Schmollers Jahrbuch 126 (2006), 307 – 312
Duncker & Humblot, Berlin

Codetermination and Personnel Turnover: Ten Years Later

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Introduction

Compared to the natural sciences, where replication studies are very common, they are rarely undertaken in the social sciences in general and in economics in particular. This deficit is surprising insofar as such studies have the potential to foster and redirect a discussion that has reached a deadlock. However, the recent discussion among economists about the likely effects of mandated works councils on firm performance is – mainly due to the availability of new and representative data – far away from such a deadlock. Moreover, the findings presented in recent publications by economists favouring mandatory works councils and researchers opposing their introduction, have converged to an extent that the initial controversy has virtually disappeared. It is, therefore, unlikely that a replication which rejects the findings of a paper whose results have been corroborated in a large number of studies using different data sets from varying time periods and applying different estimation techniques can make a substantial contribution to the discussion.

Theoretical Foundations

Kraft is certainly correct in arguing that my paper lacks a convincing theoretical explanation why workers and management are unable to voluntarily agree on the introduction of some kind of worker representation. Since the intention of my paper was to inform the discussion with empirical findings, I do not take this accusation seriously. Instead of reviewing the large body of literature, I just want to emphasize an argument first developed by Levine and Tyson (1990) who argue that cooperative solutions of a prisoner's dilemma are unlikely to occur as long as there is no exogenous regulation by a third party. Developing this argument further, Freeman and Lazear (1995) have shown that neither employers nor workers have incentives to voluntarily create councils with the power to maximize "social value". However, once created and vested with the optimal amount of rights, councils can reduce economic inefficiencies by moderating worker demands in tough times and by

assuring that firms use worker-provided information to benefit labour as well as the firm. Moreover, councils can produce new solutions to the problems facing the firm. This is more likely when both workers and management have information that is unavailable to the other side[1]. If, however, works councils increase the joint surplus of the firm-worker relationship, why do they have to be mandated? The answer given by Freeman and Lazear (1995, 29) is quite simple but nevertheless appealing:

> "... institutions that give workers power in enterprises affect the distribution as well as amount of the joint surplus. The greater the power of works councils, the greater will be workers' share of the economic rent. If councils increase the rent going to the workers more than they increase total rent, firms will oppose them. It is better to have a quarter slice of a 12-inch pie than an eighth of a 16-inch pie".

Sadowski, Junkes and Lindenthal (1999, 9) present a similar argument that deserves to be quoted in this context as it makes particularly clear why the point made by Jensen and Meckling (1979) is not a convincing one:

> "In distributional conflicts about contractually unprotected quasi-rents, it is at least optimistic, if not naive, to expect an efficient voluntary agreement about the firm's constitution. A selfish rational agent will prefer a constitution that strengthens his absolute position in ex post bargaining, even if this is detrimental to the firm value. One cannot then expect an efficient constitution of the corporation as a result of a bargaining process between co-specialised investors".

Moreover, if workers invest in firm-specific skills (that is, if they undertake "durable reliance investments") the firm's profits may well rise and help boost wages. In a world of informational asymmetries, however, the firm may be unable to check on the extent to which employees are making firm-specific investments. Moreover, workers may be reluctant to make such investments, because it makes them vulnerable: After all, such an investment will only pay off if workers can be assured of being with the same firm for some time into the future; otherwise they would suffer serious economic losses (i.e. in the case of a dismissal). Thus, if workers are protected by institutional or contractual safeguards, then they become willing to invest in the acquisition of firm-specific skills, and both parties can benefit (see Furubotn, 1988). Codetermination is, therefore, a type of governance structure that is capable of dealing with maximizing agents having conflicting interests.

Given these seemingly incompatible positions, theory certainly offers no definitive guidance as to the likely effects of mandated works councils. The beneficial (as well as the detrimental) effects of codetermination must therefore be demonstrated empirically – and this is exactly what I did in my 1996 paper[2].

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[1] For a further elaboration of this and similar arguments pertaining to the production and sharing of information see Dilger (2002).

[2] However, concentrating on firm performance in the sense of output, profits, value added, etc. leads to a rather conservative estimate of the influence of works councils,

Empirical Findings

Contrary to my 1996 paper where I report a negative and statistically significant influence of works councils on voluntary quits and on involuntary dismissals, Kraft in his replication reports insignificant or even positive and significant coefficients of the works council dummy in a number of different specifications. I will refrain from commenting on the allegations formulated in the paper (all of them are clearly unsubstantiated) and will concentrate instead on comparing my findings to the ones reported in more recent papers using different representative data sources and applying various estimation techniques.

