Voluntary co-determination produces sustainable competitive advantage

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VOLUNTARY CO-DETERMINATION PRODUCES SUSTAINABLE COMPETITIVE ADVANTAGE

Abstract

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INTRODUCTION

In many European countries, co-determination laws were introduced in order to foster democracy within the economic system. After adopting and strengthening democratic mechanisms at the political level, co-determination within companies was the next step. The reasons given for co-determination were based on moral or political grounds rather than efficiency considerations (Höpner, 2004).
Today, co-determination is criticized by some practitioners. There are attempts to restrain or even to abolish existing co-determination regulations. Recent developments at the level of the European Union (EU) have led to loopholes – companies are able to evade co-determination laws e.g. by incorporating in another EU country with less co-determination requirements. In 2005, every seventh newly founded limited liability company in Germany was incorporated under the British legal form (Bundesregierung, 2006).

While mandatory co-determination regulation has become less important, we suggest voluntary introduction of customized co-determination rules as promising for the future. A company’s competitive advantage is largely based on firm-specific knowledge created by its employees. Investments in firm-specific knowledge can neither be taken for granted nor be enforced through contracts. Employees who invest in firm-specific knowledge become vulnerable; the value of their knowledge diminishes when they work for a different employer. Therefore, employees prefer to acquire general (rather than firm-specific) knowledge unless their interests are protected. If employees refuse to make firm-specific investments, the company’s competitive advantage will be easier to imitate and hence is less sustainable.

We suggest three measures to solve this problem: (1) The board should rely more on insiders. (2) The insiders should be elected by those employees of the firm who undertake firm-specific knowledge investments. (3) The board should be chaired by a neutral person.

In addition to encouraging firm-specific knowledge investments, our proposals offer further advantages: They countervail the dominance of executives, they encourage intrinsic work motivation by strengthening distributive and procedural justice, and they ensure diversity on the board while lowering transaction costs. Our proposed measures for reforming the board may help to overcome the current crisis of corporate governance. At the same time, they
provide a step in the direction of a more adequate theory of the firm as a basis for corporate governance.

**IS CO-DETERMINATION A PHASE-OUT MODEL?**

During the 20th century, several European countries introduced co-determination regulations. In August 2006, Germany celebrated the 30th anniversary of its co-determination law. Apart from jubilee speeches, there were many critical comments. The controversial discussion on co-determination was mirrored in press reports. “Power Struggle on Co-determination”, “30 Years of Dispute”, and “No Reason to Celebrate?” were some of the headlines.

In her speech, the German Chancellor Angela Merkel stated her opinion that co-determination is a “big achievement” (Bundesregierung, 2006). She said: “The German model has an exceptional position. It hasn’t been adopted in this manner by any other country.” This statement, however, might be misleading. Today, co-determination regulations are a widespread phenomenon in European countries (Kluge & Stollt, 2006). Each country has developed its own model of co-determination; none of the models are identical (see Table 1). In some areas, there are even more comprehensive forms of co-determination than in Germany. Many co-determination laws were legislated as early as the 1970s.

Among the 25 countries belonging to the European Union (EU) in December 2006, 11 countries have relatively far-reaching co-determination laws (see Table 1). In 7 other EU countries, there are limited co-determination regulations (e.g. restricted to state-owned enterprises), and the remaining 7 countries do not have any legislation on co-determination (Vitols, 2005; Kluge & Stollt, 2006).

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Insert Table 1 about here

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Most of the co-determination laws allow the employees to take up one third of the seats at the board of directors. The German model is insofar unique as it provides for parity co-determination for companies with more than 2000 employees (i.e. 50% of the board seats are allocated to employee representatives). However, the parity is attenuated in two respects: One employee representative is a representative of middle management. Furthermore, the chairperson of the supervisory board is chosen by shareholders. In the case of a stand-off, the chairperson can cast a double vote (Vitols, 2005).

Another important feature of co-determination is the level at which it applies. Co-determination at the plant level (through works councils) gives employees co-determination rights on some topics and rights to information or consultation on other topics. Co-determination at the board level, however, allows for co-determination on all essential decisions regarding the company. In the latter case, employee representatives bear legal obligations due to the fact that they are members of the board. The two levels of co-determination are not independent; in some countries, for example, employee representatives at the board level are nominated by the works council (Kluge & Stollt, 2006).

