

# WHAT TRIGGERS THE ESTABLISHMENT OF A WORKS COUNCIL?

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## INTRODUCTION

There is a long tradition of empirical research on effects of works councils (Frege 2002, Addison *et al.* 2004). Most contributions analyse effects of existing works councils on firm performance (cf. Addison *et al.* 2004) and wages (cf. Addison *et al.* 2009). These economic outcomes may be partly explained by the circumstances surrounding the establishment of works councils (Addison *et al.* 2004). Events and circumstances triggering the establishment of works councils and the agent who trigger it are important issues, given that far from all eligible workplaces have works councils and, once established, voice regimes are difficult to change and managers usually lack the freedom to choose their ideal voice regime (Willman *et al.* 2006). The establishment of works councils changes fundamentally the intra-firm organisation in terms of the legitimacy of management decisions, employee involvement and organisational processes. Yet, trigger mechanisms for establishing a works council have not been analysed by survey studies so far. However, there are several case studies (for example Mueller-Jentsch 1995, Hall 2006, Schlömer *et al.* 2007) which allow valuable insights but lack on generalization of the findings.

We discuss theoretically relevant trigger events and associated trigger agents. We argue that an analysis of trigger mechanisms for establishing works councils should distinguish between motivation and incentives of the workforce and the management. Both agents are concerned with their rents, but workers are more likely to trigger the establishment if they are interested in enhancing their rent share (rent seeking) or if they fear losing informal rights and rents (rent protection – cf. Jirjahn 2009). First, rent protection or more specifically workers' risk protection is detailed analysed. Here, we argue that in uncovered companies exists an implicit contract between management and workers about fringe benefits, working conditions or even the security of workplaces. When this implicit contract is threatened or even cancelled, workers are willing to raise their voice in order to establish a works council because workers can not distinguish between a really bad economic situation and a rent redistribution strategy of the management (asymmetric information, cf. Freeman and Lazear 1995). This is empirically shown exploiting an organisational shock. Organisational shocks, such as an outsourcing of a part of the company for example, increase uncertainty due to information asymmetries about workplace security for the workforce. This uncertainty leads to a desire for legal co-determination representation, which helps the workforce to safeguard its interests. Co-determination based on statutory information and consultation rights differentiates works council from other voice regimes, such as informal worker representation and direct voice practices. Second, we show the association between trigger events and agents. Workforce alone triggers the establishment in around two thirds of all cases and organisational shocks are frequently associated with this. On the other side, managers are also involved in approximately one third of all cases in the establishment process and even motivated workers to call for election in a minority of cases. These managements value productivity enhancement more than rent redistribution.

This paper presents the first evidence on trigger events and associated trigger agents for establishing works councils in Germany. While Dilger (2003) and Addison *et al.* (2003) estimated the determinants of a newly established works council, they do not specify the trigger agent or event. Contrary, Jirjahn (2009) discusses trigger incentives for the workforce and shows empirically that rent seeking and rent protection are prevalent trigger mechanisms.

## BACKGROUND

Works councils' rights are laid down in Germany's Works Constitution Act. Councils shall be elected by the workforces of establishments with five or more employees. Although their creation depends on the initiative of establishment's employees, councils are not present in all eligible establishments (Hübler and Jirjahn 2003). Even if works councils can only be established by the workforce, case studies show that managers also sometimes motivate workers to call for elections, or that management and workforce cooperate in establishing a works council (Schlömer *et al.* 2007). Works councils have full codetermination rights (participation or veto rights) on a set of issues, including introduction of new payment methods, overtime work, and the use of technical devices designed to monitor employee performance. They have weaker consultation rights in matters such as changes in equipment and working methods that affect job requirements. Their information rights cover financial and economic matters (Hübler and Jirjahn 2003).

Theoretically, economic effects of works councils can be analysed using exit voice theories, transaction cost approaches, costs-benefits, and principal agent models. These models typically analyse the outcome of an existing works council and usually distinguish between two effects: productivity enhancement and rent redistribution. We analyse incentives triggering the establishment for management and workforces separately. Management is typically more interested in productivity enhancement, while workforce is more concerned with firm's rent distribution. Works council establishment can be predicted if expected benefits exceed expected costs for one agent.

