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I Z A
World of Labor
Evidence-based policy making

Do works councils raise or lower firm productivity?

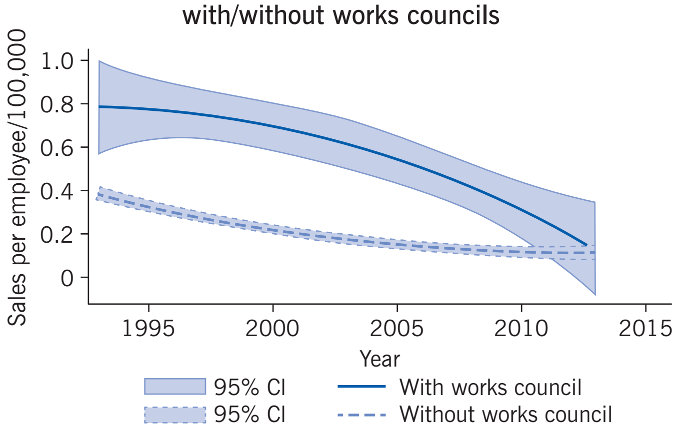
Works councils can have a positive impact on firm productivity, but only when specific conditions are in place

Keywords: works councils, productivity, employment, wages and profit effects

ELEVATOR PITCH

The German model of co-determination (*Mitbestimmung*) with works councils, in which workers are involved in the management of a company, was a role model for other countries for many years. However, since the 1990s the appeal of works councils has been declining, to the extent that now even employees are sometimes voting against representation. This was recently demonstrated by workers at the Volkswagen factory in Chattanooga, Tennessee, who voted against union representation. An important question for firms and for policymakers is whether the adoption of a works council has a positive influence on a firm's productivity and what the consequences are for a firm's profits.

Productivity of German firms, split by firms with/without works councils



Source: IAB Establishment Panel. Online at: http://www.iab.de/en/erhebungen/iab-betriebspanel.aspx

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KEY FINDINGS

Pros

- Works councils improve information flows between management and workers.
- Works councils lead to a higher investment in firm-specific human capital.
- Workers have more influence and control over management decisions and policies of the firm.
- More trust is generated between employees and employers and greater job satisfaction developed.

Cons

- Costs are incurred by the firm for the paid release of council members from employment.
- Works councils can lead to increased regulation and lagged decisions.
- Works councils can lead to conflicts between the works council and management.
- There is less investment in physical capital.

AUTHOR'S MAIN MESSAGE

Empirical research, particularly from Germany, shows that works councils can have positive productivity effects. On average, however, the effect has been decreasing over the last 20 years and a convergence in productivity is being observed between firms with and without works councils. A positive impact on productivity is more likely to be the case under certain conditions, specifically when: (i) there is a process of collective bargaining; (ii) there are no conflicts of interest between management and works councils; and (iii) co-determination is based primarily on voluntary agreements rather than on legal requirements. Policymakers should provide the necessary resources and appropriate, non-discriminatory incentives in order to encourage this.

MOTIVATION

Works councils are present in many European countries. Although they have different names and are structured differently, they play an important role in the system of industrial relations. In the US, works councils operate in the form of a company union. One of the most commonly examined implementations of a works council model is found in Germany, where this institution has a long tradition, first established in the Works Council Act (*Betriebsrätegesetz*) in 1920, then codified in the Works Constitution Act (WCA—*Betriebsverfassungsgesetz*) in 1952 and last amended in 2001.

Works councils in Germany

"*Mitbestimmung*," literally translated from the German as "co-determination," is a process by which workers have an active and participatory role in the management of a firm.

The practice was established in Germany in 1951 through the Cooperative Management Law and amended in 1976 through the Co-determination Act (*Mitbestimmungsgesetz*), which established parity co-determination for firms with over 2,000 employees.

The German Co-determination Act is the foundation of German industrial policy and is based on the principles of equality and cooperation of capital and labor, democratization of the economy and social development.