**THE RELATIONSHIP BETWEEN CO-DETERMINATION AND FIRM PERFORMANCE**

A number of different performance measures have been used in empirical studies. Most performance measures can be clustered to four areas (Vitols, 2005): Labor variables (e.g. satisfaction, commitment, and employee turnover), company operations (e.g. productivity and innovation), financial performance (e.g. profitability), and stock market performance (e.g. share price increase). Furthermore, most empirical studies examine the impact of works councils (co-determination at plant level); only a few studies explore the impact of co-
determination at the board level. The majority of the empirical studies (in both areas) focus on German company data.

**Co-determination at Plant Level**

Jirjahn (2005) and Addison, Schnabel, and Wagner (2004) provide a recent overview of empirical research on works councils. The main findings are summarized hereafter. Several studies show that works councils increase productivity under the condition that the enterprise is bound to a collective labor agreement (Jirjahn, 2003; Wagner, 2005; Hübler, 2003). Hübler and Jirjahn (2003) suggest that Germany’s system of collective labor agreements makes works councils focus more on increasing the company’s surplus, since they are less involved in the conflict of the division of that surplus. In companies that are not bound to a collective labor agreement, works councils lead to a higher wage level of employees (Jirjahn & Klodt, 1999). Works councils influence not only wage levels but also wage spreads: Enterprises with a works council have a smaller wage differential between qualified and less qualified employees (Hübler & Meyer, 2001) and between men and women (Gartner & Stephan, 2004). Moreover, works councils are related to a lower rate of personnel turnover (Frick & Sadowski, 1995; Addison, Schnabel, & Wagner, 2001; Dilger, 2002) – this effect is amplified when the enterprise is bound to a collective labor agreement (Frick & Möller, 2003). On the other hand, the combination of a works council and a collective labor agreement is associated with a lower willingness to recruit elder employees, since these companies tend to accentuate internal labor markets (Heywood, Jirjahn, & Tsertsvadze, 2005). Enterprises with a works council run a higher risk of being closed – however, this effect is significantly smaller for enterprises that are bound to a collective labor agreement (Addison, Bellmann, & Kölling, 2002). Works councils are also associated with a higher probability of performance-linked payments (Heywood & Jirjahn, 2002). Enterprises with works councils offer more training to their employees, especially when new technologies and products are introduced (Hübler,
The training’s impact on productivity is increased through the existence of a works council (Smith, 1994; Zwick, 2004). With respect to working time models, works councils are related to a higher use of working-time accounts (Dilger, 2002; Hübler & Jirjahn, 2003; Ellguth & Promberger, 2004) and shift-work (Jirjahn, 2004). This effect may be interpreted as an enhanced willingness of the employees to cooperate. The trend toward flexible production concepts poses a challenge for works councils: Enterprises with semi-autonomous teams are less likely to have works councils (Hübler & Jirjahn, 2003). However, the existence of a works council raises the probability of introducing teams (Hübler & Jirjahn, 2002), which indicates that enterprises with works councils may be catching up. Introducing teamwork combined with the existence of a works council leads to higher enterprise performance (Zwick, 2003). Askildsen, Jirjahn, and Smith (2006) find a positive impact of works councils on environmental investment and on product innovations. According to Jirjahn and Kraft (2005), works councils have a positive effect on incremental product innovations and a neutral effect on radical product innovations.

Overall, the empirical work suggests that co-determination at the plant level has the potential to create a number of positive effects if it is embedded in an appropriate general framework. Workers appear to be more willing to cooperate (e.g. by working in shifts) when their preferences are taken into account; and a lower personnel turnover is a good precondition for the acquisition of firm-specific knowledge (Jirjahn, 2005). However, some methodological problems need to be acknowledged. Longitudinal analysis is difficult to accomplish since very few plants introduce or abandon works councils during the observed period (Addison et al., 2004). Furthermore, almost all large-scale enterprises in the samples have works councils, which makes it difficult to distinguish specific effects of works councils for these enterprises (Höpner, 2004).
Co-determination at Board Level