Managerial motivation for supporting employee representation has theoretically been analysed by Freeman and Medoff (1984), and adapted to works councils by Freeman and Lazear (1995). The main objective of works councils is to provide workers with voice in order "... to foster labour and management cooperation with the goal of increasing the size of the enterprise 'pie'. ..." (Freeman and Lazear 1995). Cooperation enables a more effective communication and increases the legitimacy of management decisions, which build trust and mutual understanding (Hall *et al.* 2007). Thus increasing employee commitment and motivation makes workers willing to share their ideas to improve the efficiency of production. Further, increased motivation leads to a reduction in quitting, which implies lower hiring and training costs and less disruption in the functioning of works groups, all of which should increase productivity. In addition, the likelihood that workers and firms remain together for a long period should increase the incentive for investments in skills specific to the enterprise, which also raises productivity (Freeman and Medoff 1984).

On the other hand, employee involvement gives workers a stronger bargaining position to renegotiate firm's rents. Rent redistribution is the main reason that managers oppose the establishment of a works council, especially when the expected increase of the rent share for the workforce offsets the expected increase in total rent (Freeman and Lazear 1995). Although works councils have no legal right to strike, it can still increase workers' bargaining power using their veto rights or delaying decisions where participation and consultation rights prevail (Visser 1995). Moreover, management needs more time to prepare for consultations and persuade works councillors (Hall *et al.* 2007).

The incentive for workers triggering the establishment is generally considered that works councils are an instrument to renegotiate workers rents. Workers' concerns about the rent share can stem from two different sides: rent seeking and rent protection (cf. Jirjahn 2009). On the one hand, workers can claim a bigger slice of the pie, such that works councils are an instrument to bargain for better working conditions or even force the company to pay higher wages (rent seeking). This incentive is typically considered as workers' primary motivation. On the other hand, the works council can be an instrument to protect quasi rents which workers have created by their effort and human capital investments. Contrary to Jirjahn's terminology, we use risk protection in order to emphasise workers' uncertainty about the future as a relevant trigger. Risk protection can be prevalent, for example, with companies in economic trouble (i.e., where lay-offs are imminent or where management changes threaten the cancellation of implicit fringe benefits). In these cases, a works council is an instrument to safeguard workforce interests because works councils have legal access to information on

financial and economic matters, as well as legal co-determination rights on personnel issues such as hiring of workers, overtime regulations, lay-offs and social compensation plans. These statutory rights reduce uncertainty and the risk of arbitrary management decisions and give the workforce a voice during the transformation process, which reduce workers uncertainty and fosters trustful employment relations and cooperation (i.e., workers' voice).

## **DATA AND METHODS**

The empirical analysis is carried out using two datasets, the IAB Establishment Panel, a representative panel of all German establishments, and the IfM Bonn Works Council Survey, a unique cross-sectional dataset about co-determination in small- and medium-sized companies in Germany.

We identify the effect of an organisational shock on the probability of establishing a works council using a Conditional or Fixed Effect Logit Model in order to control for unobserved heterogeneity. Specifically, we use a k to one matching where we compare k periods without a works council with the period of establishing within the same company and estimate the influence of an organisational shock for this transition. For a more detailed description of the data and method compare our working paper version (Mohrenweiser *et al.* 2009).

## **FINDINGS**

In this section, we will firstly analyse the impact of organisational shocks on the probability of establishing a works council using the IAB Establishment Panel. Then, we turn to the IfM Bonn Works Council Survey for additional descriptive findings on trigger agents, other trigger events and associations between both.