German works councils have more influence on firms' decisions than is the case in other European countries. Employees have a guaranteed right to elect a works council for all establishments with five or more employees. Councils negotiate with management over different questions of company policy, with different (tiered) rights for different issues. The weakest right is that of information and consultation. In other cases they have the right to veto certain management initiatives. Finally, on some issues relating to new measures in the area of social and labor matters, they have the same rights as management, e.g. on new payment methods, the allocation of working hours, and the introduction of technical devices designed to monitor employee performance. The rights of works councils differ from those of unions: they do not have the right to strike or to negotiate on wages [1].

The effects of works councils are manifold but also controversial. In particular, there has been an intensive debate about the impact and influence of works councils on firm productivity. This contribution summarizes the major theoretical arguments and empirical findings, and so will be of interest to policymakers who are uncertain whether further reform is necessary and which options should be considered.

DISCUSSION OF PROS AND CONS

Information, cooperation, control, trust, and conflicts

Works councils can exert a "collective voice" role and communicate worker discontent and preferences to management. If the option of an employee "voice" rather than "exit" determines the relationship between employers and employees, this can lead to a better work ethic and less absenteeism, higher work satisfaction, and higher productivity. However, employees may also refuse to cooperate and withhold effort if an employer does not commit to taking their interests into account [2].

In addition, a greater sense of trust in management information is generated amongst employees if a works council has a degree of control in management decisions. The willingness to invest in a firm's human capital also increases. In contrast, the presence of a works council can provoke conflict in the establishment when a council might use its co-determination rights to blackmail the employer into concessions on issues over which it has no direct influence.

Importantly, the council could delay decisions on staff movements where it has veto rights. Co-determination can therefore weaken the management's authority. Conversely, the council could commit to cooperating with management and endorse work agreements where it has legal rights.

However, it should be stressed that the impact of councils on work practices is ambiguous. On the one hand, councils foster the trust that is necessary for establishing productivity-enhancing work practices, which could result in higher wages. On the other hand, councils may push for work practices that require less effort and consequently lower productivity [2]. This casts some doubt on the finding that on balance councils always induce strong positive productivity effects [3].

Whether owners and management view councils and their activities as predominantly positive or negative depends on which type of workers dominate. Establishments with a high share of blue-collar workers are more likely to be characterized by a works council presence and a negative management view toward employee involvement in decision making. When councils are installed in establishments with a high proportion of highly qualified white-collar employees, management is likely to take a more positive view. The presence of highly qualified staff is conducive to cooperative relationships between works councils and management and higher productivity. Whether this increase is driven by the qualification of the workforce or by cooperation between works council and management is an open question [1].

A further important point is how conflicts around the distribution of profits are managed and whether they are solved not at the establishment level but higher, e.g. at the industry level. In the latter case works councils can focus their activities on increasing productivity, rather than the redistribution of profits, as a tool for raising wages. However, a necessary condition for this scenario is the presence of collective bargaining [2]. One would expect that in establishments covered by collective bargaining agreements, works councils would engage more in productivity-enhancing activities than in rent-seeking activities, relative to councils in uncovered establishments. Works councils and management are more likely to agree productivity-enhancing measures when negotiations about these are separate from wage bargaining, e.g. because the latter is done at a collective rather than firm level.

Empirical investigations into works councils' net impact on economic performance are faced with the problem of being unable to capture certain characteristics of the firm that are not easy to measure. Management competence, for example, is usually not quantifiable. However, this variable may have an impact on all dimensions of plant performance, including labor productivity. Highly able managers will organize the production process in such a way that it leads to highest productivity for a given set of establishment characteristics. Incompetent managers do not recognize what are the relevant productivity-determining characteristics of an establishment and therefore their decisions are inconsistent and not clearly productivity-orientated [4].

There is good reason to expect that the effects of competence on productivity are not the same for all firms. It may well be the case that competent managers will cooperate with a works council in a way that materially enhances productivity, while incompetent managers who oppose works councils in principle will fail here [4].

