introduction of general co-determination, above all because of a reduction of economic inefficiencies (demands by workers would moderate during tough times), support for new solutions to problems (the exchange of information between management and workers would increase), and an extension of the planning horizon and greater concessions in the workplace on the part of the workers (job security would increase subjectively). Nonetheless, neither employers nor employees have any incentive to introduce co-determination themselves. The main reason given is once again that co-determination not only (as expected) increases total earnings, but it also changes the previous distribution of earnings. There is a danger for both sides that distribution may change to their disadvantage. Employers or the providers of capital fear that the shift of power that accompanies co-determination will reduce their share of earnings. For this reason they are not prepared to agree to the optimum level of co-determination for society, above all because of their fear that once co-determination has been introduced privately, it will lead to endogenous expansionary trends and increasingly weaken their distribution position. Therefore, a co-determination platform fixed by law is required to counteract these incentive effects and the accompanying fears.

It may also be argued that the above conclusion drawn by Jensen/Meckling, if it were accurate in the first place, is only valid under the respective institutional framework, in particular political regulations. In other words, other regulatory framework settings also influence the advantageousness and desirability (of certain types) of co-determination.

### III. The Coalition Theory and the Resource-Based View of Strategy

The coalition theory provides an alternative approach for co-determination. This theory interprets the firm as a coalition of individuals and interest groups, i.e., of owners of capital, managers, workers, suppliers, customers, tax authorities, and external consultants (Cyert/March 1963). The stakeholder approach also arrives at this type of pluralistic view when it asks about the influence groups relevant for the strategic planning and management process (Ansoff 1965; Freeman 1983). The coalition does not have a joint objective function a priori. This is the result of negotiation processes which serve to compensate conflicting individual

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(ibid.). The latter, however, is objected to by the employers and by their associations on the basis of the above arguments.

and sub-group specific objectives. The objective function is then the expression of the distribution of power between the members of the coalition.

A further explanation and foundation for co-determination for employees in the central decisions of the coalition can be derived from the resource-based view of strategy, which differentiates between tangible/intangible and transferable/non-transferable assets (Barney 1991; Grant 1991; Hall 1993). According to the concept, intangible and non-transferable assets are particularly relevant for achieving competitive advantage and therefore the success of the firm. These resources are, above all, know-how, training specific to the firm, and the implicit knowledge of the employees. The firm experiences sustained competitive advantages if it is successful in binding resources which are difficult to imitate and substitute. This itself demands appropriate chances of influencing things for human resources, such as those provided by a formal system of co-determination.

### **C. Co-Determination and Efficiency: Some Empirical Findings**

The attempt to check empirically the economic effects of co-determination for supervisory boards has to struggle against a whole series of difficulties. In Germany, nearly all large companies are subject to co-determination for their supervisory boards, so that there is almost no way of comparing large companies with co-determination with those without it. On the other hand, a comparison with small companies is a problem because of the significant influence of company size on efficiency. International comparisons are not very helpful either. The objection that other factors of the economic and institutional context may have been more relevant—such as the high average qualifications of the workforce, the economic rationality of the unions, the longer planning horizon used by German managers, or perhaps even the exchange rate—can be raised against all findings on the alleged efficiency or inefficiency of co-determination. Furthermore, the assessment of a national institution such as co-determination also depends on the observer's own value system and his subjective perceptions. Finally, all the relevant studies are of necessity related to the past, and may be doubted to an extent with regard to the present with a reference to possible changes to fundamental competitive relationships. These are probably the reasons why there are few empirical studies on co-determination for supervisory boards. They were carried out in the context of the Co-Determination Act of 1976 and are system-immanent in their focus.

The available studies are related to firm efficiency and are based partly on organization science, such as Witte (1980, 1982), Kirsch/Scholl/Paul (1984), Gerum/Steinmann/Fees (1988) and Bamberg et al. (1987). Other studies, however, orient towards allocation efficiency (in the sense of neo-institutional economics) as a criterion, such as Svejnar (1982), Benelli/Loderer/Lys (1987), Gurdon/Rai (1990) and FitzRoy/Kraft (1993).