There has been much less research on co-determination at the board level compared to co-determination at the plant level. Most empirical studies have focused on co-determination in Germany, particularly on the politically imposed introduction of parity co-determination in 1976. Empirical research on co-determination at board level has shown mixed and partly contradictory results, which are summarized by Vitols (2005) and Jirjahn (2005). Svejnar (1982), Benelli, Loderer, and Lys (1987), and Baums and Frick (1998) find no significant effect of co-determination on firm performance and stock prices. Other studies show a negative effect on productivity (FitzRoy & Kraft, 1993) and stock market performance (Schmid & Seger, 1998; Gorton & Schmid, 2000). In contrast, recent studies indicate small positive effects on innovation (Kraft & Stank, 2004) and productivity (FitzRoy & Kraft, 2005). Gurdon and Rai (1990) present a positive effect on profits and a negative effect on sales. Finally, Gorton and Schmid (2004) analyze the causes of the negative impact on stock market performance; they find that parity co-determination negatively affects the relationship between shareholder value and management compensation and positively affects the relationship between employment and sales – which indicates over-employment and neglect of shareholders’ interests. Gorton and Schmid (2004) point out that shareholders react to their loss of control by linking supervisory board compensation to firm performance and by increasing the firms’ leverage (through borrowed capital).

Altogether, the results about co-determination in Germany hardly lead to a conclusive overall picture. Some of the studies have been criticized for methodological problems, such as simple comparisons of mean values, the use of cross-sectional data and short data series (FitzRoy & Kraft, 2005). Furthermore, the samples, time periods, and methods of estimation vary considerably from one study to another (Jirjahn, 2005).
Studies on board co-determination outside Germany are rare, and they tend to use subjective evaluations of managers and workers (Vitols, 2005). For example, Levinson (2001) asks managers about how they perceive the effects of co-determination. The managers perceive the workers’ representation as a resource rather than a burden, which leads to a cooperative climate and an easier implementation of difficult decisions. The workers’ representatives play a rather peripheral role in board activities unless topics like personnel issues, competence development, workplace questions, or reorganizations are concerned.

Empirical research on board co-determination is inconclusive at the company level. But what about observed effects at the national level? Are co-determination and a strong national economic performance mutually exclusive? Vitols (2005) divides the EU countries into two groups: those with far-reaching co-determination laws (see Table 1) and those with limited or no co-determination laws. The group of nations with far-reaching co-determination laws shows superior performance with regard to many indicators, e.g. unemployment, labor productivity, research spending, and labor peace. The strike rate is more than ten times lower in countries with far-reaching co-determination laws. To be sure, co-determination laws are not necessarily the cause for superior economic indicators. However, the results show that co-determination and a sound economic performance are not inconsistent with one another.

Finally, Höpner (2004) examines the proposition that countries with co-determination laws suffer a “co-determination discount” at the stock market. Based on McKinsey’s “Investor Opinion Surveys”, Höpner finds no significant correlation between the countries’ share price discount and their scope of co-determination. However, there are significant relationships between the countries’ share price discount and their systems of corporate control. For example, Germany became one of the countries with the lowest share price discount after introducing new accounting standards and a better protection of minority shareholders.
To summarize, research on co-determination (both at plant level and at board level) has provided useful insights as it has shown that co-determination in general is not a phase-out model. However, the quantitative studies have been limited by the “dummy variable approach”, which differentiates only the presence and the absence of co-determination. Future empirical research could examine different intensities of co-determination (Höpner, 2004; Zugehör, 2003) or use in-depth case studies (Addison et al., 2004).

Moreover, empirical co-determination research has two theoretical shortcomings. Firstly, it analyzes the impact of co-determination under past and present conditions. It does not take into account what today is common understanding in the strategic management literature, namely that the key task of modern corporations in the future is to generate, accumulate, transfer and protect firm-specific knowledge to create a sustaining competitive advantage (e.g. Penrose, 1959; Rumelt, 1984; Grant, 1996; Teece et al., 1997; Kogut & Zander, 1996; Spender, 1996; Foss & Foss, 2000). Secondly, so far empirical co-determination research is unconnected to modern knowledge-based theories of the firm as a theoretical basis for corporate governance (Osterloh & Zeitoun, 2006). In the following section, we therefore discuss two existing theories of the firm, which claim to give a theoretical basis for corporate governance. On that basis, we develop our own view of why a specific type of voluntary co-determination is fruitful to promote knowledge-based competitive advantage for firms.

