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INDUSTRIAL DEMOCRACY: CONFLICT OR COOPERATION?

INTRODUCTION

Governmental controls in the United States have grown considerably since World War II. By the end of the 1970s, it was difficult to identify a single sector of the economy that had not been touched by such controls. Discretionary monetary and fiscal policies were expected to provide jobs for unemployed workers, control the rate of inflation, maintain a high level of demand for goods and services, and generate economic growth. Government regulation of business was expected to raise health and safety standards at work, protect the consumer against unsafe products, and in general, guide business activities in the direction determined by government-appointed regulators.

These economic policies produced disappointing results. The average rate of inflation grew steadily, reaching double-digit levels by the end of the 1970s. Unemployment continued to be a major problem. Labor productivity was declining while taxes and welfare payments were rising. Eventually, Americans realized that government interference in the economy within the prevailing institutional structures simply did not work.

Despite the failure of interventionism to accelerate economic growth, its proponents are offering a new set of governmental controls, known as national industrial policy. The purpose of national industrial policy, however, is radically different from public policies of the past. It would change this country's institutions. In the 98th Congress more than thirty bills related to a national industrial policy have been introduced.

The concept of industrial policy dates back to the beginning of the industrial age. Perhaps its oldest aspect is the notion of industrial democracy--a concept that has meant different things to different people in different periods. But the common denominator is labor participation in decision making. And in this respect, industrial democracy is simply inconsistent with the requirements of economic efficiency.

Enforced labor participation in business decisions at the board level would replace voluntary arrangements with legal regulations and shift the focus of decision making from the market (and thus, from the consumer) to the political arena. It also would weaken two fundamental institutions of a free society: the right of ownership and contractual freedom. In short, required labor participation would force firms to adopt business practices and organizational forms that they would not choose voluntarily and rationally, and which would thus be likely to hurt the very people industrial policy is supposed to help.

HOW LABOR PARTICIPATION WORKS

Labor participation in decision making has been advocated at three different levels.

1. Labor participation at the shop level. This is the oldest form of industrial democracy. The British printing and foundry industries have had elected worker "shop stewards" since the 1820s. And in Germany the idea of workers' committees dates to the 1830s. Although an attempt to legislate workers' committees failed in 1848, many of the concepts embodied in the proposed legislation were implemented voluntarily by a large number of firms. The employees and the employers found it in their self-interest to work out mutually beneficial contractual arrangements without resorting to the authority of the state. Today, labor participation at the shop level is quite common throughout the West. The so-called shop councils usually limit themselves to such issues as working conditions, employees' welfare, and complaints; in general, they serve as social agents for the employees.

2. Participation through ownership in the firms. Individual employees could always choose to purchase shares of their respective firms. In addition, many firms offer stock purchase or profit sharing plans to their employees. These programs are supposed to enhance workers' interest in their firms, raise productivity of labor, and contribute to better relations between the shareholders, managers, and workers.

3. Labor participation at the board of directors level. Known as codetermination, this type of labor participation has for many years been the focus of a major postwar social experiment in Western Europe. Recently, the practice of labor participation in the management of business firms has established a foothold in the United States--union leaders on the board of Chrysler are a well-known example. In terms of its long-run consequences for individual liberty and free markets, codetermination is perhaps the most important form of industrial democracy and so deserves the closest attention.

PHILOSOPHICAL FOUNDATIONS OF LABOR PARTICIPATION

The idea of labor participation in the management of business firms is rooted historically and justified ideologically by two divergent philosophical movements of the late 19th and early 20th Centuries: conservative German Catholicism and Marxism. The two philosophies have only one trait in common--a strong anticapitalist bias. Yet their opposition to capitalism derives from two completely different rationales. The conservative Catholic philosophy questions the legitimacy of capitalism as a moral system. The Marxist socialists, in contrast, attack the legitimacy of capitalism as an economic system.

It is curious that some conservative Catholics would fault capitalism on moral grounds. Capitalism does not reject tradition or morality. A reputation for honesty, integrity, truthfulness, loyalty, or friendship is considered a source of wealth. Capitalism, however, does free the individual from subjugation to the constraints of traditional morality, and it is on this point that many conservative Catholic philosophers (and some American conservative moralists) are particularly critical. Capitalism allows the individual to ignore moral norms in pursuit of his own preferences and choose to bear the cost of his actions (e.g., a neighbor's displeasure at beer cans tossed into the front yard).