Witte's study (1980, 1982) refers to independent industrial corporations covered by the Works Councils Act of 1952 and later to the Co-Determination Act of 1976 for the purposes of comparison. An attempt was made to measure the effects of co-determination using the financial statement and net cash flow as indicators of company success and on the enforcement of workers' interests. The subjective assessments of the works council, board, union officials, and managers of large banks were used to record the realized influence. The findings do not show any dominant influence for co-determination that was actually realized. Logically, therefore, a correlation cannot be verified between the development of a company's success and the degree of the workers' influencing potential. On the other hand, the extension of co-determination in 1976 had a positive effect on the satisfaction of workers' needs. It is also remarkable that Witte, in contrast to his research hypothesis, confirms the enormous significance of formal regulations for co-determination.

The study carried out by Kirsch/Scholl/Paul (1984) is also based on behavioral science. This study concerned companies with various legal forms, sector sizes, and legal dependencies (group members) that fell under the jurisdiction of the Co-Determination Act for the coal, iron, and steel industries, the Co-Determination Act of 1976, and the Works Councils Act of 1952. Here an attempt was made to measure the actual influence of co-determination through a comparison of subjective perceptions of boards and works councils. The efficiency criterion was the company's capacity to act, i.e., on the one hand its decision-making capacity—in other words, the capacity to identify problems, expedite the process of problem solving, and finally come to a decision—and on the other hand the capacity to implement, the target of which is the faithful implementation of the resolutions taken and the acceptance of the measures by those affected. The empirical findings show that a company's capacity to act is guaranteed more in companies with greater co-determination than in those with a weak system, and this holds true in each of the above-mentioned aspects of the capacity to act. This finding is explained by the stable cooperative patterns that have grown up in practical co-determination, and which are based on mutual recognition and regular information. In addition, the significant influence of the

statutory foundations of factual distributions of power was once again seen. The influence of the owners of capital, workers, and union representatives in the supervisory board on the whole, and also in individual decisions concerning investment and personnel planning, corresponds to the differences between the Co-Determination Act of 1951 for the coal, iron, and steel industries, the Co-Determination Act of 1976, and the Works Councils Act of 1952.

The study carried out by Gerum/Steinmann/Fees (1988) on the efficiency of supervisory boards with co-determination selected an institutional perspective. To construct a *Realtyp*, exclusively institutional-structural data was collected and evaluated for all stock corporations and limited liability companies subject to the Co-Determination Act of 1976 and stock corporations subject to the Co-Determination Act for the coal, iron, and steel industries, such as articles of associations, ownership relationships, group membership, size characteristics, the relevant trade union, and the degree of union organization. The empirical findings showed clear deficiencies with regard to the functional efficiency of supervisory boards with co-determination. Actual organizational and decision structures offer no guarantee for productive clearing of interests. The main reason for this are the inadequate responsibilities of supervisory boards, but also the counterproductive rules for regulating decision processes created by the owners of capital. It is remarkable that the problems of co-determination in supervisory boards are practically identical with those of supervisory boards in general in the German corporate governance system.

Finally, the examination by Bamberg et al. (1987) is aimed at the mode of operation and efficiency of the Co-Determination Act of 1976 for employee interests. In a combination of institutional-structural data and qualitative case studies, they arrive at the conclusion that although the information of employee representatives in supervisory boards has improved, this has not meant that they have an effective influence on company policy decisions.

The studies discussed here suggest that co-determination has at least not had any negative effects on companies' efficiency.

Similar results were obtained in studies which oriented towards allocation efficiency as a criterion. An early study recording the interplay between co-determination and profitability is the one made by Svejnar (1982). Svejnar compared the consequences of the Co-Determination Act of 1951 for the coal, iron, and steel industries, the Works Councils Act of 1952 and the Works Councils (Reform) Act of 1972 in a cohort study (1950-1976) in 14 different industrial sectors. He found no significant influence of the introduction of or amendment to the co-determination acts on productivity as a determinant of