DIFFERENT THEORIES OF THE FIRM AS A BASIS FOR DIFFERENT CORPORATE GOVERNANCE PERSPECTIVES

The Firm as a Nexus of Contracts

The dominant view of corporate governance is based on new institutional economics. The underlying theory of the firm, called the “governance perspective” (Williamson, 1999), is an
application of agency and property rights theory. It has been derived from the view of the firm as a nexus of contracts (Jensen & Meckling, 1976).

It starts with a conflict of interest between managers (agents) and shareholders (principals), caused by the separation of ownership and control in public corporations (Berle & Means, 1932). These conflicts as well as conflicts between shareholders and other stakeholders (including the employees) can be solved ex ante by contracts. Only shareholders carry a residual risk and should therefore have residual ownership and control.

In order to align the interests between shareholders and managers, firstly, the control of management must be transferred to an independent board of directors. Secondly, managers’ and directors’ pay should be tied to their performance (e.g. Jensen & Murphy, 1990; Jensen, 1993).

The wave of corporate scandals and the explosion of management compensation drew attention to flaws in the corporate governance structure according to this view. Even its proponents now admit that the explosion of executives’ and directors’ pay has proven to be ‘pay without performance’ (Bebchuk & Fried, 2004) or ‘managerial and organizational heroin’ (Jensen, Murphy & Wruck, 2004: 45). In order to improve corporate governance, the board should become more responsible to their shareholders. Board members should be made more attentive to the shareholders’ interests. For instance, board members should stand for annual election by the shareholders (Bebchuk & Fried, 2004).

The idea of board independence has been widely accepted but does not seem to contribute much to solving the problem. Most importantly, it has not led to pay moderation of CEOs and other managers. The stronger dependency of directors on shareholders might even have fueled the pay explosion, because in speculative markets it tends to align interests of CEOs to short-term share price maximization (Bolton, Scheinkman & Xiong, 2006). In addition, a meta-
analysis of fifty-four studies on board dependence shows no statistical relationship between board independence and firm financial performance (Dalton et al., 1998).

The Firm as a Nexus of Firm-Specific Investments

Blair (1995), Zingales (1998), and Blair and Stout (1999) argue that it is not in the interest of the shareholders to be the exclusive owners of residual control. Firms exist because they produce what are commonly called quasi-rents (Klein, Crawford & Alchian, 1978) or synergies (Foss & Iversen, 1997). Quasi-rents represent the difference between what the parties inside the firm jointly generate and what each of them can obtain in the market. Quasi-rents are the outcome of mutually specialized assets of people who make firm-specific investments (Rajan & Zingales, 1998). These investments cannot, or only at high cost, be protected by contracts *ex ante* when the parties enter into a relationship. They represent transaction-specific investments that cause sunk costs once the contract has been made and are subjected to hold up. What matters is that investors’ *ex post* bargaining position is weakened when the quasi-rents are divided (e.g. by discussing their wages after entering the contract). Their firm-specific investment is of little or no value outside the firm and decreases their outside opportunities during the term of the contract. It is primarily employees who are affected by such hold up. It has been shown empirically that employees who are forced to find new jobs lose, on average, 15 percent of their wages (Osterman, 1999). If they were employed in the firm for more than 21 years, they stand to lose as much as 44 percent of their wages (Topel, 1991). As a consequence, employees have no incentive to undertake firm-specific investments if their bargaining position is not protected after they enter into the labor contract (Freeman & Lazear, 1996).
This critique of the view of the firm as a nexus of contracts leads to a view of the firm as a nexus of firm-specific investments. These firm-specific investments create room for ex post bargaining after the contracts have been finalized. For this reason, corporate governance can be defined as a set of constraints shaping the ex post bargaining over the joint output of firm-specific investments (Zingales, 1998). Blair and Stout (1999, 2001) claim that it is the board that has to take over the task of governing the firm-specific investments and mediating between possibly conflicting interests of investors in firm-specific assets that cannot be contracted ex ante. The board should act as a neutral third party, which is not involved in firm-specific investments. It should act as an impartial ‘mediating hierarch’ and therefore should consist mainly of outside directors. Voting rights are only given to shareholders, thus maintaining shareholders’ supremacy.

