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Codetermination in the West: The Case of Germany

STEVE PEJOVICH

In recent years, most West European countries have joined Germany in actively promoting labor participation in the management of business enterprises. Codetermination, as this development has come to be called, is a major post-war social experiment in Western Europe. As in Germany—the undisputed leader in the use of codetermination schemes—labor participation in the management of business firms is being introduced into the social life of West European countries. The major feature of codetermination in Western Europe is that it is mandated by law. This study shows that codetermination laws attenuate the right of ownership and contractual freedom and, consequently, represent a major weakening of capitalism in the West. The laws on codetermination are in effect a major vehicle through which socialism has been creeping into Western societies.

Codetermination laws differ from one country to another. However, they all have a common denominator: labor participation in the management of business firms. Labor is represented on the board of directors and is given an active role in decision-making. Where the governing authority of firms is divided into two tiers, as in Germany and the Netherlands, the labor representatives sit on the supervisory board.[1] Where there is a single board of directors, the employees' representatives take their place in that body. Labor unions have been "bribed" into supporting the codetermination movement by having been given either the right to appoint their own representatives on the board of directors, or the assurance that they will be able to control the worker representatives, or both.

Two major explanations for the introduction of codetermination in Western Europe are the enhancement of industrial democracy and the reduction of worker alienation. The former president of France, M. Giscard d'Estaing, said "participation of workers' representatives in the life of their company reflects the workers' aspirations not to be left out of decisions that concern them."[2] The former Chancellor of Germany, Willy Brandt, stated in 1973:

1. The supervisory board is the controlling body of the firm—like the board of directors in the USA.

2. *Democratic Francaise*, October 1976.

> We consider the development of codetermination to be one of our main tasks...We will further develop company laws in the meaning of codetermination by the employees and workers' during this legislative period. Everybody knows that there are diverging opinions between the government parties; but just as we found agreement with respect to the Shop Constitution Law, we will find a mutual solution here too. In this, we start from the principle of equal rights and even balance of weight of employees and employers.[3]

The European Commission has proclaimed labor participation in the management of business firms as a fundamental objective of the community.

> The increasing recognition is being given to the democratic imperative that those who will be substantially affected by decisions made by social and political institutions must be involved in the making of those decisions. Employees not only derive their income from enterprises which employ them, but they devote a large portion of their daily lives to the enterprise. Decisions taken by or in the enterprise can have a substantial effect on their economic circumstances, both immediately and in the longer term; the satisfaction which they derive from their work; their health and physical condition; the time and energy which they can devote to their families and to activities other than work; and even their sense of dignity and autonomy as human beings.[4]

Implicit in the discussion of the codetermination movement is the conviction shown by European intellectuals that labor participation is desirable and that the real problem is one of developing the appropriate legal framework. Since the merits of codetermination are decided at the outset, no effort is made to determine the cost of this social reform.

Codetermination has also reached across the Atlantic Ocean and has established a foothold in the United States. The election of

3. M. Kreifels, "Codetermination in Germany," Conference on Codetermination, Ditchley Park, May 1980, p. 8.

4. "Employee Participation and Company structure in the European Community," *Bulletin of the European Communities*, August 1975, p. 9.

Douglas Fraser, President of the United Auto Workers, as a director of the Chrysler Corporation, is best known but not the only example of codetermination in the USA. It has, however, focused attention on codetermination in the country. Peter Drucker said:

> ...it seems apparent that codetermination, even when it is merely debated and then set aside, is an explosive issue that has important political as well as social ramifications. We in this country would do well to pay greater attention to this issue.[5]

A few early examples of codetermination in the USA have created the misleading impression that, unlike in Europe, labor participation in this country will develop contractually. In most cases, including the Chrysler Corporation, directors were elected by the stockholders and serve at their pleasure.

The California Labor Relations Act (CALRA) has in effect mandated codetermination in the agri-business in California. However, codetermination in Western Europe and codetermination introduced by CALRA are substantially different. In Europe, labor representatives on the boards of directors participate jointly with other directors in the decision-making process at the corporate level. Under CALRA a significant amount of decision-making power is simply transferred to labor unions. We shall discuss CALRA in more detail later in this study.

