The contribution of work representation to solving the governance structure problem

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This article is published in *Journal of Management and Governance* 8 (2004), pp. 129-148.

Abstract: The aim of this paper is to explain in what ways work representation may contribute to an efficient governance structure. The insights from institutional economic theories will be applied to two different kinds of employee participation, namely trade unions and works councils. From the discussion it follows, that the latter may be better equipped than the former to play an effective role in corporate decision-making, owing to its specific institutionalisation. The paper concludes with the finding that works councils could fulfil an important economic function, by protecting the interests of the employees as well as those of the shareholders.
Several agency problems can be solved. By giving the workers consultation and co-determination rights, this will reduce their dependence on unilateral decisions by the management and may stimulate them to be more cooperative, leading to greater productivity and less monitoring costs. By giving the workers information rights, the management becomes more disciplined as well. Because contrary to trade unions the works councils usually do not determine the terms of employment, the owners of the firm do not need to fear that the employees will be able to extract a portion of the firm's profits.

Keywords: corporate governance, information asymmetries, multiple agency problem, property rights, transaction costs, shareholders and stakeholders, trade unions and works councils

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1. Introduction

The ongoing debate on corporate governance deals with the way in which firms are being managed and what is the most efficient division of roles between the different participants in the firm. In the Anglo-American countries emphasis is laid on 'shareholder value', which aims at strengthening the position of the owners. Conversely, in West-European countries like Germany and the Netherlands the accent is put on 'stakeholder value', which also allows for the protection of interests of other participants in the firm (Moerland, 1997, pp. 16-17, 82-83).

Following the Anglo-American tradition, the international corporate governance literature concentrates on the problem how to motivate and discipline the managers of a company in such a way, that they will act to protect the interests of the shareholders. From the institutional economics literature we learn that when the property rights remain fully vested with the owners, opportunistic behaviour by the management might drive them to strive after their own goals, which may deviate from those of the owners. On a lower level there exists another agency problem, namely the difficulties that supervisors might have to ensure that the employees perform their duties in accordance with the aims of the shareholders. Due to information asymmetries and transaction-specific investments, workers have the propensity to shirk and to cause a hold-up situation. The main issue is how a firm is able to reduce or prevent as much as possible the residual loss caused by agency problems on either level. This can be accomplished by strict monitoring, which leads to extra costs, or by creating incentives by means of institutional arrangements.

What tends to receive much less consideration in the international debate, at least relatively speaking, is the fact that employees too are in need of protection of their interests when they have invested their human capital in one firm. However, in recent years several researchers are starting to pay more attention to the role of labour in corporate governance. Also in the United States the call for corporations to be accountable to their workers is increasing in strength (see for instance Kochan, 2003, who pleaded in this journal for more worker involvement in corporate decision-making; and Blair & Roe, 1999).

The aim of this paper is to investigate, with the aid of institutional economic theory, whether work representation can contribute to an efficient governance structure: can this be done in such a way, that the interests of shareholders and the other stakeholders, notably employees, do not conflict? To this end, section 2 provides a short introduction of the new institutional economics approach. After that, corporate governance problems are briefly explained in the light of institutional economics. In the subsequent sections, the new institutional economics approach is used to determine whether trade

unions and works councils can provide solutions to the governance problem. As a case study, section 5 pays attention to the Dutch corporate governance structure and more specifically to the effect of employee participation rights. From this it follows that works councils fulfil an important economic function, by protecting the interests of the employees as well as those of the shareholders. The final section concludes.

2. The New Institutional Economics approach

In real life economic actors usually do not have perfect information. They cannot foresee everything and as a result they do not have the capacity to always make decisions optimally. Individuals therefore also may have a tendency to behave opportunistically. In order to deal with these aspects of human behaviour, all sorts of rules, habits, and codes of conduct have come into being to affect economic action. This is the broad research area of the new institutional economics. Furubotn and Richter (1998, p. 6) define an institution as a set of formal and informal rules, including their enforcement arrangements, with the purpose to steer individual behaviour in a particular direction. Because the science of institutional economics aims at explaining the existence of institutions, in this paper the (new) institutional economics approach is used to explicate the economic rationale of work representation.

In the larger companies, of which the owners no longer run the business but have become shareholders at a distance, the issue is not only how to ensure that the workers act to the benefit of the owner, but also how to make sure that the appointed supervisors (managers) do the same. This is denoted by Alchian and Demsetz (1972, p. 782) by the expression: “who will monitor the monitor?”. In fact we are dealing here with a multiple agency problem. With respect to a firm with limited liability, the group of the shareholders can be regarded as the principal and the managers (board of directors) as the agents. On a lower level, the management can be regarded as the principal (acting on behalf of the owners) and the employees as the agents. After the labour contract has been signed and some decision authority is delegated to the agent, he might be taking advantage of the fact that he has more information than his principal with respect to his efforts. It is very likely, given the assumed characteristics of human nature, that the agent doesn’t maximize his principal’s welfare but his own (moral hazard). The resulting efficiency losses are better known by the term ‘agency costs’ (Jensen and Meckling, 1976).