The total value of a firm's capital, i.e. its capital stock, is a further variable that influences both productivity and the existence of a works council, but is often unobserved. Productivity is enhanced by a state-of-the-art capital stock, which is also linked to the probability that a council is in place. The more the capital stock increases profits, the more employees are interested in profit-sharing and a works council can help implement this. If the capital stock and management attitude are not accounted for in an empirical productivity analysis, the influence of works council effects is consequently biased.

Employment effects of works councils

The relationship between works councils and employment growth is ambiguous. It has been suggested that the introduction of a works council enhances efficiency and that subsequent productivity advantages lead to price reductions and higher demand for the product [5]. As a consequence, we would expect that the number of dismissals will fall and hires will increase. Empirical investigations of dismissals by the firm and voluntary resignations by employees show a negative relationship between works councils and both kinds of separation. Empirical analysis finds that this is particularly valid for skilled blue-collar as well as for qualified white-collar workers [6].

On the other hand, the costs of adjusting the workforce may discourage employers from expanding it. Works councils may aggravate this problem by making dismissals more cumbersome through expensive redundancy packages. It should be noted that when employment is negatively affected by external influences, the situation can be offset by increased labor flexibility within the firm. Indeed, there is evidence to support the view that councils contribute to this increased internal flexibility. The presence of councils is positively associated with the use of flexible hours. Councils also contribute to the introduction of working time accounts that help establishments adjust production to fluctuations in demand, without the requirement to pay overtime [7].

If profits are negatively affected by the adoption of works councils because of cost increases, such firms experience lower employment growth rates in the long term compared to other identical organizations. Alternatively, works councils may be of particular relevance to employees during times of redundancies. If, for example, the external economic climate worsens, the workforce might decide to adopt a works council in order to be better prepared for possible negotiations about the conditions and extent of dismissals. Thus, works councils may be the result of pessimistic expectations about the future. In which case, we would be likely to see the adoption of a works council in a firm coincide with a period of slow or stagnant employment growth [5].

Works councils offer an alternative to dissatisfied employees who deliberate whether or not to leave their job. Solving employee dissatisfaction and problems through discussion and negotiation with the management can work to improve labor relations in the establishment and may result in lower rates of resignations and dismissals [8].

Works councils, job satisfaction, and active owners

Some empirical studies have investigated the effects of unions on job satisfaction. However, less attention has been given to the influence of works councils on job satisfaction. Some of these studies suggest a negative relation. If employees prefer direct participation and autonomy at the workplace, works councils can constrain this possibility and create employee dissatisfaction. Although works councils may aim to mobilize employees to reach stronger support in formalized negotiations with the employer and to have a better chance of enforcing their demands, individual liberties may suffer from this behavior [6].

Other studies, however, indicate a positive relation between works councils and job satisfaction. Analogous to unions, works councils act as a “collective voice” institution. Employees have a better chance of expressing their dissatisfaction and of achieving positive change via councils compared to individual protest. In many cases, the employer is also interested in information about the workers’ preferences in order to adjust the working conditions. If the employer follows the council’s advice, it would be expected that employees’ job satisfaction will improve [6].

A works council with information rights concerning the firm’s economic situation can foster trust between the employer and employees. The latter are less likely to fear unjustified increases in target levels for performance standards. The activities of the council protect employees’ interests and may lead to an increase in job satisfaction. Respect and appreciation from the employer positively influence job satisfaction [6]. A works council’s behavior can therefore lead to an increase in procedural fairness and to a rise in job satisfaction, combined with increased commitment and higher effort.

Even if works councils generally increase job satisfaction, it is ambiguous whether all employees benefit in the same way. On the one hand, the presence of a works council makes wage discrimination more difficult for an employer, which most affects those who were previously most affected (e.g. female workers). On the other hand, works councils may focus on the interests of male employees, who are still the major clientele of councils in many firms. There may also be differences between blue- and white-collar employees. For example, councils have a strong influence on working-time regulations for shift working. This field is less relevant for white- than for blue-collar workers. As tasks of white-collar workers are less clearly regulated than those of other employees, councils are more engaged in open questions of working conditions for the former [6].

