The Sustainable Company: a new approach to corporate governance

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Edited by Sigurt Vitols and Norbert Kluge
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European Trade Union Institute (ETUI)
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The hegemonic conceptual paradigm for corporate governance – the ‘shareholder value’ model of the firm – is in crisis. This paradigm, which claims that the stock market is the best yardstick for company value and that share-based remuneration is the most efficient way to reward top management, has dominated reform of company and securities law for the last two decades in Europe and much of the rest of the world. However, since the onset of the current financial and economic crisis, faith in this model has been shaken. Many researchers and policymakers believe that the shareholder value model was one of the major causes of the crisis and are raising the question of whether the basic assumptions of the model are flawed.

Although calls for fundamental reform of our corporate governance system are widespread, it is not obvious what the alternative would look like. Many policy proposals can be characterized as ‘tinkering with the model’, i.e. a set of piecemeal measures for incremental changes in the system. Stronger critics appeal to the concept of the ‘stakeholder’ firm, which refers back to the merits of traditional continental European systems. However, a return to these older systems is unlikely given major changes in the institutions that supported them, such as a decline in controlling shareholdings by families and banks. Furthermore, new problems have arisen which challenge older stakeholder systems. For example, dealing with the issue of sustainability requires a much higher level of transparency than existed in traditional models. It is therefore instructive to learn from but not sufficient to draw on stakeholder models from the past.

Over the past few years, a group of researchers and trade unionists concerned with corporate governance has been working on a fundamental alternative to the shareholder value model. This group was motivated by the European Commission’s efforts to establish a European framework for corporate governance. In 2003 this intention was detailed
in the plan on *Modernising Company Law and Enhancing Corporate Governance in the European Union* (European Commission 2003). In order to enlist expertise to help implement this plan the Commission established the European Corporate Governance Forum at the end of 2004.

From the beginning the Commission’s proposals were observed critically by the trade unions. The European Trade Union Confederation (ETUC) was sceptical of an approach to corporate governance which prioritized transparency for shareholders and the so-called independent control of executives through financial market players (ETUC 2004). In this conception obligatory employee boardroom participation would play a marginal role, even though it is a widespread part of national corporate governance systems in at least 12 EU member states and exists in many European Companies (SEs) established according to European company law.

One indicator of the marginal importance of the stakeholder approach to corporate governance in the Commission’s initiative is the composition of the 15 members of the European Corporate Governance Forum. Although the financial services industry and companies are well represented in the Forum, only one member could be considered to represent stakeholders other than shareholders. Initially this was Emilio Gabagalio, former General Secretary of the ETUC, and since 2008 Niklas Bruun, a law professor at the Hanken School of Economics and well recognized international legal expert with close ties to trade unions.

The European trade unions and their academic allies recognized the need for an expert group with a broader approach to corporate governance, and in 2005 the GOODCORP expert group was established by the European Trade Union Institute (ETUI). This group included academics from a range of fields (law, economics, industrial relations and sociology) and trade unionists concerned with corporate governance issues. The first effort by this group was to advise the ETUC on an inclusive approach to corporate governance which includes employees as key stakeholders. With the help of this advice, in a 2006 resolution the ETUC made a link in corporate governance between worker interests, company governance and provisions for worker participation. The resolution pointed out that worker involvement is a strong element in European thinking on corporate governance. The resolution described the reasons why workers have an interest in the ‘good governance’ of companies: ‘Workers are not
only parties to an employment contract, but at the same time are investors and citizens. Workers should be seen as participants in the company, just like shareholders, in the sense that they sustain risks arising from the company’s choices’ (ETUC 2006). The ETUC Congress in Seville in 2007 took up this perception in its political program *On the Offensive* by linking explicitly the struggle against ‘casino capitalism’ and the short-termism of financial markets through better taxation and regulation and stronger worker participation.

At the same time another expert group organised by the ETUC under the title ‘Paths to Progress’ worked out arguments from different academic disciplines which pointed in the same direction: Corporate governance cannot be reduced to the problem of how shareholders (the ‘principals’) can control managers (their ‘agents’). Workers strongly claim the right to be fully involved in the strategic choices of companies in which they are employed. Of course, there may be different ways to move forward; these are influenced by the very different cultural roots and legal systems in EU member states and by the different experiences of trade unions. However, there is strong evidence supporting legal initiatives at EU level to strengthen worker voice and put workers in a better position vis-à-vis companies and investors. The work of this academic exercise, which was compiled and coordinated by the late Brian Bercusson, culminated in a publication with the Social Development Agency (SDA) (SDA 2006). After publication and public presentation, experts in the Paths to Progress group joined their efforts with the ETUI’s GOODCORP group. Since 2007 this group has met regularly. Frequently these meetings have been organized in conjunction with EU Council Presidency conferences on corporate governance.

Some of current debates at European level have been influenced by this expert group. For example, in 2008 the European Economic and Social Committee (EESC) started a debate on ‘what makes a good company’ by adopting an initial opinion agreed by its social committee (EESC 2008). This document stresses the deep historical roots of worker participation in EU politics by showing its significant role up to now. Political consensus on employee participation was established in Europe after World War II, starting with the European Coal and Steel Community (ECSC Treaty of 1952). This stated that legally supported employee participation was an expression of socially responsible management. Afterwards, after three decades of debates on the issue, the so-called Davignon Working Group cut the knot in 1997 and paved the way for the
European Company Statute (SE). Here, the productive role of employee participation at all levels was emphasized: ‘The type of labour needed by European companies – skilled, mobile, committed, responsible, and capable of using technical innovations and of identifying with the objective of increasing competitiveness and quality – cannot be expected simply to obey the employers’ instructions. Workers must be closely and permanently involved in decision-making at all levels of the company’ (Davignon Group 1997: 5). It should also be noted that the European Works Council (EWC) has become an aspect of good management practice. Today more than twelve thousand EWC members invigorate the democratic infrastructure of European civil society.

Members of the GOODCORP group have also contributed to an awareness of the interlinkage between the economic, social and democratic functioning of obligatory employee involvement in company decision making: If European companies want to have long-term prospects they must organise a permanent innovation process together with employees and their representatives. For this companies need the commitment and knowledge of their workers. Functioning employee participation, especially at transnational level, can – in conjunction with increasingly transnationally organised personnel management – be a firm anchor for the necessary social integration in the company.

The fruitful years of collaboration of the GOODCORP group have enriched academic discussions and influenced political debates at EU level. In recent years these efforts have been guided by the need for new thinking about the future of the firm and its role in the economy, society and environment. Under the heading of the ‘Sustainable Company’ this group has been working on the concept of a company that would be economically successful, that would care for social interests inside and outside of the company, that would respect worker rights and that would be environmentally friendly.1 GOODCORP has now reached the point where it is possible to present this book, which outlines key elements of the Sustainable Company and the legal and institutional framework that would be needed to support its diffusion.

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1. The term ‘Sustainable Company’ was used by Chris Laszlo in 2003 in a book outlining his concept of a company in which social, environmental and economic performance is aligned (Laszlo 2003). However, as will be shown in chapter 1 and elsewhere in this volume, our concept of the Sustainable Company differs significantly in that we stress the need for formal mechanisms of worker involvement and a binding legal framework for sustainability.
To briefly summarize, the first couple of chapters in this book deal with the overall thematic of shareholder value and its alternatives. In Chapter 1 Sigurt Vitols discusses the main flaws in the shareholder value model and outlines the key features of the Sustainable Company and the framework that would be needed to support it. The participation of stakeholders – and in particular workers – is needed to include ‘voice’ for long-term interests in company decision making and to counterbalance the short-term interests of many shareholders. In order to do this a comprehensive set of changes are needed in the way our companies are regulated in the areas of company and financial market law. In the second chapter Laura Horn provides an historical account of how shareholder value was implemented politically in the European Union. The shareholder value model of the firm did not evolve naturally, but rather was the result of an active process of regulatory change at the European level. In the past decade an important shift has occurred in European company law away from a harmonization project designed to protect worker interests to a competitive process in which worker voice has been marginalized.

The second set of chapters deal with the issue of worker involvement in the company. In Chapter 3 Howard Gospel lays out the arguments for why employee representation is so important to the Sustainable Company. Both theory and empirical evidence back up the idea that worker involvement can help create a ‘win-win’ situation in which workers enjoy strong rights and the company operates efficiently and in a sustainable manner. In the fourth chapter Jan Cremers provides more evidence on the role workers and their representatives can play in supporting sustainable companies. Management by itself – even when it is willing to participate in cooperative industrial relations and social dialogue – in most cases lacks the skills and knowledge needed to implement ‘best practice’ human resource policies. Here the involvement of empowered workers and their representatives is needed. In Chapter 5 Aline Conchon and Jeremy Waddington draw on the first results of a large-scale survey of board level employee representatives (BLEReps) in Europe and dispense with some common myths of shareholder value advocates regarding employee representation. Firstly, board level employee representation (BLER) is not a marginal phenomenon in Europe, but rather is part of the company law and industrial relations traditions of the majority of EU Member States. Secondly, BLEReps do not only pursue the particular interests of workers. They also assign a high priority to the overall long-term economic interests of the company.
and actively seek solutions which simultaneously satisfy both sets of interests.

The next two contributions deal with the role of shareholding by employees and incentive schemes for managers. Andrew Pendleton in Chapter 6 discusses varying experiences with employee shareholding in Europe and argues that it could play a positive role in the Sustainable Company. When properly designed, employee shareholding schemes can increase the size of the stable shareholder base and strengthen employee voice within the company. At the same time, care must be taken so that employee welfare is not overly dependent upon shareholding. In the seventh chapter Rainald Thannisch discusses the lessons that can be drawn from Germany, where recent legislation on executive remuneration has mandated sustainability considerations and strengthened the influence of BLEReps. German trade unions successfully influenced the final form of this legislation. They also give active guidance to BLEReps to reduce the role of stock and stock options in executive remuneration. Instead, both fixed pay and elements of variable pay tied to sustainability objectives (such as employee and customer satisfaction and environmental performance) should have a greater weight in remuneration.

The next three chapters deal with the question of the potential for trade unions to support company sustainability in the context of globalization, both through agreements with multinational enterprises (MNEs) and through coalitions with new actors such as NGOs. Ulrich Mückenberger discusses the chances for different trade union strategies in the field of corporate social responsibility (CSR) in Chapter 8. European trade unions can no longer rely on the nation-state to enforce labour and environmental standards given the globalization of companies and their supply chains and weaknesses in enforcement in developing countries. Therefore, trade unions should increase their efforts to support transnational norm building, which requires the construction of new coalitions with NGOs and the media. In Chapter 9 Isabelle Schömann and Peter Wilke discuss the experiences to date with international framework agreements (IFAs), which are agreements on labour, environmental and/or other standards between multinational companies and trade unions covering more than one country. IFAs are a relatively recent phenomenon, are for the most part based in European companies and are mainly limited to direct labour concerns. However, evolving practice shows an increasing inclusion of environmental standards and
dispute-resolution mechanisms, which raises the potential of a greater role of IFAs in promoting the Sustainable Company. Katrin Vitols in the tenth chapter explores the potential for improving cooperation between trade unions and NGOs. Even though the relationship between these two actors is to some extent competitive and concrete examples of working together are relatively rare, there is nevertheless a significant and growing overlap in interests in sustainability issues between the two groups. A number of examples of successful cooperation exist which could be extended to increase support for the Sustainable Company.

The final set of contributions focus on improving framework conditions for the Sustainable Company by changing the ways that product and financial markets work through better regulation. In Chapter 11 Gregory Jackson and Anastasia Petraki show how companies, investors and other key actors in corporate governance have become caught in a trap of mutually-reinforcing short-term expectations. The Sustainable Company however requires an environment in which these actors would all share long-term, sustainability-oriented expectations. Regulatory and behavioural changes thus need to cover a variety of regulatory fields and affect all key actors rather than being piecemeal in nature. In the twelfth chapter Andreas Botsch outlines a far-reaching and comprehensive (but at the same time concrete) ten point program that should help financial markets to support a sustainable economy and society. Financial reforms since the financial crisis have however only partially implemented this program. Probably the most difficult point, and the one on which little progress has been made, is the democratization of the financial system. Andrew Watt in Chapter 13 outlines the problem of market prices not adequately reflecting the social costs of carbon emission by companies and discusses different methods for dealing with this. The most effective alternative for supporting the Sustainable Company would be the introduction of a carbon tax and the strengthening of the emissions trading system (ETS) in conjunction with other measures. At the same time this could serve as a model for dealing with other problems of externalities (i.e. cases where market prices do not accurately reflect the social costs of certain practices).

This book by no means presents a finished blueprint for the reform of corporate governance. The contributions here have for the most part focused on an identification of problems and a discussion of solutions that could be implemented in support of the Sustainable Company. Other potentially important elements, such as reforming merger policy in
Europe and reorienting investment strategies of pension funds, are not discussed in detail. Nevertheless, we believe that this book can make an important contribution to the current discussion on the problems with the shareholder value model and the characteristics of an alternative to it. In the interests of the long-term sustainability of our economy, society and the planet we hope that this book will help advance this debate.

References


Chapter 1
What is the Sustainable Company?

Sigurt Vitols

1. The rise of shareholder value

Stakeholder theory has long recognized that the company is a social organization dependent upon the contribution of different groups to the production of goods and services (Freeman and Reed 1983; Freeman 1984; Hutton 1995). Employees provide their skills and knowledge, suppliers provide raw materials, intermediate goods and machinery, and investors provide capital in the form of equity or loans. The community plays a key role in providing infrastructure, education and social services such as childcare and health care. All of these stakeholder groups are needed for the firm to function properly, and all in turn are dependent upon firms for their jobs, goods and services, tax revenues, etc.

Although there has always been a tension between the profit-making motives of owners and the interests of stakeholders, after World War II many countries (particularly continental European countries) found mechanisms for including other interests in the governance of the firm (Jackson 2001; Streeck and Yamamura 2001). In the case of labour, collective bargaining was extended and deepened universally. In many countries works councils and board level employee representation were introduced or strengthened, mainly in waves in the immediate postwar years and again in the 1970s (Rogers and Streeck 1995; HBS and ETUI 2004). In the 1990s many central and eastern European countries also introduced these institutions (SDA and ETUI 2005).

This stakeholder approach to the firm has been severely threatened in recent years by the so-called ‘shareholder value’ model of the firm (see Figure 1). The intellectual foundations for this approach were provided primarily by the ‘law and economics’ school of thought, which conceptualizes social relations as a set of contractual obligations and mechanisms to resolve conflicts and reduce uncertainty (Jensen and Meckling 1976; Lazonick and O’Sullivan 2000). In the case of corporate
governance, relations between the providers of different ‘factors of production’ are seen as hierarchical, with shareholders taking the place of undisputed ‘top dog’ in this hierarchy. The argument made to justify this special position is that shareholders are the original founders of the firm and have used their capital to hire employees and managers and to buy equipment and raw materials. As a result of this special position, shareholders are ‘residual claimants’ to the firm, i.e. after the claims of other factors of production are satisfied shareholders get the rest. Although shareholders may end up with empty pockets if the firm goes bankrupt, it also can mean unlimited profits when the firm does well.

Figure 1 History of models of corporate governance in Europe

The law and economics school has downplayed the tension that this approach creates between the interests of shareholders and stakeholders by claiming that the value of the firm – at least when the firm is large and listed on the stock market – correctly reflects the extent to which companies treat these stakeholders well. It is argued that the vast amount of information (public and private) which is available to millions of investors is filtered into the stock market and that share price correctly reflects the long-term prospects of the firm. As a result, the optimal corporate governance solution is to orient the operation of the firm towards share price as the best measure of company value (Rappaport 1986).

This approach has been highly successful in providing the intellectual underpinnings for much of the change in corporate governance regulation that has taken place around the world, both at the national and international level, for the past two decades. Part of the reason for this success is that the policy implications of this approach have been
compatible with the interests of a number of powerful groups, including governments trying to reduce their role in managing the economy (e.g. through privatization) and banks wanting to increase revenues from capital market-related activities. The shareholder value system of corporate governance has three key elements:

1. A competitive market for equity capital is needed in order to correctly reflect the value of the firm through share price and to allow for the replacement of management and restructuring of the firm through shareholder activities (e.g. through hostile takeovers or shareholder activism). This implies a whole set of practices and institutions, from a competitive market for asset managers (with capital flowing to ‘better’ managers) to the ability to buy and sell shares quickly with limited impact on share price (liquid markets) to ‘minority shareholder rights’ such as ‘one share-one vote’, which allow institutional investors with relatively small equity stakes to play a major role in company governance.

2. Managers’ interests are aligned with shareholder interests through the heavy use of share-based compensation in executive remuneration packages. Stock options have been particularly important here, since they expire worthless if share price is not above a certain level (the ‘strike price’) by the end of a specified period of time, but have unlimited profit potential if share price goes up. Share-based compensation has a very direct and significant impact on the incentives and behaviour of top managers.

3. A set of gatekeepers are needed to keep the system ‘honest’. This includes: auditors (who are supposed to certify that companies are properly reporting their financial position); rating agencies (who are supposed to help investors keep an eye on developments that might change their expected returns); securities markets regulators (who are supposed to make sure that markets are ‘fair’, e.g. by enforcing insider trading and market abuse regulations); and independent directors (who are supposed to monitor the behaviour of executive directors and companies from the boardroom).

One of the reasons why the shareholder value paradigm achieved hegemony is that it provides a simple but coherent framework for addressing a wide variety of policy areas (company law, securities law, financial regulation) which at the same time has been ‘in tune’ with the
general trend of neo-liberalism. This helps explain why this paradigm has been so successful, despite (or rather, perhaps because of) the lack of empirical evidence backing up its claims.

2. Why shareholder value doesn’t work

Now that the shareholder value model has had a decade or more to function in many countries, the empirical evidence is starting to accumulate on how well the theory has worked in practice. The short answer is: not very well. This is the case for many reasons, some which are theoretical flaws in the paradigm, others which are more practical in nature. A list of these reasons includes the following:

— *Share price is only weakly correlated with company performance.* A glance at the stock chart of almost any large listed company over the past decade will illustrate this very clearly: a peak at the beginning of 2000, followed by a dramatic fall to early 2003, followed by an increase up through 2008, an almost-vertical fall to early 2009, and a partial recovery up to now. The share price of many companies is below what it was ten years ago. Does this mean that they are performing worse than a decade earlier? In most cases not: rather, the share price of individual companies is highly correlated with the general movement of the stock market. This in turn reflects the mass psychology of investors, which follows cycles from panic to euphoria and back. Especially for large companies which grow only incrementally, in the ‘sideways’ stock market of the past decade, share price is an extremely blunt instrument indeed for measuring improvements in company performance.

— *Share price does not reflect many social and environmental costs.* Economists use the term ‘externalities’ to describe the costs of actions which are borne by others than the acting person or organization. A classic example of this is pollution: a company may make profits from environmentally harmful production because the costs of this pollution are carried by society as a whole rather than by its owners. In practice there is a whole set of activities which companies may find profitable (at least in the short-term), which however come at the expense of society or the environment. Since share price reflects the financial situation and prospects of the individual firm, it will not reflect the costs of these externalities. It
is therefore a poor measure of the welfare of other stakeholders in the firm.

— *Most institutional investors are short-term and passive.* According to the theory of shareholder value, share price will reflect the long-term prospects of companies. Shareholders will look to the long-term and will exercise ‘voice’ in accordance with these interests. This will work most efficiently with widely-held companies, since investors with superior (public or private) information can buy or sell shares until stock price is in line with these expectations. However, the reality is that the average holding period of stocks by institutional investors has fallen to below one year. Even pension funds, which in principal have the greatest interest in and ability to invest long-term, mostly hire outside investment managers; these are generally evaluated on a yearly basis and thus have a strong financial incentive to maximize short-term results. Furthermore, most institutional investors have portfolios of stock in hundreds or even thousands of companies. As such they have little or no capacity to actively intervene in the governance of the companies they are invested in. In short, financial markets are dominated by short-term passive investment strategies.

— *Share-based incentive schemes create massive incentives for fraud.* The potential for huge gains that stock option plans represent for top managers creates great incentives for increasing share price through fraud. Enron, WorldCom, Tyco and Global Crossing are only the most spectacular examples showing how this incentive can work and how true performance can be hidden for long periods of time. Stock options are therefore no miracle cure for aligning the interests of managers and shareholders, but rather create a new instrument through which managers can exploit the company and its stakeholders.

— *Gatekeepers have conflicting interests and/or limited capacity to monitor.* In theory gatekeepers should keep companies and investors honest. In practice many gatekeepers cannot or do not want to do this. The role of rating agencies, which made money from giving good ratings to junk products, is well known. However, current reforms still leave rating agencies dependent upon the financial information supplied by companies. Many regulators are understaffed or do not have the tools needed for proper
enforcement of rules. And the expectation of shareholder value theory is that independent directors have almost superhuman qualities, i.e. have the experience, skills and time needed to watch over top management and corporations with operations around the world, in some cases employing hundreds of thousands of workers. In short, gatekeepers do not and cannot play the role that shareholder value theory assigns to them.

Recently, doubts about the efficacy of the shareholder value system have arisen, even among the ‘law and economics’ crowd. The argument that problems have resulted because shareholder value was only partly implemented has become less convincing, especially since the Sarbanes-Oxley Act was supposed to be the most fundamental overhaul of corporate governance in the US since the 1930s. The growing interest in Corporate Social Responsibility (CSR) is also a reflection of the recognition that shareholder value does not address social and environmental needs. However, although doubts are surfacing, in most cases the policy reforms suggested amount to a ‘patching up’ of the system rather than a paradigm shift.

3. Why we need an alternative to shareholder value

Quite simply, the lack of progress – and even steps backward in many areas – on the road to a sustainable world makes it clear that a new approach is needed to corporate governance. This deplorable state of affairs has been dramatized by a number of recent developments such as the financial crisis and new reports on global warming. We are currently facing a ‘triple crisis’ including the economic crisis, climate change and a trend towards greater inequality in income and life chances in many countries.

*The financial crisis.* One development which has dramatized the need for radical change in corporate governance is the recent financial crisis. The crisis was triggered by the failure of the US investment bank Lehman Brothers, but has its roots in the spread of the shareholder value paradigm and the rise of unregulated high-risk financial investors and products. Defenders of the shareholder value approach to corporate governance claim that a combination of transparency in company reporting and stock market-oriented incentives for top managers should lead to long-term value creation. However, recent experience has shown
that many banks accepted too much long-term risk for the sake of short-term gains and that rating agencies failed to adequately warn the markets about these practices.

One of the most widespread of these practices was the granting of mortgages in the US to families without the financial capacity to pay back these mortgages in the long term. Near-zero downpayment policies, the waiving of repayment for the first years of the mortgage and variable interest rates granted in a period of historically low rates lured millions of families into a financial trap out of which they had little hope to emerge from. In the short run, however, banks originating these high-risk mortgages were able to increase their revenues and share price, and many of their top managers profited handsomely. However, short-termism was not limited to the mortgage market and could be seen in many other credit markets, such as credit cards, auto finance and leasing, mergers and acquisitions (frequently involving private equity funds) and leverage for hedge funds. Although in many cases banks hedged their risks through the purchase of credit insurance, the sellers of this insurance were frequently other financial institutions whose own solvency was threatened in during the financial crisis.

The extent of this crisis has made clear the need for a deep and multifaceted reform of the way we regulate our financial system. Part of the solution is to bring unregulated portions of the financial system, such as hedge funds and credit derivatives markets, under the regulatory umbrella. Another part of the solution will be to align the incentives of banks and their top managers towards long-term sustainable policies (see Chapters 7 and 12 in this book for solutions on remuneration policy and financial reform, respectively).

Climate change. Recently, the lack of progress on environmental goals has been dramatically demonstrated, in particular through the reports released in 2007 by working groups within the United Nations Intergovernmental Panel on Climate Change. These reports showed that, over the past century, global temperatures have increased, that northern hemisphere snow cover has significantly decreased, and that the sea level has significantly increased. These trends have accelerated in the recent past. These changes are linked to a massive increase in the emission of greenhouse gases, e.g. an increase of 70 percent annually between 1970 and 2004. Particularly shocking in the reports were different scenarios for the future, including a ‘worst case’ scenario whereby global
temperatures would increase an average of 4 degrees centigrade by 2100. Consequences of this worst case scenario include not only climate effects, like more frequent coastal flooding and storms in some areas and intensification of drought conditions in others, but also social consequences, such as increased migration and risk of spreading of water- and food-based diseases.

The dramatic messages in these reports regarding climate change have been confirmed by other important reports by governmental agencies or commissions. The first and second progress reports on the European Union Sustainable Development Strategy and the accompanying statistical reports from Eurostat, published in 2007 and 2009, clearly showed unfavourable developments on two key sustainability indicators: targets for climate change (i.e. greenhouse gas emissions) and increased use of renewable energy sources have not been met (Eurostat 2007; Eurostat 2009). Part of the solution will be to require our companies to provide comprehensive reports on their environmental and social impact. Another part of the solution will be to reshape our markets so that environmental and social costs are more accurately reflected in prices, e.g. through a carbon tax or more developed emissions trading scheme (see Chapter 13 for a discussion of these alternatives).

Social inequality. A third problem which is receiving more and more attention in the media and public perception is the increasing degree of inequality in income and life chances in Europe. According to one study, between the mid-1980s and mid-2000s there was an increase in market income inequality between households in every EU country examined except France and the Netherlands (Franzini 2011). According to the 2009 Monitoring Report on Sustainable Development in the EU the ratio of income of the top 20% of households in the EU-27 was five times that of the bottom 20% of households by income (Eurostat 2009: 204). In 2007 one in six households in the EU-25 was at risk of poverty (Eurostat 2009: 200) and this figure may very well have increased due to the economic crisis (ETUI 2011).

Most dramatic is the explosion in the remuneration of top managers in large European companies over the past decade. In many European companies the total pay of the top manager (CEO) now exceeds the pay of the average worker by more than 100 times. As detailed in the contribution to this book by Rainald Thannisch, between 1987 and 2005 the average remuneration of executive managers in the largest 30
German listed companies increased by 445 percent. Even in the crisis year of 2009 the CEOs of these companies earned on average about 3.7 million Euros, not including pensions. CEO remuneration in comparable companies is even higher in other countries (e.g. the UK). According to the Forbes billionaire list, the top hedge fund managers have done even better, with the estimated wealth of one manager growing an astounding USD 4 billion in 2010.1

Responsibility of the company sector. A large proportion of the responsibility for this triple crisis lies with our company sector. Solving this triple crisis will thus require a major change in company behaviour:

— Companies account for the bulk of global warming and pollution, including the spread of dangerous chemicals. Therefore, a new approach to environmental policy clearly needs to include a reorientation of company behaviour in this area.

— Companies also account for the vast bulk of employment and labour income, in addition to providing on-the-job training and skills development. Concerns about the quality and quantity of jobs created, the ability to combine family and work concerns and increasing income inequality also point to the need for a change in companies’ employment policies.

— Company policies on debt levels, dividend levels and remuneration (including top executive pay) influence the financial stability of the corporate sector and the ability to invest in R&D for innovation for the future. In Europe spending on R&D is far behind the ‘3 percent of GDP’ goal originally set in the Lisbon strategy.

— The behaviour of other sectors (household and government) is also greatly influenced by the types of goods and services supplied by the company sector.

The lack of progress in solving these problems, and the fact that time is running out on the issue of climate change, clearly illustrate the need for a new approach to corporate governance.

1. For a list of top paid hedge fund managers see: http://www.insidermonkey.com/blog/2011/03/14/highest-paid-hedge-fund-managers-in-2010/.
4. What are the key elements of the Sustainable Company?

In contrast with the shareholder value model of the firm, the Sustainable Company\(^2\) has the following six key elements (see Figure 2):

— A multi-dimensional concept of *sustainability and stakeholder value* is the central guiding principle of the Sustainable Company.

— In accordance with this guiding principle the Sustainable Company has a *set of sustainability goals and a detailed strategy* for achieving these goals.

— *Stakeholders, in particular employees, are involved in decision making* in the Sustainable Company. This can occur through a number of mechanisms, including board level employee representation (BLER), European Works Councils (EWCs), collective bargaining and stakeholder advisory boards at companies.

— The Sustainable Company has an *externally verifiable reporting system* on both financial and nonfinancial (environmental, social, etc.) performance which allows for measuring progress on the achievement of sustainability goals.

— Incentives within the Sustainable Company are designed to support sustainability. A central role is played here by *tying a portion of executive remuneration the achievement of sustainability goals*.

— The ownership base of the company is dominated by *long-term responsible investors* concerned not only with financial return but also with the social and environmental impacts of their investments.

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\(^2\) The term 'Sustainable Company' was used in a book by Chris Laszlo published in 2003 (Laszlo 2003). However, as will be shown in chapter 1 and elsewhere in this volume, our concept of the Sustainable Company differs significantly from his in that we stress the need for formal mechanisms of worker involvement and a binding legal framework for sustainability.
Sustainability as the central guiding principle

In many non-Anglo-Saxon countries, company law emphasizes the responsibility of companies to a plurality of stakeholders: not only shareholders, but employees, debtors, and others dependent upon the company as well. This was part of the understanding of the responsibilities of the traditional stakeholder firm. Since the early 1990s, however, the concept of shareholder value as the central guiding principle for companies has spread beyond the Anglo-Saxon countries to continental Europe and Asia. Company law in many countries has been changed in a way which weakens this commitment by companies to a broader range of stakeholders.

The concept of sustainability, which involves generating value for stakeholders instead of just shareholders, is an alternative orienting
principle for the company. This principle builds on the older concept of the company as a community of interests and connects it with newer concerns with the interests of society and the environment as a whole.

Company sustainability goals and strategy

In order to realize the guiding principle of sustainability a concrete set of sustainability goals and a strategy for attaining these goals need to be formulated and agreed with stakeholders in the company.

Although a growing proportion of larger listed companies now have strategies for reducing greenhouse gas emissions (CDP and PriceWaterhouseCoopers 2010), strategies also need to be adopted by these companies on a greater range of sustainability issues (e.g. skills development). Furthermore, a broader set of companies (including small and medium size enterprises) need to adopt such strategies.

Stakeholder involvement

Employees are arguably the most central stakeholder in the company. One good criterion for identifying the centrality of different stakeholders is the degree to which their livelihoods are tied to the fortunes of the company.\(^3\) In the case of large publicly-traded corporations, employees are clearly much more dependent upon the well-being of the company than portfolio investors, who generally only hold small fractions of a large number of companies to diversify risk.