By concluding a labour contract, property rights are being transferred. The employees offer their working power in exchange for a wage, which gives the owner of the firm the right to direct his personnel. Moreover, the owner is entitled to the entire profit (residual) that results from the use of labour, making him the ‘residual claimant’ (Alchian and Demsetz, 1972, p. 783). All costs that arise from the specification of a contract and monitoring the compliance with the agreement are called transaction costs. In order to curtail opportunistic behaviour, the residual claimant must incur additional costs to monitor all workers and to prompt them to greater efforts. This has led to the insight

that it might be worthwhile for the owner to share the residual with other stakeholders in the firm, so as to incite all participants to dedicate themselves to improving the firm's performance (Hazeu, 2000, p. 71).

In the corporate governance literature most attention is paid to disciplinary mechanisms directed at managers. Especially the design of the reward structure has been given a lot of consideration, to ensure that the interests of the managers don't deviate from those of the owners. In addition however, setting up the right governance structure is of utmost importance. The governance structure determines the position of each of the participants in the firm. Depending on the way property rights have been allocated, the different participants are more or less induced to perform in the best interest of the owners (maximizing shareholder value) or of the firm at large (maximizing stakeholder value).

Proponents of a stakeholder society argue, that concentrating on maximizing rents for shareholders exclusively implies that management focuses on short-term profits, which may in the end be contrary to the maximization objective. Instead, in the long run, if a company would be able to remunerate all participants involved in a way that satisfies competing stakes, the shareholders will gain as well (Charreaux and Desbrières, 2001; Figge and Schaltegger, 2000). In this paper too an inquiry is made into the question how the involvement of the workforce, being one of the most relevant stakeholders, can be to the benefit of shareholders and workers alike.

3. Corporate governance problems: transaction costs as a result of incomplete contracts

This section deals with the governance problems that any large firm encounters upon after hiring its personnel, using insights from institutional economic theory. In the subsequent sections a discussion follows of the ways in which labour representation may reduce or even solve these problems.

When an individual signs a labour contract with an entrepreneur out of free will, both parties enter this agreement in the belief that they can benefit from it. However, not all contingencies can be specified in the contract. Several issues are agreed upon in an implicit way, like the obligation to perform in the interest of the firm and the right to be promoted or rewarded extra if one puts up a good performance. Yet the participants may not act in the spirit of the contract all the time, which is caused by information asymmetries and transaction-specific investments. This will be elaborated upon below.

In larger organisations work is often carried out in a team. Supervisors may not always be able to judge the activities of the individual team members, leading to free riding behaviour (Hazeu, 2000, p. 83). On the one hand the supervisors can incur monitoring expenditures to suppress this shirking, on the other hand the firm can choose to build in incentives that can motivate the employees (as well as the supervisors) to execute their tasks properly. As a consequence, several forms of merit pay have come into existence in working circumstances in which the performance is measurable.

Not only the staff carrying out the work may have the propensity to withhold information on their true capacities, the supervisors can also be tempted in not giving the correct information to their principals

(the owners) or to their subordinates. The management can display several sorts of opportunistic behaviour, to the detriment of not only the owners but also of the employees (Smith, 1990, pp. 6-19). For one thing, managers might strive after more status and more income by means of company enlargement, and this might be at the expense of the profit per share. For another, it can be advantageous for managers to try to cut a dash with innovative ideas that have actually originated with their subordinates. This may exert a negative incentive on employees to take productivity-enhancing actions in the future. Furthermore, managers are often afraid to share information with their subordinates because they fear that it decreases their personal power. In turn, the workers will not be able to rely on the information received from the top, because they might feel that they are being manipulated (Lazear, 1998, pp. 507-509). The shareholders also have a lack of information: if the company is not performing well it is difficult for them to determine whether this can be attributed to external circumstances or to mismanagement (Hazeu, 2000, p. 84).

A second cause of moral hazard behaviour can be found in the case of asset specificity (Williamson, 1985, pp. 52-63). The more the personnel has acquired knowledge which can only be utilised in their own firm, the more the need is felt to specify a labour contract in more detail. Both parties to the agreement wish additional build-in securities because of the difficulties associated with the arisen dependency, which is labelled with the term 'hold-up problem' or 'lock-in effect' (Furubotn and Richter, 1998, p. 131, 136). During the renegotiations concerning the contractual obligations the party who has made the most transaction-specific investments finds himself in a weaker position. The specific investments can be regarded as sunk costs that can only be recovered through continuation of the employment. Partly conditional on the alternatives on the external labour market, it can be either the employer or the employee who stands to lose the most. It is possible that the employer locks in the employee, if the latter has made a large amount of transaction-specific investments in the firm and cannot easily find a job elsewhere. It is also conceivable that the employee puts his employer on the spot by threatening to resign, while it is the firm that has invested much in such a worker. The detrimental effect of both situations may be that nobody wishes to invest anymore in specific knowledge, leading to insufficient use of capacity present in the firm (Hazeu, 2000, pp. 77-79).

Involving workers' representatives in corporate decision-making may help solving the above-mentioned problems stemming from information asymmetries and transaction-specific investments. This must be institutionalised in such a way, that all stakeholders, including and foremost the shareholders can benefit from it; otherwise the latter will not give their consent.