Many conservative moralists reject free markets precisely because they fear that the autonomy of individual choice does not necessarily generate a morally satisfying set of preferences. The fact is, however, that the free market does not and should not generate preferences. The conservative philosopher, who argues against the liberty of individual choice that the capitalist system allows, should direct his criticism toward the institutions that form the preferences--the educational establishment, the church, the family, and the media--rather than toward the free marketplace, which simply reveals those preferences. The conservative moralist objects to freedom of choice because it may generate selfish and self-centered behavior and suppress communal tendencies. Real world observations quickly refute this statement. In capitalism, quite a few people choose (voluntarily) to devote their time and resources to social work. Nonetheless, the conservative moralist seeks and supports laws and regulations to enforce his concept of morality.

Conservative philosophy of this type considers the firm to be a community in which labor, managers, and owners should cooperate in the pursuit of the common good. Participatory management in business firms is a predictable outcome of this line of thinking.

Marxists, on the other hand, question the legitimacy of capitalism as an economic system. They consider the right of ownership to be a major cause of economic inequalities and social injustice. The concept of alienated labor is central to Marx's criticism of capitalist institutions. It has been noted elsewhere that:

> 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 the class struggle in capitalism.[1]

Marxists thus support laws and movements that weaken the right of ownership, including proposals for labor participation in the management of business firms.

Scholars who favor a controlled economy in the West clearly see labor participation in management as a vehicle for restructuring the economy so that it conforms to their perceptions of social justice and economic equality.[2] These scholars have produced a number of studies on the beneficial effects of national industrial policy. Their crucial intellectual error is that they tout the merits of industrial democracy without reference to its costs. For example, Harvard professor Robert Reich's much quoted The Next American Frontier has little to offer in terms of a cost-benefit analysis of industrial policy.[3] Those intellectuals who question the desirability of new governmental controls and insist on identifying the social costs of industrial policy are quickly labeled as either die-hard free marketeers or blind supporters of corporate America.

LABOR PARTICIPATION SCHEMES IN THE WEST

Labor participation schemes in Western Europe differ in detail from one country to another, but they all have in common

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1 S. Pejovich, Codetermination in the West: The Case of Germany, The Heritage Lectures, No. 10 (Washington, D.C.: The Heritage Foundation, 1982), pp. 6-7.

2 See writings by "radical" economists in the U.S. For example, H. Gintis, "A Radical Analysis of Welfare Economics and Individual Development," Quarterly Journal of Economics, 89, May 1975; and the series of papers by Dr. H. Nutzinger presented at annual conferences on Analysis and Ideology in Interlaken, Switzerland.

3 See Dwight Lee, "The Faulty Logic of Industrial Policy," Heritage Foundation Backgrounder No. 299, [date TK].

that labor representatives participate in decision-making processes at the board of directors level. Moreover, all labor participation schemes in Western Europe have been mandated by law. Codetermination, therefore, turns out to be a political method of resolving certain contentious issues that affect business firms. Proponents of codetermination claim that such labor participation in management decisions enhances labor productivity, creates a better work environment, makes the employees feel more loyal to the firm, and encourages worker self-development.

Germany

West Germany has been the undisputed leader of the labor participation movement in the West. The Montan Act of 1951, the Work Constitution Act of 1952 and 1972, and the Codetermination Act of 1976 define labor participation in that country. The Montan Act covers all firms in the mining and the iron and steel industries that employ over 1,000 workers. The boards of directors of such firms must consist of eleven members. The stockholders and employees each appoint four members, and both groups appoint an additional member who cannot be connected with the firm in any economic way. The eleventh member is jointly elected by other members of the board. The Work Constitution Act stipulates that, in firms employing more than 500 workers, one third of the board of directors must consist of labor representatives elected by secret ballot.

The Codetermination Act of 1976 applies to all firms with more than 2,000 employees. In these cases, the board of directors must consist of twelve members. Six directors are chosen by the stockholders, four are elected by the employees, and two are appointed by the labor union. The chairman of the board is elected by the stockholders, and he casts the deciding vote in cases of a deadlock. This double vote gives the stockholders a slight edge on the board.

Norway

In Norway, labor participation in small firms (less than 50 employees) is subject to voluntary negotiation between the employer and his workers. Workers in medium-sized firms (50-200 employees) have the right to demand labor participation on the board, and if more than 50 percent of the employees vote for labor participation, they are entitled to elect one third of the board of directors. In firms that employ more than 200 workers, one third of the board of directors must be elected by the employees. Moreover, local governments in Norway have requested the right to be represented on the boards of directors of business firms in their communities--an interesting development that could add a new dimension to decision making by business firms.