profitability or efficiency. A central criticism of this analysis is that it is based on sectoral data. However, in all the sectors examined there were also companies that were not affected by any of the co-determination acts referred to, and this reduces the probability of valid findings. Subsequent studies by Benelli/Loderer/Lys (1987) and Gurdon/Rai (1990) on the effects on profitability of co-determination in Germany, which were based on the Co-Determination Act of 1976, used company-related data. However, both studies are also based on simple comparisons of mean values before and after the Co-Determination Act of 1976 without controlling for any other relevant economic and organizational variables. While Benelli/Loderer/Lys were unable to find any relevant effects, contradictory results are found in the Gurdon/Rai study. On the one hand, productivity fell in companies subject to the Co-Determination Act of 1976; on the other hand, their profitability rose. Gurdon/Rai obtained their data ( $N=63$ ) from a mailing action, which resulted in nearly three-quarters of respondents refusing to reply, so that we cannot speak of a representative sample of German companies. In addition, the sample groups differ greatly in the size of the companies, and this probably leads to a distorting effect on the company comparison. In fact, large companies ( $N_1=37$ ) subject to the Co-Determination Act of 1976 were compared with smaller companies ( $N_2=26$ ) subject to the Works Councils Act of 1952 or not subject to any of these co-determination acts. FitzRoy/Kraft (1993) carried out another study of the effects of co-determination on productivity, costs and profitability. The database was a sample of 68 large companies subject to the Co-Determination Act of 1976 and 44 smaller stock corporations not subject to the Act. Balance-sheet data from the years 1975 and 1983 was compared with the help of multiple regression analyses. Significant negative productivity and profitability effects were noted in both years in the companies subject to the 1976 Act. However, significant (labor) costs effects were not discovered. The main weakness of the analysis by FitzRoy/Kraft, as with Gurdon/Rai (1990), is that in the end small and large stock corporations are compared with one another and significant effects on productivity and profitability of company size differences are neglected. In so far, our argument above is confirmed, namely that an empirical study of the economic efficiency of German co-determination for supervisory boards encounters great difficulties in practice.

#### **D. Co-Determination and Corporate Governance in Europe**

For a complete description of the situation, it is necessary to sum up the status of company co-determination in Europe in the context of corporate governance (Gerum 1998). Since the 1970s, co-determination has become a guiding principle for European corporate governance, and is therefore no longer a purely German specialty. Statutes governing co-determination for employees in supervisory and management boards have been passed in several European countries, for example, the Netherlands in 1971, Denmark in 1973 and 1980, Luxembourg in 1974, or Sweden and Norway in 1976. Even in Great Britain, the 1976 Bullock Committee (1977) recommended co-determination in companies, as did the Rapport Sudreau (1975) in France with its suggestions for a special "co-surveillance". In accordance with the trend towards statutory co-determination in Europe, the EC Commission oriented its proposals towards the German pattern of supervisory board co-determination. The 5th EC Directive of 1972 provided for at least one-third of the seats for employees, and the 1975 proposal for a European stock corporation in the framework of the "three-bench model" provided for exactly one-third of the places for employees. Along with the German representation model, the 5th EC Directive also contained the Netherlands "co-option model" as an option.

As with management structure, this extensive harmonization did not find the expected positive resonance. Once again, the whole range of European social techniques for the participation of employees in company decisions is found today in the drafts from the EC Commission of 1989 and 1991: representation, co-option, independent workers' representatives, and collective agreements. As these variations are supposed to be used not only for supervisory boards but also alternatively for administrative boards, this means that in the end there are no less than eight options. These can be outlined as follows, without going into the legal details:

- Supervisory board with co-determination: this German solution was originally favored by the EC Commission and provides for employee representation of between 33% and 50%, whereby if both sides are equally represented the casting vote is to go to the owners' side.
- Board with co-determination: on the basis of the difference between executive and non-executive board members, employees are to be entitled to designate between 33% and 50% of the non-executive members. Because of the disposability of the organizational structure in boards it is very difficult to assess the consequences of this rule.

- Co-option: co-option on the "Dutch model" means that the supervisory or administrative board voted on by the shareholders' meeting selects its own members. The shareholders' meeting and the employee representatives may only object to the designation of a proposed candidate if there are reasons for doing so. A state arbitration agency then has to decide on the objection. In the Netherlands, this procedure has led in practice to supervisory boards, approximately one-third of whose members are employee representatives.
- Independent employee representatives: in this variation, the employee bench is separated completely and placed alongside the supervisory board, which is occupied solely by shareholders, or the administrative board, which consists of shareholders or executive members. This workers' representative board has the same rights to information as the supervisory or administrative boards, but has no decision-making capability. In practice, this rule calls to mind the *Wirtschaftsausschuß* (economic council) of Germany's works constitution. In the discussions on this subject, however, the independent workers' representative body is seen as the so-called "French model" and is also thought of as a possibility for Great Britain.
- Collective agreement: under the "Swedish model", a co-determination model for the board or supervisory boards is to be contractually agreed upon in a collective agreement for the company or sector, or at least achieved by means of strikes. The parties to the collective agreement have the choice between the options shown above, but may also create other organizational models for co-determination, at least for the European stock corporation.
- The idea from the Commission is that member states may choose between these alternative structures. Under a collective agreement there is even a possibility for each single company to choose one of the options. In sum, harmonization does not exist.