Roughly speaking, there are two different proposals how to give an effective meaning to workers' participation in the governance of firms. One movement stresses the importance of sharing more information with employees or their representatives, while the other goes one step further by arguing that workers should receive codetermination rights (Williamson, 1985, p. 302).

4. Reduction of transaction costs by the participation of trade unions in corporate affairs

The remainder of this paper will be dedicated to the problems and the possible improvement of the governance structure by involving employees or their representatives in corporate decision-making. One form of sharing control rights with the personnel at large concerns the institution of a works council (Furubotn, 1988; Backhaus and Nutzinger, 1982). That will be the subject of the next section. In this section, we look at the different ways in which trade unions can play a part in corporate affairs (Appelbaum and Hunter, 2003; Schwab and Thomas, 1998).

4.1. TRANSFER OF INFORMATION

The first and foremost function of trade unions is to bargain over the terms of employment on behalf of their members. This may enhance efficiency in at least two ways (see Williamson, 1985, pp. 254-256).

Firstly, oriented towards the management as the negotiating party, unions can provide relevant information with respect to the workers' preferences. And at the same time, unions can assist employees in evaluating the offers made by the employers. Trade unions are much better equipped to oversee whether a compensation package proposed by the employer is acceptable, amongst others in view of market developments. This agency role for unions enables the contracting parties to reach preferred bargains.

Secondly, delegating the negotiations to trade unions prevents opportunistic behaviour of both the individual employee and the employer who might be tempted to cause a hold-up whenever asset specificity is involved. Uncertainties caused by increasing firm specific investments boost the need of contract renewals. If unions perform this task, this can save on organisational costs in several respects. For one, the firm incurs less bargaining expenditures because it is negotiating with one representative instead of a many, potentially opportunistic, individual workers. In addition, the pay and promotion scheme is made objective and transparent, which may induce workers to voluntary cooperation and may increase the willingness to invest in firm specific knowledge.

Thereafter, unions are also better capable of monitoring the compliance with contracts (Alchian & Demsetz, 1972, p. 790) by all levels of supervisors, which serves both workers and the firm in the long run. The latter benefits as well, because non-observance of the agreement can be noticed by trade unions and will lead to negative reputation effects of the firm, making it harder in the future to hire qualified personnel (Williamson, 1985, pp. 259-261).

However, a number of objections have been put forward against the overall benefits of involving trade unions in the bargaining process. Williamson himself (1985, p. 265) notices that the heterogeneity of the workforce may lead to higher costs, when several bargains should be struck in stead of just one in order to deal with the divergent preferences of groups of workers. Also Hansmann (1990, pp. 1804-

1805) and Appelbaum & Hunter (2003, pp. 4-5) perceive unions being reluctant to bargain over more than just the basic terms of employment for fear of prejudicing or alienating part of the rank and file. In the end, such internal conflicts could weaken the union's bargaining position against management.
Furubotn (1988, p. 170) postulates that the social costs incurred by unions to defend the workers' investments may well be higher than the social costs associated with alternative contractual arrangements, but he doesn't motivate this judgement. Maybe he thinks of the negative effects of strikes or lengthy bargaining rounds. But depending on the country at issue, it could just as well be argued that trade unions might on balance improve social welfare. In the Netherlands for instance, it could be reasoned that the long lasting social embeddedness of the union movement has had a subduing effect on the wage development and has led to a high degree of industrial peace, which may well have resulted in a higher welfare level as compared to an environment in which unions act aggressively (see Van den Berg, 2000, for references).

4.2. TRANSFER OF PROPERTY RIGHTS

Proceeding from the property rights theory it can be argued that shareholders are not the only investors in a business: they provide the equity capital for the enterprise, but the workers can also be regarded as investors because they supply their human capital. The more the human capital consists of firm-specific knowledge, the more one becomes dependent on this firm. Workers may then refrain from making those investments, as a result of which the firm misses out on certain profits. This undesirable outcome may be prevented if the firm is able to build in positive incentives inducing employees to undertake firm-specific investments. One of the possibilities can be to reward those risk-taking worker-investors by giving them, or their representatives, participation rights. This way of sharing of control rights provides some assurance that the interests of all stakeholders will be considered in decision-making (Furubotn, 1988, pp. 167-170).
Confining us here to trade union participation in the governance of firms, a few different forms can be distinguished in practice. Unions may either try to influence corporate policies from the outside, by engaging in shareholder activism. Or they can try to get involved inside the firm, by seeking strategic alliances with company managers, or by occupying seats in the board of directors or the supervisory board.
Whether worker representation has a say in corporate decision-making processes at all depends very much on the legal provisions of the country at issue. In many European countries, works councils are legally mandated and are given codetermination rights in firms to a greater or lesser degree (Streeck, 1995). In addition, several EU member states have a form of statutory employee representation on company boards (Carley, 1990). On the contrary, in the United States, there are no laws that entitle employees to play a role in corporate governance (Appelbaum & Hunter, 2003, p. 1; Kochan, 2003, p. 228).

Therefore, it does not seem strange that American trade unions have tried to influence corporate policies through an available source of power, namely the shareholders' meeting. Unions dispose of very large pension funds, which they have invested in the capital markets. As a major shareholder, they can try to pressure firms to reform corporate governance policies. Equity owners have the right to vote on key corporate issues and if the value of their shares exceeds $1000, they are entitled to submit their own proposals to proxy vote (Chakrabarti, 2003, pp. 4, 8).