It also makes a difference if firms are directed by managers or owners, as their aims differ. The profit motive is dominant for owners, while managers may pursue their own interests—for example, high personal income and authority to decide. “Active owners” may forgo some opportunities in order to increase profit. They can also reduce potential problems of management self-interest in the firm by monitoring the managers’ actions.

They have access to the information flows within the establishment and have greater control over decision making. This way they can bring the establishment’s policy into line with the profit motive. Active owners’ support for works councils will depend on the effects of co-determination on profit. From a theoretical viewpoint, the net effect is ambiguous. If it is positive, active owners should support co-determination. However, if the behavior of owners and management is mainly driven by an independence motive, they will try to prevent works councils even if co-determination would contribute to higher performance [9].

Wages, investment, and training

Even though wage negotiations between council and management are barred by law, the works council may still influence wages. Empirically, works councils are associated with higher earnings. The indirect way in which this might be the case could be that if the employer does not agree to the works council’s suggestion for wage increases and wage structure, the council can threaten to be uncooperative in other areas where its acceptance is necessary, e.g. on the introduction of a new payment method. Based on this power they could delay or prevent decisions in other fields. If they contribute to higher wages in this way they can also positively affect productivity.

The impact on investment in physical capital, however, could be negative. When works councils are short-term oriented they do not favor extended investment activities, so as to retain a broader share of profits for distribution to labor. Also, the owners’ incentive to invest in new capital is sometimes negatively affected by the works council, e.g. if the works council requires the inclusion of the workforce in the returns on investments [7]. This behavior induces a decrease of productivity in the long term. However, one study does not find evidence that a works council’s formation adversely affects investment [10].

Additionally, firms with works councils make higher investments in training relative to other firms, potentially in order to increase wages via higher qualification. One study finds the fraction of former trainees still employed with the same firm five years after training is significantly higher in the presence of works councils, and that this outcome is more pronounced for firms covered by collective bargaining [11]. Long-term commitment decreases problems of delays in investing in firm-specific human capital, which has positive effects on productivity.

The cost of work councils

Works councils, particularly in Germany, are costly for firms. In contrast to other countries, the employers bear the full costs of works councils. Members of a works council are partially released from employment but still receive their full wage. Works councils also contribute to an increase of apprenticeship and further training, which also leads to higher costs. For example, it was found that a firm with a works council incurs approximately €1,800 higher net costs per apprentice and year of training compared to a firm without [11].

Possible conflicts between the management and the works council, increasing regulations, and lagged decisions also cause additional costs. Slower decision-making can mean a loss of profitable opportunities and sub-optimal allocation of a firm's resources. Decreasing profits result if works councils do not help to save costs and if the costs are not mitigated by higher output. Whether or not productivity is also affected is unclear; it can depend on the productivity of the workers released for council duty compared with the rest of the staff. The impact of the works council members on productivity during council activities should also be considered.

Effects on profits

As works councils usually induce higher productivity but also higher costs, the effects on profits are *a priori* unclear. One reason that many investigations find negative effects on profits might be that they use self-reported ratings of profitability. It can be shown that subjective profit measures are a poor measure of actual profits. More positive works council effects on profits are found if an objective measure is used, if the capital stock is considered as a determinant of profits, and if the estimations factor in self-selection. Generally, it is more likely that profits increase in firms with a works council under collective-bargaining agreements.

The impact of works councils on productivity

Most empirical investigations find a positive impact of works councils on productivity. However, some studies find no effects on productivity and some show even a negative effect, which has been interpreted as a restriction of freedom of decision making for able managers who are held back by bureaucratic, representative participation. However, when the estimations are based on subgroups the results differ. For example, negative productivity effects are revealed only for plants without profit sharing, while in plants with profit sharing the effects are positive. Most studies of small firms do not find any productivity effects. However, it is unclear whether no actual influence is at play or whether the small number of observations is responsible for the result.