So, codetermination means the participation of the employees as well as labor unions in the firm's decision-making process. Codetermination laws grant workers and labor unions an important property right: to participate directly in managerial decisions including investment plans and the allocation of earnings. As Armen Alchian said:

> The proposal for [codetermination] is simply a proposal to transfer wealth of stockholders to employees, or more accurately to transfer a share of the stockholders' specific asset wealth to the providers of generalized, non-specific resources—called the employees. And it has no other viable economic function. That is why it does not appear voluntarily.[6]

5. "The Battle Over Codetermination," *The Wall Street Journal,* August 10, 1977.
6. A. Alchian, *Private Rights to Property: The Basis of Corporate Governance and Human Rights.* (forthcoming)

Whatever the facade of words, the major objective of codetermination is a transfer of wealth from the stockholders to the employees. This redistribution of wealth has social and economic consequences which arise from the interference by codetermination with the essential characteristics of a private property capitalist economy: *the capitalization into the present market-value of foreseeable future consequences of current decisions.* This interference with the working of capitalism stems from changes in the prevailing relationship between shareholders; managers, employees and labor unions; incentive structures; and the strength of the link between decision-making and who actually bears the cost or reward from changes in the market value of assets. In general, codetermination cannot be regarded as an unimportant experiment. It has the potential for bringing about profound changes in the quality of social life. Since Germany has been the undisputed leader in the development of codetermination in the West, this study will concentrate on the development of codetermination in that country.

Philosophical Foundations

The idea of labor participation in the management of business firms has a long tradition in Germany. References to labor participation can be traced back to the early 1800's.

As with most social programs, the codetermination movement in the West is the consequence of a set of ideas. Similarly, codetermination is not in practice an exact replica of the ideas from which it was born, but to understand the development of codetermination it is then necessary briefly to discuss its philosophical foundations.

German conservative Catholic philosophy and Marxism have made major contributions to the birth of codetermination. Those two philosophical movements have only one common trait: a strong anti-capitalist bias. What were the objections to capitalism which eventually gave rise to the idea of codetermination?

The capitalist system rests on the right of private ownership and contractual freedom. These two institutions supply incentives that generate specific and predictable behaviors. The pattern of behavior that stems from the basic institutions of capitalism is consistent with both economic efficiency and individual liberty. The survival trait for the individual in a capitalist society is to seek and negotiate voluntary exchange. The behavior of the individual is guided by the principles of self-interest, self-responsibility, and self-determination.

''Methodological individualism'' is the term that is used to define the position of the individual in a free society.

Methodological individualism does not mean that capitalism rejects tradition and morality. Tradition and moral norms that have passed the test of time tend to have strong survival traits. Tradition is to the human survival what capital is to the economy. However, methodological individualism frees the individual from subjugation to the constraints of tradition and morality. The individual is free to ignore some moral norms in the pursuit of his own preferences but he must bear the cost of his actions.

The capitalist community is then conceived as a voluntary association of utility-seeking individuals. The community has no predetermined outcome. Instead of the exogenously imposed idea of ''good life,'' the emphasis in the capitalism community is on the *rules of the game* that allow each individual the freedom of choice and the obligation to bear the costs of pursuing his own preferences. Whatever outcome emerges from the interaction of utility-seeking individuals is clearly an unintended outcome. But as long as the rules of the game are fair, such an outcome must also be fair. As Hayek says, ''Capitalism is an effective way of making man take part in a process more complex than he could comprehend, and it was through the free market that he contributed to ends which were not part of his purpose.''

What classical liberals considered as the freeing of man from the constraints of religion and tradition, conservative Catholics saw as the erosion of morality and rejection of all ''absolute'' values upon which moral norms are centered. Conservative Catholic philosophy then raised the issue of *the legitimacy of capitalism as a moral system.*

The Catholic philosophy considers the community as an organic whole. Members of the community are expected to cooperate in the pursuit of the prescribed outcome (common good). The rules of the game in the community are adjusted to the requirements of the common good. The social preference function is consistent with the concept of ''good life'' and is enforced by laws, tradition, and moral teachings of the Church. With respect to the firm, the conservative Catholic philosophy emphasizes the organic unity of the enterprise in preference to individual self-interest; cooperation between workers, managers, and owners in preference to profit maximization; and a humane aspect of the process of production in preference to efficiency. Thus, the idea of some type of codetermination is a predictable outcome of its teaching.

The conservative Catholic philosophy rejects methodological individualism not because of its lack of interest in individual liberty, disregard for freedom of choice and indifference to economic efficiency, but because the autonomy of individual choices in the free market does not necessarily generate *morally* satisfying sets of preferences. The fact is, however, that the free market does not generate preferences. It merely allows each and every individual to reveal his tastes whatever they might be. The conservative philosopher who argues against the liberty of individual choice which the capitalist system allows should direct his criticism toward the institutions—such as the educational establishment, the Church, the family, and the media—that form the preferences, rather than toward the free market in which those preferences are merely revealed.

Given individual preferences, there is positive moral content in the allocative outcome to which freedom of individual choice leads in an open-market, private property community. Moreover, the capitalist system promotes the development of individuals, cultivates the strength from confronting risk, and puts a premium on the respect for promises. A reputation for honest dealing is a source of wealth. Competitive markets weed out crooks, cheaters, and liars. While the market does not make people moral (or immoral), it raises the cost of unethical behavior. Thus, the capitalist system has a strong moral content.