The traditional view of unions is that they seek to improve the position of their members exclusively, thereby reducing the profits to be distributed to shareholders. This seriously hampers any attempt of unions to reform corporate governance. In order to exert influence on the firm's policies effectively, union-shareholders must form coalitions with other shareholders and convince them that execution of their plans will not come at the expense of the corporation and the other equity holders. In addition, unions and their pension funds must meet several legal requirements that will impede opportunistic behaviour. And finally, competitive forces also act as a check upon expedient union behaviour: if a winning union campaign has forced management to increase worker benefits in a irresponsible manner, this will be punished by a declining firm performance, which in turn will lower the value of the shares and increase the risk of lay-offs. (Schwab and Thomas, 1998, pp. 1074-1084)

The reasons why unions may want to engage actively in shareholder' initiatives to improve governance structures may at the same time benefit other shareholders; even when the ultimate union goal is to advance the terms of employment of their members, 'using shareholder-tactics can have pie-enlarging effects as well' (Schwab and Thomas, 1998, p. 1035). Non-union shareholders can gain from the fact that unions have a greater incentive to monitor management than most equity holders. The former must protect firm specific investments made by the workforce, while the latter have usually diversified their risks. Unions are not only more motivated but also better equipped to oversee management performance because of their unique access to information stemming from sources such as the shop floor and their own professional staff (Schwab and Thomas, 1998, pp. 1036-1038).

Notwithstanding the absence in the US of laws entitling workers to play a part in corporate decision-making within the firm, a number of private sector initiatives have led to trade union involvement in company policies although their occurrence is still quite rare. We shall briefly discuss these initiatives and comment on their viability.

Firms and labour representatives alike have for long opposed trade union participation in American corporate decision-making. The former object to losing the exclusive right to manage, while the latter fear that it will implicate them in policies which may affect workers unequally and that it undermines their collective bargaining power (Appelbaum & Hunter, 2003, pp. 4-5; Hamer, 1981, p. 639). Nevertheless, lately these objections have sometimes been set aside. The rapidly changing economic conditions made some companies and unions realize that they have a common interest in seeing the company grow, leading to so-called strategic labour-management partnerships. Giving unions an

active voice in matters such as introducing new work practices ensures the workers that their firm specific investments in skills are protected and will pay off, so they will give their support to the reforms. This may in turn ensure the stability or growth of the firm (Appelbaum and Hunter, 2003, pp. 13, 34). Instead, if the company does not succeed to safeguard workers' firm specific assets this will cause demands for higher wages (Williamson, 1985, p. 303).

From the perspective of the unions, a serious problem with these partnerships is the ability of managers to walk out of the agreement with impunity. The lack of legal protection of work organisation may restrain unions from taking such initiatives, the more so since it is also costly to achieve, support and maintain these alliances. Last but not least, trade union involvement in corporate policies may lead to serious conflicts of interests; not only because of the already mentioned heterogeneity of workers within one firm, but also because the trade union often has members in other firms as well (Appelbaum & Hunter, 2003, pp. 35-37). The firm has a different potential problem to be aware of: if control rights are vested in (representatives of) employees who possess only general skills and knowledge, it significantly increases the chance that workers' interests will diverge from those of the shareholders. If employees have not taken investment risks in the firm the incentive to perform diligently for the company disappears, agency costs will rise and the firm will not operate efficiently (Williamson, 1985, p. 302; Furubotn, 1988, pp. 171-174).

A possibly more effective way for unions to have a say in firm policies may be through membership in the board of directors. Being a member of the corporate board comes with statutory rights to information and involvement in decisions. In the US, board membership of union officials can be attained as the result of either collective bargaining or employee stock ownership plans (ESOPs). It is claimed that union-nominated directors "with the right skills, commitment and support can be as effective contributors to governance as any other outside director" (Appelbaum & Hunter, 2003, p. 29). In practice however, these union-nominated directors are often constrained by boardroom norms and the legal system. For one, the union representatives in the corporate board are non-executive directors, who are seldom involved in issues of day-to-day governance (Appelbaum & Hunter, 2003, p. 27). Concerning their fiduciary duties, these are based on the requirement that all directors on American corporate boards must represent the interests of shareholders, which may be at odds with the duty of fair representation of union directors to their members. A very strict interpretation of labour and corporation law would preclude any employee representation in a board of directors (Hamer, 1981). With the passage of time, American courts have gone beyond this traditional reading which leads Hamer (1981, p. 661) to the conclusion that "The requirement that a member of a board of directors act in the interests of the corporation is sufficiently broad to allow him to consider the needs of employees when formulating corporate policy". However, the same author continues that there remains a tension between the duty of fair representation towards union members and the duty of loyalty towards the shareholders, in which cases the union director should renounce his right to vote in the board.