### **The Effects of an Organisational Shock as a Trigger Event**

The Conditional Logit Model confirms our hypothesis that an organisational shock during the last year leads to a higher probability of establishing a works council, which supports the idea that risk protection motivates such establishments. The unconditional probability that an organisational shock occurs is 64 percent higher before establishment than in any other years. An organisational shock increases uncertainty about the security of workplaces, implicit working conditions, and fringe benefits, to name a few. The workforce is willing to establish a works council because they cannot distinguish between a really bad economic situation and managerial rent redistribution at workers cost. A works council can overcome this information asymmetry because it provides statutory information and co-determination rights, in order to safeguard workers interests.

The firm size has also a significant positive impact on the probability of establishing a works council. Additionally, the probability to establish a works council decreases if the share of part-time workers increases. This is in line with Jirjahn and Smith (2006) who states that works councils face difficulties in effectively representing part-time employees. The insignificance of most covariates in the Conditional Logit Model can be explained by the identification strategy. The insignificance means that neither the composition of the workforce nor the coverage of a collective bargaining contract, export-share, investments per capita nor payment above the collective agreement level fundamentally changes at the time of establishment of a works council within one company. This can due to either employment protection or long-term delivery contracts.

**Table 1: Trigger Events for Establishing a Works Council.**

	Conditional Logit			
	Coef.	Z-Value	Coef.	Z-Value
Dummy: Organisational Shock	1.7924	2.04 **	0.8089	2.53 **
Number of Employees	0.0245	2.04 **		
Squared Numb. of Employees/1000	-0.0204	1.55		
<i>Reference Category: Share of Unskilled Workers</i>				
Share of Skilled Workers	0.2418	0.21		
Share of Apprentices	6.8585	1.31		
Share of Part-Time Workers	-3.6633	2.23 **		
Export-Share	0.0056	0.31		
log(Investments per Capita)	-0.0279	0.41		
Dummy: Collective Bargaining Contract	0.5983	0.97		
Dummy: Payment above Collective Agreem.	0.3745	0.69		
Year Dummies	yes			
Number of Observations	1262		1262	
LR chi(2)	675.39		6.16	
Pseudo R <sup>2</sup>	0.8394		0.0077	
Log Likelihood	-64.59		-399.2'	

Dependent Variable: Works Council status. \*, \*\*, \*\*\* significant on the 10%, 5% or 1% level respectively. Note, that we display coefficients of the Conditional Logit Model because calculation of marginal effects is only possible under the assumption that the fixed effects are zero for all establishments which contradicts our assumptions stated above. Source: IAB Establishment Panel 1999-2007.

### Trigger Agents

Descriptive statistics about the trigger agent are shown in table 2 basing on the IfM Bonn Works Council Survey subsample of companies that established works councils between 2001 and 2005. The workforce alone triggered the establishment in approximately two thirds of all cases. In the other third, the management was involved in the establishment process. In approximately 7 percent of cases, management itself motivated workers to call for an election. Management motivations for establishing worker representation are described in case studies by Schlömer *et al.* (2007). They describe a manager who knows positive effects of a works council from his previous job, especially the mediation role provided by works councillors, and therefore motivates the workforce to call for election in his new company in order to take advantage of worker representatives.

**Table 2: The Trigger Agent for Establishing a Works Council**

	Observations	Percent
Workforce Alone	37	61.67
Management Involved	19	31.67
Management Motivated	4	6.67

Sample restriction: companies that have established a works council between 2001 and 2005, answers were given by managers; Source: IfM Bonn Works Council Survey 2005.

## Other Trigger Events

Besides organisational shocks, other events can trigger the establishment of works councils as well (table 3). Contrary to descriptives in table 2, multiple answers per company were possible meaning that some managers identified more than one trigger event. In total, 18 percent of companies established a works council because managers wanted a fixed workers representative and, management wanted to improve motivation and productivity of workers (reason managerial communication). In these cases, the management was involved in the establishment process and almost all management-motivated establishments state these reasons (cf. table 4).

**Table 3: The Trigger Event for Establishing a Works Council**

	Observations	Percent
Organisational Shock	26	35.14
Workers Voice	35	47.30
Managerial Communication	13	17.56

Sample restriction: 60 companies that have established a works council between 2001 and 2005, answers were given by the managers and multiple answers were possible, Source: IfM Bonn Works Council Survey 2005.