While the conservative Catholic philosophy criticized the free market for its alleged failure to generate morally satisfying sets of preferences, Marxists raised the issue of the rights of ownership. Their position is that *private property rights are a major cause of exploitation of man by man.* In pursuing this line of analysis, Marxists revived Marx's concept of alienated labor and made it the central issue in their criticism of capitalism. Marx's analysis of the concept of alienated labor can be summarized in four steps that lead to the fundamental premise that the right of ownership is the major source of class struggle and exploitation in capitalism. First, since it does not belong to him, the product of his labor appears to the worker as an alien object. Second, the worker is then alienated from his work. Instead of being a source of satisfaction, work activity becomes merely a means for subsistence. Third, the alienation of man from his product and from his work activity results in his alienation from those who have the right to appropriate the product of his hands. Fourth, the alienation of man from another man is, because men belong to distinct social classes, in effect the alienation of one social class (the proletariat) from another (property owners). The right of ownership is then the source of exploitation and class struggle in capitalism. To a Marxist, codetermination is a step in alleviating the alienation of labor.

Sources of Current Support

The extent to which workers support codetermination is not clear. Codetermination was soundly defeated in Switzerland, the only country in which the issue was put before the voting population. Various surveys conducted in Europe show that the employees have a greater interest in the functions of the Works Council than in codetermination. One reason for this lack of interest is that codetermination is removed from the employees' individual problems. In general, workers seem more interested in information about the performance of their firms than in actual involvement with decision-making processes.

Labor's relative indifference toward codetermination is not too surprising. Workers' interests lie in the rate of growth of their incomes, not in participatory democracy. And the negotiation of collective agreements has been the best understood and historically tested method for influencing economic and social status of labor. Workers' support for codetermination depends on the ability of those who are actively promoting labor participation in the decision-making process to demonstrate to laborers that participatory democracy is indeed an effective method for raising their total compensation.

The major support for codetermination in the West comes from two groups: the intellectual community and labor union leaders. Predictably, both groups argue that their support for codetermination stems from a genuine concern for the economic and social status of labor. However, the intellectuals, as well as union leaders, support codetermination for reasons that are consistent with their own private interests.

Codetermination is a vehicle through which the intellectual community seeks to restructure Western societies in ways that conform to its own perception of justice and equality. That is, the intellectuals want to obtain for labor what they think workers should want for themselves. It is important to distinguish, however, between those intellectuals who see codetermination as a vehicle for making capitalism a better system and those who look upon codetermination as a step in destroying it.

The first group of intellectuals looks upon the modern corporation as a political entity. This view of the modern corporation justifies the critics' insistence on democratic participation of owners, managers, and employees in the decision-making process. They see codetermination a method for bestowing benefits on labor without any detrimental effect to stockholders.[7]

Another group of intellectuals that supports codetermination is the Marxists. They have revived Marx's criticism of capitalism that centers on the concept of alienated labor. Marxists support codetermination because it attenuates the right of ownership in resources. The following captures the essence of their position on codetermination:

> I would argue that in this historical period [capitalism] only an expansion of the degree of democratic and participatory control that individuals have over their lives is compatible with full personal development, rewarding social activity, the elimination of class, racial, and sexual antagonisms, and material equality. The contribution of political democracy to this end is vitiated by the totalitarian organization of production. Only democracy and participation in production—i.e. the replacement of the capitalism class by the working class as the architects of production, and the accountability of managers and technicians to the will of workers—is compatible with equality and full individual development.[8]

The support of union leaders for codetermination is predicated on the right—an important property right—to select workers who sit on the board of directors of business firms. In the absence of such a right, labor leaders would have incentives to oppose codetermination. However, once they have been able to secure this right, as they did in Western Europe, codetermination becomes a vehicle through which labor leaders could increase their political and economic in-

7. E. Batstone, "Industrial Democracy and Worker Representation at Board Level; a Review of the European Experience," *Industrial Democracy: European Experience*, Industrial Democracy Committee Research Report, London, Her Majesty's Stationery Office, 1976, p. 43.

8. H. Gintis, "Welfare Economics and Individual Development: A Reply to Talcott Persons," *Quarterly Journal of Economics*, 89, May 1975, pp. 301-2.

fluence over the character of economic life. For union leaders, codetermination is a power issue which enhances the union power because the worker-board members are either affiliated or dominated by their unions. Predictably, business firms' decisions are likely to be made on the basis of internal politics rather than economic considerations.