Up to now, however, employee involvement in company sustainability policies has remained far below its potential. In principle the following channels are available for greater worker involvement in sustainability issues in the company:

— Board level employee representation (BLER): an increasing number of companies are developing sustainability strategies, and these strategies are typically discussed at the board level. One way of involving employees in these discussions is therefore

\(^3\) Thanks to Pierre Habbard from TUAC-OECD for pointing this out to me.
representation on the company board. A majority of the 28 European countries surveyed by the SEEurope Network (EU-27 plus Norway) have legal provisions for BLER (18 of the 28 countries, 12 of these including public as well as private companies above a certain threshold) (see here in particular Chapters 3 and 5 in this volume).

— **European Works Councils (EWCs):** these can be founded at large companies (over 1000 employees) with substantial operations in at least two of the member states. Currently over 900 of these are in operation. These include employee representatives from the member states in which companies have significant operations. A recent survey of management showed that CSR/sustainability issues were discussed in almost two thirds of EWCs (Jagodzinski et al. 2008: 45). This channel could be upgraded to provide stronger worker voice on sustainability issues.

— **Collective bargaining:** trade unions are negotiating agreements on sustainability issues with an increasing number of companies. International framework agreements, of which there are more than 70, have been particularly prominent in this development (see Chapter 9 on this issue). However, sustainability issues are also increasingly negotiated at the national and local level.

— **Stakeholder boards:** a few companies have founded formal stakeholder boards including representatives of different interest groups in the company. If these boards are given substantial rights, e.g. the right to comment on and criticize sustainability reporting and strategies, this could be a mechanism to increase labour voice on sustainability issues in the firm, particularly in companies without BLER.

**Sustainability reporting systems**

Another key element of the Sustainable Company is a well-functioning sustainability reporting system. These systems have undergone intensive development over the past decade, and vary widely in content and process. However, a consensus on ‘best practice’ in sustainability reporting systems is emerging with regard to a number of characteristics:
1. **Multidimensional sustainability definition and indicators.** One criterion for best practice is a broad definition of sustainability and the inclusion of indicators covering the different relevant areas of the Sustainable Company. Current best practice is defined by the Global Reporting Initiative (GRI), which is a multi-stakeholder non-profit organization founded to create comprehensive standards for sustainability reporting. Trade union representatives are included in the governing bodies of GRI and in the development of reporting standards. The latest comprehensive revision of the standards was completed in October 2006, resulting in the issuance of the third generation (G3) of GRI standards. Indicators are defined and operationalized for the areas ‘economic’, ‘environmental’, and ‘social’, with the latter being further broken down by the subcategories of ‘labour practices and decent work’, ‘human rights’, ‘society’ and ‘product responsibility’.

2. **External verification/assurance.** It is increasingly being recognized that the credibility of sustainability reporting systems depends on the verification of the quantitative and qualitative data they produce through external agents, e.g. through a formalized audit process. Sustainability reporting should not be just ‘box ticking’ and limited to formal policies. However, it is important that these auditors have the skills and capacity to properly audit environmental and social impacts. Depending on the area, it may also be important to include trade unions in the monitoring process, e.g. in supply chains.

3. **Universal and standardized reporting:** It is important that ‘best practice’ in reporting not be limited to a small number of companies; all companies should report on sustainability and these reports should be easily accessible (though exceptions should be made in some areas for very small companies). Reporting should also be standardized so that results are comparable over time and across companies.

**Aligning company incentives with sustainability goals**

A key element of the shareholder value approach which has been brought into the discussion on corporate governance reform is the aligning of management interests with the interests of shareholders through the redesign of management remuneration systems. In particular, stock
options and other stock-related incentives (e.g. virtual stock options, grant of stock under the achievement of particular conditions, incentives for the relative performance of a company’s stock against a benchmark index) have been increasingly used in order to achieve this goal. The growing power of short-term oriented investors in conjunction with the relatively short realization periods of many stock-related forms of management compensation have raised the question of the extent to which these practices really lead to long-term value creation. Furthermore, the granting of significant stock-related remuneration creates a great incentive for top managers to misreport company finances in order to boost share prices (e.g. the wave of company scandals around the year 2000) or to corrupt the integrity of company board practices (e.g. the option back-dating scandal).

One possible corrective to this tendency is to tie a portion of management pay to the achievement of sustainability goals, such as the reduction of workplace accidents or the reduction of pollution. When a portion of managements’ variable pay is directly linked to sustainability indicators, this helps ensure that management will pay greater attention to the realization of company sustainability goals, and that the need to review management performance in the context of the pay review process will also focus the company board’s attention on these goals. Although examples of such explicit tying of variable pay to these goals are still relatively rare, they do exist in a number of companies, and generally have been reported to have achieved good results. Some of the more interesting examples found in a survey of the SEEurope network in 2008 included the following companies TNT, Royal Dutch Shell, and DSM.4

As detailed in Chapter 7, Germany recently took a big step forward with the approval of a new law regulating executive management remuneration. One of the requirements is that remuneration be tied to the long-term sustainability of the company. Examples of German companies with innovative applications of the new law include the following:

— Volkswagen (VW) has completely done away with stock options. This has been replaced by a long-term bonus for executive directors based on the achievement of specific goals, two of which include improving the satisfaction of employees and also of customers.

4. Thanks to Robbert van het Kaar and Lionel Fulton for help in identifying these examples. On the SEEurope network see: www.worker-participation.eu/European-Company/SEEurope-network.
— *RWE*, Germany’s second largest energy concern, has also introduced a long-term bonus for executive directors, based on a number of components including the achievement of environmental goals, employee satisfaction and customer loyalty.

**Long-term responsible investors**

One of the main pillars of the traditional stakeholder model of capitalism is (along with worker voice) ‘patient’ capital, which traditionally was provided by large, long-term owners such as families, the state and (in countries such as Germany) banks. In recent decades, however, the magnitude of patient capital from these sources has been decreasing:

— Some families are pulling out of ownership of companies, in part since post-founder generations may have little interest in running the family company.

— Governments in many countries have been actively pursuing privatization programs, either for ideological reasons (rise of liberal ideologies/political parties) or due to pressure on public budgets. In France, for example, roughly half of the top 40 (CAC) publicly-listed companies were wholly or partially privatized in the past two decades.

— Large banks in some countries, such as Germany and Japan, were also long-term shareholders in companies. In part this happened involuntarily, as companies became bankrupt and frozen credits were converted to equity. Many of these banks have been selling their shareholdings (Höpner and Krempel 2004).

An important supportive element for the Sustainable Company, however, is that capital markets should not penalize – and in the ideal case even reward – companies which transparently and systematically implement sustainability policies. In particular equity markets are most central, since shareholders (as owners) most directly influence company policies. The section below on ‘sustainability-friendly capital markets’ discusses some solutions for increasing the number and weight of long-term responsible investors (see also Habbard 2011, van den Burg 2011 and Vitols 2011).
5. **The way forward to the sustainable company: a supportive framework**

In extending the Sustainable Company from a few isolated cases of partial implementation of a few elements to a broad-based full implementation, a number of key changes need to take place. This section discusses these changes, including the following:

- The need for binding legislation creating a supporting framework for the Sustainable Company
- Transforming capital markets from short-term financially-oriented to long-term sustainability-oriented investment orientations
- An extended role for trade unions, including expanded expert capacities on sustainability and on working with other stakeholders (e.g. NGOs)

**The need for binding legislation**

A key issue in the development of the Sustainable Company is the degree to which a binding legislative framework is necessary. On the one hand, the argument that the government cannot simply legislate sustainability has some merit. On the other hand, the argument made by a portion of the sustainability community that sustainability is in the (enlightened) self-interest of companies, and thus can for the most part be supported by voluntary initiatives, is not plausible. The question therefore is where binding legislation is necessary and desirable to support the proliferation of the Sustainable Company. These measures include:

- A clear statement in company law that the primary purpose and responsibility of the company is not only to the shareholders to increase shareholder value, but that the company is a social entity obligated to pay attention to the interests of and increase the welfare of a broad range of stakeholder groups. Such an understanding is already embedded in the company law of a number of countries, but is not universal (most notably lacking in the Anglo-American countries).
— A legislative mandate on companies to extend their reporting beyond financial matters to include the whole range of sustainability indicators. Such a mandate already exists in a few countries, but generally only extends to a few indicators (e.g. employment levels or environmental impact). This mandate should be tied to some generally-recognized standard which significantly includes trade unions in the development of indicators, such as the GRI (Global Reporting Initiative), and to a standard which includes stakeholders (including workers) in the development and implementation of this reporting system.

— In countries where permissible topics of negotiation in collective bargaining or workers participation are spelled out in detail in law, this catalogue of bargaining issues should be clearly extended to include sustainability issues. For example, in countries with two-tier board systems, a catalogue of mandatory items to be discussed and approved by the supervisory board (including sustainability goals and strategies) should be embedded in law.

Sustainability-friendly capital markets

On the one hand it is reported that sustainability is increasingly important as an investment theme on capital markets. This is a positive sign that more and more investors are concerned with where their money is ultimately going, and may be willing to sacrifice some of their financial return in the interests of ‘doing good’. For example:

— There has been a continual increase in the proportion of assets under control of institutional investors that use one or more sustainability-related criteria for determining their investments. One estimate for the US is that such institutional investors now account for about one-tenth of assets under management. Such funds are readily available to the retail investor.5

— The sophistication of sustainability rating agencies has increased significantly. A number of these agencies have developed detailed methodologies for rating which are comparable across companies

5. See for example the websites http://www.socialfunds.com/ or http://www.ethibel.org/pdf/Forum%20ETHIBEL%20labels%20ENG.pdf
and can be administered on a relatively economical basis. Leading sustainability raters in Europe include vigeo and Sustainable Asset Management (SAM).

— An increasing number of financial investors are signing up to initiatives such as the Principles for Responsible Investment (a UN initiative to commit institutional investors to considering ESG criteria in their investment decisions) and the Equator Principles (social and environmental principles especially relevant for bank lending in the context of project financing).

On the other hand many or even most of these funds may be using a rather limited number of criteria (e.g. no investment in companies that manufacture tobacco, alcohol or weapons), and only might screen out the ‘worst offenders’. The positive incentives (in terms of easier access to capital) for adoption of sustainable company policies may thus be rather weak. At the same time, it is reported that the total amount of assets under control of investors which pursue short-term strategies is also continually rising. An examination of the turnover of shares of large companies (e.g. the German DAX 30) shows that the average holding period for shares of large publicly-traded companies has fallen to significantly less than one year. For many of these companies, shares may even be turned over a number of times per year on average. These investors base their decisions on buying and selling shares on quite short-term financial considerations, and have no interest in the long-term future of the company.

Furthermore, some of these short-term investors (such as the ‘activist’ hedge funds) actively use their power to try to force management to pursue policies that may not be in the company’s long-run interests (e.g. increasing share dividends, share buy-backs, some mergers). Although these activist investors may hold relatively small equity stakes (sometimes even less than 5 percent, the ‘standard’ definition of a significant shareholding), they can nevertheless have significant influence. The voting power of a five percent stake may be multiplied through the fact that many or even most other shareholders don’t vote on their shares, or through the ‘borrowing’ of voting rights from other shareholders. In addition, management may feel blackmailed by the willingness of activist shareholders to wage public relations campaigns against them, and thus may cave in to their demands, even if there is no clear majority of shareholders in favour of the policy.
A list of measures that could help create a more sustainability-friendly capital market environment for companies includes the following (see also Chapter 12 in this volume):

— Mandatory reporting requirements for institutional investors (including hedge funds and private equity funds) on the companies they invest in and the extent to which these companies have sustainability policies. (Reporting requirements should also be extended to the corporate governance of institutional investors, such as management remuneration, etc.).

— Constraints on short-term behaviour of investors, such as differentiated voting rights, dividend policies, and taxation rates for investors based on their length of investment (e.g. dividends only after a one year holding period, or double dividends for at least a one year holding period, and so forth).

— Encouraging more ‘patient’ capital, such as employee shareholding, and ensuring that employee shareholders have a voice in corporate governance (e.g. in France, where employee shareholders can elect a representative to the board when they hold at least 3 percent of shares) (see Chapter 6 on this issue).

— Strengthening the weight of various sustainability elements, such as workers’ rights, in the major socially responsible investment indexes.

Extending the role of trade unions

Important dimensions of sustainability, such as employment conditions and occupational health and safety, have long been core issues for trade unions. Other dimensions, such as the finances of the firm, have also been longstanding concerns of works councils and employee board level representatives. Nevertheless, many elements of the multi-dimensional concept of sustainability stretch beyond the traditional core concerns of trade unions. In this respect the Sustainable Company represents a challenge to current trade union capacities to take positions on these issues and to advise trade union and/or works council representatives on a decentralized level. Taking an active role in the Sustainable Company would thus require trade unions to build up their expertise in new areas,
either through further training and education for their officials and members, or through hiring experts or consultants for advice on specific issues. The negotiation of framework agreements on sustainability also represents an extension of trade union capacities to a new area, and will certainly involve an accumulation of learning experiences.

A recent example where trade unions are stepping into this new role is the case of Umicore, an international materials-technology group with headquarters in Belgium. In September 2007 the company signed a wide-ranging Sustainable Development Agreement with the International Metalworkers’ Federation and the International Federation of Chemical, Energy, Mine and General Workers’ Unions. This agreement contains a commitment of company management to a coherent economic, social and environmental strategy. The agreement is the start of a process of including trade unions in the formulation, implementation and monitoring of the sustainability strategy. Chapters 8 and 10 detail other cases where trade unions have introduced innovations here, including creating alliances with NGOs and other actors.

6. Conclusion

Just as Rome was not built in a day, new corporate governance paradigms are not implemented overnight. The rise of shareholder value took many decades, starting from the US and spreading from country to country. The diffusion of the model can be explained by both its conceptual simplicity as well as the overlap of its policy recommendations with the practical interests of powerful actors. The realization of the Sustainable Company will also depend upon conceptual work (i.e. the elaboration of its framework and policy prescriptions) as well as publicity work to diffuse the concept among potential supportive actors. This book is intended to contribute to this process.

References


6. Thanks to Luc Triangle for providing me with information on this example.


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Chapter 2
How did we end up here? The rise of shareholder value in EU corporate governance regulation

Laura Horn

1. Introduction

Corporate governance constituted ‘one of the most important failures of the present crisis,’ the De Larosière report commissioned by the European Commission concluded early in 2009. Yet it was only ten years earlier, with the Financial Services Action Plan (FSAP) in 1999, that corporate governance as such was put firmly on the European regulatory agenda. This not only begs the obvious question of how, and to what extent, regulatory developments have in fact contributed to the current crisis. It also points to the crucial role of regulation in establishing the political, legal and economic preconditions that give rise to a particular conception of corporate governance. The emergence of shareholder value as a paradigm for corporate governance and company law has already been discussed in the previous chapter; now it will be shown how shareholder value has been implemented politically at the EU level.

This chapter emphasizes the essentially political nature of corporate governance regulation. The main argument put forward is that the transformation of regulation in this area is part of a broader political project of economic restructuring and market-making in the European Union.1 Following a short outline of an alternative perspective on company law and corporate governance regulation, two dimensions of the legislative and regulatory changes in company law and corporate governance will be discussed. First, the chapter shows the shift from a legislative programme centred on company law harmonisation towards a regulatory approach which is based on minimum requirements and mutual recognition and which aims at adjusting the governance of corporations to the demands of liberalised capital markets. Concomitant to these changes, the chapter analyses how company law, and even more

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1. For the full argument and detailed empirical substantiation see Horn (forthcoming 2011).
so corporate governance regulation, have become increasingly focused on the rights of shareholders, while worker rights have been relegated to the area of social policies and labour law. The chapter then concludes with a reflection on current developments in corporate governance regulation in the context of financial and economic crisis.

2. An alternative perspective on corporate governance regulation

Corporate governance is here understood as the practices that define and reflect the power relations within the corporation and the way, and to which purpose, it is run (Van Apeldoorn and Horn 2007: 211). Corporate governance regulation refers to formal as well as informal and self-regulatory rules that shape the governance and power relations within the publicly listed corporation. In other words, regulation engenders the framework in which corporate governance practices emerge. More specifically, regulation defines ‘the legal, institutional and discursive parameters, both constraining and enabling the agency of those actors [...] that ultimately shape the governance of a particular firm’ (Van Apeldoorn et al. 2007: 5). The changing regulatory balance between these three interrelated domains that constitute corporate governance – company law, financial market law and labour law – constitutes an important point in this study. In this regard it is crucial to show how the primacy of shareholder interests has been constituted politically as well as legally. Company law is constitutive of the very subject it pertains to regulate. The ‘basic legal characteristics of the business corporation’, which, according to a standard textbook, comprise ‘legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership’, all have to be established and guaranteed through the state (Kraakman et al. 2004: 1). As Gourevitch and Shinn point out (2005: 89), if corporate governance structures are indeed the result of political decisions, what explains the content of these regulations? Rather than seeing corporate governance regulation in terms of de- or reregulation (as is often the case) it is the qualitative change in corporate law and other regulatory domains pertaining to the social

2. Within EU legal studies an interesting research programme on ‘reflexive governance’ has emerged which offers a perspective on corporate governance regulation, pointing to governance mechanisms such as hybridisation of norms, mutual learning and the diversity of law and practices (cf. Deakin 2009; Zumbansen 2009; Johnston 2009).
relations of the corporation that needs to be analysed. The role of the legal and regulatory framework here should be seen within the historically specific context of European market integration. Corporate governance regulation here indeed constitutes a ‘transnational legal field’ (Zumbansen 2009: 250). The implementation of shareholder value in EU company law and corporate governance regulation is seen here as a marketisation of corporate control, meaning that corporations are increasingly governed for the market (to generate shareholder value) and through the market (by means of market-based mechanisms such as ‘comply or explain’).

As Zumbansen argues, developments at the EU level have been ‘amplifying the tensions that underlie the conceptual and architectural distinction between “company” and “capital market” law’ (Zumbansen 2009: 248). That is, the points of reference of company law and capital market law are not synonymous. The latter broadly serves to facilitate efficient, well-functioning capital markets through safeguarding investor protection and providing the organisational infrastructure for capital and financial markets to operate. Company law, in contrast, covers a broader range of objectives, including the establishment and organisational structure of corporations, as well as a fundamental organising function with regard to institutional power between corporate constituencies (e.g. with regard to worker rights or board composition). While company and capital market law both emerge within particular politico-legal structures of historically specific social relations of production, capital market law is in itself far more limited in its legal objectives. Also, there are rather different jurisdictional claims: whereas the company law of a country pertains to corporations incorporated (and having registered offices) in that state, capital market and securities regulation applies to companies whose securities are listed on an exchange located in that state (Clarke 2009: 178). This shift excludes a core constituency of company law from the legal focus altogether; workers as such do not have a direct stake in capital market laws and are not recognised as directly relevant for regulatory debates.

3. Developments in EU company law and corporate governance regulation

In its 1975 Green Paper on Employee Participation and Company Structure the European Commission argued that ‘employees are increasingly seen to have interests in the functioning of enterprises which
can be as substantial as those of shareholders, and sometimes more so’ (European Commission 1975: 9). Now, just three decades later, little is left of this strong emphasis on the role of workers in company-level decision making. The Commission has recently been pushing for shareholder democracy rather than industrial democracy. And while in 1973 an authoritative textbook argued that ‘the virtual unification of national company laws in all essential aspects [...] is a political act necessitated by the desire to accomplish the aims of the Community’ (Schmitthoff 1973: 89), in 2003 the Commissioner for the Internal Market at that time, Frits Bolkestein, claimed that the objective of regulation was merely ‘to set up a framework which then enables the markets to play their disciplining role in an efficient way’ (Bolkestein 2003: 1). It is these fundamental changes in regulatory content with regard to company law, together with equally significant changes in the mode and form of regulation, that this chapter seeks to understand.

3.1 From harmonisation to marketisation

Company law harmonisation has been an important element in the drive to integrate the economies of the six founding Member States of the EEC into the single market, as stated in the Treaty of Rome. In fact, European company law was long considered the area of law most intensively harmonised (Grundmann 2004: 604). An explicit objective of the early harmonisation initiatives was to make sure that there would not be a ‘Delaware effect’ in the EEC. Schmitthoff identifies the course of actions taken by the Commission in the area of company law as ‘salami tactics’, according to which ‘one slice of national company laws after the other will be harmonised, uniform minimum standards will be established in the national company laws of the Community with respect to all important areas’ (Schmitthoff 1973: 7). This perception very much summarises the supranational ambitions of the European Commission in the 1960s, and echoes a neofunctionalist understanding of European integration through spillover. However, even in a Community of six

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3. The Delaware effect refers to the (re)incorporation of US companies in the state of Delaware, as this jurisdiction facilitates management retrenchment. Here, two competing claims are made. On the one hand, regulatory competition is assumed to lead to a ‘race to the bottom’, as shareholders have insufficient control over the decision to reincorporate. In contrast to this perspective, another assumption holds that a ‘race to the top’ can also take place, as management, under pressure from market forces, would not retrench but rather opt for strategies beneficial to shareholders. For the original argument see Cary (1974).
Member States, the differences in legal traditions were considerable. The Commission thus not only had to negotiate about legal technicalities, but early on made fundamental decisions pertaining to the role and functioning of companies which had a significant effect on the national company laws of the Member States.

The European company law programme changed significantly in the 1980s, in particular in the context of the programme for completion of the Single Market by 1992. The renewed impetus for market integration reinforced the shift towards a considerably less mandatory and harmonized company law. Instead, harmonisation in terms of minimum requirements and the principle of mutual recognition were to be applied wherever possible. This introduced an element of regulatory competition to the area of company law that marked a stark break with the previous harmonization programme, which had explicitly sought to avoid regime competition. Company law and corporate governance also became increasingly politicised in the European Union. The further harmonization advanced, the more Member States realized how integral their national corporate governance configuration was to their national socio-economic systems.

The increasing incorporation of corporate governance into a framework for financial market integration and capital market liberalisation constitutes a crucial shift in the EU approach to corporate governance regulation. The framing of corporate governance within the Financial Services Action Plan (FSAP) and the subsequent regulatory linkages and overlap between corporate governance and capital market and securities law illustrate that ‘the reach of capital market law over subjects that traditionally fall within the realm of company law is expanding’ (Winter 2004: 106). Whereas company law and financial and securities market regulation had been distinct regulatory fields under the programme of company law harmonisation, with the integration of financial markets corporate governance regulation was more and more seen as subject to capital and financial market imperatives. Aspects of corporate control had been present in early debates on company law, for instance with regard to worker participation or board structure. However, corporate governance was now increasingly perceived in a narrower sense pertaining exclusively to the internal and external control mechanisms between shareholders and managers. Crucially, the relationship between shareholders and managers came to be understood as a principal-agent one, with share price as the prime mechanism to align shareholder and
manager interests. The objective of regulation thus turned away from protection of ‘stakeholders’ dependent upon the firm, for instance creditors (which were increasingly to be covered by transparency provisions) or workers, towards a focus on creating a framework conducive to the ‘efficient’ functioning of capital markets. With worker rights consigned to social policies, this elimination of regulatory focus on any relation other than the shareholder-manager relationship constitutes an important precondition for the establishment of the marketisation project. Rather than advocating a ‘positive’ harmonization approach, the Commission’s approach has become increasingly based on identifying and subsequently eliminating obstacles to the free movement of companies and capital. Whereas corporate control used to be very much located in the domain of company law, subject to ‘positive’ harmonization, it has become increasingly regulated under aspects of capital and financial markets law.

The emergence of the company scandals in the early 2000s gave renewed impetus to the debate on corporate control mechanisms in the European Union. The auditing and accounting failures of Enron, WorldCom and other large listed companies in the US, which were followed by a number of company scandals in European Member States, brought corporate governance to the attention not only of regulators and investors but also of governments and the public at large. The impetus behind the Commission’s push for corporate governance under financial market imperatives had already become clear in the FSAP, namely the ‘much-needed legal underpinning for protection of minority shareholders and a more rationalised organisation of corporate legal structures in the single market’ (European Commission 1999: 9, emphasis added). The Takeover Directive constitutes an essential part of the political project to restructure and liberalise European capital markets. The legislative history of the Takeover Directive is a prime example of how regulatory initiatives in the realm of company law and corporate governance have been discursively and politically integrated into a comprehensive plan for financial market integration. Despite the legislative compromise and the present resilience of national pre- and post-bid defensive structures to takeover, which prevent a European market for corporate control from being fully established, the Commission has succeeded in establishing a regulatory framework in which the norm prescribes that, in case of a

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takeover, it is only shareholders who get to make decisions on the company.

The Commission’s 2003 Company Law Action Plan builds upon a report of the High Level Group of Company Law Experts that had been published a year earlier. The group’s recommendations had a crucial influence on the discursive formulation of subsequent company law and corporate governance initiatives. The High Level Group’s underlying approach signalled a significant break with the rationale underlying previous company law initiatives. The group’s chairman, Jaap Winter, acknowledged the shift to a strong orientation to capital market law, rather than the traditional company law outlook that had been dominant in European Union company law. He argued that, although formally the Takeover Directive is a directive on company law and part of the company law harmonisation process, ‘at the same time, it seeks to regulate an important element of the functioning of capital markets […] many features of the draft directive have been driven much more by capital market concepts than by company law thinking […]’ The reach of capital market law over subjects that traditionally fall within the realm of company law is expanding’ (Winter 2004: 106, emphasis added). This represents a significant shift in the underlying perception of on which grounds and to which end company law should be shaped. The High Level Group advanced a strategy that rejected the traditional harmonisation approach in favour of the integration of national company law into a transnational market. Rather than harmonized regulation of company law, in the context of this market-oriented outlook the High Level Group emphasized the role of disclosure as a regulatory tool, which has come to be one of the main principles in corporate governance codes under the ‘comply or explain’ approach.

The 2003 Company Law Action Plan had a far more fundamental purpose rather than to just prevent other corporate scandals. It is complementary to the broader framework of financial integration in that it emphasizes the role of integrated capital markets for corporate governance, and correspondingly points to the regulator’s responsibility in facilitating efficient market functioning (European Commission 2003).

The increasing regulatory overlap and complementarity between corporate governance and capital market law is most pronounced in transparency and disclosure provisions for listed companies. While transparency of corporate practices and control, as well as disclosure of assets, benefits not only shareholders but potentially also other stakeholders in the company, the nature of the information to be disclosed suggests that it is primarily (if not exclusively) aimed at shareholder interests. Indeed, the regulatory establishment of a framework of information for investors and creditors is a *sine qua non* for the ‘efficient’ functioning of the market, which subsequently is a necessary condition for a market for corporate control.

With regard to remuneration, the Commission argued that company policy on this issue should be included in the annual accounts and a corporate governance statement, and that remuneration should be disclosed in detail on an individual basis for directors. Crucially, it also recommended that executive remuneration be put on the agenda of the annual general meeting in order to include shareholders in decision making on this issue. The recommendation on independent directors sought to strengthen the role of non-executive or supervisory directors by requiring a higher degree of independence for the supervision of management. However the emphasis on independence of the board of directors implies an *ex ante* definition of the interests it should serve (namely that of the shareholders) and means an increasing externalization of this internal mode of control (Aglietta and Reberioux 2005: 267).

The 2003 Action Plan also made the case for a ‘real shareholder democracy’ (European Commission 2003: 14). The question of the proportionality of ownership and control (the ‘one share one vote debate’), which has emerged after the High Level Group’s suggestion for a ‘breakthrough rule’ in case of a takeover, involved a fundamental debate on the rights of shareholders by virtue of their share ownership. The

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6. Compare, for instance, the relative ease with which the Prospectus and Transparency Directives have been passed with the strained discussion and implementation of the recommendation on disclosure of executive remuneration.

7. As Zumbansen argues (2009: 260–61), the recommendation highlighted the embeddedness of remuneration in the various corporate governance structures in the Member States.

8. McCreevy originally used the term ‘shareholder democracy’. However, in subsequent policy debates it was referred to as ‘proportionality of ownership and control’ as a less politically loaded concept.
underlying policy objective of the debate and regulatory initiatives on the issue of shareholder rights is to stimulate (cross-border) investment in integrated European capital and financial markets. What is more, the strengthening of shareholder rights is often assumed to preempt the need for corporate governance regulation. This rather fallacious assumption is expressed well in the cheerful assertion by Peter Montagnon, Director of Investment Affairs at the Association of British Insurers (ABI), that ‘shareholder rights are an antidote to company regulation’ (Montagnon 2006: 1). The debate on the proportionality of ownership and control in 2006/07 illustrates the fault lines between actors advocating a deepening of the marketisation of corporate control and others defending national company law structures and their embedding in a broader socio-economic national context.

The European Court of Justice also played a central role in establishing a shareholder value-oriented corporate governance regime. With its interpretation of the Treaty – most importantly the primacy of the movement of capital – the ECJ has provided a politico-legal confirmation of the attempts to bring about a European market for corporate control. At the same time, it set the foundation for a fundamental challenge to the traditional continental European perception of companies as embedded in national jurisdictions. In three landmark decisions the ECJ has enforced the right of incorporating companies to choose the corporate law system of any Member State of the EU.9 In addition to supporting the freedom of establishment the ECJ also played a major role in enforcing the free movement of capital in the integrated European capital market with its rulings on a number of golden share arrangements in June 2002.10

With regulatory activities increasingly assigned to the market (and thus further removed from societal control) national regulatory arrangements of corporate organisation are more and more subject to the scrutiny of the market in an environment of growing regulatory competition. From a market perspective, even regulation that might be considered ‘efficient’ in a national context ceases to be efficient if it does not support the further integration of capital markets. In the ‘post-Ricardian’ phase of market

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integration European corporate governance regulation progresses no longer through the underlying principle of mutual recognition (and hence, implicitly, the comparative advantage of a variety of capitalism) but rather by asymmetrically targeting the systemic institutions of organised capitalism (Höpner and Schäfer 2008).

3.2 From industrial democracy to shareholder democracy

Concomitant to the increasing importance of shareholder value as a guiding paradigm, the constituency of company law and corporate governance regulation has undergone a radical change. Here it is instructive to start out again from the early years of the EU company law programme. Apart from directives to harmonise basic company law structures in the EEC, as well as plans for a European company law vehicle (realised in the Societas Europaea or SE), the Commission also sought to model company structures in the Member States through the Fifth Company Law Directive. The purpose of the Fifth Directive, first proposed to the Council in 1972, was to harmonise rules for the internal organization and decision making structures of public companies registered in a European Member State. This was a highly ambitious initiative, as it entailed mandatory provisions for a two-tiered board structure (i.e. management and supervisory board) and employee representation on the supervisory board (for companies with more than 500 employees). These developments have to be seen against the background of the increasing crisis of corporate liberal arrangements that had underlined much of the early European integration process. This neo-corporatist moment also informed the Commission’s initiatives to (re)integrate labour into an industrial policy which would ensure the competitiveness of transnational European companies vis-à-vis their US counterparts. During the debates on worker rights in company law the Commission upheld its commitment to worker participation and a dual board structure in its 1975 Green Paper *Employee Participation and Company Structure in the European Community*. The Commission’s plan essentially represented a class compromise on the company level, combining a company decision making structure with a mandatory dual board to ensure the ‘representation of a plurality of interests’ in the company ‘with a homogeneous management in a way which unitary systems find difficult to duplicate’ (European Commission 1975: 20). Not surprisingly, the attempt to engineer industrial peace through concessions of extending worker information, consultation and participation in European companies met severe
opposition from employers’ associations, both on the national level as well as from UNICE (the umbrella organization for European business) and other European level business associations.