The second trigger event category is workers' voice, which occurred in approximately one-half of the cases. Workers' voice is defined as conflicts between management and workforce, workers want more co-determination, new workers with experience in employee representation were hired, and manager knows no special reason why workers want a council. Workers' voice trigger events were frequently associated with establishment coming from the workforce alone; 72 percent of workers' voice trigger events had workforce alone as trigger agent (cf. table 4). Third, an organisational shock was specified as trigger event in approximately 35 percent of cases. Organisational shocks are defined as occurrence of a new owner, a partial plant closure, and a radical restructuring of the company. Organisational shocks were strongly associated with the likelihood of workforce alone calling for election (70 percent), but shocks also induced 27 percent of the managerial involvement cases (cf. table 4). In addition, most multiple answers covered an organisational shock, particularly new management together with the voice category that workers wanted more co-determination. This joint occurrence is easily conceivable.

**Table 4: Cross-Tabulation of Trigger Agent and Event Establishing a Works Council**

		trigger event					
		Organisational Shock		Workers Voice		Managerial Communication	
trigger agent	Workforce Alone	18	0.42	25	0.58	0	0.00
		0.70		0.72		0.00	
	Management Involved	7	0.26	10	0.37	10	0.37
		0.27		0.28		0.77	
Management Motivated	1	0.25	0	0.00	3	0.75	
		0.03		0.00		0.23	

The trigger event question allowed for multiple answers; in each cell: top left = the number of cases; top right = the percentages of trigger agents (row); bottom left = the percentages of trigger events (column). Sample restriction: 60 companies that have established a works council between 2001 and 2005. Source: IfM Bonn Works Council Survey 2005.

## CONCLUSION AND DISCUSSION

This paper presents the first survey evidence on trigger events for and associated agents in establishing a works council. First, we focus our analyses on triggering events on risk protection. We argue that a company offers an implicit contract about working conditions and compensation schemes for example. An implicit contract can be threatened when an organisational shock such as outsourcing or a partial plant closure occurs and management have to cancel fringe benefits or even have to reduce workplaces. In this situation, the workforce can not distinguish if there is really a bad economic situation or if the management only wants to increase their rent share on workers cost. Accordingly, risk protection based on this information asymmetry can trigger the establishment of a works council as a legal co-determining representative which helps workers to safeguard its interests. Empirically, we have shown that an organisational shock is a prevalent trigger of establishing a works council. We also find an increasing probability of establishing a works council for bigger uncovered companies.

Moreover, we show that workforce alone is the most frequent trigger agent in around two thirds of all cases, but the management is involved in the other third and even motivated workers to call for election in a minority of cases. Managerial motivation is mostly their expectation that productivity enhancement of works councils outweigh rent redistribution. On the other side, workforce motivations triggering the establishment alone are voice reasons such as conflicts with the management and organisational shocks such as partial plant closure and appointing new managers for example. We further show that works councils are more frequently established by workforce alone for voice reasons or when an organisational shock occurs.

The organisational shock, however, has a very narrow definition in the IAB Establishment Panel. Theoretically, risk protection comprises more than just organisational shocks due to outsourcing, spin-offs and partial plant closure. Risk protection can also be prevalent in shrinking firms, firms experiencing financial troubles and firms with a new management changing the cooperative culture. In these companies, management may also be more likely to annul implicit contracts (e.g., seniority wage rules), lay-off tenured workers, enhance the target agreement for workers' performance pay, or cancel fringe benefits. Therefore, the risk protection function of a works council can be defined much more broadly than we are able to address in our regression based on the IAB Establishment Panel. This is why the wider definition of organisational shocks in the IfM Bonn Works Council Survey could lead to a stronger trigger effect of risk protection motivation. Accordingly, Jirjahn (2009) analyses the broader defined relevance of a rent protection strategy and shows that establishing works councils is correlated with a very poor sales situation, a poor employment growth and a lack of expansive market strategy in the manufacturing sector in Germany (precisely the federal state of Lower Saxony).