The main advantage for labor unions lies in the area of information. With union representatives sitting on the board of directors of business firms, the union has access to all financial and technical data which it could use in planning and conducting collective bargaining.

American labor unions, on the other hand, have been less than enthusiastic about codetermination. For example, the President of the Machinists Union said:

> We have no interest in replacing free enterprise with a Utopian system...And we believe workers can receive a better share of free enterprise at bargaining tables than in Board rooms.[9]

Lane Kirkland of the AFL-CIO was even more blunt in ruling labor unions' support for codetermination:

> The American worker is smart enough to know, in his bones, that salvation lies—not in reshuffling the chairs in the board room or the executive suite—but in the growing strength and bargaining power of his own autonomous organizations.[10]

These flat rejections by American union leaders of codetermination suggest that labor is not ready to substitute political decisions for collective bargaining on economic issues.

History of Codetermination in Germany

Codetermination in Germany finds its source in the philosophical origins of industrial democracy. As early as 1835, Professors Robert von Mohl, Wilhelm Roscher, and Bruno Hildebrand from the Univer-

9. J. Ellenberger, "The Realities of Codetermination," *AFL-CIO Federationist*, October 1977.
10. *Ibid.*

sity of Tubingen proposed to create "workers' committees" in business firms. They felt that capitalism had failed to emphasize moral issues. Their proposal did not amount to actual codetermination at decision-making levels. The proposal was limited to giving labor the right of hearing. The emphasis was on moral appeals to conscience rather than legal changes.[11]

In 1848, the first elected German Parliament met in Frankfurt. Among other matters, the Parliament intended to pass legislation that was called *Reichsgewerbeordnung.* That was the first legislative effort to create representation of workers in business firms. According to German lawyer and codetermination expert Walter Kolvenbach, Article 3 of the *Reichsgewerbeordnung* is one of the most important developments for study of the history of the codetermination movement in Germany.[12]

The law did not pass but an interesting development occurred in subsequent years. Many provisions of *Reichsgewerbeordnung* were voluntarily implemented by a number of firms. The workers and the owners of business firms found it in their self-interest to work out mutually beneficial contractual agreements *without* resorting to the authority of the state. The point is, of course, that parties to a contract can identify opportunities for exchange, determine their own trade-offs (which are not likely to be the same for all firms) and negotiate terms of exchange at a lower cost than a third party could possibly do it for them. While law applies equally to all firms, voluntary contracts allow the owner and his workers to identify and exploit opportunities that are specific to their firm.

The voluntary emergence of contractual agreements within business firms was eventually arrested by the state. Worker committee laws were enacted in Bavaria in 1900 and in Prussia in 1905. Those laws began the process of exogenous changes in the employer-employee relationship. Instead of endogenous development of contractual agreements that could vary from one firm to another in accordance with their own specific problems, the state began to impose a set of uniform rules on all business firms.

The Constitution of 1919 incorporated the concept of codetermination in Article 165:

11. See H. Monissen, "Labor Participation in the Management of Business Firms in Germany," in S. Pejovich (ed.), *The Codetermination Movement in the West,* Lexington, Mass: Lexington Books, 1978; and H. Tenteberg, Geschichte der Industriellen Mitbestimming in Deutschland, Tubringen, 1961.

12. W. Kolvenbach, "Codetermination in Germany," Unpublished paper, pp. 2-3.

> The wage-earning and salaried employees are called upon to cooperate, with equal rights and in community with the entrepreneurs, on the regulation of wage and working conditions and on the total economic development of the productive forces.

In 1920, the Works Council law was enacted. It provided workers with the right of hearing in social and personnel questions. In 1922, a new law was passed. According to that law one or two employees must be seated on supervisory councils of business firms. *It was the first law on codetermination in Germany.* The development that began in 1848 with a proposal to establish workers' councils has eventually led to labor participation in the management of business firms.

During the Nazi years all laws on Works Councils and codetermination were abolished. In 1946, the Military Government passed the so-called Act 22 which reestablished Works Councils. In 1951, the law on the Codetermination of Employees on the Supervisory Boards and Boards of Management of Enterprises in the Coal Mining, Iron and Steel Producing Industry was enacted. The stage was then set for the current phase in the development of codetermination in Germany.

The framework of labor participation in the management of business firms in today's Germany is determined by the following three laws:

The Montan Act of 1951

The Works Constitution Act of 1952
(revised in 1972)

The Codetermination Act of 1976

Initially, the allies endorsed the idea of nationalizing the Montan industry (coal, iron, and steel). For political and social reasons the idea was eventually dropped and the Montan industry ended with a codetermination scheme. The stockholders and the employees were given an equal number of seats on the supervisory council. Labor unions dominated workers' representatives.