In a few European countries, unions are also present in company boards (see Carley, 1990, for an overview). Trade unions exercise the most extensive rights in Germany, where, depending on the size and the sector of the firm, workers are legally entitled to occupying between one-third and fifty percent of all seats in the supervisory boards of limited liability companies (Pistor, 1999, pp. 182-183; CPB, 1997, pp. 330-331, 357-359). These seats are occupied by three different groups of workers' representatives: the majority is given to employees of the company, while outside union officials also hold a considerable share; the third and smallest category is made out of members of the works councils of subsidiaries. The remaining seats are assigned to shareholders' representatives.

In this German two-tier board model, the main task of the supervisory board is to exert control over the executive board, which is in charge of day-to-day management. Observers agree, that the influence of the supervisory board is not very great. Although officially it must give its consent to important decisions by the management and must approve the annual financial report, it does not have the right of initiative. Between the three groups of labour representatives there often exists a conflict of interests and a difference of opinion on priorities; if the employee bench fails to come up with a united point of view, the shareholder bench can determine the outcome of a voting. It is suggested that because of its large share of labour representatives, the supervisory board is often circumvented by managers, which may enable them to pursue their own policies without much intervention (Pistor, 1999, pp. 183 ff; CPB, 1997, pp. 357-359).

Roe (1999, pp. 194-199, 203) dwells upon this subject by pointing at an important side effect of the arisen situation: because of the supervisory boards' weakness the German corporations lack a control mechanism, which reinforces blockholding as diffuse German shareholders do not want to invest in these so-called codetermined firms. According to this view, only concentrated shareholders are able to discipline the management effectively. This however undermines the development of a good functioning securities market. Roe (2002, pp. 9-15) thereafter extends this topic to a whole range of Western countries where blockholding more or less dominates. He demonstrates that this occurrence strongly correlates with the extent to which nation states have social norms and politics favourable to the cause of labour. Where workers enjoy a high level of legal protection, concentrated share ownership prevails. In that way, equity holders stay closer to the firm in order to diminish agency costs caused by the risk that managers are likely to give in too much to labour demands.

Whether diffused ownership is to be preferred is a matter of political choice. In countries where the stakeholder society is considered to be a great achievement, a trade-off between labour and capital is chosen in such a way, that the pie is more evenly distributed. This does not automatically imply that firms in these countries perform less in terms of productivity and employment growth or generate fewer profits for the shareholders in comparison to Anglo-Saxon firms. Indeed, De Jong (1997) finds the opposite to be true.

Whether shareholders stand to gain from sharing control rights with employees also depends very much on the exact way in which the influence of workers through representation is institutionalised.

So, to conclude this section, from the text it emerges that there tends to be an overall problem with union representation in corporate governance: as soon as the union is part of a larger trade union federation, a conflict of interests may occur (involuntarily mixed up in intra-industry competition). And even if we are dealing with a pure company union, there might always be tensions between the union promoting the interests of its members (improving wages, protecting employment) on the one hand and safeguarding shareholders interests on the other. Especially in the United States, the bargaining over terms of employment is typically carried out at the firm level and this often is of such a confrontational nature, that it may seriously hamper attempts of labour and management to cooperate in corporate decision-making.
In his call for fundamental reforms and more worker involvement in the US, Kochan (2003, p. 228-229) points at the European situation. Works councils in Europe usually do not bargain explicitly over primary terms of employment (see Carley for an overview) and in this respect they may offer a better alternative. In practice it can be observed that they are often legally mandated to have a say over many aspects of corporate policies. This is the issue we turn to next.

5. Reduction of transaction costs by means of works councils: the case of the Netherlands

In many European states, workers can exert more influence on corporate governance through works councils than through trade unions, although the degree of authority of works councils widely differs from country to country (Carley, 1990). As an example, the last part of this paper will pay special attention to the position of one of the most prominent ones, namely the Dutch works council: how might its specific institutionalisation be able to improve the operating capacity of the firm?
In the course of time several institutional arrangements have been introduced to synchronise the interests of the various stakeholders in the firm as much as possible. On the one hand solutions are sought in shaping the right reward structure, on the other in shaping the right governance structure. With respect to the former, in all large companies the management's rewards are nowadays linked to the firm's performance by means of giving them options. This kind of financial participation is still hardly been granted to the lower staff in the Netherlands but the shop-floor workers do have participation rights through the works councils ever since 1950. This brings us to the subject of the specific Dutch governance structure, which will be enunciated upon right below.

5.1 CORPORATE GOVERNANCE IN THE NETHERLANDS

Institutions on the Dutch labour market developed in a specific way, strongly influenced by corporatist ideas in the middle of the 20th century. In this range of ideas the company was seen as an interest community, in which all participants would benefit from cooperation. It was thought that if

employees would get fair remuneration and working conditions, this would enhance job satisfaction and thus productivity (Windmuller et al., 1987, pp. 362-369). Consequently, several laws have been implemented in this spirit, of which the Structure Act and more specifically the Works Councils Act are the most relevant in this context.