In this muddled situation, the EC Commission attempted at the end of 1995 to provide the discussion with new impulses through a "notification for information and consultation of employees" (EC Commission 1995). This had been preceded in 1994 by the successful publication after 20 years of negotiations of a Directive on European Works Councils (Richtlinie 94/45/EG 1994), which grants employees in transnational companies the right to be informed and consulted in the relevant cross-border situations. Put very briefly and pointedly, the Commission is now aiming for this level of participation to be the common denominator for the whole set of co-determination problems in Europe. The reactions from industry and politicians were predictable. While industrial associations see the right approach here, German trade unions in particular, but

also the EC's Economics and Social Committee, reject this concept strictly as a substitute for co-determination on the supervisory board. Consensus cannot be expected in the near future.<sup>3</sup>

## E. Convergence or Variety in Europe?

### I. Cultural Variety versus Convergence Induced by Competition

If we want to understand the heterogeneity of attitudes to co-determination and its organization, we have to fall back on the theory of industrial relations. According to this, the attitude to German *Mitbestimmung* (integration, conflict partnership) is characterized predominantly by the specific historical development of industrial relations within a country (Nagels/Sorge 1977). These are oriented alternatively towards two basic strategies: co-determination or countervailing power strategy.

On the one hand, the repression against the labor movement exercised by the state in the 19<sup>th</sup> century is decisive. The more repressive the actions of the state were, and therefore the more it influenced or was involved in solving industrial conflicts, the earlier there was an institutionalizing of conflict regulation in the form of organs for the representation of interests and therefore a predisposition to co-determination. Further developments depended on the intensity with which co-determination was secured by means of statutory regulations. If this happened relatively early on, and peacefully, as in Germany or the Netherlands, co-determination became the dominant form of the representation of interests. If, however, statutory regulations remained weak, forms of representation of interests developed that were not guaranteed by law, or a re-orientation towards a countervailing power strategy developed. This was the case in France, Belgium, or Italy. In cases in which the state was in general less repressive in the 19<sup>th</sup> century, the countervailing power strategy developed in the main, and this characterizes industrial relations and the rejection of co-determination right through to the present day in these countries. This applies above all to Great Britain and Switzerland.

The impact of these cultural concepts is not only reflected in the proposal made by the EC Commission. This is shown by empirical surveys of the co-determination potential in German subsidiaries of foreign companies, which are

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<sup>3</sup> See, however, the recent report by the Sachverständigengruppe „European Systems of Worker Involvement“ (1997).

subject to the Co-Determination Act of 1976. According to these, the potential for influence of employees in German companies dominated from the Netherlands is significantly higher than in companies whose parent company is in Great Britain or Switzerland (Gerum/Steinmann/Fees 1988: 137).

We will have to wait and see whether the globalization of markets, which leads to increasing uncertainty with respect to change of environment, will start up learning processes among employers, unions, and politicians in the direction of forms of industrial democracy that are adequate for the problems involved, i.e., which are able to adapt to the respective situations. Convergence through the flexible linking of internal opposition through statutory co-determination and of countervailing power strategy through collective bargaining, such as in Sweden (Gerum/Steinmann 1984), seems at least not implausible.