The first post-war elections in 1949 gave the conservatives (led by Adenauer) a substantial majority in the Parliament. Adenauer adopted the conservative philosophy regarding codetermination.

He wanted to promote the codetermination model which emphasized the organic unity of the owners and the employees in business firms and rejected the claim of trade unions that they speak for labor. However, under the threat of strikes and after some heated political discussion in and out of the German Parliament, Adenauer had to work out a compromise that preserved the union gains in the Montan industry.

The Montan Act of 1951 covers all firms in the mining and the iron and steel producing industries that employ at least 1,000 workers. The supervisory council of a firm in the Montan industry consists of eleven elected members.[13] The stockholders and the employees appoint four members each. In addition, the stockholders, as well as the employees, appoint an additional external member who cannot be a representative either of a union or of an employer organization nor can he be employed by that firm or otherwise connected with it in some economic way. The eleventh member is jointly elected by all supervisory board members.

The Works Constitution Act of 1952 is a clear expression of the conservative codetermination model. However, subsequent legal developments and in particular the Codetermination Act of 1976 have de-emphasized the role of conservative Catholic philosophy and strengthened the role of labor unions in the codetermination movement.

The Works Constitution Act of 1952 stipulates employees' rights at three different levels: the personal, the shop, and the decision-making levels of the firm.

On the personal level each employee is granted the right to information, hearing, and discussion of issues such as working conditions, hiring, firing, and layoffs. On the plant level, the act prescribes the institution of a *works council.* The works councils are elected by the employees and vary in size. The works council's major functions are to propose measures that enhance the employees' welfare, to monitor existing collective bargaining agreements, social legislation and other internal rules, and to receive complaints from the employees and negotiate their settlements with the employer. In general, the function of the worker council is to act as a social agent for the employees.

13. Business firms with capital assets in excess of 20 million DM may appoint 15 members to their supervisory councils. If capital assets of a firm exceed 50 million DM the firm may have the maximum of 21 members on its supervisory council.

On the decision-making level of the firm, the Works Constitution Act stipulates that in firms that employ more than 500 people, one-third of the members of the supervisory council must consist of labor representatives. The employee representatives are directly elected by secret ballot. They are not appointed by labor unions. Thus, the Works Constitution Act introduced a type of codetermination that is consistent with the conservative Catholic philosophy.

The Codetermination Act of 1976 is a clear-cut departure from the conservative philosophy that considers the firm as the organic unity. The union leadership in Germany never accepted Adenauer's codetermination model of 1952. It continued to press for the extension of the Montan model to the entire German industry. The Act of 1976 represents a definite victory for German trade unions' and neo-Marxists' position on the role of codetermination in the West.

The Codetermination Act of 1976 applies to all business firms that have more than 2,000 employees (about 470 firms). The Supervisory Board has 12 members. Of these 12, six are representatives of the shareholders and six are representatives of the employees. In firms which employ more than 10,000 workers, the supervisory board may have the maximum of twenty members with an equal distribution of seats between the shareholders and the employees.

The rights of the German workers can be summarized as follows:

> The rights to consultation and collective bargaining on the plant level are ensured by the works council of the firm which is composed of employees only. The codetermination rights on the decision level are supposed to be enforced by the employees' representatives on the supervisory board. The supervisory boards of the firms in the coal, iron and steel industry are subject to equal representation of the shareholders and the employees...German firms with more than 2,000 workers also have an equal representation on their boards, but...the chairman who holds the casting vote in cases of a deadlock is elected by the shareholders. The firms with less than 2,000 employees have a minority employer representation on their supervisory boards.[14]

14. G. Benelli, "The Codetermination Movement in the West," Unpublished paper, pp. 14-15.

Recent Experiences in Germany

It is too early to evaluate economic and social consequences of codetermination in Germany. The evidence is far from complete. Yet some problems have already surfaced, the nature of which suggest that not only is codetermination costly as a method of organizing production but also it is a vehicle for the transfer of wealth from the shareholders to labor unions and employees of business firms.

After the passage of the Montan Act of 1951 many business firms tried to escape the parity representation on the supervisory board *via* mergers, reorganization and other structural changes. Such an escape would make them subject only to the one-third employee representatives requirement of the Works Constitution Act. German trade unions successfully fought such attempts by business firms to escape the legal requirements of the Montan Act in the parliament, in the courts, and through the use of various special "agreements" (i.e. power plays) with individual firms. The same situation occurred after the enactment of the Codetermination Act of 1976. A large number of firms tried to avoid being subject to this law; the result was that the Act which was expected to apply to about 620 firms eventually applied to only about 470 enterprises, evidence that codetermination is harmful to the shareholders.

