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ontwerp voorblad: WRIK Utrecht

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# The Dutch works council from an institutional economics point of view: an efficient solution to the governance structure problem?

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August 2003

## Abstract

The aim of this paper is to explain, with the aid of institutional economic theories, why Dutch works councils may contribute to an efficient governance structure. To this end, in this study a sketch will be given of the existing structure, in which the particular Dutch two-tier system plays an important role. After a short discussion of the property rights theory, transaction costs theory and the principal-agent theory, these theories will be applied to the Dutch corporate governance structure and more specifically to employee participation rights. The paper intends to show that works councils 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 codetermination 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 the works councils usually do not determine the terms of employment, the owners of the firm do not need to fear (as expressed by Lazear 1998) that the employees will be able to extract a portion of the firm's profits. Even if the control rights are granted to workers who have made no firm-specific investments, it can be argued that the fear (as expressed by Furubotn 1988) of mismanagement is unwarranted.

**JEL-code:** J53

**Keywords:** corporate governance, information asymmetries, multiple agency problem, property rights, stakeholder value, transaction costs, works councils.

## Acknowledgements

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

## 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-Saxon 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). In the Netherlands, we distinguish the following most important stakeholders: the owners (shareholders), the management in the board of directors, the commissioners in the supervisory board, and the employees, represented by trade unions and works councils.

In the international corporate governance literature most attention is paid to 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.

Whether this subject is studied from the perspective of shareholder value or stakeholder value, doesn't really change the main issue, namely how any firm is able to reduce or prevent as much as possible the residual loss caused by agency problems. This can be accomplished either by strict monitoring, which leads to extra costs, or by creating incentives by means of institutional arrangements.

Institutions on the Dutch labour market developed in a specific way, strongly influenced by corporatist ideas in the middle of the 20<sup>th</sup> 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 Company Law and more specifically the Works Councils Act are the most relevant in this context.

The aim of this paper is to investigate, with the aid of new institutional economic theories, if the Dutch works councils can contribute to an efficient governance structure. To this end, in section 2 a sketch will be given of the existing structure, in which the

particular Dutch two-tier-board system plays an important role. The paper will then continue with describing the legal rights with which works councils in the Netherlands are empowered. They perform a peculiar dualistic task, setting them apart from most other workers' representations abroad. Not only are they supposed to represent the interests of all personnel in a firm, but also they are expected to contribute to the optimal functioning of that firm.

In section 3 a short discussion follows of the property rights theory, transaction costs theory and the principal-agent theory. These theories will be applied in section 4 to the Dutch corporate governance structure and more specifically to employee participation rights. The paper intends to show that Dutch 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 stakeholders in the Dutch firm**

The so-called pentagon of important stakeholders at corporate level in the Netherlands consists of the board of directors, the supervisory board, the shareholders, the trade unions and the works councils (Goodijk, 2000, p. 304). 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 called the 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<sup>1</sup> 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 advice, 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 by giving the former 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 postwar 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 rights.

According to the latest revision of the Act, in 1998, a works council must be installed when a firm counts at least fifty employees. Section 24 stipulates that the works council meets at least two times a year with representatives of the board of directors and the

board of supervisors to discuss general business developments. On the basis of Section 31 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. Next, Section 25 entitles the works council to be consulted on all important, well-defined economic decisions by the management. On top of that, Section 27 gives the works council the right of consent (codetermination) with respect to all social arrangements within the firm, insofar as the substance of the matter in question has not already been regulated in a collective agreement between employers and trade unions. 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. Finally, if the workers' representatives find that the management does not satisfactorily follow up their advice or has taken a decision without consulting them, they have the right to go to court. (Bakels, 2000, pp. 256-278.)

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. 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 sets itself to explain the existence of institutions, in this paper the (new) institutional economics approach is used to explain the economic rationale of the Dutch works council.

### **3. The New Institutional Economics approach**

In real life economic actors usually do not dispose of 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 institutions, habits, and codes of behaviour have come into being to affect economic action. This is the broad research area of the new institutional economics. In this section, three closely connected theories will be enunciated that can shed light upon the reasons why people decide to organize activities in a firm, and how they subsequently decide on the governance structure of that firm. These three theories are, respectively, the property rights theory, transaction costs theory and the principal-agent theory.

#### **3.1. PROPERTY RIGHTS THEORY**

It is an empirical fact that people usually treat goods more carefully, when they own these goods themselves. In other words, private property leads to responsible guardianship and it motivates the owner to make use of it in such a way, that it renders maximum profits.

In the literature three categories of property rights are distinguished: the rights to use an asset, the right to earn income from an asset and the right to transfer an asset to another party. In addition, there exists another subdivision, in which absolute property rights are set against relative property rights. The former are directed against all other individuals, like the property of land, whereas the latter can only be directed against one or more determined persons, like contracts or legal obligations (Furubotn and Richter, 1998, p. 77).