Ireland

The Worker Participation Act of 1977 provides that one third of the board of directors of Irish firms must be elected by the employees. The Act also specifies that only the employees of the firm are eligible for board membership. To avoid conflict of interest, however, the Act stipulates that the elected employees cannot vote on issues such as conditions of employment, wage policy, and collective bargaining procedures. Several other European countries have adopted similar legislation. In France, for instance, the employees in firms with at least 500 workers elect two representatives to the board of directors. In Denmark, the employees of firms with at least 50 workers elect two members of the board of directors. And in Sweden, all enterprises with more than 25 employees have two directors appointed by labor unions. In sum, many West European countries have embraced codetermination, and the European Economic Community (EEC) is active in promoting the concept.

The United States

Early examples of labor participation in the U.S. have created an impression that codetermination in this country will spread, but contractually rather than by legislation. In a number of firms, besides the Chrysler Corporation, labor representatives on the Board of Directors were elected by the shareholders and serve at their discretion. Many proponents of national industrial policy, however, would like to see labor participation mandated by law. The fact that labor, management, and owners are free to negotiate labor involvement in decision making--and have done so in many firms--is not enough for the advocates of industrial policy. They want to pass laws to require it, even when it may hinder, rather than help, labor relations and good decision making.

INDUSTRIAL DEMOCRACY: CONFLICT OR COOPERATION

Proponents of industrial democracy assert that labor participation in the management of firms would replace conflict with cooperation. The crucial analytical error of this assertion derives from the failure to comprehend the social consequences of weakening the right of ownership. The right of ownership is, in fact, a social rather than a private institution. Its major social consequence is that the guidance of production is transferred from a few individuals (regulators, planners, and bureaucrats) with limited knowledge to a social (free market) process that relies upon and uses the knowledge of all. Those who do not own property benefit from this process as well as those who own property.

The essential point is that the right of ownership and free exchange utilizes the limited knowledge of all to generate beneficial results that no person or group of persons could achieve, or even foresee. The assertion that cooperation is superior to competition has to be false--despite its plausibility. It calls for an agreement on ends that are impossible to achieve. In fact, it is market competition that actually leads to cooperation. It allows people to continuously seek and negotiate mutually beneficial contracts. The firm is a nexus of such contracts, which are voluntarily renegotiated and restructured as additional information is gained by the factors of production. If labor participation could indeed enhance the firm's productivity, it would have been negotiated voluntarily through the market, since that would benefit everyone in the production process. If labor participation in the management of business firms has to be mandated by law, its superiority over other voluntary arrangements must be questioned. Why would shareholders refuse to negotiate an arrangement with employees that would increase their wealth?

Industrial democracy is, in fact, generally a source of conflict, not cooperation, between labor, management, and owners. In a firm with such labor participation, the board of directors falls into two opposing camps: the shareholders' representatives and the employees' representatives. Prior to official meetings of the board, separate sessions are usually held by each group to work out its own position. So the discussions in the board rooms cease to be free exchanges of thoughts, ideas, and judgments. They turn out to be a bargaining process between adversaries. Moreover, a board is supposed to receive information from the management about the firm's operations. Much of this information is confidential in nature, and a director appointed by a union could easily provide the union with critical information prior to wage negotiations. Evidence from Germany suggests strongly that this happens in many instances.[4]

SOCIAL CONSEQUENCES OF LABOR PARTICIPATION

The right of ownership creates a strong marriage between decision making and cost bearing. Those who own resources decide how to use them. They capture the benefits but also have to bear the costs of their choices. Thus, the right of ownership generates strong incentives to seek the best possible use of resources.

A major political implication of the right of ownership is that it is a powerful and perhaps necessary means for the dispersion of power in a society. The right of ownership thereby satisfies a major requirement of democracy, namely, that the sources of wealth be separated from power. Contractual freedom is a consequence of the right of ownership. It replaces orders from the top with voluntary exchange in competitive markets. Contractual freedom means that individuals are free to identify alternatives and to make choices in accordance with their own preferences.