- Based on the first two waves of the *"Hannover Firm Panel"*, Schnabel and Wagner (1999) find a negative and statistically significant influence of the presence of a works council on worker turnover as well as a positive and again statistically significant influence on the percentage of long-term employment relationships[3].
- Dilger (2002) uses the 6th wave (1996) of the *NIFA-Panel* and finds that in the German machine tool industry the presence of a works council has a negative and statistically significant influence on personnel turnover.
- Holst and Schupp (2003) demonstrate – by using the 2001 wave of the *German Socio-Economic Panel* – that the presence of a works council has a significantly positive impact on the individual worker's job stability.
- Using the 8th (West Germany) and the 5th (East Germany) wave of the *IAB-Panel*, Frick and Möller (2003) find that the existence of a works council is associated with a significantly lower personnel turnover[4].
- Based on a very large *linked employer-employee data set*, Boockmann and Steffes (2005) find that the presence of a works council leads to significantly longer employment spells, i.e. decreases the hazard rate by 15–25%.

Moreover, the finding reported by Kraft that works councils seem to foster fixed-term employment relationships to build a "peripheral workforce", is not at all surprising. Recently, Düll and Ellguth (1999) as well as Boockmann and Hagen (2001) have found that the presence of a works council has a significantly positive influence on the percentage of fixed-term employees in East

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because investments in intangible assets, such as "organizational capital" are not taken into account.

3 This is in line with the findings reported by Addison, Schnabel and Wagner (1998, 2001) who use the first wave of the Hannover Firm Panel only. See also Gerlach, Hübler and Meyer (2001) who find a negative and statistically significant influence of the presence of a works council on the variation of firms' workforces.

4 See also Beckmann and Bellmann (2002) who find a negative and statistically significant influence on the presence of a works council on the "churning rate" in German establishments.

and West German firms. Their estimates suggest that the works councils try to protect the insiders by accepting new employees to be taken on only if the recently hired persons cannot be used by management to threaten the incumbent workforce in the sense that the latter must fear expropriation of their quasi-rents, i.e. in the case of a dismissal.

Looking at the prevalence of "marginal" jobs (that is, jobs paying less than the social security threshold level), a completely different picture emerges (Düll / Ellguth 1999): Among the West German firms with a works council, 45 % have marginal employees while in firms without a works council the respective share is 65 % (in the former firms, 5 % of all employees are in marginal jobs while in the latter it is 22 %). In East German firms the differences are less pronounced, but still significant: 30 % of the firms with a works council and 35 % of those without such plant-level interest representation have marginal employees; the respective shares are 2 % in the former and 7 % in the latter firms. Even after controlling for other factors, it appears that the presence of a works council has a negative and statistically significant influence on the percentage of marginal employees. Thus, the results presented by Kraft have already been produced by other researchers.

Minor Points

I must admit an omission in my 1996 paper: I have not clearly explained how I calculated my dependent variables (the dismissal and the quit rate). The calculation – which has been adopted by most, if not all of the following papers – is as follows:

(1) RD = [(dismissals + 1) / employees]

(2) RATE = ln (RD / 1-RD)

where RD is the relative number of dismissals.

Moreover, if Kraft were as familiar with the unemployment statistics provided by the Federal Labour Office as he pretends to be, he would acknowledge that the data I used to construct my measure of unemployment can easily be calculated from the annual "structure of unemployment survey". In this survey, persons entering unemployment provide information not only on their individual characteristics but also information on their last employer.

Summary

Summarizing, it appears that a large number of empirical analyses using the best data sets that are currently available for Germany deliver results that are virtually identical to the ones I reported in my 1996 paper (this does, of

course, not rule out entirely that my paper is plagued by certain methodological weaknesses). However, the findings presented by Kraft in his replication are incompatible not only with my findings, but also with the more recent studies quoted above. Not surprisingly, the only study reaching similar conclusions than Kraft in his replication has been published by Kraft (1986) himself. That study, however, used a very small data set from the German metal industry and employed some difficult to justify measures of worker representation. I therefore leave it to the reader to decide whether he / she finds Kraft's or my (and my colleagues) empirical evidence more convincing.

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