The Structure of Limited Liability Companies and Private Companies Act of 1971 (hereinafter Structure Act) determines the governance structure of large Dutch firms with limited liability (Van het Kaar, 1998, pp. 1-2, Boot, 1999, pp. 533-543), on which this paper focuses. Enterprises above a certain size (with respect to the value of the shares put out and the number of employees) are obliged to have a board of supervisors, which takes over the most important controlling rights from the shareholders. Its main power is the appointment and dismissal of the board of directors, which is the actual management of the firm. Important decisions of the management have to be approved by the supervisory board. The resulting governance structure is a two-tier-board model. Unlike German workers, Dutch workers have no representation on the supervisory board, the members of which are expected to operate in the interest of all stakeholders. These so-called commissioners are appointed through a system of 'controlled cooptation'. This implies that they can choose new members themselves, but the shareholders as well as the works council exercise some degree of influence because they have the right to nominate and refuse candidates. This expresses the original intention of the Structure Act, namely to provide a balance between the position of capital and labour in large[1] companies.

In the latest years, however, criticism on the functioning of the commissioners has increased. Shareholders believe that in the current functioning of the two-tier-board model their financial interests are not optimally protected, especially with respect to anti-takeover measures. Both shareholders and employees often think that the two boards do not operate independently enough, which is frequently denoted by the term 'old boys network' (Van het Kaar, 1998, p. 2; Goodijk, 2000, p. 305). After having obtained expert advise, the government has recently proposed to strengthen the position of the shareholders vis-à-vis the management, by giving the former the right to appoint and to dismiss the members of the supervisory board and the right of approval in case of an important merger or take-over. This proposal could lead to a shift in the balance of power in favour of shareholders to the detriment of the employee representatives, according to Van het Kaar (2002, pp. 1-3).

However, compared to the situation in most other European countries, the influence of labour on the individual company's policies is still quite large in the Netherlands. This statement applies only to the works councils, not to the trade unions, which mostly exert influence on the national and the industry level. At the end of the Second World War, the latter officially refrained from active participation in the management of firms in return for ample representation on official economic advisory bodies to the government. In the nineteen sixties and seventies unions have tried to gain more power within firms but that proved unsuccessful (Windmuller et al., 1987, pp. 95-99, 385-388). Instead, trade unions have always had the first right to negotiate on the terms of employment by concluding

collective labour agreements on sector level. On company level, these agreements often need to be elaborated and this is where the works councils come in (Bakels, 2000, pp. 281-283).

The Dutch Works Councils Act dates from 1950 but has been altered and extended several times since (Bakels, 2000, pp. 253-255). Originally, the Act exuded the spirit of cooperation between employers and employees, which was felt very strongly in the first post-war years. Management was included in the works council and even occupied the chair, while workers' representatives possessed only rights to information and to discuss business affairs with the sole aim to improve the functioning of the company. The 1971 amendment granted workers participation rights with respect to social issues as well, marking the start of the dualistic task of the works council, which is so typical for the Netherlands. On the one hand, the works council must stand up for the interests of all personnel. On the other, the works council is legally obliged to operate for the sake of the firm at large. The most far-reaching revision of the Act took place in 1979, when the management could no longer be a member of the council and the workers received major advisory and codetermination rights, which will be elaborated upon in the next subsection.

When the influence of the workers' representatives on company policies within Western Europe is compared, Streeck (1995, pp. 339-343) finds that the Dutch, Swedish and German works councils possess the most extensive legal rights, although this does not necessarily mean that they have the most power in practice. Confining ourselves to the Dutch case, we shall focus on the formal role of the works council in the corporate governance debate. The issue to be resolved is whether the works council, as an institutional arrangement, can enhance the firm's performance.

5.2 THE CONTRIBUTION OF DUTCH WORKS COUNCILS TO AN EFFICIENT GOVERNANCE STRUCTURE

Allowing employees to have a say in the firm's policies implies the transfer of property rights. Like the possession of certain assets, the disposal of certain control rights induces the holder to behave in a responsible manner. The control over the use of labour partly remains with the workers themselves, better enabling them to protect their human capital investments. This will reduce their dependence on unilateral decisions by the management and may stimulate them to be more cooperative, leading to greater productivity and less monitoring costs.

As mentioned in section 5.1, the functioning of the supervisory board and the dominant position of the board of directors have come under considerable criticism, whereupon it has been decided by the government to shift some of that power to the shareholders. The possible corrective function of the works council has been neglected in this debate (Goodijk, 2000, p. 303, 308). In the remainder of this paper we try to show that the legal rights vested in the works council provide an important supplement to the controlling role of the supervisory board.

According to the latest revision of the Act, in 1998, a works council must be installed when a firm counts at least fifty employees. The council has the right to be sufficiently informed on all relevant

matters so as to perform his tasks optimally. Among others, this information is necessary in order to be able to oversee the management's compliance with the law, with the collective labour agreement and with other regulations concerning safety, health and well-being, as laid down in Section 28 of the Act. This same Section also requires that the works council actively promotes equal treatment of men and women within the firm as well as the hiring of minorities and disabled workers. In addition, Section 23 empowers the works council to submit proposals on its own initiative, to which the management is obliged to respond. Workers' representatives have been granted extensive consultation and participation rights, including the right to go to court if the management fails to observe these rights. In order to use all these rights effectively, the position of the members of the works council is legally protected and they are allowed - within certain limits - to meet during working hours, to follow training courses and to consult outside experts at the expense of the employer. (Bakels, 2000, pp. 256-278.) Although in practice the power of works councils differs between firms, in general they have become a respected discussion partner and make a considerable contribution to corporate decision-making (Goodijk, 2000, p. 306).