There are many problems with the practice of codetermination. For instance, the election procedure has taken up to 56 weeks. Companies have spent millions of marks for travel expenses, printing costs and the loss of working hours. Another cost is associated with the fact that the supervisory board consists of two groups: the shareholders' representatives and the employees' representatives. The result is that prior to the official meetings of the board separate sessions have to be held by those two groups to work out their respective positions. Thus, the discussions in the board room are not really free exchanges of thoughts, ideas, and judgements but a sort of bargaining between the two sides. A case in point would be Volkswagen's decision to open a plant in the USA. The decision was delayed for over two years due to a costly political debate, as economic decisions were opposed by union political control.

The question of conflict of interests has also surfaced. The management is supposed to give the supervisory board all the information about the firm. The members of the supervisory board are, in turn, expected to keep information secret. However, representatives of labor unions feel that when it comes to jobs, wages and workers' welfare, their obligation to employees supersedes any secretary obligation.[15] This was the case in many firms such as Volkswagen and AEG. Also, if a union can (through its representatives on the board) arm itself with critical information about the firm, it would have a serious advantage in wage negotiations and other decisions.

Codetermination and Property Rights

Economic activity involves social interaction at two levels. The first level involves the development, specification, and modification of property rights by which the community seeks to resolve social problems that have their source in economic activity. Property rights define the *rules of the game.* Changes in property rights are changes in the rules of the game.

Writing on the concept of property rights, I. Fisher said:

> "A property right is the liberty or permit to enjoy benefits of wealth while assuming the costs which those benefits entail...Property rights, unlike wealth or benefits, are not physical objects nor events, but are abstract social relations. A property right is not a thing."[16]

Property rights are defined as the sanctioned behavioral relations *among men* (such as laws, regulations, and customs) that arise from the existence of scarce goods and which pertain to their use. The set of property relations, which describe the position of each individual with respect to the utilization of scarce resources defines the general character of social and economic life in the community, thus defining the country's economic system. Individuals respond to incentives, and the pattern of incentives present at any time is influenced by the prevailing property rights structures.

The second level of social activity involves decision-making—individual choices and contracts (exchanges) within the prevailing property rights structures. People seek contracts and negotiate terms of exchange expecting to reach a higher level of satisfaction. Thus, the second level of social activity is concerned with maximizing the

15. M. Paul, "Germany's Requiring of Workers on Boards Causes Many Problems," *The Wall Street Journal,* Dec. 10, 1979, p. 1 and 29.
16. I. Fisher, *Elementary Principles of Economics,* New York: Macmillan, 1923, p. 27.

behavior of individuals and with the allocation and use of resources. Importantly, the prevailing property relations determine the extent of contractual (exchange) activities.

Codetermination affects both levels of social activity. That is, the effects of codetermination are not limited to marginal adjustments within the system. Labor participation in the management of business firms changes the prevailing property relations between the shareholders, managers, employees, and labor unions; it affects the institutional structures. The analysis of codetermination must then identify changes in property rights structures and establish their effects on the rules of the game before turning to the question of how the game is played.

In the real world, institutional structures cannot be assumed to be unchanging. As new property rights develop and as the old ones are modified the country's institutions change. The issue is the analysis of the consequences of changes in property rights that could be attributed to the laws of codetermination.

The laws on codetermination trigger institutional restructuring that is exogenous to the system. The laws change the prevailing relationship between the shareholders, managers, employees, and labor unions. Consequently, they affect the location of decision-making powers, appropriability of rewards, and the relationship between risk taking and bearing of costs in labor participatory firms. Through those effects, the laws change the way the game is played, especially managerial decisions, wage negotiations, vector of labor compensation (fringe benefits, share of profit, contractual wage, etc.), employment policies, and equity financing. Proponents of codetermination use the government to pass legislation that results in a politically determined transfer of wealth from one group of people to another. The relevant issue for economic analysis is to look into the effects of the institutional restructuring on the allocation and use of resources in the community. For every aspect of the market that is touched by new rules must cause distortions in the allocation of resources.

Laws on codetermination do not emerge in response to the requirement for new contractual forms. In a capitalist society we observe a large number of different types of firms such as single proprietorship, partnerships, cooperatives, not-for-profit firms, and corporations. All these firms have emerged through voluntary contractual negotiations and survived competition from other types of firms. In fact, capitalism generates a selection process among various types of firms that is consistent with economic efficiency. Different types of firms seem to survive in different markets. Partnerships appear more efficient in labor intensive industries such as law, while the corporate firms are more likely to survive in capital intensive industries.

The crucial evidence is that the codetermining firm has not emerged voluntarily in the West; it has not survived by demonstrating its superiority over competing types of firms. There is no law in the USA or Western Europe that prohibits codetermination. If that type of organization were really efficient it would have been negotiated voluntarily. The very fact that the government has to mandate the codetermining firm and protect it from competition is evidence of its inefficiency.