**The Firm as a Nexus of Knowledge-Specific Investments**

Blair and Stout’s proposal is important but nevertheless neglects to address the crucial differences between firm-specific investments in knowledge and physical or financial capital. There are fundamental differences between firm-specific investments in knowledge and physical goods.

*Firstly*, as far as knowledge investments are concerned, it is not only too expensive to contract firm-specific investments ex ante before entering a contract, but it is simply impossible. A knowledge worker cannot contract his or her future knowledge as such due to the “knowledge paradox” highlighted by Arrow (1973: 171): The value of knowledge invested in the potential acquirer is not known until after the knowledge is revealed. Once revealed, the potential acquirer has no need to pay for it.
Secondly, the generation of knowledge cannot be evaluated in the same way as physical goods during the contract term. Only insiders or peers can evaluate firm-specific knowledge generation and transformation, because outsiders are rarely able to comprehend the processes involved, and are thus not able to protect knowledge investors from a deterioration of their bargaining position during the interim period when joint knowledge has not yet led to a recoverable output.

Thirdly, the information asymmetry between management and outside directors leads to the external board members being dependent on executives for information. Under present conditions, a board dominated by outside directors has to rely largely on information provided by the top executives.

These arguments link corporate governance to the “competence perspective” of the theory of the firm (Williamson 1999), which today dominates the strategic management literature but which so far was not considered in the corporate governance literature. The “competence perspective” or the knowledge based theory of the firm suggests that firm-specific knowledge investments are crucial for a sustained competitive advantage of the firm. As a consequence, corporate governance should involve inside knowledge workers in the decision-making process of the firms’ boards. There are two justifications. Firstly, according to the “competence perspective”, firm-specific knowledge, in particular of a tacit nature, is the most critical resource. Outside board members cannot understand the firm’s tacit knowledge base and its strategic relevance (Coff, 1999:126; Barney, 2005:946). Secondly, contractual provisions such as regulating exit, the vesting of options, and repayment schemes are in most cases no valid alternatives to board representation of knowledge workers. The reason is that the underlying conflicts between shareholders and knowledge workers concerning the appropriation of the quasi rents appear in full force only at the level of the board where all
conflicting parties should be represented. Such conflict resolution is also in the interests of the shareholders themselves as it leads to an increase in the value of the firm.

NEW CORPORATE GOVERNANCE DESIGN

The distinct characteristics of firm-specific knowledge investments justify that knowledge workers are represented on the board. All other stakeholders, with the exception of shareholders, are better able to form ex ante contracts and therefore need not be represented on the board. Knowledge is indeed a special resource unlike any other resources, as highlighted by Arrow’s (1973) knowledge paradox. All other resources can in principle be contracted, though sometimes at a high cost. This is not the case for knowledge as long as it is not encapsulated in a marketable product. Moreover, even in this case the problem of attributing the contribution of each worker to the product is unresolved. Thus, the knowledge workers and the shareholders should be involved in the residual control as they bear the brunt of the non-contractible residual risk. Contrary to what has been proposed by the dominant view of shareholders’ supremacy, this leads us to propose the following board arrangements:

Firstly, the board should rely more on insiders. The percentage of insiders relative to outsiders should be determined by the relationship of firm-specific knowledge capital to financial capital.

Secondly, these insiders should be elected by, and responsible to, those employees of the firm who make firm-specific knowledge investments. The board should no longer be solely an instrument of financial investors, but also an instrument of knowledge investors, and should have the task of aligning the interests of these constituents.

Thirdly, a neutral person should chair the board. His or her main task is to enable the board members to engage in a productive discourse to the mutual benefit of all members of the firm.
Moreover, he or she has to ensure that the conditions are such that the board members are prepared to contribute to the firm’s common good and to refrain from rent seeking.

**Insiders on the Board**

Insiders of the firm, especially those who are knowledge workers, have three major advantages over outsiders on the board. Firstly, they are better informed about the issues and problems concerning the firm’s business (Baysinger & Hoskisson, 1990; Hillmann & Dalziel, 2003), in particular they can better understand the firm’s tacit knowledge base (Coff, 1999:126). The more firms compete on the basis of innovation, the more this applies. In times of high uncertainty and rapid change, it is no longer possible to maintain control through targets set by hierarchical control, because targets in these cases have to be reset at regular intervals. It follows that control has to be based on a mutually agreed, ongoing revision of goals that takes into account new search procedures.

