Board-Level Employee Representation

Ernst Maug

Panel LBS CCG Event “Who Should Run a Company”, May 10 2019
Introduction

- Board-level employee representation (BLER)
- Who has it? – A global perspective
- Who should have it? – The controversy
- How well does it work? – The empirical evidence
- Volkswagen – A case
World map of labor representation

Source: CBR-LRI database from the Centre for Business Research at the University of Cambridge (Adams, et al., 2017)
International trends

- From 117 countries (CBR-LRI data set)

- 27 grant board-level employee representation
- 28 changes in 19 countries between 1970 and 2016
  - of which 22 led to more employee rights and 6 to less employee rights

- 92 have work councils at the plant level
- 78 changes of these laws in 58 countries between 1970 and 2016
  - of which 60 led to more employee rights, 18 led to less employee rights

The argument of the opposition

“The campaigns for ‘worker participation’ or ‘industrial democracy’ or codetermination on boards of directors appear to be attempts to control the wealth of stockholders' specialized assets ... a wealth confiscation scheme.” (Alchian, 1984)

- Worker entrenchment (Pagano & Volpin, 2005)
- Long-term contracts become fixed commitments, increase operating leverage and cost of capital
“(...) in incomplete, imperfect markets, a stakeholder system of corporate governance that stresses cooperation between management and employees may allocate resources more efficiently in the long run than a shareholder system.” (Fauver and Fuerst, 2006, p. 674)

- Protection of firm-specific human capital increases investment (in HC) and productivity (Blair 1998, 1999)
- Commitment to implicit long-term employment contracts improves risk-sharing (Kim, Maug, Schneider, 2017; literature on family firms)
Codetermination in Germany

Supervisory Board (≤500 employees)

- Shareholder

Supervisory Board (≤2000 employees)

- Shareholder
- Labor

Supervisory Board (>2000 employees)

- Shareholder
- Labor

Only employees working in Germany count
Employment protection all employees

Employment changes after adverse industry shocks

All employees

Shock

Shock + Shock x Parity

0% 5% -5% -10% -15%

Non-parity

Parity
Employment changes after adverse industry shocks

- Shock
- Shock + Shock x Parity

All employees
White collar

Non-parity
Parity
Employment protection across occupational Status

Employment changes after adverse industry shocks

Shock + Shock x Parity

All employees

White collar

Skilled-blue collar

Shock

-15%

-10%

-5%

0%

5%

Non-parity

Parity
Employment protection across occupational Status

Shock + Shock x Parity

Employment changes after adverse industry shocks

All employees
White collar
Skilled-blue collar
Unskilled-blue collar

Shock

Non-parity
Parity

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Labor Representation
### Why are unskilled and low-qualified workers not insured?

#### Employee representatives by occupation and qualification

<table>
<thead>
<tr>
<th>Occupational status</th>
<th>1990</th>
<th>1999</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unskilled blue collar</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Skilled blue collar</td>
<td>42.3%</td>
<td>22.5%</td>
<td>22.3%</td>
</tr>
<tr>
<td>White collar</td>
<td>36.1%</td>
<td>54.5%</td>
<td>56.3%</td>
</tr>
<tr>
<td>Union representative</td>
<td>21.6%</td>
<td>22.9%</td>
<td>21.4%</td>
</tr>
<tr>
<td>Sum</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Number of labor rep's (firms)</td>
<td>97 (15)</td>
<td>231 (35)</td>
<td>229 (48)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Qualification</th>
<th>1990</th>
<th>1999</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low-qualified</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Qualified</td>
<td>86.8%</td>
<td>92.1%</td>
<td>59.4%</td>
</tr>
<tr>
<td>Highly qualified</td>
<td>13.2%</td>
<td>7.9%</td>
<td>40.6%</td>
</tr>
<tr>
<td>Sum</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Number of labor rep's (firms)</td>
<td>76 (15)</td>
<td>178 (35)</td>
<td>180 (48)</td>
</tr>
</tbody>
</table>