> Indeed, labor can start, and in rare cases has started, firms of its own. Moreover, firms are free to write any kind of contracts they wish with their employees. If they choose to, they can offer no-dismissal, no lay-off contracts (tenure at universities). If they choose to, they can establish worker councils and agree not to change production methods without worker approval. Moreover, employers would establish such practices if the benefits exceeded the costs. Furthermore, if laborers value the security and "self-realization" which such participatory arrangements afford them at more than their costs to the employer, they are in a position to offer voluntary changes which it will pay the employer to take...Since (with minor exceptions) these arrangements are not observed, we infer that workers do not value the security, management participation, "self-realization," etc. at more than the cost of providing them.[17]

The Allocation of Resources

Whatever the facade of words, a major purpose of codetermination is to bring about redistribution of income. Emotion-charged terms such as "industrial democracy" and "labor participation" are merely code words for using the political system to secure wealth

17. M. Jensen and W. Meckling, "Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination," *Journal of Business*, 52, 1979, pp. 472-3.

transfers. The argument that under codetermination productivity of labor will increase in response to changes in workers' total compensation and reduced alienation destroys the case for codetermination that is mandated by law.

Codetermination shifts the responsibility for decisions to a group of people who are not at all affected by the consequences of the decisions. No matter what the outcome of the decision is, the worker receives contractual wages—his risk is limited. Codetermination puts stockholders into an uninviting situation—if the corporation makes an investment decision that is successful, the gains are shared with labor. If, on the other hand, the investment decision is not successful, stockholders alone bear the losses. Codetermination violates the risk-reward relationship which, in turn, must raise the cost (reduce the supply) of equity capital.

Economic analysis of codetermination presupposes a "political" model capable of explaining the behavior of the board of directors, the affects of majority-voting on the management of business firms, and the perception of the average worker concerning the relationship between his work effort and rewards from labor participation in the decision process.

It follows that economic analysis of codetermination faces a serious problem just getting off the ground. The best we can do at this time is to identify social institutions that codetermination tends to affect and infer some predictable behavioral effects of labor participation on the allocation of resources.

The freedom of contract and the right of ownership are, as it was said earlier, two fundamental institutions of capitalism which are endangered by forced codetermination.

Forced codetermination restricts individuals' freedom to negotiate the most beneficial organizational forms. The freedom of contract means that labor participation in corporate management could emerge out of voluntary contractual arrangements as have many other types of firms. Indeed, there are cases in which codetermination has emerged voluntarily. If codetermination raises the firm's productivity or bestows benefits on labor in excess of stockholders' costs, why do we need laws on codetermination?

Codetermination also interferes with the right of ownership. Labor participation in the management of business firms implies the political action of granting labor a voice in areas of decision-making that have traditionally been the prerogative of ownership, either directly or through hired representatives (e.g. managers). What is important to bear in mind is that current decisions about the use of resources have future consequences (measured by changes in the value of resources). Different property rights arrangements imply different assignments of benefits and losses from current decisions. In a private property capitalist economy the owner bears all the future consequences of his (or hired representatives') current decisions.

Codetermination causes a separation between decision-making and risk bearing.[18] In a codetermining firm those who participate in decision-making processes do not bear *all* changes in the value of the firm's assets. Codetermination then attentuates the right of ownership. Attenuation of ownership means a change in the quality of decisions. Given the workers' time horizon, which is limited to their expected employment by the firm, the labor participatory firm has more incentives to choose investment alternatives and business policies that shift incomes forward and postpone costs. For example, consider two investment alternatives of equal costs. The expected present value of one alternative is $1,000 while the other yields only $750. However, if the returns from the first alternative are discounted over a period of 20 years and those of the second over only five years, workers could easily push the management in the direction of choosing the less profitable one. Even in the absence of sharing in the firm's profits, wage negotiations and their perception of job security would provide workers with incentives to prefer business policies that promise larger annual earnings over a limited time period to those policies that maximize the firm's worth.

If codetermination means a transfer of wealth from the shareholders to labor we can predict the following chain of events. The rate of return from capital invested in labor participatory firms (mostly corporations) will fall. The resulting flight of capital into the other (non-participatory) alternatives such as small firms, human capital, bonds, foreign investment will change investment patterns in the economy. The rate of capital formations in the corporate sector will be smaller and in other areas greater than it would otherwise be. The rate of return in non-participatory investments will fall while the marginal productivity of labor will rise. In the corporate (participatory) sector the rate of return from investment will rise while the marginal productivity of labor will fall. In equilibrium, corporate firms will produce smaller outputs and charge higher

18. See P. Pejovich, "Codetermination: Labor Participation in Management," *Modern Age*, Winter 1978, p. 36.

prices than they would otherwise. Conversely, prices will be lower and outputs greater in non-participatory sectors of the economy. If this simple scenario is predictive of the general effects of codetermination, labor participation in the management of business firms will result in the reallocation of resources away from the most efficient, technically advanced and productive sector of the economy and toward less efficient, technically less capable and less productive alternatives. A general decline of the level and character of the economy could then be predicted.