A second important advantage of having insiders on the board is that it lessens the board’s dependence on CEOs for supplying information. Knowledge workers as directors are a well-informed source of inside information not filtered by the CEOs. These inside directors have superior explicit knowledge, as well as tacit knowledge, on the specific issues and problems facing the firm.

Thirdly, it is not in the interests of outside executive directors, who are also CEOs of other firms, to seriously challenge the policies, especially the remuneration of executives. It is well known that outside CEOs view the board through CEO eyes, i.e. through a lens that does not seriously challenge the power of the CEO. For example, a study by O’Reilly et al. (1988) found that the pay of the compensation committee members was a better predictor of CEO compensation than the actual performance of the firm. Thus, the membership of employees in
the compensation committees would have a moderating effect upon the mutual hiking up of compensations by the cross-board membership of outside CEOs.

**Representation of Knowledge Investors on the Board**

To solve the problem that contracts cannot be formed ex ante and that the insiders may be subservient to the very managers whom they are supposed to control, we propose an institutional solution: *Financial and knowledge investors should be represented on the board.* The relationship of the two groups ought to be proportional to the relation of investment in financial capital and investment in firm-specific knowledge capital. As a consequence, in a firm in which firm-specific knowledge investment is very important, the board should contain a large percentage of representatives of knowledge investors. If such employees have to leave the firm, they do not only lose their relational capital but cannot convincingly show another employer what their contribution was worth. Investing in such a way means losing bargaining power compared to investment in general marketable knowledge. In contrast, knowledge that has the same marketable value irrespective of the firm in which it is used should not be represented on the board. Examples are professionals working in consultancies, accounting firms, or legal companies, who often have closer relationships to their customers than to their firm. When they decide to work for another company, they often take their customers with them and have no sunk costs.

There are several proposals for measuring knowledge capital (e.g. Bontis, 2001; Lev, 2001; Lev & Radhakrishnan, 2003; Strassmann, 1999). To get the firm-specific investment of employees in knowledge capital, the knowledge capital must be reduced by a factor that, on the one hand, captures the average reduction in wages employees of the firm would suffer if they had to work in another firm. On the other hand, it should include the average investment
the firm has made in the knowledge of its employees. This calculation requires an econometric analysis in which average wage rates in the firm are estimated, depending on a set of individual characteristics of the employees, as well as a variable that measures the time each employee spent in the firm.

As an alternative to this intricate process, a firm could voluntarily offer its employees a share of seats in the board corresponding to the attractiveness it desires to exhibit towards potential contributors to firm specific knowledge. Such a procedure has the advantage of being future oriented.

We suggest that each employee has voting rights according to his or her firm-specific investment. It ranges from zero to one. The size of this investment is captured by the estimated individual reduction in wage an employee would sustain if he or she had to transfer to another firm. Employees who sustain no estimated loss from having invested in their firm-specific knowledge, or who gain an estimated net profit from knowledge investments by the firm, should have no vote.

Neutral Chair of the Board

We envisage a neutral chair whose task it would be to guarantee an open discussion on the board so that all aspects can be duly considered. He or she should establish, as good as they can, what has been called an ideal speech situation (Habermas, 1987; Steinmann, 1990). In particular, he or she has to make sure that the procedural rules are strictly observed and that all relevant arguments are heard and considered. The chair should make an effort to secure consensus on the board, especially when complicated issues are at stake. Unanimous decisions on the board should be required for constitutional issues of the firm (Buchanan &
Tullock, 1962; Romme, 2004). The chair should also decide when, and when not, it would be useful to have the executives partake in the meetings of the board, thus securing the board a further measure of independence. The chair is therefore a specialist in procedures; he or she should not have any voting rights in order to remain truly independent. This can be compared to the task of a judge in relation to the jury.

The neutral chair of the board should be elected by the unanimous vote of its members. This ensures ex ante neutrality and grants him or her independence vis-à-vis any special faction of the board. Therefore, this person should be an outsider to the firm and should not be connected to the firm through previous employment or through any other capacity. Thus, we reject the common practice of appointing former CEOs as chairpersons of the board.