After the Commission’s failed attempt at coordinating corporate control systems in the European Community with regard to board structure and worker participation, the diverging national systems of ‘industrial citizenship’ were no longer to be harmonised from the late 1980s onwards. Rather, the objective was to ensure that these different systems could be integrated in, and made to sustain, the Single Market, and that to this end a minimum level of worker rights were guaranteed. Mandatory provisions were abandoned in favour of a more flexible approach providing national policymakers and companies with alternative solutions to implement information and consultations rights. Worker rights were increasingly relegated to the area of labour law, which was covered by DG Employment and Social Affairs (Streeck 1997). Consequently, the focus changed towards establishing information and consultation rights rather than participation rights with potentially redistributive consequences. None the less, even under these circumstances worker rights proved to be controversial. The case of the aborted Vredeling directive illustrates how far the corporate liberal push to institutionalise worker rights, however limited, into European law was contested and eventually defeated by the emerging neoliberal project for liberalising the European economy. Still, there have been important legislative developments in the area of worker rights in the 1990s and early 2000, in particular the European Works Council Directive and the European Company Statute and its accompanying directive.11 Worker participation as such, however, has increasingly been marginalised and obscured by an approach to corporate governance focused almost exclusively on shareholder value.

4. Corporate governance in crisis?

While the European Court of Justice has constitutionalised the freedoms of establishment and capital, there are in fact signs that the implementation of shareholder value has been reaching the limits of political space within the European state formation. Even before the

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11. For more information on the SE, see e.g. the website of the SEEUROPE network of the ETUI at www.worker-participation.eu/european-company. For a critical assessment from a labour law perspective, see Davies (2003).
recent financial and economic crisis, an alliance of trade union representatives, members of the European Parliament and NGOs at the European level began to contest the implementation of shareholder value oriented corporate governance. At the same time, ‘economic nationalism’ surfaced in several Member States at a time when the number of hostile bids and cross-border M&As was at an all time high. In the 1990s, organised labour at the EU level (in particular the ETUC) was mainly active in the institutional framework of the Social Dialogue. However, as the Commission presented its Company Law Action Plan in 2003, it became clear that there was no mention of worker rights in the policy programme. This was a turning point for the ETUC’s position on the Commission’s project. The ETUC strongly opposed the underlying orientation of the Action Plan, arguing in its reaction to the consultation that ‘governance is presented as a problem limited solely to the relationship between shareholders and management, as though an enterprise were a private entity that concerned the interests of shareholders alone’ (ETUC 2003: 4). In May 2006, the ETUC Executive Committee adopted a resolution on corporate governance at the European level, in which it was argued that the ‘European corporate governance framework should lay down proper institutional conditions for companies to promote long-term profitability and employment prospects, define mechanisms that prevent mismanagement and guarantee transparency and accountability with regard to investments and their returns’ (ETUC 2006: 1). The European Parliament has also taken a more critical position on shareholder value oriented corporate governance by calling on the Commission to take ‘the European social model into consideration when deciding on further measures for the development of company law; this also involves the participation of employees’ (European Parliament 2006: 2).

Still, in the recent crisis the pathologies of market-based corporate governance have become even more painfully clear. According to an OECD report in early 2009, ‘the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements’ (OECD 2009: 2). Similarly, the De Larosière report, which was commissioned to provide policy recommendations on strengthening EU financial market supervision and regulation in the context of the current crisis, has identified corporate governance as ‘one of the most important failures of the present crisis’ (De Larosière 2009: 29). The initial reactions to the financial crisis came from the Member States (in form of bank bailout and rescue programmes) rather than as a concerted
European action. The European Union has however now drawn up several regulatory initiatives as direct response to the failure of several external corporate governance mechanisms that have become central in corporate governance practices in the European Union. Despite some hesitant regulatory activism and the introduction of new oversight and supervision bodies there seems to be little actual change yet in the corporate governance and company law programme. Corporate governance failures in the unfolding of the credit crunch and the subsequent crisis have to be seen against the background of the broader financial and macroeconomic system.\textsuperscript{12} In accordance with the recommendations of the De Larosière group with regard to corporate governance the EU has so far focused on initiatives pertaining to executive remuneration as well as the regulation of credit-rating agencies.

4.1 Executive remuneration

While the actual impact of the Recommendation on Executive Remuneration of 2004 has been minimal (European Commission 2007), the debate on executive remuneration, in particular in the financial services and banking sector, has become central in the context of the current financial and economic crisis. Linking executive compensation to share price, as well as insufficient supervision and disclosure of remuneration schemes, has led to excessive risk taking by financial institutions and to ever increasing levels of remuneration. As the OECD points out, even executive directors with large equity positions in their companies took excessive risks, since their high compensation and short term bonuses offset any expected losses on their equity holdings (OECD 2009). Executive remuneration has turned out to be an easy target for regulators, as popular outcry over bonuses created a political climate in which few would dare object to regulatory tightening in this area. The EU has launched several initiatives in this field.\textsuperscript{13} The Recommendation on Remuneration in the Financial Services Sector advises Member States to improve risk management in financial firms by aligning pay and bonus

\textsuperscript{12.} For a broader analysis of international regulatory responses to the global financial crisis see Helleiner et al. (2010).
incentives with sustainable and effective risk-management. Another recommendation with the objective of further aligning remuneration with a long-term/sustainable company perspective complements the 2004 and 2005 Recommendations. The Commission has announced that it will make further legislative proposals, in particular with regard to the revision of the Capital Requirements Directive. However, most provisions for more disclosure and control mechanisms over executive remuneration pertain to shareholders and the board only, rather than granting other stakeholders voice, or at least a consultation status (outside boards where employee representatives are present) on these important issues. These arrangements are predicated on the assumption that shareholders are indeed interested in using their voting rights, and by extension are focusing on more than just immediate short-term profit.

4.2 Failure of external control

Market-based corporate governance relies on disclosure and transparency as well as share price as indication of the value of a company. How to calculate this value is of course a political question. In the context of the financial crisis, the recent shift to fair value accounting aggravated the situation of many financial institutions and companies. As the De Larosière group noted (2009:8), ‘the rapid recognition of profits, which accounting rules allowed, led both to a view that risks were falling and to increases in financial results’. Yet accounting standards were not the only market mechanism where conflict of interest and the lack of international regulation contributed to the crisis. In particular, credit rating agencies have been singled out as important actors for financial services. Under the provisions of the final 2009 regulation, credit-rating agencies operating in the EU are obliged to register their operations and comply with transparency guidelines and provisions for independence and good governance. More importantly still, the financial crisis also exposed the failure of external control. While the marketisation of corporate control has been a fairly successful political project to subject listed companies to more and more market control, ‘the market’ does not

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appear to be so keen on making necessary investments in time and information to exercise these control rights in voting and monitoring companies. As the OECD points out (2009: 53), ‘shareholders have contributed importantly to failures of boards and companies by being too impassive and reactive’. A range of regulatory proposals, mostly at the national level, have been suggested to get shareholders, in particular the rather unwilling institutional investors, to become ‘good corporate citizens’ (The Economist 2009). This development clearly demonstrates the contradictory nature of regulatory projects geared at safeguarding the rights of owners of capital; having pushed an extensive political project to hand the control of companies to shareholders, the state is now at a loss as it simply cannot force them to then exercise prudential ownership.

And yet the Commission seems at least to grasp the internal contradictions in its corporate governance programme. In a recent Green Paper it concedes that:

> the financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least [...] The Commission is aware that this problem does not affect only financial institutions. More generally, it raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders (European Commission 2010: 8).

This tentative expression of a potential change in regulatory orientation raises several important questions. At this stage, it remains to be seen whether the by now firmly embedded marketisation of corporate control will prove resilient to these regulatory changes spurred on by the crisis. However, parallel to these immediate reactions, the Commission is also developing the company law and corporate governance agenda further. Here we can see that the discussion about corporate governance has become increasingly politicised, with the European Parliament taking an ever more critical position on the Commission’s policy initiatives. The case of the Commission’s decision to drop the 14th Company Law Directive for the cross-border transfer of the registered office of a company, which resulted in an EP resolution, or the debates over the Alternative Investment Fund Manager Directive demonstrate that, in contrast to just a decade ago, corporate governance has indeed become a contested concept. The Commission is also continuing with regulatory
initiatives which fit the pattern of its earlier proposals. Recent developments such as the Consultation process on the future of the Company Law Action Plan, the proposal for the Private Company Statute (SPE) of June 2008 and the main results of a commissioned study on *Monitoring and Enforcement Practices in Corporate Governance in the Member States* indicate that the main thrust of the Commission’s approach has not shifted towards ‘harder’ regulation, nor that the regulatory focus has shifted towards safeguarding a broader and more inclusive perspective on the constituency of the corporation.

### 5. Conclusion

This analysis has highlighted the *political* nature of the developments in company law and corporate governance regulation at the European level. On the one hand there has been an increasing politicisation of governance and control mechanisms in the current crisis, most prominently in the debate on executive remuneration debate. At the same time, the trajectory of corporate governance regulation has not been fundamentally challenged. Transparency and supervision have become the spearheads of the EU reaction to the financial crisis. However, *binding regulation* on issues such as ESG (environmental, social and governance) reporting or board-level employee participation are needed to establish an alternative to the shareholder model. It is the task of European regulators to consider the social purpose of company law and corporate governance regulation - shareholder value is but *one* principle for how corporations could be governed.

### References


Chapter 3
Employee representation and the Sustainable Company

Howard Gospel

1. Introduction

This chapter focuses on the relationship between employee representation and participation at work, the governance of the firm and the notion of the Sustainable Company. It asks whether worker representation at the workplace and in governance is needed to ensure company sustainability and whether representation can improve various outcomes for the employee, for organisational efficiency and for broader economic and social well-being.

Employee representation has gone by different names over the years, such as worker participation, employee involvement, industrial democracy and employee voice. Here we use these terms interchangeably to mean decision rights and actual involvement by employees in the organisation – be it a private sector firm, a public body, a third sector organisation, or whatever. However, we focus primarily on the private sector because of its size and importance and the challenges posed in the sector to sustainability.

The Sustainable Company has already been considered in chapter 1. Here we suggest it is an organisation which has the following characteristics. First, it survives over time. It also aspires to grow in terms of assets, output and employment. Second, it is competitive, productive and innovative. These are both characteristics of and necessary conditions for sustainability. Third, it operates in a way which allows short-term needs to be met without compromising longer-term needs. Thus, it serves no purpose if the company maximises output, profits, or share value at the present time at the cost of destroying resources and capability in the longer term. Fourth, this means that the Sustainable Company has to be attentive to the aspirations of people both inside and outside the organisation, as well as to its relationship to the natural environment within which it operates. Finally, sustainability is not only about
promoting the growth of one single existing enterprise but is also about supporting other organisations and stimulating the creation of new enterprises. Firms do not and cannot exist in isolation, but rather operate in the context of other firms (Gospel 2007).

This approach stands in contrast to a different perspective which sees private firms in terms of a simple input-output relationship with goals of short-term cost-minimisation and value-maximisation. In recent years the latter has increasingly come to be taken as synonymous with ‘shareholder value’ maximisation, viz. an increase in dividends and stock price to the benefit of shareholders (Friedman 1962; Jensen and Meckling 1976; Fama 1980).

This chapter is organised as follows. Section 2 outlines various mechanisms of worker representation and participation in the firm. These range across a spectrum from more individual and direct to more indirect and collective mechanisms. In section 3 various arguments are considered at a theoretical level, both for and against employee representation. These arguments fall into two main categories – those which are broadly political/moral on the one hand and those which are primarily economic/business on the other. Section 4 then considers some of the evidence as to how different mechanisms have affected outcomes – here concentrating mainly on economic outcomes. Finally, Section 5 draws some conclusions as to possible likely future scenarios linking worker representation and the Sustainable Company and ways to strengthen such a relationship.

2. **What constitutes employee participation?**

   **Definitions of different possible mechanisms**

Here we consider the different mechanisms of employee participation, both at a conceptual and at a more concrete level.

At a conceptual level, there are a number of ways of viewing employee representation. A basic perspective distinguishes direct and indirect representation: the former occurs where the individual worker or small group of workers is directly involved in decision-making, often around work tasks; the latter occurs where there is some sort of body through which employees (in larger numbers) can express voice through representatives. Indirect forms of representation may include joint
consultation through works committees/councils or collective bargaining through a union negotiating body or both. In these cases representation can be exclusive or inclusive. In the former case the representative body acts only on behalf of certain employees, for example union members. In the latter case the representative body acts for all employees.

Another perspective sees systems of representation as steps on a ladder. The first step is where a worker may be represented by a fellow worker on an individual matter. The second step is where there is provision for information and consultation for employee representatives covering a group of workers or the whole workforce. The third step is where workers are represented by a works council or trade union which has certain rights and powers and which may bargain on their behalf. A similar and broader perspective sees representation in terms of a rising hierarchy of forms, from information (where workers are informed by their managers), to consultation (where workers are informed, but where there is also an exchange of views, albeit with management ultimately deciding) and to negotiation (where there is a measure of contestation and joint decision-making). A further step might involve employee involvement in higher level decision making and corporate governance through representation on a company board (Heller et al. 1998). While these two perspectives imply both discrete representative categories and a hierarchy of importance it may well be the case that various steps or forms may co-exist.

Further conceptual considerations may be stated. Representation may exist on different types and levels of issues, ranging from those which affect workers’ immediate jobs (task issues), to those which affect substantive issues (wages and conditions), to those which are more business related (policy issues) and those which concern how the organisation is governed (strategic issues). In addition, representation may be seen as either events-driven or process-driven. Where it is events-driven, it is triggered by reaction to a specific, usually employer-initiated, event, such as a reorganization of work or a plant closure; where it is process-driven, representation is part of an ongoing process in which an employee representative body is permanent and has a proactive agenda. Further, there may be single or multiple channels of representation, on a task-based quality circle, a works council, a trade union, a company board, or a combination of two or more of these. Finally, systems may be *de facto* or *de jure*. In other words, they may be voluntarily-based and reflect customary practice or a particular power balance or else they may
be legally-based and mandated by the state. Where there are multiple channels and multiple bases, the question arises whether these processes are likely to complement or conflict with one another.

At a more concrete level, consider a spectrum of actual types of participation. One feature of all systems of employee representation is some sort of information sharing. The possession of information by employees and their representatives may range from information on tasks, on performance or on broader strategic plans. Information sharing is thus not a type of employee representation as such but is integral to all forms. By itself, however, it is merely information waiting to be used.

Direct participation often goes along with various titles such as job design, job enrichment, quality of working life and high involvement work systems. In practice, this usually involves some sort of management initiated group schemes, such as team briefings, quality circles or problem solving groups. Such arrangements are often associated with sophisticated Human Resource Management (HRM). It should be noted that they are to be found in both non-union and union companies and workplaces. Moreover it is often the case that such arrangements are not just initiated by employers, but can be prized by employees, especially where they exist alongside other mechanisms (Guest 1997).

Joint consultation and works councils can be of various kinds. They can be voluntary (as in the UK) or legally-based (as in Germany, France and other continental European countries). Again, they can be union-based in the sense that in effect they are dominated by union members and basically run by the union or they can entail no real role for the union. In this latter respect, in the EU context, there have been two developments in recent years: first the Directive which allows for the creation of European Works Councils and second the Directive which allows for the establishment of national works councils or similar arrangements (Information and Consultation Directive). The take-up of the former has been important and has often gone along with trade union representation (Gumbrell-McCormick and Hyman 2010).

A comment should be made on financial participation by employees. This can take various forms. First, there are schemes which provide employees with a small minority of shares, e.g. 1 to 5 per cent of the total number of shares. Where these are non-voting shares they merely give employees a financial benefit and a claim on the firm’s cash flow. Even where shares
have voting rights such proportions are clearly very small. Second, there are schemes where employees may have a larger proportion of shares, say 25 per cent or more. Where these are voting shares this can provide a significant say in governance, especially where this exists alongside an employee ownership council or where a collective body such as a works council or trade union provides advice and some sort of coordination. Of course, at the furthest end of the spectrum are worker cooperatives where the organisation is fully owned by employees (Pendleton 2001).

Collective bargaining through a trade union or unions has always been one of the most significant ways by which employees are represented in decision making. Collective bargaining has the advantage for workers in that it can cover a wide range of issues, from more immediate tasks and working rules, through to pay and conditions and more strategic matters such as divestment and investment. However, it must be stated that it has often been most effective at either workplace level, covering issues such as wages and working arrangements, or at industry level covering wages and conditions. Collective bargaining has tended not to penetrate so much through to the corporate level and the area of decision-making on matters such as corporate governance and company strategy. In the case of multinational companies, especially those headquartered outside the EU, penetration is a particular challenge. A further problem is that not all employees are union members and in most countries union membership has been falling, especially in the private sector. This raises both moral and practical issues around collective bargaining through trade unions: moral in the sense that how should non-union members be included and practical in the sense of whether unions which are declining in membership and strength can penetrate through to these sorts of issues.

Finally, as will be discussed in chapter 5, employees may be represented on company boards, either on single boards or on dual boards. Such arrangements have origins going way back in countries such as Germany and were extended immediately after the Second World War or at certain national critical junctures thereafter. Where they exist, they have the advantage that they give employees rights to information, a say and some decision rights at the top level in companies. However, in most cases, employee representatives are in a minority on company boards and arguably can be by-passed by other directors and senior managers who, among other things, possess more information. Of course, in many countries in Europe, either there exist no legal rights and very little actual practice in terms of board level employee representation.
This notion of types of representation and a spectrum or steps begs certain questions. How do we know that steps are upward from information, to consultation, to bargaining and to board-level codetermination? We take the answer to this as pretty self-evident. Merely being informed is one thing, being able to respond to that information is another, being able to negotiate is yet another and being able to co-decide is even greater. In practice, employers would admit this and have on the whole preferred not to have statutory provision in this area if they can avoid it. But what do ordinary employees prefer? We have information that they like to be individually informed and that they prize direct involvement on work tasks. However, we also know that on some matters (such as pay and conditions) they welcome collective action with other employees. On key matters at critical junctures they also believe in high level involvement, if they can attain it. Do these types come down to either/or choices? Again, the evidence seems to be that, for employees at least, a number of mechanisms are valued simultaneously and for different matters (Freeman and Rogers 1999; Freeman et al. 2007). Though we have little by way of survey evidence, the reality would seem to be that employers also value multiple mechanisms.

3. Arguments for and against representation

The conceptual and theoretical literature on employee representation, participation and voice at work is immense. Here we concentrate on the cases for and against representation and pick out two strands, one broadly political or moral, the other primarily an economic or business case.

First, the political or moral case for participation may be summarised as follows. Over time people have come to be given or, more usually, to assert rights in society. These include rights such as rights to fair treatment under the law, rights to property, rights not to be discriminated against and rights to vote and to be represented in the national legislature or executive. In civil and political society these have been slowly established over the centuries and have come to be accepted in most countries, though with periods of regression and with many rights not fully established.

At work, there has been a somewhat similar accretion of rights, for example the right to leave one’s job, the right to certain types of pay or benefits and the right not to be discriminated against. Some of these rights are negative (e.g. again the right not to be discriminated against)
and some of them are positive (e.g. the right to holidays with pay). Some rights are what legal and political philosophers call ‘property rights’ (e.g. the right to perform a certain kind of work in a certain kind of way), whereas others are ‘benefit’ rights (e.g. one has a claim against the employer for certain benefits, such as paid holidays after having worked for a certain length of time).

Shaping such rights are ‘decision rights’ viz. the right to decide about the other rights and indeed about other aspects of the organisation where one works. Decision rights have built up at work, but slowly and with some regression in different countries and different firms at different points in time. Just as there are rights to vote and to decide certain things in civil society and in political democracy, there should be industrial rights at work and the capability to assert these rights.

Second, the economic or business case for participation may be summarised as follows. Organisations need to be efficient in the broadest sense of being competitive, productive and innovative in order to survive and prosper. They do this by bringing together resources (financial, capital and human) under effective management. However, to be able to do this effectively over a long period of time, they need to engage the intellectual and physical capital of their workers and indeed to be able to draw on broader social capital in society. The argument then is that workers are much more likely commit, to be loyal and to be flexible where they also have voice. Where they do not, they are more likely to withhold these contributions and to exit the firm.

This argument may be put more broadly than at the level of the single firm. Consider the case of investment in human capital. Individual firms may underinvest in human capital and seek to free ride on training done by other firms. However, where firms in an industry or locality agree to act collectively and to invest in training, all other firms may be more likely to invest, especially where this is agreed with the trade unions in an industry and monitored and enforced by a works council at workplace level (Streeck 1989).

Of course, there are arguments against both the moral/political and the economic/business case. One argument against the moral/political case is that the owner has the residual right to decide on what should happen with the firm. Setting aside the fact that ownership is highly complex in large modern firms, this ignores the fact the employees also have
investments in the firm and have accumulated investments they may lose. Another argument is that employees are not really interested in participation and that in the end a few representatives actually participate rather than the majority of employees. This is a problem in particular in large complex multinational organisations. Of course, this disinterest is a problem in any democracy, but we do not give up on the idea for this reason.

An argument against the economic/business case is that professionals have more expertise and can take a bigger view of the enterprise. However, it may be argued that employees have specialist knowledge and a considerable amount to contribute. Though it may take longer and be more costly to decide, in fact decisions are often better and employees are more committed to them when they are involved (Lazonick 2004). A related argument is that employees pursue narrow self-interest in the immediate present. However, in practice there is really no reason to believe that their time horizons are any shorter than those of many investors. Further, it might also be argued that employees may seek rents at the expense of those outside the firm, such as potential customers and potential employees. Again, this is possible and checks and balances are necessary to prevent this from happening.

In practice we can typify these two arguments along two dimensions: along the vertical dimension are decision rights (high to low) and along the horizontal dimension efficiency (also high to low). We thus have the relationship as set out in Figure 1.

Figure 1 **Rights vs. efficiency**

![Rights vs. efficiency diagram]

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Howard Gospel

The Sustainable Company: a new approach to corporate governance
The bottom left-hand box (low rights and low efficiency) is where no company and no set of employees would want to be. This is the direct opposite of sustainability. The top right-hand box (high rights and high efficiency) is the ideal and might be seen as the location of the truly sustainable enterprise. However, there are two other boxes and here there are trade-offs. The bottom right-hand box (low rights but high efficiency) represents a trade-off in favour of the latter – curtailing rights enhances efficiency. The top left-hand box (high rights but low efficiency) represents a trade-off in favour of the former – enhancing rights curtails efficiency. Ultimately, of course, whether such trade-offs exist or whether the moral/political and the economic/business coincide and work together are empirical questions.

4. Empirical data

The empirical evidence in this area is considerable. Other chapters deal with some of the literature; here we focus briefly on major debates and the most authoritative summary research.

As suggested above, information sharing is part of all of these participation mechanisms. Empirically we have a number of studies on this, mainly from the US, Japan and the UK. The most recent summary of the literature suggests that provision of more information to employees has a positive effect on performance in terms of profitability and, for Japan, lower labour costs and higher productivity (Peccei et al. 2010). The presence of a union seems to elicit more information sharing than other mechanisms, at least in the US and Japan.

Direct participation via job redesign and work group involvement (e.g. team briefings, quality circles or problem solving groups) appeals to employers as well as employees. In addition, the majority of studies suggest that it has a positive effect on certain outcomes such as employee commitment. However, the literature suggests that such forms of voice have no effect on higher level performance or governance outcomes. Moreover, some of the related literature also suggests that these schemes are likely to last longer and to have more positive effects where they are allied with other forms of indirect or representative participation (Guest 1997; Gospel and Willman 2003; Wilkinson and Dundon 2010).
The evidence on joint consultation and works councils is somewhat mixed. We take two examples here. In the UK, with a voluntary system, joint consultation committees cover around a fifth of the labour force and evidence of any positive effect is limited, except that they do seem to elicit more information for employees (Cully et al. 1999; Peccei et al. 2010). In Germany, with its legally based system, works councils operate in most large firms and have extensive information, consultation and codetermination rights. Several recent articles have summarised the literature (Addison et al. 2004; Frege 2002; Frick and Lehmann 2004). These studies suggest that significant productivity advantages accrue to plants with works councils over those without. For a recent overview of the German literature in a comparative perspective see Vitolis (2005).

In recent years European Works Councils have been established in a number of European-based multinationals. The initial verdict on these is that their coverage has varied between sectors, being strongest in areas of manufacturing, such as motor vehicles, and that some have been able to provide real voice in company activities, especially where they are backed by trade union representation (European Foundation 2004). Performance outcome effects have not been evidenced.

The literature on employee financial participation and shareholding suggests that, in most countries and for the most part, employees hold a relatively small proportion of shares in such schemes, usually less than 5 per cent of total equity in enterprises with such schemes. Such schemes are more likely to exist in medium-sized to large firms. In terms of outcomes the literature finds a positive effect of share ownership plans on productivity. No link, either positive or negative, with profitability has been clearly demonstrated. However, the causal link with productivity is debated, as it is unclear whether high productivity may drive employee share ownership or vice-versa. Overall, the impact of employee share plans on higher level corporate governance practices appears to be limited (Pendleton 2001; Kaarsemaker et al. 2010; Kessler 2010).

Relatedly, we refer to employee stakeholding via pensions. In countries such as the US and UK there are some examples of large pension schemes with employee representatives sitting on trustee boards and being active in terms of certain policies of a socially responsible nature. However, pension fund participation in governance is constrained by the fact that, for financial reasons, activism is not possible within one’s own firm. More generally, trustees are required to act in the best interests of the schemes’
members in a manner consistent with overall liabilities and returns. Furthermore, trustees may lack sufficient knowledge for active involvement. These factors place significant restrictions on the management and investment activities of pension funds. However, where there is union involvement and where trustees have the information and motivation, they can have some effect on corporate governance in companies in which they invest (Jackson and Vitols 2000; Kakabadse and Kakabadse 2004).

There is a very extensive literature on trade unions and collective bargaining. Overall, unions and collective bargaining have a positive effect on pay, employment, productivity, financial performance and investment. However, this effect is modest and probably declining over time. In addition, however, the evidence suggests that unions are a force for fairness in the workplace: they narrow pay differentials, improve health and safety and boost family friendly policies (Freeman and Medoff 1984; Metcalf 2005; Schnabel and Wagner 2008). By contrast, the effect that unions have on corporate governance and strategy is limited, in part because they have rarely had much voice at the level of the company. Moreover, in the private sector, union membership is falling and is increasingly restricted to larger and older workplaces (Block and Berg 2010; Gomez et al. 2010).

For board level employee representation we are obviously restricted to countries which have such arrangements. Taking Germany, which has the most extensive system and the best literature, we may make the following points. Arrangements vary with the size of firm, but basically either parity or one third of the seats on supervisory boards of large firms go to employee representatives, which may include trade union officials. Most big firms have such representation, which is highly correlated with size. In terms of effects, there has been considerable debate in recent years. Some recent studies (Schmid and Seger 1998; Gorton and Schmid 2000) present findings that parity codetermination caused a significant decrease in share price relative to companies with one third codetermination. However, these studies have been strongly criticised on methodological grounds (Frick et al. 1999). Baums and Frick (1998) find no negative effect on share price following on the introduction of parity codetermination and significant court decisions. Kraft and Stank (2004) and Fitzroy and Kraft (2005) show a small positive effect of codetermination on innovation and productivity.
Some critics of the German system argue that employee codetermination is not compatible with stronger capital markets (Pistor 1999; Roe 1999). However, a number of studies now show how employee representatives in Germany are adapting to a growing shareholder value orientation of German management. These studies suggest the emergence of stakeholder coalitions which include institutional investors, resulting in a kind of ‘negotiated shareholder value’ in Germany (Vitols 2004; Höpner 2001; Jackson 2005).

In conclusion, the evidence on the economic effects of employee representation suggests that there is not a trade-off between high decision rights and high efficiency viz. the top left and bottom right boxes, but rather, for the most part, rights and efficiency go together viz. the top right box. It would also seem that different mechanisms have varying effects at different levels and that there is a case for combining mechanisms.

5. The future of the Sustainable Company

We have argued that worker representation in decision making does not hinder efficiency, but instead probably enhances it. In this sense it would seem to contribute to the Sustainable Company in terms of innovation, productivity and competitiveness. It may also have this positive effect not just within a single company, but also across companies in an industry or a country.

This then raises two final questions: (1) why do not more firms and, indeed, more employees, support worker participation in its multiple forms?, and (2) what can be done to strengthen participation?

A lack of interest, or indeed outright opposition, from employers largely flows from an instinctive desire to preserve managerial rights at the expense of employee rights. It may also flow from fears and a desire not to be a first mover in terms of extending employee rights, for fear of the unknown and for fear that they might incur a disadvantage. Undoubtedly also inertia and a quiet life also play a part. Any lack of interest on the part of employees may also flow from fear and a desire not to ‘rock the boat’. Moreover, for employees, where greater rights and voice are not on offer, there is some comfort in not asking for them and not suffering consequent disappointment.
There are a number of ways forward which may strengthen employee participation. One may be to leave it to employers to recognise the benefits of greater employee voice for improving performance and sustainability. As we have seen, however, there are real problems with this approach. Another might be to leave it to pressure from workers and their trade union representatives. This has much to commend it and see here recent developments in framework agreements which are referred to in this book. Again, however, as seen, there are real problems with this, not least also given the shrinking membership and power of unions, industrially and also politically. Writing many years ago, in their classic book on *Industrial Democracy*, Sydney and Beatrice Webb (1897) had much to say for voluntary action by employers and employees. Ultimately, however, they believed that statutory regulation was essential for giving workers a voice at work. They argued that it was less likely to be reversed and that it could be more universal. Their analysis still has much to commend it, both at the national and international level.

References


Chapter 4
Management and worker involvement: cat and mouse or win-win?