Codetermination is a costly political reform. Let us now summarize some conspicuous costs of codetermination:[19]

(i) *Monopoly in the market for business organizations.* There is no law in the USA or Western Europe that prohibits codetermination. If that type of organization were really efficient, it would have emerged contractually. The fact that the law has to mandate the codetermining firm, and to protect it from competition by other types of firms, is evidence of its relative inefficiency.

(ii) *Increased cost of equity capital.* The fact that stockholders must be forced by law to accept codetermination is the best evidence that they are adversely affected by it. Labor representatives on the board of directors represent those who have no claim on the capitalized value of assets. A major consequence has to be a higher cost of equity capital to offset lower returns to the holders of stocks and bonds.

(iii) *Changes in the pattern of investment.* Labor representatives on the board of directors have incentives to push for investment decisions that promise to maximize near term cash flow.

(iv) *Reallocation of resources.* An increase in the cost of equity capital means that the average rate of return in labor participating firms will fall. The result will be a shift of capital toward non-participatory alternatives such as smaller firms, human capital and foreign investments.

Codetermination in California

As it was suggested earlier in this study, codetermination in Western Europe and codetermination introduced by the California Labor Relations Act are substantially different. In Western Europe, labor representatives on the board of directors participate jointly with other directors in the decision-making process at the firm's level. Under the California Labor Relations Act (hereafter CALRA) a significant amount of decision-making power is simply transferred to labor unions. According to Cottle et. al., CALRA has made it possible for labor unions to: assign jobs to union members, allow or forbid field workers to be retained by the employer for more than one growing season, require workers to donate to selected political organizations, establish the type of pesticides to be used on crops, impose research restrictions on the universities in California on the development of labor-saving machinery, and, under the good standing rule, tell individual farms which workers may be hired. CALRA has placed many management prerogatives in the domain of labor unions—but not of labor. It has significantly reduced the opportunity set of the management in the agri-business. For example, the union's right to enforce the good standing rule and to forbid a worker's right to negotiate his employment with an employer leads one to question whether individual workers in the agri-business in California are now freer than they were before CALRA. Rather than joining the management as is the case in Western Europe, labor unions in the agri-business in California can dictate to it.

According to Cottle et. al., the labor union in the agri-business in California has enough power to control the rate of output and to appropriate monopoly profits.

Conclusion

This study is an attempt to trace the history and development of codetermination in Western Europe and to assess its economic, political and social consequences. The study concentrates on the

19. S. Pejovich, "The Costs of Codetermination," *Review of Social Economy*, December 1980.

20. R. Cottle, H. Macaulay and B. Yandle, *Government Regulation of Wages and Conditions of Work: The Case of the California Labor Relations Act*, College Station: Texas A&M University Press, forthcoming. To the best of my knowledge, this work is the only one on the subject of forced codetermination in the USA.

codetermination movement in Germany because that country has been the undisputed leader in promoting various codetermination schemes.

The idea of codetermination is not a recent phenomenon. It arose from naive but serious misconceptions about the nature of capitalism. Predictably, the actual implementation of labor participation has generated the consequences that deviate from the intentions of its ideological founders.

Economic consequences of codetermination are misallocation of resources, redistribution of income, reduced supply of equity capital, and changes in the pattern of investment. Economic consequences of codetermination are traceable to using political mechanism rather than market mechanism in solving practical economic problems. The unions' rise to power is a major political consequence of codetermination. Most importantly, codetermination has failed to emerge out of voluntary contracts as have many other organizational forms. The result is that codetermination has to be mandated by law. Social consequences of forced codetermination, then, are easy to identify. Forced codetermination *restricts* individuals' freedom to seek and negotiate mutually preferred contractual arrangements and *attenuates* the right of ownership in capital goods. Social consequences of codetermination represent a major departure from capitalism. Codetermination does not merely weaken capitalism—it attacks capitalism at its very roots.

10 The Heritage Lectures

Should labor participate in the management of business? In recent years West European countries have followed Germany's lead in experimenting with codetermination, a method of giving workers a voice in executive decisions.

Steve Pejovich, director of the Center for Free Enterprise at Texas A&M University, offers an analysis of codetermination —its origins and its effects on free enterprise.

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