Breakdown by qualifications excludes union representatives
# Studies I: Stock returns

<table>
<thead>
<tr>
<th>Authors</th>
<th>Year</th>
<th>Event / Law</th>
<th>Performance measure</th>
<th>Sample size</th>
<th>Sample period</th>
<th>Result of CD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baums &amp; Frick</td>
<td>1998</td>
<td>1976 Law</td>
<td>Stock returns (28 court cases)</td>
<td>28</td>
<td>74-95</td>
<td>Insignificant</td>
</tr>
<tr>
<td>Petry</td>
<td>2018</td>
<td>1976 Law</td>
<td>Stock returns (5 legislative events)</td>
<td>458</td>
<td>75-78</td>
<td>Negative</td>
</tr>
</tbody>
</table>

- Event studies reflect opinion of the stock market at the time
- Reliable with repeated, well-understood events (e.g., M&As, divestitures)
- Unreliable if event itself is poorly understood by the market (and everybody else)
Studies II: Market-to-book ratios

<table>
<thead>
<tr>
<th>Authors</th>
<th>Year</th>
<th>Event / Law</th>
<th>Performance measure</th>
<th>Sample size</th>
<th>Sample period</th>
<th>Result of CD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fauver &amp; Fuerst</td>
<td>2006</td>
<td>-</td>
<td>Tobin’s Q</td>
<td>786</td>
<td>2003</td>
<td>Positive</td>
</tr>
<tr>
<td>Gorton &amp; Schmid</td>
<td>2004</td>
<td>-</td>
<td>Tobin’s Q</td>
<td>250</td>
<td>89-93</td>
<td>Negative</td>
</tr>
<tr>
<td>Kim, Maug, Schneider</td>
<td>2017</td>
<td>-</td>
<td>Tobin’s Q</td>
<td>142</td>
<td>90-08</td>
<td>Insignificant</td>
</tr>
</tbody>
</table>

→ Tobin’s Q is the corporate finance researcher’s Swiss army knife

→ Measures investment opportunities and the extent to which opportunities are exploited
  – If more marginal projects are realized, Tobin’s Q decreases
  – Issue with marginal and average Q
## Studies III: Productivity

<table>
<thead>
<tr>
<th>Authors</th>
<th>Year</th>
<th>Event / Law</th>
<th>Performance measure</th>
<th>Sample size</th>
<th>Sample period</th>
<th>Result of CD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benelli, Loderer, Lys</td>
<td>1987</td>
<td>1951 Law, 1976 Law</td>
<td>ROA, ROE, payout ratio, others</td>
<td>40</td>
<td>73-83</td>
<td>Insignificant</td>
</tr>
<tr>
<td>FitzRoy &amp; Kraft</td>
<td>1993</td>
<td>1976 Law</td>
<td>ROE, Value added, TFP growth</td>
<td>112</td>
<td>75-83</td>
<td>Negative</td>
</tr>
<tr>
<td>Gurdon and Rai</td>
<td>1990</td>
<td>1976 Law</td>
<td>Capital/labor ratio, Change in ROA</td>
<td>63</td>
<td>70, 75, 80, 85</td>
<td>Positive (prof.); negative (prod.)</td>
</tr>
<tr>
<td>Kraft &amp; Ugarkovic</td>
<td>2006</td>
<td>1976 Law</td>
<td>ROE</td>
<td>179</td>
<td>71-76, 81-86</td>
<td>Positive</td>
</tr>
<tr>
<td>Renaud</td>
<td>2007</td>
<td>1976 Law</td>
<td>Profits, value added</td>
<td>179</td>
<td>71-76, 81-86</td>
<td>Positive</td>
</tr>
<tr>
<td>Svejnar</td>
<td>1982</td>
<td>Laws in '51, '52, '72</td>
<td>Productivity</td>
<td>14</td>
<td></td>
<td>Insignificant</td>
</tr>
<tr>
<td>Vitols</td>
<td>2006</td>
<td>-</td>
<td>ROE</td>
<td>504</td>
<td>00-04</td>
<td>Insignificant</td>
</tr>
<tr>
<td>FitzRoy &amp; Kraft</td>
<td>2005</td>
<td>1976 Law</td>
<td>TFP</td>
<td>179</td>
<td>72-76, 81-85</td>
<td>Positive</td>
</tr>
<tr>
<td>Kim, Maug, Schneider</td>
<td>2017</td>
<td>-</td>
<td>ROA</td>
<td>142</td>
<td>90-08</td>
<td>Insignificant</td>
</tr>
</tbody>
</table>
Another approach: companies‘ revealed preferences