**ADVANTAGES OF OUR PROPOSAL**

**Providing Incentives for Knowledge Investors**

It is worth repeating our plan’s greatest strength. Employees have a stronger incentive to become knowledge investors, i.e. to invest in firm-specific knowledge capital. This incentive is particularly important for highly educated professionals who, under the present corporate governance conditions, have little incentive to become more fully engaged with the firm they are working for. Investing in firm-specific knowledge reduces their outside options and thus their bargaining position inside and outside of the firm.

These missing incentives stand in sharp contrast to the emphasis on firm-specific knowledge as the most important source of sustained competitive advantage in the dominating strategic management literature. In contrast, our plan provides these incentives and contributes to building up firm-specific knowledge capital and therewith leads to sustainable efficiency rents for firms. Our proposal helps us to overcome one important flaw of the “governance
perspective”: This theory disregards the individuals’ incentives to generate and transfer knowledge (Dosi & Marengo, 2000; Osterloh, Frey & Frost, 2002). It only considers value generation and disregards the interaction between value distribution and value generation (Asher, Mahoney & Mahoney, 2005).

**Countervailing the Dominance of Executives**

Insiders who possess great familiarity with internal processes and with internal tacit knowledge are able to monitor the executives more efficiently than outsiders, since they are less dependent on the information provided by executives. In addition, their function as representatives of the employees strengthens participation and self-governance by the corporate community as a part of corporate governance. Anyone breaking the rules is more easily identified by colleagues than by superiors and can be informally admonished. This assures that others are doing their part in contributing to the firm’s common good and are refraining from rent seeking (Osterloh & Frey, 2004).

**Strengthening Intrinsic Work Motivation and Loyalty**

Many employees, in particular knowledge workers, are to a considerable extent intrinsically motivated. In order be creative, knowledge work needs autonomy (Amabile, 1996), which is the most important condition for becoming intrinsically motivated (Deci & Ryan, 2000; Frey, 1997; Osterloh & Frey, 2004; Osterloh, 2006). But such intrinsic motivation is undermined if individuals feel treated unfairly or exploited by conditions in which distributive justice is disregarded. At the same time, loyalty to superiors and to the firm as a whole diminishes,
which has been shown by the literature on psychological contracts (Rousseau, 1995) and Organizational Citizenship Behavior (Organ & Ryan, 1995).

**Ensuring Diversity on the Board while Lowering Transaction Costs**

The neutral chair has a second important function on the board. On the one hand, representation by shareholders and knowledge workers ensures that a multitude of different aspects are represented on the board. Such diversity is important for making wise strategic decisions (Grandori, 2005), particularly in diversified and decentralized organizational structures (Child & Rodrigues, 2003). On the other hand, diversity of interests and control rights also raises the transaction costs of the decision-making process on the board (Hansmann, 1996), a disadvantage that needs to be counterbalanced by the advantages of having diversity. The neutral chairperson, as a specialist in procedures or a ‘facilitator’ (Grandori, 2001), is able to find generally acceptable solutions to conflicting issues.

**CONCLUSION**

*Mandatory co-determination* regulations (both at plant level and at board level) have been established across Europe. Despite heavy criticism against co-determination laws, empirical research produces an uneven overall picture: Some studies show negative effects of co-determination; however, there are many studies that exhibit neutral or positive effects of co-determination on various measures of performance. We suggest that co-determination laws might force a too rigid framework upon companies. They do not make sure that enough knowledge investors are represented on the board and thus have an incentive to invest in firm-specific instead of general knowledge.
In contrast, *voluntary co-determination rules* have a promising future. We argue that it is in the enlightened self-interest of shareholders to introduce customized co-determination rules. Our approach takes into account that a modern corporation’s key task is to generate, accumulate and transfer firm-specific knowledge. Firm-specific knowledge investments are the essential basis for a sustainable competitive advantage. Financial *and* knowledge investments must be combined to produce what are commonly called synergies or quasi rents. As a consequence, these quasi rents need to be divided in a way perceived to be fair by the participants. In particular, knowledge investors should not feel exploited; otherwise they will refuse to make firm-specific investments and will prefer to make investments in outside options. Corporate governance must secure their ex post bargaining position, once the (necessarily incomplete) labor contracts have been fixed. It is the board that has to take over this task.

With this end in mind, this paper advances three specific proposals:

*Firstly*, the board should rely more on *insiders*. The percentage of insiders relative to outsiders should be determined by the relationship of firm-specific knowledge capital to financial capital.