Jan Cremers

1. Introduction

This chapter discusses the positive contributions that worker involvement makes to the company, and argues that stronger worker involvement could bring major improvements in the way our companies operate. Managers generally do not have the capacity and tools by themselves to follow ‘best practice’ in HRM. Thus we find many examples where worker representatives play a crucial role in promoting best practice. However, most managers are not convinced of this positive role, which helps explain why worker involvement does not diffuse more on a voluntary basis. As a result the European Union is not currently pursuing the right approach to worker involvement. By implication, worker involvement should play a strong role in helping to build and diffuse the Sustainable Company in Europe and beyond.

2. A clumsy opening

Some years ago I was involved in a research project commissioned by the Dutch paritarian fund for works council training (GBIO). It was a study on the assistance sought for and commissioned by work councils and management in social dialogue at company level (Bruin et al. 2003). The results gave a divergent picture. Works councils mainly participated in educational activities and used the assistance of trainers. Management in contrast made use of the HRM department and/or of business consultants and lawyers. The assistance for management tended to be dominated by the advice of (often expensive) legal advisors or business consultants and by specialists for topical issues. Training of managers on how to communicate in an open way with worker representatives was not done, although almost 60% of the 200 managers interviewed expressed a need for assistance in questions like how to deal with information rights and other worker involvement or how to create a climate for feedback.
and joint policy-making. One respondent characterised a substantial part (40%) of his fellow managers as too ‘clumsy’ for dialogue with worker representatives. Experienced leadership of a company is no guaranty for a successful and constructive dialogue, even when management has a positive attitude and full commitment towards worker involvement. In the German literature the same confession was heard: ‘managers are not capable to cooperate with success because they never learned how to do it’ (Reppel 2001). On the other hand we know from the experience in several EU Member States that it always takes two to tango. Dialogue depends on the engagement of both sides.

Assistance of HRM departments seemed to fail and so did the external advice of business consultants. Due to the fact that worker involvement is often not part of the HRM staff core business (which is dealing with recruitment, an ageing workforce, work organisation, health and safety matters and restructuring) this staff probably lacks the necessary competencies. It also has to be taken into account that no HRM department exists in many SMEs. And present-day management training is completely dominated by Anglo-Saxon business literature and short-term shareholder value concepts. In mainstream managerial thinking and academic managerial studies the notion of worker involvement is almost completely absent.

After this research was completed we started to question the competencies of management to deal with worker involvement – even of those managers that take the information, consultation and co-decision rights very serious. Our conclusion in 2003 was that we had to pay more attention to management’s role in the dialogue at company level. This led to several questions: to what extent is a manager competent enough to create added value for both partners? Where can he or she find the necessary know-how and expertise? and: How can we equip a manager with present-day skills that fit with the Rhineland model?

At the same time several research projects lead to the conclusion that, in those companies where works councils function effectively, the primary core areas for their activities are personnel policy and health and safety issues. In a case study published in 2007 the work and functioning of fifteen works councils was assessed over a longitudinal period of two years (Cremers 2007). The dynamic between HRM and indirect forms of worker participation (through representative bodies like works councils) was a secondary concern in that research. Works councils are normally
defined as indirect forms of worker participation in order to demarcate this type of participation from more spontaneous, less regulated types of workplace involvement (like social events or direct communication at the workplace). The study confirmed the important contribution that more institutionalised forms of worker involvement can deliver to HRM-related internal personnel policy.

3. **Give more power to your people**

Reflections on the role of and possible input by employees in the functioning of a company are as old as the first disputes a century ago between the behaviourist and Taylorist tradition of ‘scientific management’ on the one hand, and the Human Relations approach on the other hand. The need to have employees participating in the management of change was introduced by Burnham in 1941 with his notion of the ‘managerial revolution’.

However, one can say in general that, in the mainstream management literature, extra-financial features like human resources were always marginalized if not ignored. They were certainly not seen as very important for the long-term well-being of the firm. Mainstream management concepts fail to fully value the contribution of essential human assets to the competitive success of the firm. In the Anglo-Saxon tradition the focus never went far beyond the level of more influence (and attention given) to middle management and supervisors. In training sessions they had to learn how to coach and to coordinate the work of the ordinary workforce. In this conceptualization HRM is at most a linking pin between central management and lower managerial echelons. Whether this philosophy is ‘value for money’ depends in the opinion of the management on the contribution to the managerial ruling of the company.

The role of the linking pin is nowadays often outsourced to business or professional services consultants. In part this is done because HRM departments have become too static in their policies. HRM is a synonym for a part of the organisation that is fixated with systems that make an organisation more efficient. This policy dehumanises management

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1. Heading of an article by Ravi Mattu in the *Financial Times*, 7 October 2010.
instead of engaging it with employees. Partly it is the result of the fact that externalisation has become fashionable. Notably in the field of HRM policies it is nevertheless questionable whether real engagement with and commitment for the long term ‘social climate’ in a company can be secured by a commercial relationship with external advisors.

An example of an effort to get out of this dead end street without opting for more fundamental worker participation is the way British Gas is nowadays acting. Based on the notion that an organisation is as good as its people and that as a consequence how ‘well the organisation engages with employees’ can make the difference between failure and success, British Gas management is seeking commitment from lower staff by organising presentation events that are supposed to function as ‘kick-offs’ paving the way for organisational change.

However, the question is whether this is enough if the challenge is to empower employees to have a stronger say in the company and to become an ‘agent of change’. In the Anglo-Saxon world methods of direct involvement are still more fashionable than indirect representative participation. But the direct way has strong limitations. Management by speech is per definition short term, building trust by direct contact and interaction has undeniable merits, but how binding are these promises and how sustainable is this trust? Will people still be convinced once they are back at the workplace or at home? Is the result of dialogue tenable in case new management comes in?

In a series of Dutch studies conducted in the period 2000-2007 I had to conclude that ‘takeovers, mergers, changes of management at the top of the company hierarchy or new strategic choices of company policy all produce the effect that the history of a council looks more like a pattern of “trial and error” than of systematic and continuous growth to maturity’ (Cremers 2008).

This qualification of ‘punctuated maturity’ is probably a qualification that gives more justice to the relationship between management and labour than the thoughts of a linear and progressive growth and improvement of the relationship, as workers representatives can be confronted with successive managers in a relatively short period of time. When confronted too often with this shift the workforce easily develops an attitude of ‘wait and see’, and it is questionable if a new social event will bring back commitment and engagement. Is it not more appropriate or, to put it in it
the terms of this book, more sustainable to look at the contribution of stable, even institutionalised forms of participation?

4. Direct and indirect involvement

Interesting in this perspective is the stabilising role that representative indirect involvement of workers can play. We have some examples in the German, French and Dutch contexts that can be seen as promising practices. Before summarising these experiences I want to spend a few words on the relationship between direct and indirect involvement of workers.

Table 1 Direct versus indirect involvement

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<th>Types of involvement</th>
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<td>Direct involvement</td>
<td>Management by speech and direct communication</td>
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<td>Rap sessions and social events</td>
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<td>Team meetings and quality circles</td>
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<td>Representative / indirect involvement</td>
<td>Shop stewards and trade union delegates</td>
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<td>Works councils</td>
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<td>(Joint) permanent committees</td>
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<td>Board representation</td>
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Direct involvement has a great advantage from the company leadership’s perspective; it can be flexible, installed and activated in urgent times and modelled in a tailor-made fashion. Or like it is said in recent guidance from the European Confederation of Directors’ Associations (ecoDa 2010: 51): ‘Direct communication between directors and employees can be an effective way of driving a message home across an organisation. They help to ensure that everyone is “singing from the same hymn book”.

Talking to people, more individual interaction between the leadership and the workforce and honesty with the employees about the challenges the company faces can help clarify many things. And it can also lead to a better understanding of worker concerns. The basic philosophy is that this type of direct participation can serve as a mechanism for feedback and a possibility to create broader commitment for decisions taken. Whistle blowing is also an important aspect: ‘Stakeholders – including individual employees and their representative bodies – should be able to freely communicate their concerns about illegal or unethical practices to the board. Their rights should not be compromised for doing this.
Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company in terms of reputation effects with an increasing risk of future financial liabilities’ (ecoDa 2010: 51). It is therefore to the advantage of the company to establish procedures and safe harbours for complaints.

But too often there are pronounced organisational limits to direct communication from the leadership’s perspective. In the guidance quoted above it is immediately added that, in cases where such communication takes place on the initiative of individual directors, such contacts should be in line with a general ‘internal governance’ policy developed by the board. If such a policy is not yet developed it is good practice to inform the chairperson and CEO before taking any such steps. In any case the directors should emphasise that, in all such direct meetings with employees, ‘the chief executive is ultimately in charge of the management of the company’. Directors should therefore avoid ‘discussing detailed management issues with employees to minimise the risk of mixed messages’ (ecoDa 2010: 51).

These considerations illustrate the limits of non-institutionalised involvement. It is meant to be effective in passing information top-down and to contribute to smooth execution of daily business. The role of (a delegation of) employees as a partner in organisational development or in the reflection on long-term strategies is given only some lip service. Besides, from the employee perspective, participants can be left with non-binding commitments or arbitrary short term promises. Over a longer period the centre of power may change and conflicts may appear between the new leadership and traditional management. As the commitment of management can differ over the years and changes at the top can have a serious impact, the impression remaining can be that this direct participation is offered without real engagement in the long term.

Indirect and representative involvement is about building trust through long-term engagement and accountable, binding deals. In earlier research several positive incentives or conditions for an improved dialogue have been identified. Management that clearly expresses a vision on dialogue and co-decision, that relates the future prospects of the company with the well-being of the workers, that approves in a positive way of the engagement of the members of a works council and that is willing to elaborate a joint agenda is an (almost) absolute condition for the adequate functioning of worker representation.
The problem is that managers often see indirect participation as time-consuming and a costly administrative burden. Even in the Netherlands, which has a national tradition of works councils since 1950, I had to conclude in 2003 that 40% of the employers interviewed expressed serious doubts about a positive contribution of their works council and were therefore not convinced that the benefits outweighed their costs. Another 17% were straightaway of the opinion that the benefits did not offset the costs.

However, in the same research, the employers interviewed endorsed the opinion that, the more a works council had the capacity to reflect on and contribute to a range of policy issues, thus fulfilling a broader role beyond the classical issues of health and safety and HRM, the more the characterization ‘useful’ was appropriate (Cremers 2008).

The range of positions formulated on the employers’ side went from the ‘need to develop a knowledge coalition between management and labour’ to ‘no crop will flourish on concrete’. It is not so long ago that the term ‘people’s manager’ was quite fashionable. Is he or she still there and, if not, where did he or she go? The question that we want to raise first is whether there is any awareness of this at the level of the European Commission. In other words, is it possible to find any substantial EU notion with regard to the functioning of a company?

5. The poverty of the European Commission’s thinking

The European Commission was, at least until the early 2000s, aware of the dynamic between a human resource-oriented management culture and the well-functioning of employees and their involvement and representation. However, there has been a slow but permanent shift in this thinking. The most prominent illustration of this shift can be found in the thoughts developed on corporate social responsibility (CSR). The European debate on responsible business conduct goes back to the early 1990s. CSR at that stage was defined as a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with stakeholders (for a critical assessment see De Castro 2008).

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2. A Dutch manager on the attitude of his fellow managers with regard to worker involvement.
In the 2001 *Green Paper Promoting a European Framework on Corporate Social Responsibility* the European Commission (EC) dedicated a paragraph to what it called the ‘internal dimension’, of which workers are an integral part of. Socially responsible practices primarily involve employees and relate to issues such as investing in human capital, health and safety and managing change. For HR management it is a challenge to attract and retain skilled workers. What is necessary is a responsible recruitment strategy, and encouraging lifelong learning has to be a key element of this strategy. The EC, with DG Employment and Social Affairs as the main author, called for the active management of employees. Although there is no direct link to worker involvement and the focus is mainly on recruitment, employees are at least recognised as key actors within the company.

In the 2002 Communication *Corporate Social Responsibility: a business contribution to sustainable development*, which is formulated as a follow-up of the Green Paper consultation, the interests of the business environment has clearly prevailed over other inputs (e.g. from trade unions and civil society). The EC talks about the image, reputation and success of enterprises; developing practices which take account of environmental and social ‘considerations’ will help to modernise business activities and thereby will increase their long-term competitiveness. CSR can lead to a ‘stronger commitment of employees’.

Notwithstanding this, according to the Commission the European Union is still committed to fully integrating economic, social and environmental considerations as well as fundamental rights (including core labour standards and gender equality) into its policies and actions. Reference is made to ILO core labour standards and to the OECD guidelines for multinational enterprises. However, the reference to employees vanishes almost completely after DG Enterprise takes over the lead in the CSR debate. From 2006 on the debate is dominated by the aim to make the regulatory environment more business friendly. Business in turn must ‘develop its sense of social responsibility’ (*Working together for growth and jobs* – European Commission 2005). Europe has to become a ‘pole of excellence’ (*Implementing the partnership for growth and jobs* – European Commission 2006) and it is recommended that companies should integrate social and environmental concerns into their business operations and in their interaction with their stakeholders on a voluntary basis.
In a Memo dated March 2009 it is said that CSR can deliver a direct contribution to profitability and that there is a benefit to the company image and reputation. Companies can act out their corporate values. Loyalty from employees helps productivity and product quality. But there is no longer reference made to labour standards, ILO conventions or employee involvement. It is worthwhile to quote the end of this Memo where the Commission states that CSR remains a priority for the European Commission: ‘It is part of a long-term strategy and is about quality of life, which is something that should not be put to one side in an economic downturn. Although there might be pressure on companies to reduce their CSR in the short-term, we hope that they will think about the longer term as well’ (European Commission 2009: 3).

To summarise: in the CSR debate no substantial progress has been made with regard to the impact of employee involvement or the ‘internal dimension’. In fact the EU stays far behind the formula already stated by the OECD as early as 2000 in the guidelines for multinationals, where it is said that a ‘human capital’ approach presupposes the right to negotiate, the right to receive information and the general promotion and improvement of the internal cooperation between management and labour. The starting point in the guidelines is the respect for the right of employees to be represented by trade unions and other *bona fide* representatives of employees, and the engagement in constructive negotiations, either individually or through employers’ associations, with such representatives with a view to reaching agreements on employment conditions. In addition, consultation and co-operation between employers and employees and their representatives on matters of mutual concern are central parts of the OECD principles of corporate responsibility (OECD 2000).

### 6. Conflict management and the search for the people’s manager

In the Dutch literature several attempts have been made to elaborate scenarios for the future role and impact of worker involvement. In a recent publication the dynamic between the representation of the workforce and HRM management was an integral part of the extrapolation (Van der Meer et al. 2010). What is interesting in the ideas formulated is that they highlight the contribution that the interaction between management and labour can deliver to social innovation. In that respect these publications
are closely related to several German publications that want to bring in company culture (for instance Oechsler 2001 and Nerdinger et al. 2008). Similar notions also play a role in several consultative social policy projects initiated by French transnationals.

The authors share the view that a mix of direct communication and indirect representation has to be set up as a ‘vital infrastructure’ for successful social innovation. A basic assumption in the underlying human capital approach is the idea that organisational development is dependent upon the knowledge that can be mobilised in a company. In this context managerial theory is as important as the practical understandings present in a company. As a consequence, the necessary conditions for success in the long term will not be present if labour is only seen as a commodity.

The debate about the sustainability of a company in Germany has already for more than a decade revolved around ‘company culture’ with co-decision and the impact of indirect, representative involvement of workers (Bertelsmann Stiftung/Hans Böckler Stiftung 1998). The starting point is the recognition of the fact that a positive climate will lead to higher competitiveness and a better image. Beyond this, several authors consider worker involvement and other ‘soft’ values which are strategic factors for success. In the joint activities of the Bertelsmann Foundation and the Hans Böckler Foundation German co-determination is even characterized as a competitive advantage that should be strengthened by employers, unions and political actors.

The authors admit that this has not led to a situation where complaints about time-consuming decision making and poor compromises have disappeared. And indeed, further improvement of the legislative frame for co-determination has not been reached (neither in Germany nor in the Netherlands).

Nevertheless, this way of thinking about HRM is dominated by the conviction that a company’s survival, adaptability and ability to change do not depend in the first place on technical aspects and hierarchical capacities and competences. To a certain extent this is also a pragmatic vision: the human factor can be influenced and the social climate can be shaped and reshaped, whereas all other production factors are more and more equally available on the market and their distinctive competitive dimension is vanishing. The human factor is the starting point that has to work with, form and reshape these ‘hard’ factors.
Social and personnel policy in a company, being at the intersection of the purposes and aims of the company and the workers, can therefore only be successful if workers and their representatives bring in their interests and their know-how in a structural manner. For this reason Reppel (2001) calls German co-determination the ‘turntable and flywheel’ of the modelling of human resource policy; a policy based on this notion can serve as a building block for worker participation and engagement in change and for an innovative agenda.

The challenge is to elaborate a cooperative ‘design’ task, with management, works councils and workers as the designers and bearers of organisational progress and change. Managerial thinking has to go beyond the plain thinking of workers as a ‘reservoir’ for know-how and labour. In a dialogue with the workforce the complexity of problems (and of their solutions) has to be scrutinised. Decision making based on processes of worker involvement and elaborated in a (sometimes painful) fundamental dialogue will not only lead to greater acceptance, but probably also to better and faster implementation.

In the German context these notions have led to research dedicated to the added value of worker involvement and even to calculations of economic benefits. In the Anglo-Saxon research tradition the (rather instrumental) approach has mainly been to examine the interaction of direct and indirect types of involvement and the effect on labour efficiency and productivity. In that approach, indirect involvement is identical with trade unions; direct involvement stands for group dynamics and team involvement. Recently, some authors found that a combination of low team and low representative involvement leads to inferior labour efficiency compared to other conditions. They also found a negative interaction between team voice and worker representative voice, supporting an interpretation that these types do not complement each other with respect to worker productivity. According to Kim, types of voice can interfere with, or neutralise, each other and this occurs more frequently than the mutual reinforcement some might expect. Nevertheless, the combination does ultimately have a positive impact on economic performance, consistent with the thrust of recent European policy-making and in contrast to the ‘direct-voice-only’ trends in the US and UK (Kim et al. 2010).

The last word has not been said in this debate and strong research-based evidence that a concept of participation culture has a positive long term
and sustainable effect on the innovative capacity of a company is still lacking. In some research, however, an indication is found that participative company practices lead to successful adaptation to new circumstances and to an improved climate for innovation (Nerdinger et al. 2008).

Bearing in mind the recent experiences during the crisis one could argue that this model has, in the meantime, proved to be sustainable. Some evidence can be found that companies (and countries) with stronger regulatory traditions and frameworks for industrial relations have survived with less negative consequences, not only for the workforce, but also for the long-term perspective of the company. Future oriented innovative company policies benefit from improved and consolidated worker involvement. Mature industrial relations must be built on the notion that conflict management coincides with divergence and convergence of interests. Partners have to enter into conflicts, not circumvent them.

The representative forms of worker involvement do not disappear in this approach; co-decision structures and bodies change from a countervailing power into a pro-active partner in innovation. This is where HRM should come in again. For HRM policy the challenge is not simply to go beyond the notion that labour is not a commodity. The real challenge is to construct and stimulate worker participation in operational processes as well as in strategic decision making and to develop transparency in information and communication (Oechsler 2001).

7. Challenges for HRM and a new dynamic

In the Dutch context similar challenges can be described. Van der Meer and Buitelaar have summarised the historic relationship between human resources management (HRM) and employee participation in the Dutch ‘services industry’ (Van der Meer 2010). They address the need for an interactive relationship between HRM and employee participation which converges in the learning organisation. After comparing and weighing various roles, HRM is considered as a complex intermediary function: as a ‘knowledge broker’. This requires, on the one hand, a knowledge coalition between human resources managers and the works council, and, on the other hand, an employee-participation coalition between the
works council and direct involvement in work-progress meetings. The cases described (high-tech ASML, global chemical company DSM and steel group Corus) demonstrate the value of new forms of participation arrangements that are often combined with modernised classical co-decision bodies in the role of structural guarantor and knowledge partner. Worker involvement is no longer limited to classical information and consultation; participation becomes an integral part of the company culture. HRM has to adapt to this situation as a focus on knowledge management has important consequences with regard to the relationship between HRM and employee participation. It gives the HRM department great responsibilities, as this department should not only play the role of management’s long arm through ‘human resource control’ or ‘human resource accounting’. It also has to act as a linking pin between different forms of participation. The authors conclude that the technological innovations, the increase in financial and organisational scale and the almost continuous reorganisations that can be observed in many firms and institutions give cause for a new perception of the tasks and roles of both the HRM professional and employee participation – a perception in which these two roles are more related to one another. Ultimately, HRM and the works council have to develop a partnership (an ‘employee participation’ coalition) to facilitate a diversity of innovation coalitions in a firm, a service or an organisation.

Interestingly enough, the HRM challenges referred to in this chapter not only demand a new role of the representative workers bodies. Trade unions are also faced with these new challenges. The extent to which direct or representative participation mechanisms are effective may be influenced by the relative strength of unions (or worker representatives) in the workplace. This requires a policy of partnership, not of competition between worker representation in and outside of the company. In my longitudinal research I found some evidence that, in situations where the relationship between works councils and trade unions is based on mutual enforcement and not on competition, the functioning of the works councils improves. Trade unions were considered to be an important partner and a crucial source of information and assistance (Cremers 2007).

The interaction between direct and indirect participation and the broader defence of workers rights has already led to interesting examples. For example, the European Metal Workers Federation (EMF) was – jointly with European Works Councils (EWCs) – a partner in European
negotiations within some transnational companies. In the Thales group two deals were concluded (one on improving professional and occupational developments and the other on career development).

The aim of these European agreements is to considerably strengthen the employability of workers within the Thales group of companies. This is done through the implementation of an annual anticipation process linked to future employment prospects in which employee representatives are closely involved. After the signing Thales’ management stated that the trade unions had demonstrated a high degree of open-mindedness and responsibility regarding the implementation of a negotiated European social policy. The negotiator Bart Samyn, Deputy General Secretary of the EMF, made it very clear after the signature what the impact was for the EMF by stating that the agreement ‘constitutes a milestone in the construction of Social Europe because of its rich and detailed content. The agreement illustrates the fact that employee representatives have an important role to play in the future management of employment trends’ (EMF 2009).

In the former SUEZ group (which later on merged into GDF-SUEZ) a similar agreement was signed in 2007 between the central management, the EWC and the European Public Service Union (EPSU). The main aim was to reflect on internal mobility and recruitment policy in the group and to anticipate qualification needs and an ageing workforce. But the agreement also had a chapter on precarious workplaces. Implementation took place in 2008 with the first experiments in France and Belgium. The implementation was a joint affair in which national and European worker representatives were actively involved. The agreement was renegotiated after the merger of SUEZ and GDF and signed in February 2010. It had two interesting dimensions: a collective and an individual. The collective dimension was about future labour market evolutions (both quantitative and qualitative) and created instruments for a collective dialogue with worker representatives. The individual dimension was dedicated to strengthening career guidance and stronger individual assistance. A second agreement in the same group envisaged several joint challenges: integrity of people and of company life, improvement of living and working conditions and the safeguarding of health and safety. Once again, national and European trade unions joined forces with the members of the EWC and had dialogue with management, but also with labour physicians and occupational health experts.
Worker involvement is needed in order to tackle external challenges of adaptation to a world of change and to create internal and integrative consensus between the main actors. In the examples given the structural participation of workers becomes a crucial condition for success. And that is what sustainability and the Sustainable Company is all about: worker involvement as a cornerstone for the necessary strategic and long term changes in the work environment and work organisation in equilibrium with environmental constraints and consumer interests. The fact that this path is strewn with thorns should be an argument to invest more in people, not to just worry about the improvement of the business environment and complain about administrative and regulatory burdens.

References


Chapter 5
Board-level employee representation in Europe: challenging commonplace prejudices

Aline Conchon and Jeremy Waddington

1. Introduction

As argued in this volume by Vitols, Kluge, Gospel and Cremers, worker participation is a central element of the Sustainable Company.¹ In particular, representation on company boards can give employee representatives not only voice but also formal decision-making rights at the highest level of the company.

However, the mainstream literature on corporate governance – represented by the shareholder-value oriented approach – says little on the subject of board-level employee representation (henceforth BLER). Focused on the regulation of the relationship between agents (managers) and principals (shareholders), supporters of agency theory neglect the possibility for employees to be represented on the board of directors or supervisory board (Jensen and Meckling 1976; Fama 1980; Fama and Jensen 1983a, 1983b, 1985). In doing so, they ignore (or, at least under-appreciate) existing provisions for and practices of BLER. For instance, the European Commission’s 2010 Green Paper on corporate governance in financial institutions does not touch on BLER a single time (European Commission 2010). Only a careful reading of the 2005 Commission recommendation on non-executive or supervisory directors (2005/162/EC) helps discover a brief mention of such a ‘system of workers’ representation’ in the annex. A final illustration is that, whereas BLER is widespread in Denmark, Norway and Sweden, BLER rights are only mentioned in a brief footnote in the 2009 code of corporate governance in the Nordic countries (2009:8). Such observations fuel the idea that BLER is a marginal phenomenon in Europe. This idea is so widespread that it can even lead some proponents of the stakeholder-

¹. See also Vitols (2010).
based approach² to believe that Germany is the only country providing workers with participation rights: ‘In most other countries, there is no legal basis for the participation of non-shareholders in the control of a corporation’ (Brink 2010: 643). To what extent does this perception reflect reality? Is BLER so scarce that it deserves little attention?

Furthermore, advocates of the shareholder value approach to corporate governance argue that shareholder interests best reflect the interests of the corporation as a whole. Against this background, the interests of all other actors are said to be so particularistic that focusing management attention on them would be detrimental to the company as an autonomous entity, just as it would impede the decision-making process as soon as these actors would be represented on the board.³ “Sectional” interests are abhorred, because they threaten teamwork and prevent boards pursuing the general good of the company unswayed by other considerations’ (Hill 1995: 257). On the other hand, several academic researches demonstrated that, if the purpose of BLER is to serve worker interests, it also serves company’s interests as well (Hassel and Rehder 2001) and can – more often than expected – even be aligned with shareholders’ interests (Adams et al. 2010). How can we adjudicate the obvious conflict between these two competing standpoints? Where does reality lie?

This chapter summarizes some results of a study, making two main points in relation to the above problematic. The first point is that BLER is in fact a ‘real existing’ mechanism which is not only widespread (based on a variety of national legislation providing workers with participation rights) but also alive and well in many European countries. This is based on the first results of a European census of those board-level employee representatives (henceforth BLEReps). The second point challenges the assumption that BLEReps pursue particularistic interests at the expense of the firm. This is demonstrated by the preliminary results of a questionnaire-based survey conducted by the authors, which show that BLEReps consider both social and economic matters dealt at board meeting as equally important, thus aligning them with the interests of the company as a whole.

³. This argument is explicitly presented in a report on corporate governance issued by one of the influential French think tanks: ‘The board of directors, if it should not be a rubber stamp, cannot however be a forum where diverging assessments of company management could be outspoken’ (our own translation) (Institut Montaigne 2003: 37).
2. The Extent of Board-Level Employee Representation in Europe

2.1 National institutional settings in Europe

An illustration of the importance of BLER as a modality of worker participation in the European social model is its institutionalisation within European law. Indeed, the 2001 Directive supplementing the Statute for a European company with regard to employee involvement offers, for the very first time, a precise definition of the phenomenon: “Participation” means the influence of the body representative of the employees [e.g. works council] and/or the employees’ representatives in the affairs of a company by way of: [1] the right to elect or appoint some of the members of the company's supervisory or administrative organ; or [2] the right to recommend and/or oppose the appointment of some or all of the members of the company's supervisory or administrative organ’ (art.2 Council Directive 2001/86/EC).

Despite this acknowledgement, very little interest has been shown for this specific workers’ right. On the academic side, it is almost possible to count on one hand the number of cross-national studies devoted to BLER in Europe. Moreover, their scope of analysis is restricted to the study of institutional settings by detailing national legal provisions (Carley 1990; EIRR 1991; Schulten and Zagelmayer 1998; Taylor 2006; Calvo et al. 2008; Fulton 2009). But, in doing so, they produced first-hand knowledge and have helped reveal the extent of de jure BLER in Europe. Taking advantage of the invaluable work achieved by Kluge and Stollt (2006) in this regard, we provide updated national information on BLER in table 1.

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4. Kluge and Stollt set up (initially with the support of the Hans-Böcker foundation and nowadays in cooperation with the Amsterdam Institute for Advanced labour studies) the SEEurope network, which is a network of experts in the field of worker involvement in the European Company and related developments (see detailed information on http://www.worker-participation.eu). This network has been of great value in producing the country reports on BLER upon which the information presented here is based.
Table 1  **Board-level employee representation in the European Economic Area**

<table>
<thead>
<tr>
<th>Companies covered</th>
<th>Proportion of BLEReps</th>
<th>Nomination by Trade union</th>
<th>Selection mechanism</th>
<th>Eligibility criteria: only employees?</th>
<th>Company board structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT</td>
<td>•</td>
<td>1/3</td>
<td>• Appointment by WC</td>
<td>•</td>
<td>D</td>
</tr>
<tr>
<td>BE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BG</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CY</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CZ</td>
<td>•</td>
<td>1/3 -1/2</td>
<td>Agreement w/ board/employer</td>
<td>Vote</td>
<td>D</td>
</tr>
<tr>
<td>DE</td>
<td>•</td>
<td>1/3 - 1/2</td>
<td>• Vote</td>
<td>• except TU seats</td>
<td>D</td>
</tr>
<tr>
<td>DK</td>
<td>•</td>
<td>1/3 (min. 2-3 members)</td>
<td>No legal procedure</td>
<td>Vote</td>
<td>M+D</td>
</tr>
<tr>
<td>EE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>D</td>
</tr>
<tr>
<td>ES</td>
<td>•</td>
<td>2-3 members</td>
<td>• Appointment by TU</td>
<td></td>
<td>M</td>
</tr>
<tr>
<td>FI</td>
<td>•</td>
<td>Based on agreement (max 4)</td>
<td>• Vote or agreement</td>
<td>•</td>
<td>M+D</td>
</tr>
<tr>
<td>FR</td>
<td>• (•)</td>
<td>Min. 2 members Max. 1/3</td>
<td>• vote</td>
<td>•</td>
<td>M+D</td>
</tr>
<tr>
<td>GR</td>
<td>•</td>
<td>1-2 mbrs</td>
<td>De facto by TU fractions</td>
<td>vote</td>
<td>M</td>
</tr>
<tr>
<td>HU</td>
<td>•</td>
<td>D: 1/3 M: by agreement</td>
<td>Must be consulted</td>
<td>• Appointment by WC</td>
<td>M+D</td>
</tr>
<tr>
<td>IE</td>
<td>•</td>
<td>1/3 (legally)</td>
<td>• vote</td>
<td>•</td>
<td>M</td>
</tr>
<tr>
<td>IS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>M</td>
</tr>
<tr>
<td>IT</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>M+D</td>
</tr>
<tr>
<td>LI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>M</td>
</tr>
<tr>
<td>LT</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>M+D</td>
</tr>
<tr>
<td>LU</td>
<td>•</td>
<td>Min. 3 members, max. 1/3</td>
<td>• • Vote by emp. reps</td>
<td>•</td>
<td>M+D</td>
</tr>
<tr>
<td>LV</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>D</td>
</tr>
<tr>
<td>MT</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NL</td>
<td>•</td>
<td>Max. 1/3</td>
<td>• Appointment by GSM</td>
<td>No employee</td>
<td>D</td>
</tr>
<tr>
<td>NO</td>
<td>•</td>
<td>Max. 1/3</td>
<td>• Vote</td>
<td>•</td>
<td>M</td>
</tr>
<tr>
<td>PL</td>
<td>•</td>
<td>Min. 2-4 mbrs Max. 2/5</td>
<td>• Vote</td>
<td>No restrictions</td>
<td>D</td>
</tr>
</tbody>
</table>
Table 1 leads us to two conclusions. First, no less than 18 countries out of the 27 EU Member States plus Norway provide workers with the right to be represented on the supervisory board or board of directors of their company in a deliberative manner. By itself, this statement challenges the first prejudice we pointed out: worker participation on company boards is not a rare phenomenon. In fact, what best characterises BLER in Europe is not its supposed marginality but rather its institutional diversity. Indeed, according to Kluge and Stollt (2009), national settings of BLER rights vary according to four factors: the characteristics of the company; the characteristics of the board; the ways in which workers are represented; and the manner in which BLER is introduced.