Our findings allow some interesting inferences. First, establishing of works councils triggered by uncertainty basing on information asymmetries of workers is based on works councils unique characteristic of statutory information and consultation rights. These rights differentiate works councils from other voice regimes like informal worker representation and direct voice practices. Moreover, risk protection can partly explain the observed pattern of coverage of works councils over firm size where larger companies are more likely to have a works council. Larger companies tend to be older and therefore have had a higher probability to be hit by an organisational shock in the past.

Our findings are also relevant for other countries of the European Economic Area (EEA), which following adoption of the EU's 2002 Information and Consultation of Employees Directive (ICE), are now all required to have provisions for the establishment of representative structures for employee information and consultation within national undertakings i.e. at workplace and/or company level. The rights specified in the Directive differ from the German Works Constitution Act, which provides more robust rights on the timing and quality of information provision, a more rigorous definition of consultation and, in addition, co-determination rights on a range of issues which in effect provide works councils with veto rights on personnel matters. These differences are likely to dilute the extent of the

risk protection provided by national legislation introduced under the Directive as compared to Germany, and hence the incentive for workforces to seek the establishment of works council-type arrangements. Moreover, the Directive also provides considerable leeway for individual member states in framing their implementing national legislation (Carley and Hall 2008).

How far the findings of the present study are relevant to other EEA countries can be considered along two dimensions. The first is the robustness of information and consultation rights. Under Austrian and Dutch legislation, for example, these are equivalent to those specified in Germany. The same broadly applies to the rights of local trade organisations within companies under the basic agreements which govern industrial relations in the Nordic countries. In France and Spain, however, statutory consultation rights are weaker than in Germany – hence the rent protection incentive for workforce is reduced. In the UK and Ireland, where universal rights to employee information and consultation were unknown until the coming into force of national legislation implementing the EU directive (Hall 2006), the recent legislation's information rights are less precisely specified than in continental Western and Nordic Europe and consultation rights are weaker. Moreover, framing of the UK regulations leaves open the possibility for management and workforce representatives to negotiate 'private' arrangements outside of the formal procedures of the UK legislation. These so-called 'pre-existing' agreements (Hall, 2006) do not necessarily have to meet the information and consultation standards specified in the UK legislation. Nonetheless, even in the UK and Ireland, the weaker consultation rights do not necessarily impinge on the potential for obtaining credible information about firms' economic situation which are necessary to overcome the information asymmetries after an organisational shock. Therefore, a works council basing on the ICE Directive can also be an instrument for risk protection, for example, when the management cancel implicit contracts about fringe benefits or working conditions. In addition, weaker co-determination rights may result in a weaker incentive for workforces to trigger the establishment of a works council. Management incentives for promoting the establishment of works council-type arrangements are, however, likely to be less impacted by these differences. Hence, in countries such as the UK and Ireland, management might be a relatively more prominent trigger agent, and this appears to be confirmed by case study evidence (Hall *et al.* 2007).

The second dimension is the extent to which rights to information and consultation, and the corresponding works council-type structures, are well established and hence the likely costs and benefits well known to management and workers. In countries such as Germany, where the current legal framework has essentially been in place for more than half a century, then an equilibrium situation prevails. In contrast, where information and consultation rights have only recently been introduced, as in the UK, and a situation of transition prevails, both management and workforces have greater uncertainty about the potential costs and benefits involved. Equilibrium means here especially that, on the one hand, workers and managers are aware of works councils' statutory rights. These rights are taught in Germany, for example, during the apprenticeship where two thirds of a birth cohort is trained. On the other, unions see works councils as a complementary industrial relation institution in Germany and this mutual recognition evolved over a long period accompanied by an intensive conflict (Mueller-Jentsch 1995). Nevertheless, the role of works councils in a historically developed country-specific system of industrial relations is hard to predict and therefore country-specific institutions do not allow a direct application of our results.

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