The most far-reaching power is derived from Section 27 of the Works Council Act, under which the management must obtain the council's consent for any decision on social matters, if not already regulated by a collective agreement. This includes codetermination not only on working hours, holidays, health and safety at work, and payment systems, but also on job evaluation schemes, rules on hiring and firing and promotion, and vocational education and training facilities. By these rights, the employees are able to influence their own position, particularly in reference to the protection of transaction-specific investments. Moreover, the right of initiative stemming from Section 23 and the stimulating tasks laid down in Section 28 can encourage the workers to be supportive and even innovative, as they may benefit from it themselves. Summing up, it may be stated that the above-mentioned sections of the Works Council Act provide incentives for workers not to act opportunistically but on the contrary lead them to behave in the interests of the company at large.

Economists sometimes cast doubt upon the efficiency benefits to be gained from the founding of participation rights to workers. Lazear (1998, pp. 517-523), for example, contends that 'worker empowerment' needs to be well balanced. On the one hand, if staff commitment is too small it may induce workers to withhold relevant information and display too little creativity at the expense of labour productivity and the firm's performance. On the other, if too many codetermination rights are granted the danger exists that workers indeed become more productive, but that they are also able to appropriate a larger share of the pie at the expense of the shareholders.

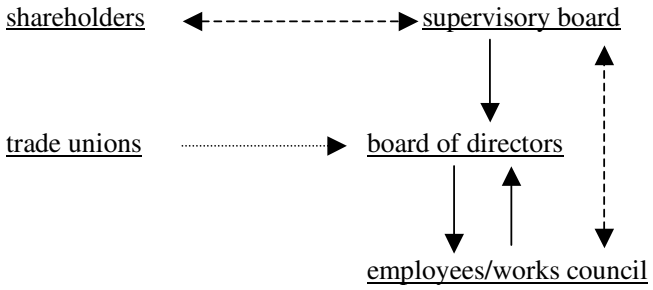
In the Dutch setting this is not really feasible because the works councils hardly ever have the right to determine the wages or other fringe benefits. For many years the unions have legally been given precedence over negotiating the terms of employment on sector level. As soon as wages and working hours are settled upon by a collective labour agreement, which applies to the vast majority of the Dutch work force, a works council is not allowed to renegotiate this on company level (Bakels, 2000,

pp. 281-283). At the same time the direct influence of Dutch trade unions on company policies is small. Contrary to most other European countries, there exists no formalized relationship between works councils and trade unions. The latter may try to get their own members elected as members of the works council, but nationwide over one third of all council members do not belong to a union (De Vries and Schins-Derksen, 2000, p. 34). This leads to the conclusion that owners do not need to fear that through the transfer of property rights the employees will be able to extract a portion of the firm's profits.

Also the fear of mismanagement due to opportunistic workers' behaviour is unwarranted in the Dutch setting, even if participation rights are granted to employees who have made no firm-specific investments. In most companies at least a part of the workers do have acquired firm-specific knowledge, which stimulates the commitment to the firm and makes it more difficult to move into another job. Also the level of unemployment in the sector and the region might restrain workers from searching for a career elsewhere. Moreover, also without any firm-specific investments many employees tend to develop both a strong commitment to their firm the longer they are employed at that firm (Hazeu, 2000, p. 80), and strong ties to the community in which their workplace is located (Hansmann, 1998, p. 44).

In a hierarchical organisation there often exists the matter of imperfect and asymmetric information. Agents behaving opportunistically may be tempted to take undue advantage of this situation, thereby prejudicing the principal's interests.

Several principal-agent relationships can be distinguished within large Dutch firms with limited liability, which is illustrated in the figure below[2].



In the scheme the five most important stakeholders are shown. According to the Structure Act large firms with limited liability must install a supervisory board that is expected to operate on behalf of all stakeholders, notably capital (the shareholders) and labour, which explains the two discontinuous arrows in the figure. The dotted arrow runs between the parties that negotiate the terms of employment. The three continuous arrows display the principal-agent relationships. Two of those need not much further explication. The supervisory board must monitor the functioning of the board of directors and the latter must monitor the functioning of the employees. What's unusual though,

concerns the monitoring role of the works council vis-à-vis the board of directors, which is a direct consequence of the works council's legal right to information to be supplied by the management on all relevant matters.

As discussed in section 3, managers acting out of self-interest may not only harm the shareholders' interests but in the process they may also take decisions that are unfavourable for their subordinates. Because there are a lot of critics who have shed doubts on the monitoring effectiveness of the supervisory board, the legal powers of the works council provide an additional institutional arrangement by means of which the management's opportunistic behaviour can be curtailed.

In many respects workers are in a much better position than remote shareholders to monitor the management because of their vicinity and knowledge of daily affairs. A possible counterforce may be, however, that workers are often quite heterogeneous and therefore might lack unanimity of interest to monitor the management effectively (Hansmann, 1998, p. 45). On the other hand, when different categories of employees all are represented by a mandatory works council with many legal rights, this council can very well form an effective disciplining mechanism.