Characteristics of the company determining whether or not the undertaking falls within the scope of the law on BLER vary from one country to another on the basis of: the company’s ownership (only state-owned enterprises or also private companies); the company’s legal form (e.g. in Czech Republic, Slovenia and Slovakia only public limited companies are covered); and the size of the company. Indeed, the workforce threshold for compulsory implementation differs significantly from countries with no or low thresholds (e.g. no thresholds are fixed in Austria for triggering BLER provision in PLCs, and very low ones apply...
in the Nordic countries, e.g. the starting level in Sweden being 25 employees); to countries with medium-level thresholds (50-500 workers); and countries with high thresholds (a Luxembourg-based company is not compelled to apply BLER provisions unless it has a minimum of 1000 registered employees).

As for the characteristics of the board, two elements should be considered. First, the board structure itself – which could be a monistic structure consisting of a board of directors or a dualistic structure comprising a supervisory board and a separate management board – is likely to make a big difference. Indeed, under a dualistic structure the two functions of corporate management on the one hand and supervision of business administration on the other hand are strictly separated, whereas they are more ‘confused’ in the monistic model. In actuality, the convergence in national company laws owing to the extension of the choice between the two models in countries where previously only the monistic system existed (such as France) is diluting the distinctiveness of this feature (Hopt and Leyens 2004). The second important element relating to the characteristics of the board is the number or proportion of seats allocated to BLEReps, which varies from a minimum of one seat in Greek state-owned companies to the well-known German parity co-determination, in which half of the board seats in companies with over 2000 workers are allocated to BLEReps. The most frequent proportion of worker representatives is in fact 1/3, which is the case in Austria, the Czech Republic, Denmark and Hungary.

Another factor of variation is the way in which workers are represented on company boards. In some countries (Germany and Czech Republic) some seats are ‘reserved’ for external trade union representatives.5 However, the vast majority of BLEReps in Europe are employees of the company on whose board they sit. The only exception is the Netherlands, where the works council can make proposals for a third of the board members but these persons can neither be employed by the company nor trade union representatives. As a consequence, the representatives nominated by the works council often come from academia or the political sphere.

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5. In the specific case of Germany, trade unions nominate those external trade union representatives, who are then up for election by the entire workforce.
Finally, we should also stress that, in most countries, BLER has to be introduced automatically, i.e. when a company fulfils the legal criteria. However, although this is legally foreseen, this does not mean that representation at board level is always ensured in practice (especially in SMEs). In some countries an initiative from the workers’ side is needed to trigger the application of BLER provisions. For instance, in Slovenia the works council has this right whereas in Denmark an initial vote has to take place among the workforce.

2.2 Assessing the extent of BLER: identification of employee representatives in eleven countries

Analysing the extent of the legal framework providing workers with the right to be represented at board-level is one part of the story. Providing evidence on the extent to which this right is exercised in practice is another part. The preliminary results of a census of BLEReps we are conducting in Europe helps assess the latter.

With the aim of going from a knowledge based only on a *de jure* understanding of the phenomenon to the in-depth study of *de facto* duties and capacities of this institution, we developed a new and promising research project in late 2008. At this time a research team composed of Norbert Kluge (ETUI), Aline Conchon (ETUI) and Jeremy Waddington (University of Manchester) launched, along with the Hans Böckler Foundation, a project centred on a questionnaire-based survey. The driving idea behind this project was to send a common questionnaire to all BLEReps in Europe to enable a cross-national comparison. The objective is to target each BLERep, meaning that we are in principle working with a population rather than with a sample. Key to the distribution of the questionnaire is the access to, or assembly of, databases with the names and addresses of BLEReps.

To get access to existing databases we made contact with different actors: national and/or sectoral trade unions who might have such a list of BLEReps; national training organisations offering services to this type of...
employee representative who would have assembled a database of contacts; and academic researchers who conducted similar questionnaire-based surveys at national level and who could therefore guide us to their source of information. For countries where such databases are non-existent (the majority of the 18 targeted countries) we gathered BLEReps’ names on the basis of the list of companies entering into the scope of the national law regulating BLER, which most of the time is provided in an annex to the law. Where this was not available contacts with national actors helped us to elaborate this list of companies. Once we got access to this list, we searched for information on the composition of boards in company annual reports available online and/or on the websites of national business registers.

We decided to split the exercise into two batches of countries, the first one comprising 10 European Member States plus Norway. For this batch, the inventory of BLEReps started in December 2008 and ended in November 2010 with a final result of 16,771 individuals identified, as shown in table 2.

In terms of absolute numbers, one could conclude that counting about 17,000 individuals with a BLER mandate does not lead to qualify the phenomenon as ‘marginal’. It is worth mentioning that this amount of ca. 17,000 BLEReps has to be considered as a minimum value for several reasons. First, so far we only finished the census of BLEReps in eleven countries. The seven countries in the second batch include countries with widespread BLER rights such as Czech and Slovak Republics. Moreover, and as shown in above table, our first calculation encountered methodological limits, so that 16,771 must be considered as a preliminary result that will be reassessed as we finalise the research.

In short, the prejudice of marginality is challenged by the fact that the majority of EU countries provide workers with the right of getting involved in the decision-making process of the company at its top level; and that this institutional right is realised (in practice) by a large number of employee representatives.
3. Board-level employee representatives’ conception: a judicious combination of economic and social considerations

As detailed in the introduction, a second common prejudice fuelling arguments against BLER is grounded in the idea that BLEReps will pursue particularistic interests – in particular by focusing exclusively on social matters – at the expense of safeguarding the corporation’s interests as a whole. Moreover, their supposed lack of interest or consideration for economic matters would lead them to take positions on the board which
would impede the financial, strategic and economic development of the company.

The analysis of the underlying conception borne by BLEReps, or their ‘project’ as Reynaud (1997) would call it, challenges this prejudice, thanks to the preliminary results of responses to some of the questions of our questionnaire-based study. Indeed, the underlying conception of the linkage between the economic and the social spheres, as reported by BLEReps, is that both spheres are interdependent, thus both economic and social matters are mutually reinforcing.

3.1 Defining practitioners’ conceptions: an analytical framework

We derive the notion of ‘underlying conception’ from what we consider to be the key dividing line between shareholder-value oriented and stakeholder-oriented approaches to corporate governance theory. Some statements clearly express this, such as the following one from proponents of the stakeholder approach: “The theoretical problem is that surely “economic effects” are also social, and surely “social effects” are also economic. Dividing the world into economic and social ultimately is quite arbitrary. Indeed, one of the original ideas behind the stakeholder management approach was to try to find a way to integrate the economic and the social” (Harrison and Freeman 1999: 483-484). This quote highlights the fact that each of the two main approaches to corporate governance can be categorised according to how they conceptualize the linkage between the Economic and the Social. On the one side, advocates of the stakeholder approach claim that the economic and the social spheres are interdependent and have to be considered as going hand in hand. On the other side, those in favour of shareholder value-oriented corporate governance consider these two spheres as distinct and independent, even if one could be viewed as a complement to the other.

Applying this perspective to our research object means that we have to determine in which of these two camps BLEReps fit in, i.e. how do they characterize the nature of the linkage between the Economic and the

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9. For Reynaud, when looking at collective regulation, i.e. the process whereby industrial relations actors ‘produce, sustain or change rules’ [our translation], the researcher should bear in mind that ‘rules have a meaning only reported to a joint action (to simplify we will say, whatever the variety of purposes: to a project)’ (Reynaud 1997: 80) [our translation].

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Social within the company. Therefore, BLEReps could opt for one of these two views: 1) the economic and the social are two separate spheres of action, with the former – the sphere of economic, strategic and financial matters – being the sole prerogative of the top management/shareholders duo, while the latter is referred to as ‘social dialogue’ between top management and workers on working conditions such as salaries; or 2) the economic and the social spheres are intrinsically interdependent and no decision can be made in one of the spheres without involving the other. Indicators based on this distinction are actors’ attitudes towards the economic (strategic and financial topics) and social (employment and working conditions) matters discussed at board meetings. Indeed, BLEReps could think that economic matters are only top management and shareholders’ business whereas, as employee representatives, they should focus only on social matters; or that economic and social matters are equally important and should be addressed in a concomitant fashion by themselves, as well as by all other actors.

3.2 Empirical evidence: BLEReps conception of the linkage between the economic and the social sphere

As reported below, the questionnaire-based survey we are conducting aims at investigating a broad and at the same time basic question: what do BLEReps do? In order to do so, we broke down this initial question into four problematics. Firstly, what practical activities do BLEReps undertake in order to fulfil their duties as a board member? Answers to this would help us determine what the project and expectations of various actors (employees, trade unions, company management, shareholders, BLEReps themselves) are towards this specific employee representative mandate. Secondly, what dependent variables (e.g. their personal profile,
their potential unionisation, the company-level industrial relations system, the national-level industrial relations system, etc.) could explain differences? Thirdly, to what extent are BLEReps embedded in networks (especially with trade unions) and how do these links operate? Finally, what roles do BLEReps play, i.e. what are the priorities they define among the range of activities they undertake and the range of subjects they address at the board? Linked to this last question, whose interests (e.g. that of shareholders, national employees, international employees or trade unions) do they defend?

For the purposes of this chapter we will concentrate here on some elements of information related to the latter problematic. Moreover, we will restrict our discussion to the analysis of preliminary findings. Indeed, to date, the research project is still in its empirical phase and data has so far only been entered for France and Denmark, which thus are the two countries we will focus on. We would like to stress the qualification ‘preliminary’, since at the time of writing this chapter data entry has only been completed for those replies received from the first round of mailings. A total of 1,180 questionnaires were distributed to Danish BLEReps, of which 215 have been returned, constituting a response rate of 18 per cent. The corresponding figures for France are 519, 105 and 21 per cent.

Over 87 per cent of the Danish respondents were male and the median age was between 51 and 52. On average, Danish respondents had been employed by the company on whose board they sat since 1986 and had served on the board for between 5 and 6 years. Over 92 per cent of Danish respondents sat on the board of a limited company, the majority of them based in Denmark (77.7 per cent). Almost 73 per cent of the French respondents were male and the median age was between 50 and 51. On average, French respondents had been employed by the company on whose board they sat since 1984 and had served on the board for between

9. The gender balance of BLEReps is quite similar to that of board members in total (82% of Danish board members in the largest listed public company are male according to the DG Employment database on women and men in decision-making, from 2009 data, available at: http://ec.europa.eu/social/main.jsp?catId=777&langId=en&intPageId=675). By contrast, BLEReps are more feminised than the overall population of board members in France (73% of French BLEReps are male, vs. 90% of total board members). It is far too early to go into more depth and draw definitive conclusions; rather, we plan to wait for the collection of our full set of data and, critically, a detailed analysis of our target population to discover possible bias.
4 and 5 years. Over 53 per cent of French respondents sat on the board of a public limited company, all of them based in France. In both countries BLEReps had mainly been appointed to the board through a direct election by employees (92 per cent in Denmark and 97 per cent in France).

Three key questions contained in the questionnaire help provide evidence in addressing the question of the conception held by BLEReps with regard to the linkage between the economic and the social matters.

Table 4  **What interests guide your decision-making on the board?**

<table>
<thead>
<tr>
<th>Interests guiding decision-making</th>
<th>Danish representatives</th>
<th>French representatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees [S]</td>
<td>81.8%</td>
<td>94.8%</td>
</tr>
<tr>
<td>The company [E]</td>
<td>61.4%</td>
<td>64.5%</td>
</tr>
<tr>
<td>Shareholders [E]</td>
<td>24.2%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Trade unions at the workplace [S]</td>
<td>10.3%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Local labour market [S]</td>
<td>5.6%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Wider society [S]</td>
<td>4.2%</td>
<td>15.7%</td>
</tr>
<tr>
<td>Trade union confederation [S]</td>
<td>2.8%</td>
<td>/</td>
</tr>
<tr>
<td>Environment</td>
<td>2.8%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Federal/sectoral/national trade union [S]</td>
<td>1.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Other</td>
<td>1.4%</td>
<td>/</td>
</tr>
</tbody>
</table>

Note: respondents were asked to rank the interests that guide their board–level decision by marking 1, 2, 3 and so on. The above table presents the sum of the results from first two positions in the ranking, hence the percentage figures add up to more than 100 per cent. [S] indicates a ‘social’ interest and [E] an ‘economic’ interest.

According to Table 4, in both countries the defence of employees’ interests – a social one– is ranked in first place. However, it is worth noting that the interest of the company – an economic one – comes second, well ahead of other items. One might have expected the social dimension represented by both employee and trade union interests to occupy the top two places. These initial findings could lead us to believe that the economic and social dimensions are considered equally important.
Table 5  **Most important issues raised at board meetings**

<table>
<thead>
<tr>
<th>Issue raised at board meeting</th>
<th>Danish representatives</th>
<th>French representatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adoption or review of accounts and balance sheet [E]</td>
<td>82.8</td>
<td>86.5</td>
</tr>
<tr>
<td>Employment situation/trends [S]</td>
<td>61.4</td>
<td>49.0</td>
</tr>
<tr>
<td>Sale or closure of plants/relocation of production [E]</td>
<td>60.9</td>
<td>12.5</td>
</tr>
<tr>
<td>Acquisitions or mergers [E]</td>
<td>34.9</td>
<td>37.5</td>
</tr>
<tr>
<td>Investment [E]</td>
<td>34.4</td>
<td>45.8</td>
</tr>
<tr>
<td>Research and development [E]</td>
<td>29.3</td>
<td>38.5</td>
</tr>
<tr>
<td>Health and safety [S]</td>
<td>27.9</td>
<td>17.7</td>
</tr>
<tr>
<td>Taking out loans and credits [E]</td>
<td>24.7</td>
<td>14.6</td>
</tr>
<tr>
<td>Appointment/removal of management board/executive committee/senior managers</td>
<td>23.7</td>
<td>11.5</td>
</tr>
<tr>
<td>Purchase or sale of subsidiaries [E]</td>
<td>23.3</td>
<td>27.1</td>
</tr>
<tr>
<td>Product market policy [E]</td>
<td>18.1</td>
<td>30.2</td>
</tr>
<tr>
<td>Environmental matters</td>
<td>17.2</td>
<td>13.5</td>
</tr>
<tr>
<td>Profit distribution, dividends or settlement of losses [E]</td>
<td>14.9</td>
<td>28.1</td>
</tr>
<tr>
<td>Vocational training [S]</td>
<td>13.5</td>
<td>11.5</td>
</tr>
<tr>
<td>Increase/reduction in the company’s share capital [E]</td>
<td>13.0</td>
<td>6.3</td>
</tr>
<tr>
<td>Industrial relations [S]</td>
<td>11.2</td>
<td>31.3</td>
</tr>
<tr>
<td>Appointment/removal of auditors</td>
<td>6.5</td>
<td>3.1</td>
</tr>
<tr>
<td>Gender policy/promotion of women [S]</td>
<td>2.8</td>
<td>10.4</td>
</tr>
<tr>
<td>Remuneration/compensation of senior managers</td>
<td>2.3</td>
<td>16.7</td>
</tr>
</tbody>
</table>

Note: each respondent could tick up to five categories, hence the percentage figures add up to more than 100 per cent. [S] indicates a social issue and [E] an economic issue.

Table 5 tends to confirm our initial reading. Indeed, the top two places are both occupied by a financial and economic issue – the company’s accounts and balance sheet – and a socially-oriented one – the employment level and trends. Next come two other economic matters identified as amongst the most important for both French and Danish BLEReps, namely ‘acquisitions and mergers’ and ‘investment’. On the...
other hand, the social matters which (according to the duties attributed to the board by the law, the company’s articles of association or the manual of board procedures) may be raised at board level, such as ‘health and safety’, ‘vocational training’ and ‘industrial relations’, do not appear to feature prominently among the priorities of BLEReps. But this might be explained by the fact that those issues ‘may’ be raised but are not always raised in practice. Precisely in order to avoid such a bias deriving from the interdependency with formal board duties, we developed a less directive and more general question, which led to the results presented in Table 6.

Table 6 Most important objectives as a board-level employee representative

<table>
<thead>
<tr>
<th>Objectives pursued at board level</th>
<th>Danish representatives</th>
<th>French representatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintaining employment levels within the company [S]</td>
<td>50.2</td>
<td>31.3</td>
</tr>
<tr>
<td>Raising employee issues at the board [S]</td>
<td>40.0</td>
<td>48.0</td>
</tr>
<tr>
<td>Informing board members of the situation of the company [E]</td>
<td>37.2</td>
<td>34.4</td>
</tr>
<tr>
<td>Preventing business administration abuses, corruption or maladministration [E]</td>
<td>30.7</td>
<td>13.6</td>
</tr>
<tr>
<td>Providing employees and their representatives with information [S]</td>
<td>14.5</td>
<td>20.8</td>
</tr>
<tr>
<td>Emphasising long-term strategy, rather than short-term objectives [E]</td>
<td>12.1</td>
<td>32.3</td>
</tr>
<tr>
<td>Maximising dividends [E]</td>
<td>6.5</td>
<td>/</td>
</tr>
<tr>
<td>Raising union issues at the board [S]</td>
<td>1.9</td>
<td>10.4</td>
</tr>
<tr>
<td>Representing other commercial stakeholders, such as customers, suppliers or contractors</td>
<td>0.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Representing other non-commercial stakeholders, such as NGOs or environmental actors</td>
<td>0.5</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Note: respondents were asked to rank the tasks that are most important to them as board–level representatives with 1, 2, 3 and so on. The table above presents the sum of the results from the first two positions in the ranking, hence the percentage figures add up to more than 100 per cent.
[S] indicates a ‘social’ objective and [E] indicates an ‘economic’ objective.

Results presented in Table 6 tend to confirm that social and economic matters are both considered together. Indeed, as for Table 4, a social matter is ranked first: ‘maintain employment levels within the company’ for Danish and ‘raise employee issues at the board’ for French
representatives. ‘Informing board members of the situation of the company’, with an equivalent percentage, is also identified as important among the tasks fulfilled by BLEReps in both countries. A more economic consideration comes next, albeit a different one for the two nationalities: ‘preventing business administration abuses, corruption or maladministration’ for the Danes, and ‘emphasising long-term strategy, rather than short-term objectives’ for the French BLEReps.

These preliminary findings lead us to believe that BLEReps’ underlying conception is a matter of a judicious combination of economic and social considerations, without one strongly prevailing over the other. However, not least in view of the stage reached by our research project, we are deliberately cautious since these findings derived from answers received from only two out of the eighteen countries investigated. We are still awaiting final receipt of replies from all the countries before embarking on a cross-variables analysis which will, among other things, help explain the differences in replies observed for those two nationalities.

All things considered, the conception borne by BLEReps is far from being one in which the social dimension constitutes the single main priority. For these practitioners, the economic and the social spheres are considered interlinked and interdependent. By the way, the nature of the linkage between the economic and the social dimensions is a social construction – an argument supported by Michael Piore (2003) for instance11 – so that we found it difficult to classify some items in the two categories. In this regard, our analytical framework would undoubtedly benefit greatly from the one developed by authors prominent in the recently established schools of economic sociology, belonging either to the new economic sociology (Smelser and Swedberg 2005) or to the French-speaking approach of the nouvelle sociologie économique (Lévesque et al. 2001). We are convinced that this may well represent an interesting way forward for further research.

11. ‘View[ing] the distinction between the economic and the social realms [...] as itself a social construction’ (Piore, 2003: 121).
4. Conclusion

By way of conclusion, our empirical studies provide support for challenging the two prejudices we underlined. BLER cannot be viewed as a marginal phenomenon given the fact that legal provisions granting this right are widespread in Europe and that those employee representatives holding such mandates are numerous. Moreover, our preliminary findings tend to prove that BLEReps are concerned with both social and economic dimensions, thus taking into account the interests of the corporation as a whole.

It is precisely because BLEReps help defend the company’s interests instead of particularistic ones that several actors argue for the spread of this form of employee involvement as a relevant way of ensuring the sustainability of businesses. Indeed, for more than a decade now, support has been growing for the widespread institutionalisation of BLER in companies, mainly from trade unions,12 trade union related organisations (see for instance TUAC12, 2005, 2009 and 2010) and trade-union friendly political parties.14 As for any collective regulation in the field of industrial relations and, in this particular case, in corporate governance, involvement of all key actors – employees, employers, States and their respective representatives – is required so as to change or produce rules on the specific issue of BLER with the objective of fostering the implementation of Sustainable Companies.

Certainly, prejudices are still common when addressing the issue of worker participation at board-level because too little research has been devoted to this topic, which is one reason why the European Trade Union Institute commits itself to increase and develop knowledge on this topic (see one of the latest ETUI publications: Gold et al. 2010). However, much remains to be done, which opens new research perspectives in the field of industrial relations and corporate governance studies.

12. For example, the CGT and CFE-CGC’s claims for an extension of French legal rights for worker participation has been renewed in the light of the 2000s corporate governance crisis (Conchon 2009).
13. The Trade Union Advisory Committee – an international trade union body with consultative status vis-à-vis OECD – has been and still is particularly reactive towards OECD’s various publications on the topic of corporate governance.
14. The German social democrats – SPD – have recently demanded an extension of German codetermination rights (Bundestag hib-Meldung nr. 206/2010 of 17 June).
References


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Chapter 6
The contribution of employee share ownership to the Sustainable Company

Andrew Pendleton

1. Introduction

Central to the concept of the Sustainable Company is the notion that the interests of key stakeholders are aligned in a manner which contributes to the successful economic performance of the company. This implies that the company pursues social goals besides those of economic performance narrowly defined. Foremost amongst these social objectives is the welfare of employees. Where employee welfare is incorporated into the goals of the company, there are likely to be beneficial effects on the company’s performance. The truism that happy workers are engaged and productive has an intuitive plausibility, though clearly their efforts have to be effectively harnessed to secure successful corporate performance. A key element of worker welfare is that workers should share in the success of the company, as well as being adequately remunerated and treated with respect.

Employee share ownership has a potentially important role to play in ensuring that workers benefit from the success of the company. The award of shares in the company provides a reward that is usually additional to wages and, in so far as share awards are financed out of profits, provides for sharing in the company’s success. Alternatively, workers may subscribe to shares or acquire options to receive shares at some point in the future. Although employees clearly have to contribute in these cases, they usually do so on privileged terms arising from their status as employees. Unlike cash profit-share payments, share ownership provides potentially recurring benefits by enabling workers to benefit from capital gains in the value of the stock and from regular dividend payments linked to profits. A further potential benefit of share ownership, unlike other forms of profit-based payments, is that it can give employees a voice in the governance of the firm. How far it does so, however, varies widely. The circumstances in which share ownership gives effective governance powers to workers and their representatives will be discussed...
in this chapter. The involvement of employees in corporate governance based on share ownership potentially reinforces those other effects of share ownership that contribute to the Sustainable Company.

It is argued in this chapter that employee share ownership is a highly varied phenomenon across Europe. In some cases, employee share ownership provides for worker ownership of the company, whilst in others workers share ownership with family owners or institutional investors, and indeed hold only a small minority of company shares. We first outline the various means by which employees may acquire shares in their employer. We then go on to consider the main benefits that share ownership provides for employees. These benefits are grouped into two types: return rights and control rights. In outlining the nature of these rights, and how their characteristics may vary, we also consider the effects upon the company and its sustainability.

2. The nature, character, and incidence of employee share ownership

There are several types of employee share ownership plans. One involves the award of shares to employees free of charge, with the distribution typically either equal or based on tenure or salary (‘similar terms’). Such awards may be explicitly linked to the profits of the company, and may require a certain level of profitability (or some other criteria) to trigger the award. A benefit of this type of employee share ownership is that awards are usually made to all or nearly all employees, thereby ensuring that the vast majority of workers benefit whatever their income. Clearly, the company bears all or most of the cost of this arrangement though taxpayers may also bear some of the costs if these awards are made free of income tax (as is usually the case in ‘approved’ plans). Employees do not bear any immediate and direct risk from acquiring shares in this way (as long as shares do not substitute for salary), though they do of course become exposed once they incorporate these shares into their savings portfolios.

An alternative form of employee share ownership is a share purchase plan. In this case employees are able to purchase shares in the company, often at a discount, and without the transaction fees that private share purchases normally involve. Any discount may be exempt from income tax, whilst any growth in value of the shares may also be exempt from
income tax (but liable to capital gains tax on sale of the shares). In some plans, the company may match the share purchases made by employees, and this provides both an inducement for purchases and protection against downside risk for employees. If no matching shares are provided, share purchase plans are clearly a potentially risky form of share ownership for workers. A further potential disadvantage of share purchase plans, from a sustainability perspective, is that workers’ capacity and willingness to contribute will be influenced by their income and other resources. Research shows that the main participants in this kind of plan are higher income employees and occupational groups: income is the strongest determinant of both the decision to participate and the level of contribution (see DeGeorge et al. 2004; Kerr and Tait 2008; Pendleton 2010). Participation rates in these plans can be quite low, and may depend in large part on the occupational composition of the workforce. A benefit to companies of share purchase plans is that they generate financial inflows to the company at low cost. Clearly they are free of interest charges and, unlike public offerings of shares, do not usually require a full prospectus. Furthermore, if workers’ contributions to purchase the shares are administered by an external savings bank or administrator, much of the administration costs may be externalised. Transactions costs may therefore be relatively low.

A further common form of share ownership plan is the stock option plan. In this instance, employees are granted rights to acquire shares at some point in the future, typically between three and ten years’ time, at current (or discounted) prices. On the assumption that share values increase in the interim, employees may exercise the options, immediately sell some of the shares to pay the full purchase price, and be left with a residual amount of shares. In some cases a savings plan is available for workers to generate the lump sum to purchase the shares in their entirety. Equally, employees may choose not to exercise the options, and indeed will in most cases not do so if share price has deteriorated. In this respect share option plans can be an attractive instrument for workers in that they are immune from downside risk during the option period. However, in countries where there is an ‘up-front’ tax liability on the award of the options, workers will have to make payments for the options before any gain is realised.

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1. Employee share plans offered by EU-listed companies are usually exempt from the requirement to issue a full prospectus as long as they issue an Information Memorandum setting out the main details of the offer.
Of particular interest to those concerned with promoting the Sustainable Company is the ESOP (confusingly an abbreviation for Employee Share Ownership Plan). In this instance, an employee benefits trust or foundation acquires the shares in the first instance. Over time, shares might be released to employees either for free or by subscription. Or they might be retained in the trust for the long term. A potential benefit of this type of arrangement is that the acquisition of shares in the company is not dependent on employees’ wealth and liquidity, and substantial blocks of equity may be acquired without the coordination costs that would arise if employees were to purchase them directly. Furthermore, the trust rather than the workers bears the risk of the immediate acquisition. Indeed, the company may bear the risk in so far as the trust’s purchase of shares is financed against the assets or income streams of the company. ESOPs therefore are an attractive means for acquiring large blocks of company shares, and may be used as a vehicle for securing majority employee ownership. Employee trusts may also provide the means for more effective and influential voice in corporate governance than is found with the schemes outlined earlier. This is because employee share ownership is concentrated within a single institution rather than dispersed amongst individual employees.

Employee share ownership of various types has been promoted by the European Union over the last few years as part of a broader programme to encourage employee financial participation. The European Commission issued a Communication to the other European Union governance institutions in 2002 advocating the wider use of financial participation on the basis of a few key principles (initially formulated in a European Council Recommendation in 1992). These included the notion that financial participation should be voluntary, open to all employees, be clearly communicated to employees, be supplementary to wages and salaries and avoid unreasonable risk. In October 2010 the European Economic and Social Committee (EESC) adopted an Opinion that also promoted financial participation. This Opinion notes that ‘companies which issue large numbers of employee shares have a group of demanding but patient and loyal shareholders, their own employees, supporting them in resisting the prevailing short-termism of the financial markets. Sustainable corporate decisions and acceptance of long-term corporate social responsibility by managers rather than excessive risk-taking are the desirable side-effects of their kind of employee financial participation’ (EESC 2010: 8). It is also noted that participation by employees based on ownership rights can contribute to better corporate governance.
3. Benefits to employees and companies

Employee share ownership plans have two main sets of benefits to employees, which in turn give rise to further benefits for employees and companies. These benefits relate to the return and control rights that are associated, to varying degrees, with employee share plans.

3.1 Return rights

Employee share ownership plans usually give rights to returns from the activities of the company in the form of dividends and capital gains. Where shares are provided free of charge to employees, then the allocation of shares is itself a benefit to employees. These return rights usually provide a supplement to wages and salaries, thereby boosting employee incomes.

An anxiety for employees and trade unions is that shares may be distributed to employees in lieu of wages. This may expose employees to risk and also undermine collective bargaining. To avoid these situations, the ETUC and European trade unions have argued for some time that share ownership plans should supplement wages, not substitute for them. This principle is enshrined in the principles guiding share ownership plans adopted by the European Commission in 2002 (Commission of the European Communities 2002). In some countries, such as France, direct wage substitution by financial participation (profit sharing rather than share awards) is prohibited by law. As it happens, share ownership plans rarely substitute for wages. This is probably because, in most instances, share ownership plans are operated separately from wage determination systems (and collective bargaining where it exists). The capacity for managers to reduce wages is therefore highly constrained in practice.