- Companies never opt to use BLER voluntarily (Jensen & Meckling, 1979)
  - Would be easy to invite employee representatives to the board
  - Employees are willing to give up wages (3%-3.5% of their wage) – why is this not sufficient to entice firms?
  - What about firm-specific human capital? Why would shareholders not internalize these benefits?
    → There are no first-order gains to be had from employee representation

- Other question: Do companies try to get out of BLER?
Number of employees across firm-years

- No evidence for German companies concentrating in the 1,900-2,000 employee bracket (outsourcing, break-ups, etc.)
- There are no first-order gains from avoiding employee representation.
...but companies do limit employment growth where it counts.

The 50-employee threshold separates small from medium-sized companies.

- Significant concentration in the 48-49 employee bracket to avoid mandatory works councils (at 50)
## Volkswagen: An Example of Ill-fated Employee Participation?

### Dieselgate – a quick chronology

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2015</td>
<td>• CEO Winterkorn wins power struggle</td>
</tr>
<tr>
<td></td>
<td>• Gets support of Porsche family (largest blockholder) and head of works council Osterloh against Piech (head of supervisory board).</td>
</tr>
<tr>
<td>September 2015</td>
<td>• VW publicly acknowledges use of illegal manipulation devices; stock prices drops by 20%; Winterkorn resigns</td>
</tr>
<tr>
<td>January 2017</td>
<td>• VW settles with US authorities</td>
</tr>
<tr>
<td></td>
<td>• Winterkorn testifies to Bundestag he had “no early and unequivocal notification about the testing problems”.</td>
</tr>
<tr>
<td>February 2017</td>
<td>• Piech tells prosecutors that CEO Winterkorn had been informed.</td>
</tr>
<tr>
<td>April 15, 2019</td>
<td>• State prosecution service accuse Winterkorn of an especially grave case of fraud.</td>
</tr>
</tbody>
</table>
VW was known for its "harmonious" labor relations

Executive compensation is very high...
- Winterkorn received EUR 15.9 million in 2014, the last year before Dieselgate
- Highest compensation in the DAX 30 index
- Robustly defended by Osterloh, head of work council

...but so is that of the work council
- Osterloh’s base salary EUR 200,000; plus significant bonus payments, total peaked at EUR 750,000
- Capped at EUR 96,000 to avoid legal conflict
- Law says salary according to "normal career progression"

Is this the collusion the literature talks about?
It’s not all about BLER: Volkswagen Ownership structure

Ownership of Volkswagen as of December 31, 2018

- Voting rights:
  - Free float: 11%
  - Porsche: 52%
  - State of Lower Saxony: 20%
  - Qatar Holding LLC: 17%

- Capital:
  - Free float: 43%
  - Porsche: 31%
  - State of Lower Saxony: 12%
  - Qatar Holding LLC: 14%
Conclusion

- Employee representation is more common than often assumed

- BLER does help to protect employment insurance effectively
  - ...but only for those who are represented

- The empirical evidence on productivity and shareholder value is inconclusive
  - BLER neither helps nor hurts shareholders
  - ...and they seem to understand this

- Case: Governance needs to balance different interests