In this paper we focus on relative property rights that are exercised within a firm. In an ideal world in which parties act entirely rationally and dispose of full information, individuals can transfer property rights and write it down in complete contracts. This means that the agreement can be monitored and enforced costlessly. In reality, incomplete information and limited cognitive competence unavoidably lead to incomplete contracting because it will be too costly to specify all contingencies (Furubotn and Richter 1998, pp. 3-4, 8).

In the traditional view on the hiring of labour the following transfer of property rights takes place: the employee offers his working power in exchange for a wage, which gives the owner of the firm the right to exercise control over the use of this labour. 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). In this situation

the owner has the incentive to maximize the firm's profits, but conversely the employees do not have any incentive to perform well. As long as they receive their wage for a certain number of working hours, they might be inclined to behave opportunistically (for instance shirking).

For that reason, 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). As a consequence, the specifications of the labour contract will change: to prevent (ex post) opportunistic behaviour, it becomes essential to supplement the contract (ex ante) with specific arrangements (Furubotn and Richter, 1998, pp. 169-170). Next to further specification of individual contracts, another form of sharing (a part of) the control rights with the personnel at large concerns codetermination, either voluntary or mandatory (Furubotn, 1988; Backhaus and Nutzinger, 1982).

### 3.2. TRANSACTION COSTS THEORY

The transaction costs theory originates from the seminal work by Coase (1937), while Williamson has elaborated and extended this theory from 1975 onwards. According to Coase firms emerge as an alternative to the market, if people can save on costs in that way. By contracting the suppliers of production factors within a firm, the entrepreneur can circumvent several uncertainties of using the price mechanism (Coase, 1937, pp. 390-392). The terms 'contracting costs' and 'organizational costs' are often used to distinguish between transaction costs on the market and within a hierarchy, respectively. By concluding a contract, property rights are being transferred. All costs that arise from the specification of a contract and monitoring the compliance with the agreement are called transaction costs. This shows that the property rights theory and the transaction costs theory are closely connected. In the former theory the emphasis is put on the allocation of property rights and their ensuing ex ante incentives, while the latter theory stresses the ex post costs that result from the contracting and searches for the most efficient governance structure (Williamson, 2000, pp. 598-599, 608-610).

Transaction costs economics assumes that human behaviour can be characterized by bounded rationality and opportunism (Williamson, 1985, p. 44). The first recognizes limits on cognitive competence, the second is regarded as a possible consequence of information asymmetries between contracting parties, which may lead to moral hazard (see section 3.3 below).

Further, Williamson (1985, p. 52 ff.) distinguishes three main dimensions with respect to which transactions differ, namely asset specificity, uncertainty, and frequency. The first one is considered to be the most important: if one of the contracting parties has made a lot of transaction-specific investments this results in a large amount of dependence, which may be abused by the other party. Secondly, transactions often involve uncertainties, both with respect to the behaviour of the contracting parties and with respect to (market) developments. And thirdly, the costs of transactions depend on the rate of recurrence with which parties interact: if they have to deal with each other frequently this may lead to substantial investments in transaction-specific assets, and subsequently to mutual commitment, ruling out competition by other market parties. The choice whether to organize through a market or through a firm depends upon the degree in which these three dimensions matter in certain circumstances and upon the degree in which bounded rationality and opportunism are present. The more people operate in a complex and insecure environment, the more often people choose to establish a firm because in these circumstances the transaction costs of an internal organization can be lower than when external market contracts are concluded. However, transaction costs are not banished within a firm, in which imperfect, asymmetrical information between the principal and the agent can play an important role.

### 3.3. PRINCIPAL-AGENT THEORY

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. The principal assigns a task to the agent, who is expected to act in the best interest of the principal. 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. This kind of opportunistic behaviour has been termed 'moral hazard' (Hazeu, 2000, pp. 58, 80-81).

The resulting efficiency losses are better known by the term 'agency costs', with respect to which three categories are distinguished, namely monitoring expenditures, bonding expenditures, and residual loss (Jensen and Meckling, 1976/1996, pp. 318-319).

Residual loss can be described as the money value of the principal's welfare loss if the agent's economic decisions are not on a par with the principal's interests. In view of this possible divergence of interests the principal will try to steer the agent into the desired direction, by establishing appropriate incentives for the agent and by incurring monitoring costs. It sometimes pays the agent to expend resources (bonding costs) aimed at signalling to the principal that he does serve the interests of the principal, for instance in a situation in which the agent has made much transaction-specific investments.