In fact, research shows that firms using share ownership plans often pay higher wages and salaries than comparable firms, even before the share ownership element is added in (Pendleton 1997). The only exceptions where wage substitution can be observed are in the case of start-up micro companies (often in the high technology area), where shares or share options are attractive to companies because of cash-flow constraints (Core and Guay 2001), and in the case of concession bargaining, where unions and managers explicitly trade shares for wages in response to
crisis situations (as happened recently amongst British Airways pilots and in the German automobile supply industry).

The use of shares as a supplement to (high) wages has several benefits for the company. One, the boost to remuneration helps to bond employees to the firm, potentially leading to lower employee turnover. Furthermore, the fact that most employee share ownership plans have some deferral characteristics (i.e. the employee does not receive the full reward until sometime in the future, when shares come out of trust or options mature) helps to bind employees to the firm. Given that the dividends accruing to employee shares will be recurrent, and will increase with the frequency of share awards, the benefits of share plans to employees are likely to be cumulative over time. Research has indeed shown that employee turnover is lower in firms and workplaces with share ownership plans (SenGupta et al. 2007). It has been argued that this provides the basis for share plans to contribute to high productivity: firm-specific human capital will be enhanced by long employee tenure. Furthermore, low quit rates mean that employers can secure gains to employer-provided training, either in firm-specific or general skills. Research has shown that firms with employee share ownership have a higher propensity to offer training to employees (Pendleton et al. 2001; Pendleton and Robinson 2011; Robinson and Zhang 2005). Of course, securing long-term tenure also saves on recruitment and hiring costs.

A further way that share ownership plans may help to bind employees to the firm is that employee shares align employee remuneration with the state of the labour market. As argued by Paul Oyer (2004), the value of employees’ equity is likely to correlate with the business cycle: when the economy is doing well, share prices are likely to rise across the board (alongside any firm-specific increases, or ‘alpha’). This is also the time when the labour market is likely to be most active, and when employees might be most likely to find alternative job opportunities. Increases in the value of shares (especially those that are deferred) may help to ‘lock’ employees into the firm. High levels of remuneration provided by wages plus shares are also likely to enhance the quality of recruits the firm is able to attract. Although this has not been systematically investigated in relation to share ownership plans, it has been demonstrated by research into the effects of profit sharing (Lazear 2000).

The regular provision of shares, or the opportunity to acquire shares on privileged terms, provides a means of medium and long-term savings for
employees. This form of savings is relatively illiquid (though many firms do provide favourable terms for employees to cash in their employer shares), thereby assisting the accumulation of savings. The possession of these savings, bearing in mind the low propensity to save amongst many groups of workers, helps to insulate workers against shocks to their personal circumstances. This may well assist the company in so far as the effects of domestic issues on employee stress and well-being may be minimised, thereby potentially leading to lower absenteeism and more active employee engagement and productivity.

The evidence suggests that share ownership is a reward that is appreciated by employees, though some find cash equivalents more valuable than awards of stock or options (Hall and Murphy 2002). This can give rise to higher levels of employee satisfaction with their employer, and higher levels of engagement and commitment amongst employees. There is substantial evidence of higher job satisfaction and organisational commitment amongst employees who participate in employee share ownership plans (Kaarsemaker et al. 2010). However, it may be that other forms of employee participation are also necessary for these favourable attitudes to be realised (Pierce et al. 1991; Buchko 1992). One proviso though is that, in so far as employee participation in share ownership plans is voluntary, those taking part may have higher levels of commitment and engagement to start with.

Although employee shares may contribute to long-term savings, it is undesirable for employer shares to form too great a component of savings or pensions. The collapse of Enron, where substantial proportions of many employees’ pension savings were held in Enron shares, is a salutary lesson here. Some countries (e.g. France) limit the amount of employee shares that may be held in pension plans whilst others have limits on the amount of company stock that may be held in occupational pension funds (e.g. the UK).

3.2 Control rights

The other main benefit to employees is that employee share ownership can provide control rights. Shares normally provide voting rights as well return rights. In principle, employee share ownership may allow for a greater employee role in corporate governance, and provide for additional disclosure of information to that which they receive as employees. Much
depends, however, on the size of the combined employee stake. In most stock-market listed companies employee shareholders will own only a small fraction of the company, and will find it difficult to exert influence upon governance. This is especially so where there is a dominant blockholder, as is often the case in many European companies. Furthermore, in many of these plans, employees may not seek active involvement in governance as they perceive the primary reward from share ownership to be financial. Where employees as a whole own a larger stake, the potential for involvement and influence is correspondingly greater. Whether they achieve this depends in large part on whether there are institutional mechanisms for employee shareholders to coordinate their interests and activities. We will turn to this shortly.

There are several potential benefits of employee involvement and influence in governance. Most obviously, it is likely to provide a means of ensuring that the company functions for the benefit of employees as well as shareholders. It may also mean that the company itself as an entity is protected because it will usually be in employee interests for it to be so. This may mean that the company is able to take a more long-term approach to its strategy and operations.

One obvious way that employee share ownership can assist in this is by providing protection against hostile takeovers. For instance, the ownership share held by Aer Lingus employees in Ireland played a critical role in fending off a hostile bid by Ryanair which, if successful, would undoubtedly have led to deterioration in pay and conditions for Aer Lingus employees. In the US, employee share ownership combined with executive ownership also provides a blocking mechanism in many listed companies (Useem and Gager 1996). However, in many companies with employee share ownership in Europe, the employee stake is too small to provide an effective defence against hostile takeovers. For instance, although many employees in Cadbury Schweppes owned shares in the company, their combined stake was not large enough to prevent the unwelcome takeover by Kraft.²

Although employee share ownership may be insufficient to block hostile takeovers in most cases, it nevertheless provides some protections for

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2. A complication here was that Kraft claimed that it would keep open a British plant that the Cadbury management had slated for closure. Kraft subsequently reneged on this.
employees. As shareholders, employees will receive the takeover premium that is usually paid in takeovers of listed companies. They will also receive the tender information prepared by the bidder, and this is likely to be more substantial than the information they receive as employees under takeover consultations.

A limitation of employee share ownership as a means to enhance employee involvement in governance is that employee shareholders may be too fragmented to provide a strong unified voice. The role of institutions that unify employee shareholders is therefore critical to effective voice in governance. There are several ways that this may occur. One possibility is that trade unions provide a unifying mechanism to exert influence in governance. In the past many trade unions have been reluctant to provide a representational function for shareholding on the grounds that this blurs the distinction between capital and labour, and could mean that unions sit on both sides of the table during pay bargaining. This is most likely to occur where workers hold a majority of stock in a company and can therefore be seen as owners of this company. Some left-wing unions in countries where the union movement is organised along political lines (for example, France and southern European countries) tend to have ideological objections to employee share ownership. Other unions, especially those representing ‘white collar’ workers, have tended to become more favourable towards employee share ownership in recent years. Even so, unions have become involved in the supervision of share plans or in the governance of companies on behalf of employee shareholders in relatively few companies.

An alternative means to coordinate and extend employee-shareholder involvement in governance is to secure representation on the company board. This rarely occurs precisely because of fragmentation of employee ownership and limited aspirations for a role in governance. Existing directors do not usually go out of their way to invite employee representation on the board. An interesting case is France, where recent legislation gives employee shareholders the right to nominate employee board directors where employees hold 3 per cent or more of the company’s stock (Ginglinger et al. 2009). This instance aside, employee shareholder board-level representation is usually only found when the ownership stake of employees is fairly high and where there are other institutions to coordinate and pursue employee interests. However, in other cases where there is legally mandated board-level representation
(as in Germany), employee share ownership may give additional legitimacy within the board to employee representatives.

Another means to enhance employee shareholders’ role in governance is employee shareholder associations. These coordinate and represent the interests of employee shareholders within the company. Once again this seems to be a phenomenon associated with French companies. For instance, the aerospace group Thales has employee shareholder associations in its operations in Italy, Belgium, Germany, Spain, Greece, Norway, Netherlands, and the UK as well as further afield in countries such as Australia and Canada. There is a Federation of Associations of Staff Shareholders (FAST) to bring these national associations together. Similar the French ophthalmic optics company Essilor, which operates in around 100 countries, has nationally-based shareholder associations which are brought together by an international federation (Valoptec). This federation accounts for around eight per cent of the equity of the company and 14 per cent of the voting rights. The objectives of Valoptec are to play ‘an active role in the life, decisions, and long-term strategy of the (Essilor) group’, and it seeks to achieve this via its three representatives on the company board.

Another way of pooling employee votes is to reassign individual votes to the trustees of an employee benefits trust or foundation, who then vote on the stock for the employees. In the Austrian steel company Voestalpine AG, the voting rights of the 13 per cent stake held by Austrian employees are allocated to the Voestalpine Mitarbeiterbeteiligung Privatstiftung, which then votes at the annual general meetings of the company. This foundation is run by a management board, of whose members half are nominated by the management of the company and half by the works council. The management board is chaired by a works council representative. The same arrangement operates for an advisory board, which votes the stock at the annual meetings. The voting rights of employee shareholders in countries outside Austria are transmitted through European Works Council representatives to the Foundation but based on arrangements that fit with domestic company law. The employees are the second largest shareholder in the company, and the

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3. The voting rights are reallocated through an agreement between the employee and the foundation. These voting rights are restricted in that they terminate when the employee retires from the company. The other condition of receiving shares is that there is a five year blocking period during which the shares are held in the foundation.
bundled stake is in excess of 10 per cent, which means that there is some protection against hostile takeovers. The size of the bundled stake also means that the foundation has the right to nominate a member of the company’s supervisory board.

An alternative means of achieving a similar outcome to pooling employee votes in a trust is a form of employee ownership where all (or some) of the company’s shares are held collectively in trust. The trustees (or directors of the trust company), who may be elected by the employee beneficiaries, exercise the voting rights of the shares held in the trust. These shares may be held in trust in perpetuity – this can provide an effective means of securing long-term employee ownership. Alternatively, some shares may be distributed to employees but a sufficient block is retained in collective ownership to provide a blocking vote. The British retailer John Lewis Partnership has all of its shares held in a partnership trust, having been gifted by the company’s owner from the late 1920s onwards. This provides the underpinning for the governance structure in the company. Employees elect the members of the Partnership Council, who in turn nominate the board of directors of John Lewis. Meanwhile, the employees receive return rights via an annual profit share, which may be viewed as the dividend on the shares held on their behalf. John Lewis is widely seen in Britain and beyond as a highly successful model of employee ownership – the company has been a consistently good performer over many years. This form of employee ownership has been advocated as a form of corporate ownership and governance that enables a focus on long-term performance and high standards of consumer service (Matrix 2010). However, a limitation of this approach to employee ownership is that, as the shares are not sold to employees, the acquisition of the shares by the trust is likely to be dependent on the goodwill of the former owner. Shares will either need to be donated to the trust or financed with the assistance of the exiting owner.

A final issue is whether involvement by employee owners in governance has a positive effect on company performance. There is not a great deal of evidence on this issue as employee shareholder representation on company boards or other governance institutions is not common. This tends to preclude reliable statistical analysis of the effects of representation in governance. An exception is France, where a law in

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4. Austrian company law allows for a hostile bidder with more than 90 per cent of the shares to force the remaining shareholders to sell their shares.
2002 enabled employee shareholder representation on the company board when employees own a combined stake of 3 per cent or more of company stock. Ginglinger et al. (2009) find that the presence of employee shareholder directors amongst firms listed on the Societe des Bourses Francaises 120 index (the largest French companies by market capitalisation) is positively associated with increased stock market value and profitability. However, there is no evidence that their presence has any effect on corporate payout policy. Against this, an American study of employee ownership (Faley et al. 2006) finds that firms with a significant employee stake in ownership under-invest in capital assets and have lower productivity and short-term profitability. It is suggested that employee shareholders use their governance voice to maximise returns to labour, and that this pushes corporate policies away from shareholder value maximisation. However, there is no evidence presented in the study that these employee shareholders have any direct involvement in or influence on corporate governance, so these findings have to be a matter of conjecture.

4. Conclusion

Employee share ownership is becoming more common in Europe. Employee ownership potentially gives employees and their representatives return and control rights, but the nature and extent of these differ considerably between plans, companies, and national environments. There are a variety of benefits that firms and their workers may gain from the application of these rights. Although there can also be some downsides, such as exposure of employees to risk, the overall conclusion is that employee share ownership can make an effective and significant contribution to the Sustainable Company. There has been growing interest in employee share ownership in many European member states over the last decade and the use of employee share ownership plans seems likely to grow. From the perspective of the Sustainable Company, the challenge is to provide effective involvement in governance as well as financial returns to employees.
References


Chapter 7
Reorienting management remuneration towards sustainability: lessons from Germany

Rainald Thannisch

1. Introduction

Trends in the level and structure of management remuneration in large companies in Europe and elsewhere have been criticized almost universally in the recent past. High pay for top executives increases social tension and takes away resources from companies that could otherwise be used for productive investments for the future. The increasing proportion of remuneration which is based on short-term performance and stock price creates incentives for risky and short-term behaviour. Therefore, one key measure to encourage the sustainable strategies needed for the Sustainable Company is to change the way our top managers are paid. First, total remuneration needs to be kept at levels which are socially acceptable and which do not excessively drain resources from the company. Second, the structure of remuneration should reward managers for developing strategies and undertaking actions which support the long-term interests of companies and their stakeholders, rather than focusing on short-term performance on the stock market.

In this respect Germany offers an interesting example from which other countries can learn. First of all, Germany has one of the strongest systems of board level employee representation in Europe. Half of the board seats are allocated to worker representatives in companies with more than 2000 employees domestically. These representatives are generally included in board committees, including the remuneration committee. The policies that German trade unions develop can therefore have an impact on management remuneration. Second, a law was passed in 2009 which includes many of the demands made by the German Trade Union Confederation (Deutscher Gewerkschaftsbund, or DGB) regarding the structure and level of executive remuneration in listed companies. Some companies have already introduced new remuneration systems which take into account sustainability objectives, such as employee and
customer satisfaction. More examples will be emerging in the future which will be worthy of examination.

2. Trends in executive pay and the political debate in Germany

The observation of trends in remuneration in Germany shows that executive pay in the largest companies has become decoupled from general trends in wages, salaries and incomes. In 1987 a member of the executive board (Vorstand) in one of the DAX companies (i.e. one of the largest 30 listed companies) earned 14 times the pay of an average worker. This level could be regarded as socially acceptable. Today this ratio is over 90, and in individual cases even more than 200. In the crisis year of 2009 the CEOs of the DAX companies earned on average a little less than 3.8 million Euros (not including pension contributions). For all members of the executive boards of the DAX companies this figure was just below 2.4 million Euros. Between 1987 and 2005 the average remuneration of executive managers in the DAX companies increased by 445 percent. In comparison, gross domestic product roughly doubled in the same period of time.1

The explosive increase in executive pay has led to a very critical public debate in the past few years. Given that many see no justification for this trend, it can safely be assumed that the confidence of many Germans in the social market economy has decreased. Nevertheless, it took the financial crisis of 2008-9 and the run-up to the Parliament elections in 2009 to move the government to introduce the first substantial regulation of executive remuneration. Up until then political measures had for the most part been restricted to voluntary appeals. The only exception here was the initiative in 2005 by the then-governing social democratic-green coalition for a law on transparency in executive remuneration, which however is still criticized to this day by representatives of industry.

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1. For data on these trends see Schmitt and Schwalbach (2007) and Deutsche Schutzvereinigung für Wertpapierbesitz (2010). Some of the figures above are based on the author’s own calculations.
3. Corporate governance and board level employee representation in Germany

German company law mandates a two-tier board structure for large German companies: an executive board (Vorstand) and a supervisory board (Aufsichtsrat). While the executive board in stock corporations (Aktiengesellschaften) is responsible for day-to-day operations, the duty of the supervisory board is to oversee and advise the executive board.\(^2\) Furthermore, a list of items for which supervisory board approval is necessary must exist. According to law the supervisory board is responsible for appointing and removing members of the executive board.

The supervisory board is also responsible for determining remuneration plans for the executive board members. However, the general practice in the past was to delegate this responsibility to one of the committees, frequently to a specialized remuneration committee, but also sometimes to a presidial committee.

The supervisory board of large companies is also subject to legal provisions for board level employee representation:

- In companies with more than 500 employees a weaker form of board level employee representation applies according to the Third Part Act of 2004 (previously regulated by the Works Constitution Act of 1952). One third of the seats on the supervisory boards of these companies are reserved for representatives elected by the employees of the company.

- In companies with more than 2000 employees a stronger form of board level employee representation applies according to the Co-Determination Act of 1976. This law reserves half of the seats on the board for employee representatives, the other half going to representatives of the shareholders. When there is a tie vote, however, the supervisory board chair, who is chosen by the shareholders, receives a double vote. In the case of a 12-person supervisory board, six representatives are chosen by the shareholders’ general meeting and six are democratically elected by...

\(^2\) In limited liability companies (Gesellschaften mit beschränkter Haftung, or GmbH), the function of the executive board is fulfilled by the managing director(s).
the company’s workforce. Of these six, four must be employees of the company (one of these has to be a representative of the managerial employees) and two are nominated by trade unions representing the company’s workforce.

— The strongest form of board level employee representation is regulated by the Montan Co-determination Act of 1951. This applies only to companies with more than 1000 employees in the steel and mining industries. In contrast with the quasi-parity codetermination under the 1976 Co-Determination Act, Montan co-determination defines true parity, since the representatives of the shareholders and employees must jointly choose a further ‘neutral’ member who can cast a tie-breaking vote.

Due to co-determination, employee representatives and trade unions have a special responsibility for appropriate executive remuneration. However, it can be assumed that the initiative for the continual increase of executive remuneration almost always comes from shareholder representatives and only very rarely from employee representatives. At least up until the financial crisis, the primary driver for this trend was the increasing importance of shareholder value and the stronger orientation of the real economy toward financial markets. The duty of confidentiality for supervisory board members prevents empirically-grounded generalizations about decision making in German company boards. However, as will be described in the next section, transparency in the level of executive remuneration has been improved recently.

4. Legal changes through the 2009 Act on the Appropriateness of Management Board Remuneration (VorstAG)

The reluctance of the German government to get involved in regulating executive remuneration was only overcome in 2009. This change was doubtlessly due to the serious financial and economic crisis. As a result of this crisis the financial market orientation of remuneration came under heavy criticism and was accused for example of being a ‘fire accelerant’.

3. For an overview see Hans-Böckler-Stiftung (2009).
In this context the conservative (CDU/CSU) and social democratic (SPD) parties, which were in a Grand Coalition in the German Parliament at that time, organized (first separately and then jointly) expert groups on appropriate executive remuneration. As a result of these expert groups a legislative proposal was drafted which was followed critically but constructively by the German Trade Union Confederation (DGB). In August 2009 the Act on the Appropriateness of Management Board Remuneration took effect.

This law introduced, among other things, the following legal changes:

— A more precise legal definition of ‘appropriateness’ of remuneration in § 87 Section 1 of the Stock Corporation Law (AktG): As of 2009 the supervisory board is responsible for seeing that the total remuneration of an executive board member stands in an appropriate relation to the responsibilities and performance of this member as well as to the financial position of the company. Prevailing standards for remuneration are to be exceeded only in special circumstances. New here is the consideration of the performance of the board member as well as ‘prevailing standards’, including wage and salary standards within the company. In the case of listed companies the remuneration structure is to be oriented towards sustainable company development. Variable remuneration should be based on long-term (multi-year) performance.

— A strengthening of the duty for the ex-post recovery of executive remuneration (so-called ‘claw-back’ provision) in § 87 Section 2 AktG, when the financial situation of the company has deteriorated to the point that the continuing provision of remuneration would be ‘expensive’ (Section 1) for the company.

— The introduction of cost-sharing through a deductible for Directors’ and Officers’ Insurance for executive board members (§ 93 Section 2 AktG).

— Responsibility of the entire supervisory board for executive remuneration and contractual arrangements. These responsibilities under § 87 Section 1 und 2 AktG can no longer be delegated to a board committee. Decision making powers over remuneration questions are reserved for the entire supervisory board. However, preparatory work by a committee is still allowed.
— Clarification and underlining of the already-existing liability of supervisory board members in the case of inappropriate remuneration for executive board members (§ 116 Aktiengesetz).

— The introduction of a non-binding vote of the shareholder assembly on the remuneration system (§ 120 AktG). The vote implies neither rights nor duties for the shareholder assembly. In particular the responsibilities of the supervisory board according to § 87 AktG are unaffected.

5. The position of the German trade unions

5.1 Trade union activity before the financial and economic crisis

The DGB and its member trade unions had already demanded state regulation of executive remuneration before the crisis. Trade unions criticized the excessive increases in management pay as unfair and unjust in terms of income distribution and effort, especially since workers experienced a reduction in incomes in real terms between 2000 and 2007. Furthermore, trade union discourse focused on the deficiencies of contemporary remuneration systems, particularly in encouraging the orientation of company policies towards short-term shareholder value (Hexel 2008; Thannisch 2009).

Against this backdrop, in June 2008 the DGB executive committee demanded a precise definition of appropriateness of executive remuneration in § 87 section 1 AktG and an anchoring in § 76 of the duty of the executive board to take into account not only the interests of shareholders but also of workers and the general public when running the company. A further demand was the strengthening of co-determination in the supervisory board through the requirement that decisions on executive remuneration be taken in the whole board rather than delegated to a board committee (DGB 2008).

5.2 Constructive accompaniment of the VorstAG

These demands were for the most part taken over in the VorstAG, which certainly was in part due to the critical-constructive accompaniment of the law by the DGB and its member trade unions. In a statement on 25
May 2009 the executive committee of the DGB strongly supported the draft law proposed by the Grand Coalition. Against the backdrop of the deepening crisis, which the trade unions saw as being initiated by questionable incentive and pay systems in the financial sector, the DGB welcomed the initiative of the government to orient company policies more strongly towards long-term and sustainable goals.

In particular the DGB welcomed in the draft law the more precise definition of ‘appropriate’ in executive remuneration and the inclusion of a long-term component in remuneration. However, the DGB demanded the mandatory consideration of the pay structure in the company as well as explicit reference to social and ecological goals and responsibilities. In addition the DGB supported the provision that any annual remuneration of an executive board member over 1 million Euros should only be 50% tax deductible as company expenses.

The DGB also welcomed in the draft law of the CDU/CSU and SPD governing coalition the strengthening of the supervisory board as a whole through the placement of responsibility for remuneration decisions with the supervisory board plenary (DGB 2009).

In summary, two of the key trade union demands – a more precise definition of appropriate remuneration and responsibility of the whole supervisory board – were taken over in the law. The trade unions were also able to get support of the SPD for a concretization in company law of the interests companies are supposed to serve. However, despite an increased lobbying effort, the trade unions were not able to get support of the conservative parties for this provision. This concretization was however made in the German Corporate Governance Code, as will be shown in the next section.

5.3 Anchoring the company’s interest in the German Corporate Governance Code

The German Corporate Governance Code includes eighty recommendations and suggestions for listed companies. Companies are not required to follow these. However, they must report on an annual basis which of these they have implemented (‘comply or explain’).
In the plenary session on 18 June 2009 the German Corporate Governance Code was modified to take into account the new law (VorstAG). Above and beyond this, as a result of a motion by the DGB, the following formulation was inserted into the preamble: ‘The Code clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise)’.4

This company interest is concretized in Section 4.1.1 of the Code: ‘The Management Board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value.’5 Previously this section read as follows: ‘The Code clarifies the rights of shareholders, who provide the company with the required equity capital and who carry the entrepreneurial risk.’6 With this formulation the German Corporate Governance Commission distanced itself from shareholder value and instead adopted stakeholder value as a goal. From the point of view of the German trade unions, this change in the code is a step forward with relevance for the future political, legal and scientific discussion on a sustainable economy.

5.4 No demand for a legally binding maximum limit

Within the German trade unions there were different positions on the question of whether a demand should be made for a legally binding maximum limit (or cap) on executive remuneration. Some persons were in favour of such a cap, or at least for a fixed ratio between lower or middle level workers’ incomes and a maximum level for manager remuneration.

In the end it was decided not to demand such a cap. Underlying this decision was the recognition that companies are very different with

regard to the level of executive remuneration, the specific conditions and profitability of their sectors, their co-determination and company cultures and (in particular) the level of wages and salaries. These differences make it very difficult if not impossible to define a maximum limit applying to all companies.

Furthermore it was argued that the definition of a cap could lead to pressure for remuneration levels to increase up towards this maximum level. For example, remuneration levels below this maximum could be interpreted as a lack of confidence in the members of the executive board.

An exception here is the cap of 500 000 Euros which the government imposed in 2009 for executive board members of financial institutions rescued with taxpayer money. This was strongly welcomed by the DGB. This rule was correctly extended in November 2010 to the management level directly below the executive board.

The lack of support for a universal cap does not however mean that the DGB and the trade unions do not believe that there should be limits on remuneration. To the contrary, the DGB and its trade unions recommend that maximum limits should be included in the remuneration contracts of every executive board member. The inclusion of such a provision in the legal justification of the VorstAG is a direct result of a trade union initiative (Hexel 2010).

5.5 Trade union recommendations for board level employee representatives

The DGB, the Hans Böckler Foundation and the DGB member trade unions have published a series of recommendations for board level employee representatives. The most important of these recommendations are discussed below.7

Appropriateness of remuneration
The first and most important recommendation is that board level employee representatives should ask if the principles of the remuneration system really correspond to the collectively agreed company goals. It is important to have clarity about the intended effects of incentive

7. See here in particular Seyboth and Thannisch (2010).
mechanisms. This includes gathering all necessary information on the mechanisms of performance-oriented remuneration and to allow enough space during the supervisory board meeting for a debate on the provisions of contracts with executive board members. There is a potential danger that every parameter included in the remuneration system will receive an inappropriately high degree of importance. Furthermore, parameters not included in the system but nevertheless of key importance for the company might be neglected. If executive remuneration is primarily oriented toward share price it should not be a surprise when sustainability goals are forgotten or even seen as burdensome.

Sustainability management and the responsibility of top management for it should be discussed in a special meeting of the supervisory board. The necessary operationalization of qualitative strategies and goal setting is possible. Companies have extensive experience in this area. Concretization of these goals however is more difficult than simply setting purely financial targets.

As described above, the VorstAG states that the (vertical) wage and salary structure within the company is to be considered in the definition of ‘prevailing remuneration’. The German Corporate Governance Code also states in Section 4.2.2 that the compensation structure in place in other areas of the company should be a frame of reference for this. The ratio between the level of executive remuneration to the level of wages and salaries as well as to the level of middle management income should therefore be considered by board level employee representatives.

**A simple and transparent remuneration system**

There is much to be said for a simple and transparent remuneration system, with as much reference as possible to collective bargaining or company norms, particularly in the case of retirement provision. This helps increase public and internal company acceptance of executive remuneration.

A further reason for keeping the remuneration system as simple and transparent as possible is to help prevent manipulation of the financial accounts. Such manipulation can be encouraged by complicated and difficult to understand remuneration systems.

One part of a transparent remuneration system is limiting so-called supplementary payments and payments in kind, which have become
much more important than in previous decades. In principle it is recommended that these be limited to measures that are related to job performance, such as agreements on the use of a company car.

**Strengthening the fixed component of remuneration**

When examining the structure of executive remuneration as a whole, it is apparent that the increase in remuneration overall in the DAX 30 companies in the last 20 years is for the most part attributable to the increase in the variable portion of pay. One reason for this is the use of principal-agent theory in designing remuneration systems. The core of this theory is the assumption that a manager (agent) will not be as careful with the money the shareholder (principal) gives him to administer as the shareholder himself would be. The solution that is proposed is to link the interests of the manager with the interests of the shareholder by paying the manager according to performance and to give him a share of the company’s capital.\(^8\)

This approach has been increasingly criticized recently because of the incentives that are created to manipulate the company accounts and to prioritize short-term goals over the long-term interests of the company. Furthermore, from the point of view of economic psychology, performance incentives can lead to a suppression of intrinsic work-related motivations since attention is diverted from job performance directly to the remuneration system (Frey and Osterloh 2005).

Each board level employee representative should therefore realize that the massive increase in executive remuneration is almost entirely attributable to the increase in variable pay. Furthermore, variable components of pay lead to a narrow focus on the parameters used to determine remuneration. From a trade union perspective it is therefore recommended that the fixed portion of remuneration should be increased and, correspondingly, the variable portion should be reduced to a limited amount. A multi-year remuneration plan is not always long-term in its impact. Fixed remuneration in contrast can strengthen an orientation to the long-term.

The fixed portion of remuneration should therefore account for at least 60% of the annual remuneration (in the case of multi-year variable pay this should be based on an annual average of the expected variable

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In light of current practice by listed companies this is certainly an ambitious goal. In order to prevent an upward spiral of remuneration, comparison within the sector regarding ‘prevailing remuneration’ should be oriented to average rather than the highest level of remuneration. At the same time care should be taken so that an increase in fixed salary does not lead to undesired increases in other components of remuneration. An example here is the pension contribution, which frequently is coupled to the level of fixed pay. In this case the norms for pension provision should be altered simultaneously with the increase in fixed pay.

**Limits on variable pay**

From a trade union point of view, for the reasons discussed above, it is recommended that the variable portion of pay be limited or reduced – without however drastically increasing fixed pay, as some are demanding. The variable portion should account for a maximum of 40% of total annual remuneration. There are good reasons for reducing this even further.

The VorstAG allows a great degree of latitude in the mix of short-term and longer-term incentives. If the result is supposed to be a longer-term orientation of management, it is recommended that short-term components in variable pay be completely avoided and instead longer-term incentives over at least four years be agreed.

Here care should be taken that variable components of remuneration should also be influenced by negative financial developments in the whole period of observation, as the German Corporate Governance Code also recommends (Section 4.2.2.).

**Inclusion of social and ecological goals**

In the design of remuneration systems it is important to consider not only the interests of the shareholders but also the responsibility of the company toward the community and social interests as a whole. Therefore, from the trade union point of view, ecological and social responsibility should also be considered. The inclusion of these goals in the variable portion of pay is an important step toward fulfilling the legal obligation to orient remuneration systems toward sustainable company development.