## II. Harmonization versus System Competition

The deviation from the convergence or harmonization strategy in the co-determination question in the 1980s described in Section D was only one aspect of many parallel developments in Europe. While the EC's integration concept originally aimed at widespread harmonization of regulations in member states, there was a clear reversal of direction in the Community's integration strategy in the 1980s (cf. the European Commission's (1985) White Book). The main reason for this was that integration through harmonization had proved to be infinitely laborious. Harmonization of regulations by the EC was unable to keep pace with the speed with which the number of regulations by member states increased, nor was it possible to bring the different provisions to a common denominator. This is the reason why EC legislation has since then emphasized *competition of systems* as a coordinating mechanism, which is most clearly expressed in the "subsidiarity principle" established in the Maastricht Treaty.<sup>4</sup>

This strategy reversal was accompanied by a fundamental rethinking in the theory of economic policy. In recent years, convergence or harmonization of legal or organizational structures has increasingly been regarded as undesirable. It certainly cannot be denied that harmonization has the effect of reducing certain transaction costs, and therefore also increases efficiency not only in a controlled

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<sup>4</sup> The "subsidiarity principle" states that the European Community may only intervene if the aims of the treaty and the aims of individual measures "cannot be adequately achieved at the level of member states and can therefore be better achieved at Community level because of their range or their effects" (Art. 3b ECT).

process of integration, but also in an uncontrolled globalization process. The following reasons are usually put forward in favor of harmonization in order to establish a single market (Ehlermann 1995): the removal of distortions of competition which cause serious costs differences; the protection of "essential interests" which are endangered by the elimination of restrictions on competition; and finally, the elimination of restrictions in the way of the basic freedoms of the single market.

These can, however, be countered by the following arguments (Streit/Mussler 1995): the above reasons for harmonization are considered to be inconclusive. Those in favor of competition of systems regard harmonization as a restraint of competition analogous to a cartel, in which third countries are seen as the outsiders. In addition, harmonization as practiced is subject to legal application problems that cause transaction costs. And finally—and this is the main argument—harmonization waives the advantages of system competition.

From the point of view of the classical-evolutionary theory of competition, the advantages of system competition are based on the following "conjectures" (Streit/Mussler 1995):

- System competition is a process that enables institutional innovations to be discovered and checked.
- System competition has a controlling function on the political providers.

The starting point of these assumptions is the constitutional lack of knowledge of all societal agents. Institutions are interpreted as fallible "hypotheses" on the system of human coexistence that have to pass permanent trials (Albert 1986; Mussler/Wohlgemuth 1995). Competing institutional supplies are evaluated by institutional consumers, i.e., by the owners of mobile factors. They provide information on different societal solutions for problems. This is advantageous in that it is to be assumed that the institutional consumers and suppliers are unaware of the most suitable respective solution. Variety of systems or regulations also means system or regulation competition, and is therefore a process for discovering the institutions or regulations that fulfill the desired purpose at the lowest costs (Hayek 1968; Sinn 1992). Exaggerated harmonization would forbid this competition and prevent transaction costs from being lowered. Market integration would be inhibited.

If the possibility of a faulty or unsuitable statutory provision is considered in addition, competition between systems of rules permits a relatively low-risk and low-conflict method of correcting errors, compared with harmonized policies. The controlling effect of competition arises from private agents being able to compare different institutional attempts at solving problems and to sort out

inferior ones. There does not necessarily have to be an exchange of the legal system itself, but there may also be, corresponding to the cultural peculiarities, efficient institutional innovations within the prevailing legal system.

System or regulation competition also has a second control function. It consists of system competition imposing restrictions on the room for maneuver of political competitors as institutional suppliers. National governments exposed to system competition are subject to constant control by the owners of mobile factors in that the latter are able to evade the sphere of influence of a government by moving to that of another government. This is also linked to the hope that system or regulation competition can reduce the influence of lobbies to eliminate welfare state incrustations or "institutional sclerosis" (Olson 1982). However, it must be taken into account that international legal uncertainty limits system competition (Wagner 1997).

From these arguments one cannot conclude that harmonization or convergence are never preferable. It would seem that it is to be preferred in cases of cross-border externalities. But the non-existence of privately organized convergence does not imply that it might not be desirable. We have already pointed this out in Section B.II. However, it must be taken into account that variety of regulations such as different co-determination rules reflects a variety of preference and culture on the one hand, and on the other differences in development. As we have shown, different countries have opted for specific institutions and solutions in accordance with their special preferences and cultural peculiarities and on the basis of respective development levels. A forced adaptation to general levels, or the compulsory adoption of outside institutional arrangements, probably has a tendency to cause welfare losses. This is also shown by analyses from development economics (Wagner 1997a).

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