From the preceding three subsections it can be concluded that the principal-agent theory ensues from both the property rights theory and from the transaction costs theory. The owners of the firm aim at the best possible trading results. In order to realise this a certain governance structure is chosen and contracts are being concluded with the management, in whom many discretionary decisions are vested. In turn, managers vest discretion in other employees on a lower level in the firm. To avoid agency costs as much as possible, all labour contracts need to be specified in such a way, that the property (control) rights are allocated optimally.

In the corporate governance literature most attention is paid to the possible 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, 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).

#### **4. Corporate governance problems and solutions**

Before we return to the specific Dutch situation, the first subsection below deals in some more detail with the governance problems that any large firm encounters upon after hiring its personnel. The remainder of the section will further discuss the corporate governance structure of Dutch firms the way it was described in section 2, paying special

attention to the position of the works council and how its specific institutionalisation might be able to improve the operating capacity of the firm.

#### 4.1. TRANSACTION COSTS AS A RESULT OF INCOMPLETE CONTRACTS

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, as was noted in section 3, 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 below.

In larger organizations 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 fight against 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. 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).

#### 4.2. REDUCTION OF TRANSACTION COSTS BY THE DISTRIBUTION OF EMPLOYEE PARTICIPATION RIGHTS

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, which brings us to the subject of the governance structure. As described in section 2, 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 next two subsections 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.

##### *4.2.1. 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 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 either refrain from making those investments, as a result of which the firm misses out on certain profits, or they will try to protect their interests through the membership of a trade union, leading on balance to extra costs<sup>2</sup>. These undesirable outcomes 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 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).

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 explained in section 2 of this paper, in the Netherlands 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. 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 in other countries often cast doubt upon the efficiency benefits to be gained from the founding of participation rights. Lazear (1998, pp. 517-521), for example, con-

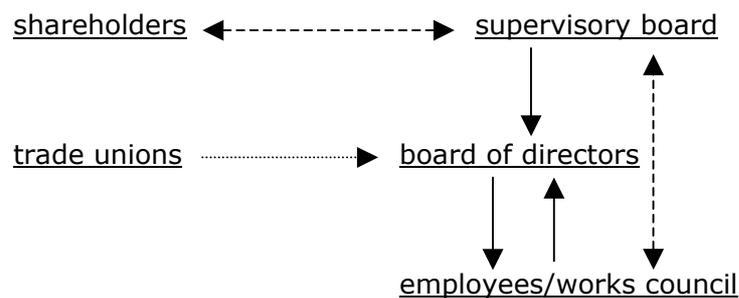
tends that 'worker empowerment' needs to be well balanced. On the one hand, if staff commitment is too small it may induce workers to withhold relevant information and display too little creativity at the expense of labour productivity and the firm's performance. On the other, if too many codetermination rights are granted to the employees the danger exists that they do 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. 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.

A related argument against vesting control rights in employees stems from Furubotn (1988, pp. 171-174). He claims that if codetermination rights are assigned to workers who have not invested in firm-specific knowledge, it significantly increases the chance that their 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.

However, even if participation rights are granted to workers who have made no firm-specific investments, it can be argued that this fear of mismanagement is unwarranted in the Dutch setting. 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).

#### 4.2.2. Transfer of information

In a hierarchical organization 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. In section 3.3 it was already mentioned that large firms deal with a multilevel agency problem. Several principal-agent relationships can be distinguished within large Dutch firms with limited liability, which is illustrated in the figure below<sup>3</sup>.



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 4.1, 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<sup>4</sup>.

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 organization, 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. From another perspective, 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 will make both sides better off (Backhaus, 1982, pp. 190-192, 198-199). Since cooperation between employers and employees in the Netherlands has a longstanding tradition, the specific set of tasks assigned to the works council contributes to a win-win situation. In the ongoing corporate governance debate the positive effects of the works council should therefore not be underestimated.

## 5. Conclusions

The legally imposed corporate governance structure of Dutch firms reflects the time-honoured practice of cooperation between labour and capital. In the Netherlands, the Works Council Act had been changed several times, each time extending the rights of the workers' representatives. Especially after the amendment of 1979 the works councils have become formally recognized as an important stakeholder in whom certain control rights have been vested. The Structure Act of 1971 is another consequence of emphasising stakeholder value, but the recent government's proposals suggest a certain shift towards the Anglo-Saxon shareholder model.

This paper has looked at the merits of the stakeholder model 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 can benefit labour and capital alike.

## 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 Furubotn (1988, p. 170) argues that the social costs incurred by trade 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. Depending on the country at issue, it could be argued that trade unions have a subduing effect on for instance the wage development, which might on balance improve the social welfare.

- 3 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.
  
- 4 In the literature on employee ownership of the firm, it is also recognized that 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 (Hausmann, 1998, p. 45). On the other hand, when employees are represented by a mandatory works council with many legal rights, this council can very well form an effective disciplining mechanism.

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