Altogether it is desirable that at least 25-50% of variable pay be linked to the fulfilment of social and ecological goals. Specific criteria that could
be used here include the achievement of social and environmental targets agreed upon in the supervisory board, e.g. the long-term preservation of specific production locations or the reduction of pollution by a certain amount. Another possibility is to make a portion of variable pay conditional upon performance according to one or more social and/or ecological indicators. The DGB specifically recommends including employee satisfaction as measured by the *Gute Arbeit* (i.e. Good Work) Index.\(^9\)

A positive development is the implementation of some of these recommendations in practice already. For example, the supervisory boards of VW, RWE and Deutsche Telekom have coupled a significant proportion of executive remuneration to employee satisfaction.

**Contractual maximum limit (cap)**

Experience shows that, in times of positive economic developments, the complexity of remuneration systems can lead to variable pay reaching unforeseen levels.

The VorstAG states that the supervisory board should provide for unusual developments by agreeing a maximum limit or cap for the variable proportion of pay. This formulation has an almost-binding character and it is therefore strongly recommended that all board level employee representatives take this into account.

**Responsibility of the entire supervisory board**

As described above, the VorstAG includes the new rule that the supervisory board can no longer delegate decisions on executive remuneration to a committee. Board level employee representatives should therefore make sure that all aspects regarding the level and structure of remuneration be decided in plenary sessions of the supervisory board. Here it is not acceptable to decide only on framework conditions and to delegate the rest to a board committee. Furthermore, it must be ensured that the whole supervisory board always has access to the complete contractual arrangements with executive board members, and that parameters for variable pay be considered by the whole supervisory board on a periodic basis to determine if adjustment is needed.

\(^9\) For more information on this see: [http://www.dgb-index-gute-arbeit.de/](http://www.dgb-index-gute-arbeit.de/).
6. Co-determination as a core element of sustainable company management

From the trade union point of view, co-determination plays a key role in the debate on sustainable company development and management pay.

Two recent studies (Vitols 2008; Vitols 2010) have shown that board level employee representation is significantly related to lower levels of remuneration. In the first study, the inclusion of trade union representatives in the supervisory boards of listed German companies led to lower total remuneration and use of stock-market linked remuneration. In the second study, the presence of board level employee representatives in the 600 largest European listed companies was associated with lower total pay and less use of stock options.

Furthermore, through board level employee representation, it is possible to bring aspects of discussions in civil society into supervisory board activities, including the determination of executive remuneration. The new regulations in the VorstAG, such as the duty to consider the pay of employees in the company, require the kind of critical consciousness of the type that employee representatives are likely to have.

From supervisory board practice we know that the implementation of new legal requirements is a top priority in co-determined supervisory boards. Many companies are trying to strengthen the fixed component of executive pay and limit variable pay. Furthermore, several companies have begun to reorient variable executive remuneration toward indicators such as customer and employee satisfaction. Nevertheless there is much to do to enhance sustainability in the structure of management remuneration.

For sustainable company policies in the future we therefore need the preservation and further development of co-determination in Germany. Without board level employee representation, decision making would quickly become the province of a ‘closed shop’ of a few people from the shareholders’ camp.

During its 19th regular federal congress in May 2010 the DGB presented wide-reaching proposals for the further development of co-determination. One demand is the reform of the 1976 Co-Determination Act according to the model of the Montan Co-Determination Law. A neutral person supported by both employee and shareholder representatives should be
added, thereby replacing the double voting right for the shareholder nominated chairperson. The executive board member responsible for personnel affairs (Arbeitsdirektor) should not be appointed without approval of the majority of the board level employee representatives. Furthermore, the DGB demands the extension of co-determination rights to more key strategic fields. A catalogue of actions which must be approved by the supervisory board (zustimmungspflichtige Geschäfte) should be defined in law. These should include plant closures, production relocations and sales of parts of the company. A qualified majority should be able to make additions to this catalogue of mandatory items for approval (Schmidt and Spindler 2008).

Furthermore, the DGB demands the introduction of minimum standards for board level employee representation in companies with a European legal form. Standards for participation that were achieved through the European Company (SE) are increasingly being undermined, for example through cross-border mergers and in the proposal for a European private company. More specific details could be worked out in a special commission for this purpose (DGB 2010).

7. Conclusions

One of the key elements in implementing the Sustainable Company is to restructure incentives in management remuneration away from the short-term and share price toward the long-term and the interests of employees and other key stakeholders. Recent experience in Germany shows how progress can be made in this regard. An important step forward was taken with the passage of a new law in 2009 regulating executive remuneration. This law created an obligation and framework for the inclusion of sustainability goals in remuneration, and also gave employees an important role in this process through defining the responsibility of the whole (co-determined) board for remuneration decisions.

The German trade unions play a key role in this development. First, they had an active role in lobbying for regulation of executive remuneration. Through their involvement in the legislative process a number of key trade union demands were taken up in the legislation. Second, the German trade unions have developed a set of recommendations for board level employee representatives and have actively encouraged these representatives to implement these recommendations. As a result a
number of companies (e.g. VW, RWE and Deutsche Telekom) have adopted innovative remuneration systems which take into account important sustainability parameters, such as employee and customer satisfaction.

This law could no doubt be strengthened, and other aspects of regulatory change have remained far behind trade union demands. Nevertheless Germany has taken important steps forward and deserves further observation as more companies introduce sustainability elements into their remuneration systems. In this sense Germany provides an important case study from which we can learn important lessons about how to move ahead with the Sustainable Company.

References


Chapter 8
Chances and obstacles for international trade union strategies in the CSR field

Ulrich Mückenberger

1. Introduction

A company cannot sustainable if it does not comply with certain basic social, ecological and human rights standards. This was always true within national boundaries. And it is all the more true where firms operate on a denationalized global level. Gary Gereffi (2005) analyses the newly expanding phenomenon of ‘global value chains’ (GVCs). He comes to the conclusion that such chains need chain management (executed by the lead firm of the chain) in order to produce quality products. Chain management by the lead firm often involves social and environmental standards and economic upgrading in developing or threshold countries. Social standards in most cases include the four ILO core labour standards and more elevated health care and training standards plus procedures to implement these standards throughout the value chain all over the globe.

There are several reasons for why firms care for these minimum standards and for why the support of other societal actors is needed in order to implement them. As I argue in this chapter, this provides opportunities for international trade unions to realize some of their basic objectives on the global level. Many multinational companies (MNCs) see their quality needs in line and compatible with good labour standards. However, they cannot only depend on the ‘good will’ of the headquarters due to difficulties in monitoring subsidiaries, the lack of enforcement mechanisms/courts in many countries and so forth. The MNCs therefore need transnational mechanisms and allies. This holds particularly for the enforcement of social standards beyond the boundaries of the firm, e. g. where self-employed, supplier chains, etc. are involved. Moreover, MNCs need to be protected from competition from what I shall describe later on as ‘bad’ and ‘ugly’ companies.

This is why there are on the one hand problems with purely unilateral voluntary approaches (like global codes of conduct), which frequently
lack effectiveness in a serious sense. On the other hand it is unrealistic to expect the rapid buildup of the type of nation-state enforcement that exists in ‘Western’ countries in the rest of the world. This forces us to think about alternatives such as CSR to make the Sustainable Company possible. My proposition in this chapter is that a new type of transnational labour law which builds on networks and hybrids might at least partly bridge this gap.

2. Five generations of CSR

Corporate Social Responsibility (CSR) is commonly characterised by three properties. First, the enterprise behaves in a way which takes into account its responsibility vis-à-vis ecological, social or, in a wider sense, societal progress. Second, this behaviour respects, but goes beyond what is properly regarded as the legal obligations of the firm. Third, this going beyond legal obligations in favour of society is based on a voluntary decision of the enterprise rather than on a statutory duty. What we are interested in here is CSR as a source of transnational social standards and how trade unions can impact them in a way which is in line with international trade union objectives.

However, before entering into this field, we shall examine some lessons learned from conventional CSR studies in order to identify the type of CSR which might be of interest to globally active trade unions. With a view to transnational social standards brought about by enterprise self-regulation, Nadvi and Wältring (2004) provide a useful overview. They identify five generations of CSR which form succeeding historical layers, though these are not schematically separated from each other.

The first layer is company codes of conduct (COCs). Individual firms define standards (quality, transparency, accountability, social or ecological) which they intend to apply and implement firm-wide. The means for making them enforceable are firm-defined COCs, which receive legal validity vis-à-vis employees via their incorporation in individual

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1. For a recent account of these CSR properties see Mückenberger and Jastram (2010).
2. In the following, I go a bit beyond Nadvi and Wältring when using their typology by adding some observations on the legal character of these standards. This seems to be crucial for trade union expectations and impacts concerning CSR.
employment contracts. Insofar as these codes of conduct are directed to extra-firm actors (e.g. supplier firms, self-employed homeworkers, etc.) they are incorporated into contracts for services or supplier contracts, thus achieving legally-binding character according to the law of contracts and the law of torts. The standards are thus linked to the legal enforcement structure via courts – an enforcement structure, however, of the nation-state, normally the one in which the lead firm is based. We shall find that this leads to problems in the case of transnational social standards.

The second layer is sector codes and labels. Standards are no longer defined by the individual firm, but rather by a plurality of firms of the same branch and/or by sectoral associations of firms or employers. Compared to the first layer, this second layer has purely political or cultural particularities rather than legal ones. A broader economic interest is involved, not only the one of the individual firm and its chase for competitive advantage – a bit more ‘collective capital’ rather than ‘individual capital’. This involves a propensity for more medium- and long term considerations as opposed to pure short-termism (à la shareholder value) vis-à-vis social standards. With regard to legal enforceability sector codes operate exactly like the firm codes – internally (employees) as well as externally (suppliers, etc.). Another particularity lies in ‘labels’ which involve a mechanism totally foreign to COCs. Labels are visible on products and express the certification by the label provider that the product was produced according to their standards (e.g. social or environmental). Labels never achieve nor intend to have legal validity. They aim at consumer preferences on the commodity market, specifically that those consumers wanting to behave ‘socially ethically’ will give preference to those commodities which are labelled to have been ethically produced, even if they are more expensive. Although empirical experience with ‘ethical consumption’ as a means of enforcement of social standards is not too encouraging we will come back to it. Consumer behaviour becomes more and more important in the field of transnational standards operating in a legal ‘no-man’s-land’ beyond the borders of the nation-state. But it should be remembered that labels have no legal enforcement of standards in mind – they aim at implementing these standards via ethically or politically conscious purchasing preferences of consumers.
Layer number three is business-defined international standards. Here for the first time the transnational\(^3\) enters the playing field. The type and the legal validity of the COCs is similar to the first layer. The intended standards are defined by the firm on its own and they enter into the legal sphere via incorporation into employment and/or supplier contracts. Layer three, however, is an increasingly important case for transnational social standards. This is the field which has been discussed as ‘global value chains’ (GVCs) (Gereffi 2005). GVCs are characterized by the increasing transnational ‘disintegration of production and integration of trade’ (Gereffi 2005). They are either buyer-driven or producer-driven. They span a variety of countries and continents and assemble components and value-added all over the world. With COCs the lead firms tries to set and implement standards like in the case of layer one, but in a much more complex and sophisticated manner. The standards have to meet the requirements of a multicultural work situation and environment – and their enforcement has to as well. Within the first members of the GVC the chain is much less transparent than within a purely national context – given that e. g. apparel suppliers and sub-suppliers are self-employed or homeworking families in Bangladesh or Sri Lanka or elsewhere.\(^4\) Whether or not e.g. child work or discriminatory work practices were involved in the earlier in-firm and outside-firm stages of the GVC is by no means evident and transparent. Lead firms of GVCs (e.g. Karstadt has around 200 suppliers, sub-suppliers, etc. all over the world) often have a serious interest in compliance with their COCs. They want to sell high-quality products in the western hemisphere. In order to do so they need to ensure product quality, skills and diligence along the entire GVC. For achieving this they are prepared to a certain degree to comply with higher social standards. But, despite this interest, lead firms are often not capable of monitoring and enforcing the standards of their COCs. Apart from that the legal environment is becoming more and more complex. Frequently, foreign jurisdictions and

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\(^3\) Here and in the following, I use the term ‘transnational’ in the sense I defined it in an earlier paper (Mückenberger 2010). ‘Transnational’ refers to cross-border relationships which involve not (only) states and governments but also (or only) non-state actors (like firms and/or civil society/NGOs). In contrast, ‘international’ refers to state/government (only) relations according to international law; ‘supranational’ refers to the relationships of Member States and/or their non-state actors to an encompassing unit (like the European Union) to which parts of the sovereignty of the Member States have been conferred and the decisions of which therefore have priority (‘supra’) over the sovereignty of Member States and the autonomy of their citizens. A discussion of this terminology is neither possible nor necessary here.

\(^4\) The case is becoming even less transparent when the GVC is ‘interrupted’ or ‘commissioned’ by a firm like Li & Fung (Hongkong) which acts as a comprehensive interface between the West (as a plurality of demanders) and Asia (as a plurality of suppliers).
conflicts of law are at stake, which makes recourse to the courts difficult or hopeless.

In the fourth layer we find business and non-governmental organisation (NGO)-defined sector-specific transnational codes and labels. In fact in this layer we approach what in former times was called labour, however, in a different shape and on the global level. The first three layers were all voluntary in the sense that business alone (firms or groups/associations of firms) decide upon whether or not a standard is binding and should be complied with. Whereas the legal properties regarding COCs and labels are the same as in the previous layer, the big difference in layer four lies in third-party involvement. NGO participation in the articulation of social standards frequently proves to be more effective than when these are defined by business alone or even by business and trade unions. It is true that NGOs represent a great variety of actors and actor constellations – ranging from mafia-like and business-oriented to those favouring universal public goods. Nevertheless: NGOs can have and frequently possess an independent opinion and voice. In contrast with business and trade unions, which may take a limited sector-oriented industry policy-stance, NGOs can have a wider societal perspective and, with that, can take a more long-term and sustainable approach. They will often be in favour of the application of transnational social standards because they know that short-termism and pure exploitation of workers is unsustainable for society – even for business itself. NGO involvement in transnational social standards can be observed in two ways, both of which are important for the trade union perspective. NGOs can partake in the formulation of social standards in COCs. But they can equally be involved in the supervision and monitoring – hence the enforcement – of already fixed standards. The latter function has been studied under the heading of ‘advocacy networks’ (Keck and Sikkink 1998), the former under the heading of ‘transnational norm-building networks’ (Mückenberger 2010).

In a summary of the existing empirical literature dealing with the effectiveness of COCs Bob Hepple (2005) finds indicators for a correlation of compliance and third party-involvement: the more third parties were involved in the formulation and supervision of transnational standards in COCs, the higher the probability that these standards will be effectively implemented. Third party involvement can have legal implications. For example, NGOs can help appeal to factory inspectors or courts when binding standards are not complied with by certain employers. But third party involvement can also function outside of the
legal sphere and in the case of contraventions against legally non-binding standards. In this case their weapon often is ‘naming and shaming’, i.e. they make public and transparent certain hidden contraventions by multinational firms against recognized (though not always legally binding) social standards. In such a manner they put pressure on the enterprise to comply with the standards in order not to lose their public prestige (like in the case of Nike, a member of the UN Global Compact, which was publicly accused of tolerating child labour in its value chain suppliers in Asia). We shall re-encounter the compliance-factor ‘prestige’ later in this article.

The last layer in Nadvi and Wältring (2004) is tripartite-defined generic social standards. In the CSR case, with transnational COCs and labels, tripartism can mean involvement of employees/unions and third parties. In practice the third party can be NGOs, but also scientific experts, consultants or certification representatives, or even state/government actors. As to the legal validity of standards we can only repeat that there is no proper transnational way of enforcement. Standards have to be incorporated in a way which make them applicable and enforceable before national courts. Otherwise they remain without legal support. The same is the case with labels which do have the objective of being legally binding, since they are supposed to function via markets and ethical preferences of clients.

This quick overview over the historical development of CSR-based transnational social standards gives an insight which is of utmost importance for trade union strategies vis-à-vis transnational social standards contained in CSR-based COCs and labels. The more we enter the transnational sphere the ‘thinner the air’ becomes with a view to legal bindingness of these standards and the capacity to make recourse to the courts and other enforcement actors. That means that trade unions will look at enforcement strategies that differ clearly from the strategies which were adequate to the nation-state environment in Europe. But it also means that, out of the five CSR layers identified by Nadvi and Wältring (2004), only the last two (which involve more than business itself in norm-building and norm-enforcement) can be called ‘standards’ in the sense of what we are looking for with a view to international trade unions.

Before turning to that again it is worthwhile to look at another historical typology of CSR which comes to a similar conclusion. Hepple (2005) identifies four phases when synthesizing post-World War II CSR und
COC development. In the years between 1944 and 1960 ILO conventions and recommendations emerged. Then, from the 1960s till the 1980s, the initiative shifted to the MNCs. The late 1980s showed an increase in private COCs, which Hepple argues were a preventative action by MNCs against public statutory intervention. Finally, from the late 1990s onward, a new start of public supervision in enterprise COCs can be observed (e.g. ILO, UN Global Compact, OECD, ISO and trade union efforts regarding International Framework Agreements or IFAs). According to Hepple the overall tendency is ‘from public to private, from external to internal’. What is of interest here is the emergence of a new mode of public supervision of global enterprise behaviour. This builds the public counterpart to the emerging civil society activities in the transnational norm-building field. These are the two components of what I shall describe later as ‘global hybrid labour law’.

Both historical typologies confirm our interim result concerning transnational social standards. To expect or wait for top-down public regulation and its enforcement via legal rules and institutions seems rather implausible. Parallel to observing state activities vis-à-vis the sustainable company on a global level, we should at least draw attention to mechanisms of norm-building and norm-compliance operating transnationally in the private sphere which make use of the internal structures, interests and motivations within the MNC and their global commercial networks. Are there any incentives for them to comply with transnational social standards? How can we enhance these incentives? And: how can these norm-building processes be linked with state and inter-state activities?

3. The problem: the ugly

This question is all the more urgent as the empirical findings as to the firms’ private preparedness and intrinsic motivation to comply with transnational standards (whether or not legally binding) are not so encouraging. Without giving an overview of the empirical literature here, one author is chosen in order to identify the problem to be solved.

Subhabrata Bobby Banerjee (2007) subtly named his critical empirical study on CSR Corporate Social Responsibility – the good, the bad, and the ugly. The ‘good’ are those firms and management representatives who take the imperatives of CSR seriously and who follow the rules of societal
accountability. This implies compliance with transnational social standards. The ‘bad’ are those who reject the CSR concept and the imperatives stemming from it (under Freedman’s motto: ‘the firm’s responsibility is to make profit’) and pursue a course of unfettered profit accumulation. It would seem that they would respect transnational social standards only when profit maximisation requires so or when forced to comply by external power or by law. The ‘ugly’ are those firms and representatives that hide their motives of profit accumulation behind a façade of accountability. In order to do so, they conduct a relentless public relations campaign converting the bad into good. Concerning social standards the behaviour of the ‘ugly’ implies an opportunistic approach. Open and transparent contraventions would damage the firm’s public relations and are hence avoided or reduced. Hidden and invisible contraventions, however, do not come to the attention of the public and are hence tolerated and continued. It is a fake approach – guided not by respect or conviction but rather by disguise and opportunism.

Banerjee finds many of his study objects falling under the last category. I do not want to give a critical account of his empirical sample and the generalisability of his results. Here instead I want to discuss his typology with regard to the perspective developed in this chapter.

At first glance, we have no problem with the ‘good’. They are intrinsically motivated and will comply with the standards whether legally binding or not. However, even here the situation is more complex. The firm – even in a national context – is not a homogeneous entity. It is rather a nexus and network of interests, perspectives and treaties. Top management may be persuaded by CSR principles, but middle management and supervisors may be more interested in output and performance. CSR can thus be converted further down in the hierarchy into contrary principles of behaviour. This is all the more the case when we enter the transnational playing field. Within a global value chain, the commitment of top management in the lead firm to CSR may conflict with the interests and culture in the supplier area. Extra-firm self-employed sub-suppliers may bring contrary attitudes into the game. In short, compliance with transnational social standards is not guaranteed, even in the case of the ‘good’. Tensions and contradictions will arise between the CSR-based

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5. According to Friedman, ‘the only responsibility of business leaders is to generate and maximize profits within the prevailing legal framework’ (Friedman 1982: 133).
COCs and social standards and practice in remote territories where the work is done. Sometimes the only remaining lever to ensure compliance along the entire GVC is to make the remote contraventions publicly known to force the lead firm to take measures to make their COC effective everywhere (e.g. this was the pattern in the Nike case mentioned above).

In the case of the ‘bad’, enforcement and effectiveness of transnational standards is a question of self-interest and/or power. Compliance with these social standards is probable if compliance is of vital interest for the firm (e.g. as discussed above to ensure product quality, skills and diligence along the entire GVC). If this self-interest is missing the firm can only be forced to comply by the state (via mandatory rules and their enforcement), by trade unions (e.g. via IFAs) or by NGOs (via consumer boycotts, etc.). Ensuring compliance in this case is not easy, but at least the incentives are clear.

This is not so in the thought-provoking case of the ‘ugly’. At first glance, they differ totally from the ‘good’ because of their opportunistic attitude vis-à-vis CSR-based social standards. However, a closer look reveals that they have more in common with each other. The superficiality of CSR – in the former case with intrinsic motivation, in the latter pure façade – is the common element between the two. The difference between intrinsic motivation and façade is less far-reaching than assumed at first glance. In order to make that clear I pointed to the differentiation and diversity inherent in the interests and motivations of ‘the’ multinational firm when I discussed the ‘good’. Even if transnational social standards stem from the serious conviction of the lead firm’s responsible senior management, practical enforcement sometimes requires a publicly endorsed appeal to the lead firm. The same is the case – and this is why I try to relativise the difference between the ‘good’ and the ‘ugly’ – where the lead firm tries to profit from CSR and COCs by using them as a pure façade. In case they are publicly discovered in contravening their own publicly-upheld rules they will have to save their face and reputation – façade or not – regarding compliance with their COC and the standards therein.

From a policy point of view, I therefore do not see such a large difference between the two types of use of CSR as appeared at first glance. In both cases the enforcement of social standards cannot be taken for granted. In both cases a public alarm and naming-and-shaming system may be necessary to increase the self-interest of lead firms to properly monitor and enforce the social standards contained in their COCs. In both cases
employees and trade unions in the areas and plants at stake need cross-border networking with their fellow workers, alliances with civil society partners and media inside and outside the area where they wish to implement the social rights of workers. Moreover, these networks and alliances for social rights may be an equally important ingredient in the power play with Banerjee’s third type – the ‘hard’ enemies of CSR, the so-called ‘bad’.

4. International trade unions and CSR

From a trade union point of view, only those COCs and standards which fall in layers four and five of the Nadví/Wältring typology (2004) can be acceptable. Only these have a chance to effectively limit managerial prerogative and to extend coverage to all members of GVCs (including suppliers, etc.). Therefore the question arises of how trade unions can make these work best. In this context I come back to my concept of hybrid global labour law and to the role of allies (NGOs, churches, journalists, etc.).

Against the historical and policy-field background just described let us then turn to the question of which means of action transnationally operating trade unions have available in order to make CSR and social standards effective. Chapters 9 and 10 in this book provide empirical data on existing COCs and IFAs. Here I shall argue more normatively by discussing which strategic points of view should be taken into account by trade unions in order to make CSR and transnational social standards effective and by pointing to selected examples where such strategies have been applied.

The emphasis here will lie on (1) trade union activity in the building of transnational CSR-related social standards (norm-building). Then observations will follow concerning (2) the impact on the implementation of such social standards already fixed. Factors will be identified which favour effectiveness of such transnational social standards (3) and factors which do not support effectiveness (4). A matrix tries to synthesise the factors discussed (5).
4.1 Norm-building

It is well-known that the legal nature of the ILO core labour standards, which were declared to be binding for all ILO members in 1998, is disputed. Whether a member state is bound by ILO Conventions which it did not ratify according to international law is more than doubtful. This is why a new type of norm-building has emerged in connection with the 1998 ILO Declaration. Actors involved in other modes of transnational norm-building often refer to the four core labour standards and incorporate them into other sources of legally binding rules. I call this new type of norm-building a step toward ‘hybrid global labour law’. Public norm-building actors (like states or international organisations) enter into a certain context with private norm-building actors (like firms or civil society-organisations) which, as an outcome, transfers ‘legal vigour’ to the norms created. It is true that the ‘legal vigour’ of ILO Conventions and of firms’ COCs differs. Norms created in this way may be interpreted differently by various jurisdictions, thus having different outcomes. They can be trapped in what Fischer-Lescano and Teubner (2006) call ‘regime collisions’. But at least they end up with a legally binding nature which did not exist (or remained disputed) before. This is what makes hybrid global labour law interesting for international trade unions.

It is therefore useful for international trade unions (as is already done in this field) to get involved in this process of building hybrid labour law in two different ways. The first is to systematically identify where processes of incorporation of the core labour standards into other sources of law occur (or could occur) and to sort out mutual relationships and possible synergies. The second is to get involved in this process of norm-building through network-building, public pressure and mobilisation power.

We know that the core conventions form part of the cornerstones of the UN Global Compact and of ISO 26000. They are frequently referred to in the COCs of lead firms in global value chains. They appear in agreements between management and European works councils, world works councils and/or global trade unions (FIAs). But they rarely appear in International Investment Agreements (bilateral or multilateral ones). Furthermore, multilateral investment agreements (MAIs) have lost momentum, and also differ enormously. Some are binding, some are not. Some contain ecological and human rights ones in addition to core social standards, while others do not.
A systematic examination of these hybrid constellations, their chances and short-comings, their re-enforcement or contradictions and their effectiveness would not only create a new strategic point of reference for international trade union activity. It would also mark areas of possible intervention through networking and solidaristic action in order to expand coverage and enhance effectiveness of the norms so established.

4.2 Norm implementation

Rapid global norm-building processes are conducted by non-state (mainly economic, sometimes social) actors. Here the norms are not transformed into state law and also do not require such a transformation. These processes can therefore occur quickly and flexibly, but are not subject to any public monitoring or deliberation. In addition, their actual effectiveness is largely unclear. COCs, CSR-based supply chain-related norm-building and standardisation and global civil constitutions (Fischer-Lescano and Teubner 2006) are forms of ‘private ordering’ and deal with contractual justice, human rights, minimum work conditions, copyright, rights to Internet usage and non-competition clauses. Transnational global networks are their origin. The lowering of transaction costs, the avoidance of opportunism (free-rider behaviour) and (sometimes) an improvement in social justice are their goals. These instances of norm-building sometimes only follow what has already become a common standard in the economy.

The impact of international trade unions on norm implementation is all the more important since CSR rules are by definition voluntary. Other rules are mandatory only to a certain extent or in certain territories. This implies that compliance with these rules cannot be taken as given. Even in the case of legally binding norms compliance often has to be enforced via media, pressure, lobbying, courts, etc. The more we enter into the grey zone of not fully binding or hybrid norms, the more we enter into the transnational space beyond the nation-state and the more precarious the picture of compliance and effectiveness of norms so created becomes. The struggle for effectiveness of norms for transnationally acting unions is a bigger challenge than the struggle for norms themselves.

Oran Young (1999) clarifies the notion of effectiveness in the application of environmental norms, for which compliance is as precarious as for social norms. He identifies three different layers of effectiveness. The
'output' of norms can be observed and measured to the extent to which the targets of norms (e.g. lead firms in GVCs) give orders (to employees, partner firms, sub-contractors, etc.) to comply with the norms. As opposed to output, ‘outcome’ refers to the extent to which such orders to comply with the norms are actually followed and respected. ‘Impact’ of norms goes a step farther by referring to the extent to which the objectives pursued by the norms have actually been met through their application. Obviously, impact is what we have in mind when we consider effectiveness of norms. But output and outcome can give us indicators for the degree of effectiveness. At least in the negative sense we can postulate that, where there is no output and/or outcome, the impact will be zero – or, alternatively, due to causes other than the norms in question.

I believe that, first of all, international trade unions have an informational and networking function here. They should systematically collect data on output, outcome and impact and to pass them on to employees, other unions, other firms, the media, scientific collaborators, representatives of NGOs and states and international organisations. Expertise on the practical state of the art of compliance with norms is fundamental to the struggle for their enforcement and effectiveness.

4.3 Factors in favour of effectiveness of transnational standards

We do not have much reliable empirical data on the factors which positively impact compliance with transnational norms (from a legal point of view see Aviram 2003; Hepple 2005). This holds for both legally binding and legally non-binding norms. This is why we are bound to use hypothetical assumptions which have a certain empirical plausibility but require solid empirical verification in future research. I point out some of the assumptions made by Amitai Aviram (2003) because they contain important policy implications for international trade unions.

Aviram deals with the questions of why and under what circumstances legally non-binding norms tend to be complied with despite their voluntary character. The manner in which these norms are implemented often does not require formalisation or official sanctioning. The transnational networks are guarantors of their implementation and enforcement without any third party intervention. Private ordering gains validity through three mechanisms (it should be stated here that this is
hypothetical, not empirically deeply tested). The first mechanism is the repeated game. Actors who have a (mainly economic) desire for repeated transactions with other actors will adhere to the norms of the other actors without the formal threat of sanctions. In order to continue the contractual relationship they comply with legally non-binding norms. The second, and most well-known, mechanism is reputation. Actors, above all global players who desire to maintain a certain reputation, tend to comply with the norms they are expected to adhere to by the media, epistemic communities and the general public. In order to maintain their prestige they comply with legally non-binding norms. The third mechanism is network advantages. Actors belonging to networks which provide information, benefits, cooperation, etc. tend to comply with the network norms, whether legally binding or not. For them, the advantages that come with belonging to the network outweigh the advantages of opportunistic norm-deviation. Eventually they comply voluntarily (without legal constraint) with the norms.

The reach and the effectiveness of such mechanisms deserve to be matters of research interest. But they are equally important for international trade unions’ struggle for compliance with transnational social standards. These mechanisms demonstrate (hypothetically) that there are levers against opportunistic behaviour by firms which unions can profit from in order to achieve norm compliance. The power of these levers depends on two fundamental conditions: information and networking (both inside and outside unions). There have to be centres of knowledge about opportunistic behaviour of actors in order to make other actors aware of missing compliance. In order to create practical weapons from this information trade unions have to draw up networks of information and cooperation which concern transparency of misbehaviour in repeated game and network-structures and where firm prestige is at stake. This networking is useful for the workforce in the GVCs and their unions. But it may be even more effective when networking takes place with actors outside the trade unions, such as journalists, scientists, NGOs, public officials, churches, etc. This external networking increases public pressure and thus increases the probability of compliance with social norms. It is true that many trade unions are already active in this area.