Differences in productivity effects can be observed between the manufacturing and service sector and between plants that are covered by collective bargaining and those that are not. No effects were detected in firms that are not covered by collective bargaining [2]. Some additional productivity effects were revealed in manufacturing plants under collective bargaining.

International comparisons

While the effects of works councils on firm-level performance have been extensively addressed in Germany, similar studies are less available for other European countries. However, in one undertaken in the Netherlands, managers were asked whether they believed that works councils have a substantial positive, neutral, or negative impact on efficiency. Fifteen percent of the managers reported a negative view while 8% had a positive view. The authors argue that a formal leadership style contributes negatively to managerial opinion of a works council's effectiveness. Proactive councils are not appreciated at all by executives, and managers believe that a works council is only effective when it takes a passive role [12].

International comparisons are available mainly in the form of case studies. A new investigation based on the European Company Survey 2009 compares 25 EU countries aggregated in five clusters (Germanic, French, Anglo-Saxon, Scandinavian, and Transition) [13]. A very negative influence on the firms' economic situation is found in the Germanic cluster compared to a positive one in the Anglo-Saxon setting. The authors conclude that works councils obstruct firm performance in countries where worker involvement is mandatory and where employee delegates have been given substantial legal power. On the other hand, voluntary agreements characterized by information and consultation, which dominate in the Anglo-Saxon countries, appear to have a positive effect. However, the effect of trade union presence is significantly negative in the French and Transition clusters. No clear effects on productivity can be derived from these results.

LIMITATIONS AND GAPS

While from a theoretical perspective both positive and negative influences of works councils on productivity can be identified, it is not clear which dominates without empirical analysis. Though the empirical results are not clear either. These can be complicated by certain characteristics and influences in management or worker behavior that cannot be easily measured (such as management competence, for example, which is usually not quantifiable), or possible issues of "causality."

An important question in this respect is whether works councils are adopted because labor productivity is high or whether works councils foster increasing productivity. In contrast to earlier studies, more recent studies analyze whether differences exist between subgroups. These studies show that the productivity impact of works councils differs between small and large firms, between younger and older firms, between enterprises that are managed by the owners and those with a professional executive office. Nevertheless, the causality is not always clear.

Additional questions are whether works councils have really improved information flows within firms with a resultant increase in productivity, or if employees in fact only choose works councils in establishments with a good economic position and high productivity. Also, are works councils only successful when they practice trustful cooperation with the management, or are there situations in which conflicts help to solve the problems?

More empirical evidence is required. Not only are better methods required for determining causal effects, big data is also needed in order to allow for more detailed splitting into subgroups. New surveys with more questions regarding company-internal behavior need to be initiated. More empirical research on managers and members of works councils working within different structures would also be valuable.

SUMMARY AND POLICY ADVICE

Although the majority of empirical investigations reveal that productivity is higher in firms with works councils compared to firms without, this evidence on its own cannot be considered a sufficient argument to adopt works councils.

On the one hand, more clear causality analysis is required and the conditions for a successful productivity impact have to be established. Research to date tells us that the prerequisites for this would at the minimum include:

- an environment of trustful cooperation between works council and management;
- unhindered information flows within the establishment;
- an absence of opportunistic behavior on both sides; and
- voluntary agreements rather than legal requirements.

On the other hand, a detailed look at the impact on profits is also necessary. Future empirical studies on works council effects should focus more strongly on international comparisons and on the effects on profits. Previous results have been ambiguous. A lack of detailed investigations of the costs of works councils is a decisive reason for this lack of evidence.

If works councils do improve productivity but employees do not recognize these advantages, the legislator and politicians should support the formation of works councils. Conversely, legal requirements for works councils to be established may be detrimental to the firm if the works council hinders an increase of output per employee or per working hour.

Policymakers should therefore provide only the necessary resources and appropriate, non-discriminatory incentives. Firms should also base their relationship to the works council on cooperation and trust rather than on confrontation, as this contributes to increased productivity.

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Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

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