To begin with, the works council meets at least two times a year with the board of directors, at which representatives of the supervisory board are also present. This gives workers the opportunity to provide both boards with information from the shop floor, which is very important in any hierarchical organisation. In this way, the commissioners of the supervisory board may obtain particulars they can use to monitor the management more effectively. If someone seats on the supervisory board who was recommended by the works council, the last-mentioned could meet with this so-called 'labour commissioner' more often. These contacts are usually not very frequent and quite informal, because all commissioners are supposed to act in the interest of the whole firm, and not on behalf of a subgroup of stakeholders. Still, those contacts can be valuable in terms of information exchange (Van het Kaar, 1995, pp. 76-82, 107-109).

Under Section 31 of the Works Council Act the board of directors is legally bound to provide all information to the workers' representatives concerning important economic developments and decisions. This must be done timely, so as to enable the works council to take the proper steps. After the required information has been supplied the works council is authorized to give a weighty advice (on the basis of Section 25), concerning the industrial organisation, or even to give its consent or veto when the plans concern social matters (on the basis of Section 27). What is more, Section 28 instructs the council to monitor the managements' observance of the law and to inspect whether the management correctly implements all the arrangements stemming from the collective labour agreement. To the extent that the workers' representatives are not capable to interpret the information supplied properly, they have the right to hire external counsellors. In short, it may be concluded that the above-mentioned sections of the Act provide the works council with effective checks and balances, if exploited to the fullest.

In times of an economic downturn, providing company details to the workers' representatives also sees to it that some necessary and painful management decisions will be recognized and accepted, thus preventing industrial unrest (Lazear, 1998, pp. 508-509). After all, the works council's dualistic task is assumed to ensure that not only the interests of the employees will be taken into consideration, but the prosperity of the undertaking as well.

In an atmosphere in which all contracting parties are treated equally or at least are being given a substantial say in company matters, this can induce workers to be more prepared to communicate their views to management (Lazear, 1998, p. 510). If works councils codetermine the environment of the workplace, this will lead to more information flows and the willingness to compromise in such a way, that it may make both sides better off (Backhaus, 1982, pp. 190-192, 198-199). The specific set of rights and tasks assigned to the Dutch works councils can serve as a model for a condition in which work representation may contribute to a win-win situation. In the ongoing corporate governance debate the positive effects of the role of the works council should therefore not be neglected.

6. Conclusion

Several different manifestations of worker participation in corporate governance can be distinguished in Western market economies. Whether the involvement of trade unions or works councils in corporate decision-making can improve the firm's governance, depends very much on the specific way in which work representation is institutionalised.

It is argued that giving more information rights to unions can enhance efficiency because in that way workers can be assisted in making the right choices, which the unions in turn can better communicate to the employers, leading to improved contracts. In addition, collective bargaining on behalf of the union members can save on transaction costs and may prevent the hold-up problem.

If unions are allowed to have a say in the companies' policies, the shareholders may or may not profit from that. On the one hand, unions who want to protect the jobs of their members also have the objective of seeing the company grow. But on the other hand, codetermination by union officials always puts them in an awkward position of weighing the interests of the equity holders against those of their members, aside from legal constraints. After all, the first and foremost function of any trade union is to bargain over the terms of employment; this could lead to a different division of the pie at the detriment of the shareholders.

A better alternative might be provided by giving workers participation rights through works councils that are not involved in the bargaining process over wages and the like. This paper has looked at the merits of the stakeholder society and has tried to show that from a theoretical point of view the Dutch works council can contribute to an efficient governance structure. Owing to the particular dualistic task imposed on works councils, they are required to protect both the interests of the employees and the firm at large. The granted rights to be informed, to be consulted and to codetermine may

significantly reduce agency costs on all levels of the organisation. Whereas the Structure Act is aimed at an effective way of monitoring top-down, the Works Council Act supplements this by monitoring bottom-up. The resulting disciplinary mechanism towards the management may benefit labour and capital alike.

Acknowledgements

For helpful comments I thank Christoph van der Elst, Anna Grandori, John Groenewegen, Robbert van het Kaar, Jacques Siegers, Erwin van Sas, Jan Kees Winters and two anonymous referees, as well as the participants of the workshop On Institutional Analysis, held on 29-30 June 2002 at the University Pompeu Fabra in Barcelona.

Notes

1 Although the establishment of a supervisory board is not mandatory for smaller firms, many of them have installed it voluntarily (Bakels, 2000, p. 285). The reason is often that the individual shareholders are in the first place investors who do not wish to interfere with the firm's policies. Moreover, the professional managers usually have a head start when it comes to expertise and information. In those circumstances shareholders welcome the foundation of an autonomous supervisory commission, which is able to monitor the operations of the board of directors more effectively. However, contrary to the firms to which the Structure Act fully applies, the voluntarily installed supervisory boards do not have the power to appoint and dismiss the board of directors, as this right is reserved for the shareholders.

2 In fact, the scheme could be enlarged with one more agency relationship at the lowest level of the firm, at which the works council can be considered as the agent who is supposed to act according to the wishes of his principal, being the employees who have elected the members of the works council. Because in the Dutch practice the 'rank and file' on the whole is not actively involved at all (and apparently doesn't want to be) in the works councils' activities (Van het Kaar and Looise, 1999, pp. 68-69), this paper doesn't discuss this principal-agent relationship.

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