Legislated labor participation in the management of business firms, however, changes the prevailing property relations between the shareholders, managers, employees, and labor unions, and it

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4 See G. Benelli, C. Loderer, and T. Lys, "Labor Participation and Private Business Policymaking Decisions: The German Experience with Codetermination," paper presented at the Tenth Annual Conference on Analysis and Ideology, Interlaken, Switzerland, June 1983.

triggers institutional restructuring of the economy. Thus, codetermination necessarily has economic and social consequences. That labor participation in Europe had to be mandated by law and that, in the U.S., Congress rather than industry is taking the lead are good indications that such institutional changes are inefficient. Industrial democracy and labor participation merely provide a pretext for using the political system to transfer wealth from those who own property in business firms to those who do not. As economist Armen Alchian put it:

> 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.[5]

An excellent statement by two professors from the University of Rochester captures the logical inconsistency of the argument that codetermination is beneficial to workers:

> Labor can start, and in rare cases has started, firms of its own. Moreover, firms are free to write any kinds 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 can 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.[6]

In the West, various types of firms exist: single proprietorships, partnerships, cooperatives, not-for-profit firms, corporations, and institutes. None of these organizational arrangements has been mandated by law. All have emerged through voluntary negotiation and survived competition from other types of firms. If labor participation has to be mandated by law, it would not seem to be in the interests of the individuals concerned.

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5 A. Alchian, Private Rights to Property: The Basis of Corporate Governance and Human Rights, unpublished manuscript.

6 M. Jensen and W. Meckling, "Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination," Journal of Business, 52, 1979, pp. 472-473.

SOME RESULTS OF CODETERMINATION IN WESTERN EUROPE

It takes time for a major institutional change to exert its full effect on the economy. And codetermination is still in its infancy in most European countries. Nonetheless, some evidence is beginning to come in.

Avoidance of the Law

When the Codetermination Act of 1976 went into force in Germany, it applied to almost 650 firms. Yet by the early 1980s, it covered only 480 firms. Almost 100 firms had reduced their labor force below the 2,000 limit, while other firms reincorporated themselves into legal forms not covered by codetermination laws. The fact that so many firms were willing to incur the cost of avoiding labor participation suggests that codetermination is rather a major burden to shareholders. Moreover, if the size and legal forms of business firms before the Codetermination Act of 1976 represented the most efficient structure--and there is little reason to presume otherwise--the adjustments after 1976 represent the social costs of industrial democracy. If codetermination laws were beneficial to both owners and labor, why would firms try to qualify for exemptions from the law?

Risk Aversion

Labor representatives on the board of directors can influence business decisions even if they control only a minority of seats. They can affect policy decisions by various methods, such as alleging conflict of interest, challenging the legality of business transactions, or trading concessions.

The ability of employees to influence the decision-making process of the board of directors of business firms was examined in a 1983 study by G. Benelli, C. Loderer, and T. Lys.[7] Contrary to the predictions of national industrial policy advocates, they found that, in choosing between investment alternatives, employees are interested in maximizing the firm's near-term cash flow rather than its wealth. They prefer investments that offer the most stable returns, because shareholders' gains are associated with changes in the market value of the firm's stock, while the employees' gains come from immediate improvements in cash flow. It is rather like a choice between investing in a growth stock (say, IBM) versus an income-producing stock (say, utilities).

The empirical evidence, in other words, suggests that, with labor participation, business firms select less risky investments over growth opportunities. Benelli and his associates found that the stock return variance has declined significantly for all German industries subject to codetermination laws.

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[7] G. Benelli, C. Loderer, and T. Lys, op. cit.

Politics and Decision Making

A few examples of German experiences with labor participation indicate that its ultimate effect could well be a transfer of business decisions from the realm of economics into the realm of politics.

Discussions in the board room, for instance, become less free exchanges of thoughts, ideas, and judgments than a sort of bargaining between the two sides. A case in point would be Volkswagen's decision to open a plant in the United States. The decision was delayed for over two years due to a costly political debate, in which sound economic decisions were opposed by politically motivated union representatives.

CONCLUSION

Industrial democracy has failed to emerge out of voluntary contracts, and many European firms have sought often expensive methods of avoiding legislated codetermination requirements. This does not suggest that codetermination is the blessing claimed by industrial policy proponents. Little wonder. It restricts individuals' freedom to seek and negotiate the most beneficial organizational arrangements. The evidence shows that labor participation weakens the right of ownership and causes corporate decisions to become politicized. In general, there is no reliable evidence to support the view that industrial democracy mandated by law can generate net social benefits for society.

Industrial democracy would weaken two fundamental institutions in the United States: the right of ownership and contractual freedom. It is about time that the proponents of industrial democracy substituted scholarship for political lobbying, appealed to evidence instead of emotions, and provided the intellectual marketplace with studies on the full extent of industrial democracy's social consequences.

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