*Secondly*, these insiders should be elected by, and responsible to, those *employees of the firm who make firm-specific knowledge investments*.

*Thirdly*, a *neutral person* should chair the board. His or her main task is to enable the board members to engage in a productive discourse to the mutual benefit of all members of the firm. The chairperson also has to make sure that the board members are prepared to contribute to the firm’s common good and refrain from rent seeking.

Our proposals have major advantages over the reforms suggested by the dominant corporate governance approach. With respect to *corporate governance design*, our proposals provide
incentives for knowledge investors; they countervail the dominance of executives; they strengthen intrinsic work motivation and loyalty to the firm through distributive as well as procedural justice; and they ensure diversity on the board while lowering transaction costs.

With respect to corporate governance theory, our approach links corporate governance to the theory of the firm. On the one hand, we consider the “competence perspective” or knowledge-based theory of the firm focusing on value generation and on the production of a sustained competitive advantage. On the other hand, we take account of the “governance perspective” of the theory of the firm, based on new institutional economics, which focuses on the distribution of values. Thus, our approach overcomes the separation of theories focusing on value generation or value distribution by showing how value generation and value distribution interact.
REFERENCES


<table>
<thead>
<tr>
<th>Country</th>
<th>Criteria for Board-level Representation</th>
<th>Workers’ Representation</th>
<th>Selection of Workers’ Representatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Joint-stock companies</td>
<td>33% of the supervisory</td>
<td>Workers’ representatives are appointed by the works council and have to be members of the works council.</td>
</tr>
<tr>
<td></td>
<td>Limited liability companies with more than 300 employees</td>
<td>board</td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Joint-stock companies with more than 50 employees</td>
<td>33% of the supervisory</td>
<td>Employees and external trade union officials are elected by employees as workers’ representatives.</td>
</tr>
<tr>
<td></td>
<td>board</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>&gt; 35 employees</td>
<td>33% of the board of</td>
<td>Only employees can be elected as workers’ representatives.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>directors (at least 2</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>members)</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>&gt; 150 employees</td>
<td>Agreement between</td>
<td>If no agreement has been reached between the personnel groups, workers’ representatives are elected by employees.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>employer and personnel</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>groups</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>500 – 2000 employees</td>
<td>33% of the supervisory</td>
<td>Only employees can be elected as workers’ representatives. Trade unions nominate candidates for the trade union seats. There is a special regulation for the iron, coal and steel industry.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>board</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 2000 employees</td>
<td>50% of the supervisory</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>board</td>
<td></td>
</tr>
</tbody>
</table>

1 The information in Table 1 is based on Kluge and Stollt (2006). Table 1 presents the most relevant regulations for companies. However, the co-determination laws regulate some exceptions and separate rules (e.g. for state-owned enterprises).
<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
<th>Percentage in the supervisory board</th>
<th>Representative Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>Joint-stock companies and limited liability companies with more than 200 employees</td>
<td>33% of the supervisory board</td>
<td>Workers’ representatives are appointed by the works council and have to be employees of the same company.</td>
</tr>
<tr>
<td>Luxemburg</td>
<td>&gt; 1000 employees</td>
<td>33% of the board of directors</td>
<td>Workers’ representatives are appointed by the works council and have to be employees of the same company.</td>
</tr>
</tbody>
</table>
| Netherlands  | > 100 employees  
Equity capital > 16 Mio. €  
Existence of a works council | (up to) 33% of the supervisory board | All members of the board have to be independent. Workers’ representatives cannot be employees of the same company; they are nominated by the works council and appointed by the general meeting of shareholders. |
| Slovak Republic | Joint-stock companies with more than 50 employees                  | 33% of the supervisory board         | Only employees can be elected as workers’ representatives. |
| Slovenia     | Joint-stock companies with a supervisory board  
(defined in the companies’ statutes) | 33 – 50% of the supervisory board | Workers’ representatives are appointed by the works council. In companies with more than 500 employees, there is an additional representative on the management board; this representative is proposed by the works council and appointed by shareholders. |
| Sweden       | 25 – 1000 employees                                                       | 2 members of the board of directors   | Workers’ representatives are appointed by trade unions that have concluded a collective labor agreement. |
|              | > 1000 employees                                                            | 3 members of the board of directors   |                                                                                           |