6. Commercial lawyers observe that nowadays contract linkages tend to shift from one-off isolated contracts to continuously repeated ‘chains’ of contracts between the same parties, which they call ‘relational contracts’. These relational contracts seem to gain ground in global value chains which are characterised by global ‘disintegration of production’ and ‘integration of trade’ (Gereffi 2005).
But efforts to systematise information and networking can be increased. This requires an understanding which goes beyond traditional trade unionism.

4.4 Obstacles to effectiveness

Such a strategic orientation by international unions is made more plausible when we look at the obstacles which norm compliance faces. In a recent literature review concentrated on compliance with rules contained in COCs in the apparel industry Naoko Ogawa (2009) identified five factors hindering actual compliance. The first could be called ‘double bind’. Multinational corporations (MNCs) define rules for their suppliers or sub-contractors concerning social or ecological standards in their COCs. At the same time, however, they put such strong pressure concerning price or time of delivery on their suppliers that the latter are unable to comply with the COC rules. We know the double bind of the synchronous command ‘don’t do that’ and ‘do that’ from research on schizophrenia. The second factor is the mirror image of the first: ‘missing help’. According to what we know from the literature suppliers and sub-contractors of lead firms are in most cases not capable of mastering the implementation of rules set up in MNCs’ COCs. They need education and technical support. Instead of providing this help the MNCs demand too much performance from the suppliers (as in the first factor). A third factor is external: ‘ineffective ethical consumer behaviour’. Consumers in the western hemisphere often criticise unethical production and propagate ‘ethical consumption’, i.e. boycotting unethically produced commodities. But in practice consumers often prefer low-price products to products produced according to fair standards. In effect the market pressure on suppliers of unfairly produced goods (which could be a possible result of ethical consumerism) is zero. A fourth negative factor against compliance is the weakness of the institutional monitoring and sanctioning mechanisms of international organisations: ‘mismatch between norms and enforcement levers’. The ILO possesses, beyond ‘naming and shaming’, no means of effectively inducing norm-compliance. The WTO possesses such means – trade norms have the same power as ‘repeated game’-rules! – but it resists making use of these means for social or economic purposes. Social standards and effective enforcement levers are systematically mismatched (decoupled). The fifth factor lies in the countries of the third world themselves: ‘missing enforcement infrastructure’. Many non-
OECD countries have a precarious government or state as a whole. They may, in their post-colonial phase, have established progressive, pro-labour norms and statutes. But they do not possess the infrastructure to enforce them. Or, even worse, they are under pressure from globalisation and exempt export-oriented production zones from these norms (see also Teklè 2010). In both cases a widening gap between norms and implementation can be observed.

4.5 Synthesis of the factors considered

These factors equally have to be considered carefully in order to find out international trade union responses to them.

Table 1 Factors of effectiveness and their potential for trade unions

<table>
<thead>
<tr>
<th>Factor</th>
<th>Unfavourable contributors</th>
<th>Favourable contributors</th>
<th>Trade union mobilisation potential</th>
<th>Experience to date</th>
<th>Potential (from 1 = high to 5 = low)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Double bind</td>
<td>Power of lead firm</td>
<td>Prestige</td>
<td>Works council in lead firm</td>
<td>Little</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Employee competition</td>
<td>Reputation game</td>
<td>Public relations</td>
<td>Little</td>
<td></td>
</tr>
<tr>
<td></td>
<td>No outcome</td>
<td></td>
<td>International trade union solidarity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Missing help</td>
<td>Power of lead firm</td>
<td>Reputation game</td>
<td>ILO</td>
<td>Cambodia textile</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>No impact</td>
<td></td>
<td>International trade union solidarity</td>
<td>Cotonou</td>
<td></td>
</tr>
<tr>
<td>Ineffective ethical</td>
<td>No outcome</td>
<td>Power of lead-firm</td>
<td>Public relations</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>consumerism</td>
<td></td>
<td>Prestige</td>
<td>More networking with NGO’s</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weak international</td>
<td>Power of lead firm</td>
<td>Prestige</td>
<td>ILO</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>organisation</td>
<td>Power of nation states</td>
<td></td>
<td>International trade union solidarity</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>No output</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
This table tries to visualise chances for and obstacles to MNC’s compliance with transnational social standards with respect to (possible) trade union impact. As the last column shows, chances are assessed as very low (5) for two factors, low (4) for one factor and moderate (3) for two factors. In the case of the factor ‘double bind’ trade union activity can profit from the fact that there might be interest divergences within the enterprise (e.g. top management may be more interested in norm-compliance than middle and lower management or suppliers due to quality- and prestige-orientation) and also that there are possible coalitions with media and wider public. In the case of factor ‘weak infrastructure’ trade union interest in social standards can coincide with an interest of the lead firm in quality along the global value chain. Here, the Cotonou Treaty and the Cambodia garment experiment are quoted in the table as positive if limited and temporary examples. The Cotonou Agreement (Benin 2000) set up a new development strategy between the EU and the ACP (African, Caribbean, Pacific) countries. Whereas the forerunner agreements (the four Lomé Agreements) provided for a mere financial advantage for the ACP-countries (i.e. no EU-tariffs for imports from ACP-countries which, after 1994, conflicted with the WTO ‘most-favoured nation-principle’) the Cotonou Agreement provides for measures of development partnership involving supervision and monitoring procedures, NGO and other third party involvement and a general improvement in governance. In the case of the Cambodian garment industry Cambodia, in cooperation with the USA and the ILO, agreed to improve working conditions in garment factories in exchange for increased import quotas into the USA for its products. With this lever economic advantage was conditioned on norm-compliance and as such served to enhance labour standards within the industry. Both examples (Hepple 2005) demonstrate a positive impact from MNCs and states on the social standards of a developing country and the infrastructure to implement them. This potential impact could serve trade unions as an entry-gate for their strategies. The factor ‘consumer power’, though not yet strong, could be positively developed in favour of trade unions if the
precondition of active cooperation and coalitions with media and NGOs would be effectively fulfilled. In the case of the factors ‘missing help’ and ‘weak international organisations’ transnational trade union levers to achieve more compliance with social standard seem quite weak.

The table shows both that chances for a positive trade union impact on the practical enforcement of transnational social standards are relatively low and also that they require a trade union orientation towards outside actors like media, civil society and NGO representatives. This leads to the following conclusions.

5. Re-inventing trade unionism on a transnational level

Trade unions operate in a sort of no-man’s-land when dealing with MNCs and transnational relations (see Gerlach et al. 2011). They can hardly rely on organisational power as it existed in industrially developed nation-states. The continuous increase in workforce in big enterprises – a fundamental factor enabling mass unionism in western societies – never took place in a comparable way in the non-OECD world. Instead, there has been a huge, and obviously increasing, share of non-standard and even informal work (Teklè 2010). The power play in the setting and implementing of social standards takes place in a field beyond the nation-state. International organisations either do not care about social standards or have no proper means to implement them. This is why traditional trade unionism (in the sense of the ‘countervailing power’ concept, collective bargaining, trade dispute and collective agreement) has no proper basis here. There may be collective bargaining with single MNCs – as in the case of FIAs. But it takes place under exceptional conditions and is dominated by European firms and therefore is not generalizable.

International trade unionism will have to be aware of these conditions which differ from trade unionism within the boundaries of the nation-state. I want to draw attention to two of them which might allow for an adequate and interest-oriented trade union reaction: the structure and interests of the firms involved and the existence and interests of possible allies.
5.1 Firms

As we know from industrial sociology, firms cannot be dealt with as homogenous entities. Instead, they must be perceived as a sophisticated nexus of interests and treaties. This is still more obvious in the case of the economic structure of GVCs. The lead firm takes a crucial interest in both the high quality of the product, with all components produced elsewhere in the world, and high prestige with respect to all members of the chain. This makes them vulnerable to the undercutting of standards everywhere in the value chain. Other members of the chain may have divergent interests with respect to cheap labour and delivery times.

This diversity of interests coexisting within the capital side of the world economy provides for ‘corridors of action’ for trade unions. They can draw public attention to illegal or immoral behaviour somewhere in the GVC. This will have a double effect on top management in lead firms. They can take that as a source of information on practices which are contrary to the enterprise COCs and try to eliminate these practices. At the same time, top management is under public pressure to confront these illegal or immoral practices. Otherwise they risk loosing their public image which is essential for their (internal or external) corporate identity. The second effect may leave space for opportunistic behaviour, particularly when public attention is only temporary. But there still is a lever to grasp for transnationally-acting unions.

5.2 Allies

This point of view already connects with the one on the opening of trade unions towards other social actors with a certain capacity to impact the public. This element of need to reinvent trade unionism is known from the developed world. Where trade union power is weakened due to a crisis of standard employment and shop floor representation, voice for the workers’ interests has to be organised or ‘extended’ from outside milieus. Civil society actors (like NGOs) and moral actors (like churches), which are both publicly visible via media, must be made allies in the global struggle for standard-setting and -implementing.

This is already practiced frequently. But in my view the attitude of trade unions toward possible allies should not be too pragmatic – or pragmatic only. We know that sometimes trade unions unite with environmental
actors on single issues, but have conflicts with them on other issues. This can equally be the case with moral entrepreneurs for human rights, etc. A sustainable coalition with these actors requires a long-term and fair assessment and recognition of the respective interests and a discursive way to deal with interest coalitions. This does not hold vis-à-vis civil society or church representatives only, but equally vis-à-vis enterprises (e.g. lead firms of GVCs) and their partly converging, partly diverging economic or political interests.

5.3 Strategic options

What seems to me to be paramount for trade unions in a globalising world is therefore multidimensional. They should engage in transnational norm-building – be it in the form of own agreements on a global level or in the form of impacting transnational norm-building by other actors and in other (e.g. hybrid) constellations. They should also engage in transnational norm-enforcement because compliance with established norms can never be taken as given.

But in order to be effective transnationally, trade unions have to make themselves visible and connected with other actors involved in the big project to civilise globalism. This involves being embedded in transnational network structures, coalitions with NGOs, civil society organisations, economic actors and associations and global state organisations. Well-founded and professional public relations activity seems necessary to achieve that.

References


Chapter 9
Towards a sustainable economy: the potential contribution of international framework agreements

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1. Introduction

In recent decades rapid globalisation has been accompanied by a growing political debate on international labour and production standards. Liberalisation of trade and capital movements represents a challenge to established national structures of industrial relations because it allows international companies to transfer activities to countries with less regulation and lower working standards. Common mechanisms and standards based on international legislation with enforcement options are almost non-existent. The frameworks of the International Labour Organisation (ILO) and the General Agreement on Tariffs and Trade (GATT) set minimum standards defined by key ILO labour norms which for example ban child labour and define a right for workers to organize themselves. In practice this situation leaves management and labour in a kind of legal no man’s land in terms of framing day to day bargaining at European and international level.

However, many multinational enterprises (MNEs) are now being pressured to pay more attention to the social, environmental and societal impact of their activities. This is due to public discussions on working conditions and socially responsible production initiated by trade unions, NGOs and consumer groups. One response to these discussions was the development of so-called corporate social responsibility (CSR) policies by MNEs. Stemming from the US, CSR has also been promoted in the European Union in the European Commission’s Communication of 2002 as being ‘a business contribution to sustainable development’ (European Commission 2002). Here CSR is defined as the voluntary integration of social and environmental concerns into a company’s business operations and its interaction with its stakeholders. The expectation is that MNEs will voluntarily go beyond the minimum requirements and obligations stemming from legislation and collective agreements (European Commission 2001).
In the first phase of CSR a wide range of multinational initiatives were launched. Initially these were unilateral (codes of conduct, declarations and so forth). At the same time, in a growing number of companies, trade unions and management started negotiations in a more coordinated way and agreed on so-called international framework agreements (IFAs), other forms of global transnational agreements and company framework agreements.¹ With these agreements both sides recognized the need to acknowledge basic labour standards and forms of social dialogue on an international level.

In recent years, the quantity and quality of IFAs and other comparable agreements have increased impressively, attracting the attention of both international and European institutions and emphasising the need for more research. Studies have been carried out based on the concept that IFAs may pave the way for the internationalisation of industrial relations. This would happen through establishing worker involvement as a benchmark for strengthening international social dialogue between labour and management in MNEs (Schömann et al. 2008). In the same vein, recent research projects have tended to characterise the European dimension of certain framework agreements as a possible institutional answer to the need for a legal and/or contractual framework at European level (Telljohan et al. 2009).

IFAs are therefore increasingly forming part of the contemporary understanding of what constitutes a good and sustainable multinational company (Kluge and Schömann 2008), particularly with regard to the current role of IFAs in sustainability. Recently, an ETUC study (ETUC et al. 2010) focused on the potential role of IFAs in promoting sustainable development in specific areas such as health and safety and the environment. Interestingly, the findings show that IFAs are potential vehicles for the development of more sustainability-oriented behaviour, especially with regard to MNE environmental responsibility. However, on this topic MNEs tend to favour NGOs over trade unions as negotiating

¹ International framework agreements share the characteristic that they result from a negotiation process between trade unions and the management of MNEs. According to the European Industrial Relations Dictionary (Eurofound), the term ‘international framework agreements’ (IFAs) has been adopted as a means of clearly distinguishing negotiated agreements from voluntary and unilateral codes of conducts: http://www.eurofound.europa.eu/areas/industrialrelations/dictionary/definitions/internationalframeworkagreement.htm.
partners. Furthermore, the study concluded that IFAs can be a good global instrument for promoting sustainable health and safety strategies in MNEs, thus strengthening the traditional role of trade unions. The global nature of IFAs and their ‘European’ characteristics embedded within the CSR debate result in an instrument which can contribute to sustainable development strategies. This would be achieved by promoting good company practices complementing recent public efforts for more economic, social and environmental sustainability.

In this chapter we analyse the evolution of IFAs over the past ten years as a starting point for developing some ideas on how this type of agreement can contribute to the realization of the Sustainable Company. We start with a discussion of current EU CSR policy and then turn to health and safety and environmental issues to illustrate how IFAs can be used to cover a broad range of CSR topics. Finally, we present some conclusions and recommendations for further development of transnational agreements.

2. The CSR debate as a political framework

At the broader political level the debate on sustainable development and corporate social responsibility sets the general framework for discussions and negotiations in MNEs. The objective of sustainable development is threefold: economic efficiency, social fairness and environmental sustainability.

The 2009 review of the EU Sustainable Development Strategy stressed the evolving role of sustainable development in EU policy-making in relation to CSR. It emphasised that CSR ‘is an opportunity for enterprises to combine economic, social and environmental objectives’ (European Commission 2009: 3). Greater commitment to CSR on the part of European enterprises should enhance Europe’s capacity for sustainable development, especially by promoting dialogue between stakeholders. This clearly reflects the growing expectations in the European Union with regard to the evolving role of companies in a changing society.

The debate on the role of business in achieving sustainable development is intrinsically linked to the CSR debate, as the policy tools proposed include CSR-related initiatives. CSR remains an ‘umbrella term’ under which various kinds and degrees of multinational commitments and
activities are categorised which have (directly or indirectly) a social, environmental or societal impact. The main characteristics of CSR activities are twofold: they are (i) business driven and (ii) adopted and implemented on a voluntary basis. Furthermore, the Commission’s Green Paper on CSR of 18 July 2001 stated that CSR means ‘not only fulfilling legal expectations, but also going beyond compliance and investing more in human capital, the environment and the relations with stakeholders’ (European Commission 2001: 6). Although the European Commission often refers to the reconciliation of these three issues with business interests as the ‘triple bottom line approach’, CSR policies and activities give rise to much criticism by stakeholders such as NGOs and trade unions.

In a nutshell, these criticisms arise from the vague, ambiguous and multidimensional nature of CSR, the lack of a clear definition of the concept, the recurrent (ab)use of CSR as a public relations exercise without any real commitment and the lack of transparency and accountability with regard to MNE’s CSR activities. Furthermore CSR activities are criticized as having a corrosive on the social and environmental acquis. This happens for example by bringing down labour standards through choosing the lowest common denominator as a reference point or by operating a selection policy among stakeholders that runs counter to or dilutes the legitimate interest of other players such as workers (ETUI 2004). As the first European Multistakeholder Forum on CSR concluded, CSR as the voluntary integration of environmental and social considerations into core business operations is above and beyond legal requirements and contractual obligations and is based on dialogue with stakeholders.

The ETUC has stressed that particular attention should be paid to the role of employees and their representatives since they are an integral part of the company (ETUC 2004). CSR should involve a change in attitude which permeates the entire company and makes environmental and social considerations an intrinsic part of day-to-day management and decision-making, thereby challenging corporate thinking on a worldwide basis. Also, reacting critically to the Commission’s various Communications (European Commission 2006), the European Parliament published and adopted a report questioning the validity of a purely voluntary approach to CSR and arguing that companies should be encouraged to produce an annual CSR report (European Parliament 2006). The European Parliament also unanimously passed a resolution...
on ‘mandatory reporting on the social and environmental impacts of business’ (2007).

So far there are only a few cases of negotiations on CSR-related practices between trade unions and MNEs. In most negotiations CSR includes IFAs as an emerging form of social dialogue at global and European level. Recent reports (Schömann et al. 2008; Telljohann et al. 2009) provide evidence that IFAs are viewed by management as an integral part of good CSR practice. There is a consensus that IFAs serve as a platform for entering into social dialogue with employees – from headquarters to plant level – and thus have an additional function as ‘risk management’ tools. Because internationally there is no common legal framework and enforcement is deficient in many countries (even of core labour rights), IFAs are seen as an opportunity to improve the right of employees and introduce basic elements of an international social dialogue. Especially in companies without board level employee representation this can increase employee transparency and ‘voice’ in company policy. IFAs strengthen cooperation between worker representatives and formalise a corporate environment and culture that supports the active involvement of employees and their trade unions. Additionally, IFAs’ scope of application in many cases is not limited to the MNE and its subsidiaries only but also covers its subcontractors and suppliers. Finally, IFAs are based on usually well-functioning social dialogue and working conditions and develop them as competitive benchmarks, influencing shareholders and investors.

Many IFAs have been signed with MNEs with headquarters in the European Union and/or with a wide range of activities in the EU. The high proportion of EU-based MNEs involved in negotiating IFAs has a significant influence on the parties involved, the scope and content of the agreements, implementation and monitoring. This has led a number of scholars (Telljohann et al. 2009; Béthoux 2008) and the European Commission (Pichot 2006) to distinguish between international and European framework agreements.

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2. Interestingly, however, a comparison of MNE websites on the subject of CSR/sustainable development activities shows that the visibility of CSR-related initiatives is much higher than of IFAs (ETUC et al. 2010).
3. International Framework Agreements: an attempt to conclude new agreements

In the political debate and in industrial relations research a transnational document must meet a particular set of criteria in order to be categorised as an international framework agreement. In the literature the following factors are used to characterise an IFA:

— IFAs are signed by international or European trade union federations and representatives of the multinational’s management. They define minimum standards and industrial relations principles on a transnational scale.

— An IFA must contain an explicit reference to fundamental social rights as defined by ILO principles. These include bans on child and forced labour and principles of non-discrimination, freedom of association and collective bargaining.

— By signing this document MNEs commit themselves to enforcing labour laws in the various subsidiaries of the company and also to persuading their suppliers to accept these rules.

— In all cases IFAs are based on negotiations and bargaining between management and trade unions.

— The agreement must allow for complaints by the partners. Many IFAs include dispute settlement procedures involving the social partners. They are given the right to complain about violations of fundamental social rights in subsidiaries and to solve problems internally at an early stage through social dialogue.

Apart from their contribution to corporate culture and to the quality of social dialogue at the international level, IFAs lack a clearly defined legal status. Even though national legislation, public purchasing policies or stakeholders may strongly favour such developments their adoption is based entirely on the voluntary cooperation of companies. The question of whether legally binding IFAs would be a better alternative is still controversial. In a similar vein, there is a growing debate on whether an optional legal framework in this field would encourage or halt the development of these tools (Ales et al. 2006).
The driving force behind the promotion of IFAs is the adaptation of international trade union organisations to the emerging need to internalise industrial and labour relations in the global context. Throughout the entire process – including initiation, bargaining, elaboration and implementation – international trade unions play a decisive and active role. Their involvement constitutes an important factor in the political value of IFAs.

IFAs are in most cases quite short agreements (2–3 pages) with a general reference to social and political rights in the workplace. Additionally, most agreements include paragraphs on social dialogue at the company level, information and consultation procedures and the obligations of the signatory parties.

Most IFAs concentrate on reaffirming social rights and rendering them effective. Almost all IFAs (ca. 90 per cent) contain provisions on the prohibition of discrimination and the promotion of diversity. Other fundamental social rights defined by the ILO, such as the right to freedom of association and the prohibition of child and forced labour, are also core elements of IFAs. This shows that fundamental social rights are of outstanding importance for the parties involved in working out IFAs.

The reference in most IFAs to ILO principles confirms their overall objective of promoting core labour standards. For global union federations as signatory parties of IFAs, this reference strengthens their role as a promoter of labour relations regulations at the international level. Furthermore, the reference to ILO conventions serves as added value, since the conventions impose obligations on those countries that have previously ratified them. More specifically, if a company refers to the ILO standards in its IFA, it automatically commits itself to promoting and effectively implementing those standards. This also applies to countries which have not ratified ILO core labour standards, thus promoting such rights via multinational operations.

As IFAs are the result of social dialogue, unsurprisingly, collective agreements on wages and working hours – and more recently the social impact of restructuring or training – are included. This explains the high percentage of IFAs dealing with such issues. Most IFAs refer to health and safety issues, wages and working hours.

Given the role of international trade unions as a driving force behind IFAs, it should come as no surprise that negotiated documents deal
predominantly with fundamental social rights and other labour standards. However, this does not exclude broader societal issues, such as CSR or business ethics. A smaller but increasing number of IFAs deal with for example with the fight against AIDS and include awareness campaigns or related health programmes for employees and their families. As an indicator of a company’s social responsibility through business engagement in a region, a number of IFAs include provisions for local community development. Around half of all agreements include environmental protection provisions.

As private norm-setting agreements IFAs are an emerging form of social dialogue at transnational level and increasingly refer explicitly to CSR. This includes norms for subsidiaries and supply chains. A majority of existing IFAs contain provisions defining their application to the company’s suppliers and subcontractors. This comparably high rate indicates that the signatory parties have acknowledged the demand for effective social regulation for workers in global supply chains. Again, the possible added value of IFAs in this field is significant.

However, the content of clauses on the application of the agreement to suppliers and subcontractors varies considerably. In many cases, the company commits itself to informing or encouraging suppliers and subcontractors to respect the relevant parts of the agreement. These MNEs agree that respecting these provisions is beneficial. For example, the Renault IFA declares that it will ‘inform its own suppliers of the contents of this declaration [...] and urge them to consider adhering to it’ (IMF 2004). Although it encourages suppliers to introduce and implement these provisions, Renault does not explicitly require this procedure as a condition for long-term relations or indicate any form of consequences if these principles are not adhered to. Renault states only that ‘the actual adoption of these principles is a basis for long-term relations’.

A number of IFAs go beyond these general commitments and confirm adherence to the IFA as an important criterion for being chosen or retained as a supplier or subcontractor. In the case of Royal BAM, the IFA stresses that ‘respect for workers’ rights [is] a crucial element’ and declares that it will ‘refrain from using the services of those trading partners, subcontractors and suppliers which do not respect the criteria listed above’ (BWI 2006).
Demonstrating even stronger mechanisms, some IFAs, particularly in the textile sector, include detailed sanctions. In a few cases suppliers and subcontractors not respecting the principles of the agreement face termination of the contract. IKEA is an appropriate example. In its IFA the company points out that continuous non-compliance with these requirements will result in sanctions, including withdrawal from the supplier pool. IKEA has agreed with the Building and Wood Workers’ International (BWI, formerly IFBWW) a monitoring procedure to control implementation of agreements among suppliers (Schömann et al. 2008).

Similarly, changes in the company’s structure are regulated in only a few IFAs. Companies such as Arcelor or PSA refer to the direct application of the Global Framework Agreement for current and future subsidiaries. EDF clearly exemplifies this: ‘In the event that a new company comes within the scope of the above, local stakeholders shall be offered the opportunity to join in the Agreement, should they so desire’ (ICEM 2009). The choice by a future subsidiary to not join the IFA would, however, cause serious problems for the coherence of the group’s CSR and its perception among stakeholders (Schömann and Sobczak 2008).

IFAs can also be seen as a result of international interest representation based on company-oriented trade union networking at an international level. Some IFAs are the result of growing trade union cooperation on a global scale. The IFAs of many MNEs in the chemical sector (Endesa, SKF), the service sector (Telefonica, OTE, France Telekom), the food sector (Chiquita, Danone) and the metalworking and automotive sector are firmly embedded in and in many cases initiated by international trade unions.

These examples indicate a direct connection between international framework agreements and the further development of stable supranational structures of interest representation, information, consultation and dialogue. However, so far the existing agreements are very weak when it comes to the question of enforcement. In many cases the agreements only acknowledge existing ILO labour rights and establish rules for a broader international dialogue in a company. Therefore, IFAs are part of a social dialogue process. They incorporate new topics (such as CSR) as well as ‘old’ topics of trade union interest (such as health and safety). We will use the latter to analyse the potential of IFAs in more detail.
4. **IFA clauses on health and safety and the environment: new spheres of action or old wine in new bottles?**

Within the framework of ETUC policy on sustainable development, a study focusing on the potential role of IFAs in promoting sustainable development (ETUC et al. 2010) was recently completed which dealt specifically with health and safety and environmental clauses. The aim of the research was to investigate the extent to which IFAs and global social dialogue deal with occupational health and safety and environmental issues as part of MNEs’ CSR policy and sustainable development strategy. The research focused first on the analysis of 72 IFAs signed up to June 2009 which referred to environmental issues and occupational health and safety in any manner. In addition to this quantitative analysis 14 case studies were conducted based on interviews with management and worker representatives.

Other MNC policies were examined as well in order to locate these agreements in a broader context. The 14 IFAs were selected as representative case studies based on criteria in order to ensure diversity in terms of economic sector; the Global Union Federation that was signatory; head office countries, including some outside the European Union; the date of signature (to allow for the evaluation of older agreements and their implementation, and for the identification of new trends in recently signed agreements); and the degree of attention paid to occupational health and safety (OHS) and environmental issues. The majority of the IFAs selected contained clauses on both issues; four have no provisions on the environment; and one IFA has no provisions on either OHS or the environment.

The main findings of the study show that IFAs are potential instruments for the development of more sustainability-oriented activity, especially with regard to the environmental impact of MNEs, which is an area in which MNEs tend to favour NGOs as negotiating partners over trade unions. Furthermore, IFAs tend to be a good global instrument for promoting MNEs’ sustainable health and safety strategies. Health and safety at work provisions are usually embedded in most national legislations and collective agreements. The reference in IFAs to health and safety strengthens the traditional role of trade unions.
As global negotiated tools for promoting core labour standards on the basis of the social dialogue culture of MNEs, IFAs reflect the issues that are considered part of social dialogue at the national level (where a given MNE’s headquarters is located) as well as at the international level. While these issues vary substantially from one place to another, certain topics such OHS usually occupy a prominent position in the negotiations between workers and companies, especially in the European Union. Environmental issues, by contrast, have been integrated progressively and at a later stage. Interestingly, environmental issues are often coupled with health and safety matters in the text of IFAs.

This latter finding mirrors the increasing trade union interest in sustainable and green jobs in the context of the ILO’s ‘decent work’ initiative. At national level, historically, trade unions have dealt with environmental issues within the framework of occupational health and safety, in terms of the ‘internal environment’ (namely, the workplace) and/or the ‘external environment’ (in other words, the context and means through which a company carries out its activities). Trade union bodies – such as committees and occupational health representatives – have developed over the years the necessary technical expertise on OHS and integrated related environmental issues. The inclusion of OHS together with environmental issues in IFAs reflects national trade union realities.

In the same vein, trade unions are demanding a greater role in corporate governance on environmental issues, since environmental issues are gaining more visibility in MNEs’ CSR initiatives and are having an increasing impact on working conditions and working environments. However, the integration in IFAs of environmental issues, which traditionally were negotiated between trade unions and MNE managements, raises a number of difficulties. While MNEs are starting to include environmental issues in IFAs in order to be ‘consistent’ with their broader CSR communication strategies, many take the view that workers cannot meaningfully contribute to the debate and so seek other partnerships, for example with NGOs. Furthermore, in some MNEs management thinks that environmental issues should be dealt with in other contractual frameworks than IFAs. This reflects differences between the trade unions, which link OHS and the environment, and MNEs, whose environmental policies are developed by environmental departments with little connection to the human resource departments which are usually responsible for IFA negotiations. Environmental issues
are also generally dealt with via more voluntary initiatives (such as codes of conduct) that omit or limit worker and trade union participation.

Not all IFAs refer either to health and safety or environmental issues. Approximately half of all IFAs do so, whereas environmental issues appear only in approximately one-quarter of them. Furthermore, references to health and safety issues tend to be detailed and comprehensive, whereas environmental issues remain vague. These findings are rooted in the traditional core competences of trade unions at national level, where OHS is a familiar and established theme of social dialogue. This is reflected at European and global level when trade unions and MNE managements negotiate and sign IFAs. In addition, the inclusion of OHS and environmental clauses in IFAs depends on the existence of related MNE policies: either IFAs complement such policies and the issues are included in a more or less detailed manner, or the issues are dealt with sufficiently in other policy documents and do not form part of the IFAs.

These findings can be explained by the main focus of IFAs, which is to promote core labour standards with reference to international norms such as the ILO core conventions (including health and safety), with much less emphasis on environmental standards (Schömann et al. 2008). On the global stage the UN Secretary General has launched the Global Compact initiative which seeks to make business a partner in achieving social and environmental improvements globally. The OECD Guidelines for MNEs also promote sustainable development. However, there is little reference to corporate environmental responsibility. In addition, while ILO core labour conventions are referenced in IFAs, international environmental standards are not yet part of IFA ‘best practice’. Conceivably, references to international conventions on chemical management (e.g. Rotterdam, Stockholm and Basel) or to the UN Framework Convention on Climate Change will develop within the framework of IFA negotiations in the near future, depending on the need for such references and awareness of their existence.

The sectors in which MNEs operate are important variables. The inclusion of health and safety and environmental clauses, as well as differences in their formulation, reflect the specific needs of particular sectors, where exposure to risk might be higher or more visible and where the impact on the environment of the MNEs’ activities is significant. Across international industry sectors, health and safety plays a major role in IFAs signed by the International Metalworkers’ Federation, the
International Federation of Chemical, Energy and Mining Workers and the Building and Wood Workers’ International, while such clauses are less visible in IFAs signed in service sectors (Union International Network – UNI). Similarly, environmental clauses – although less frequently – are found in IFAs signed by MNEs in which environmental concerns are on the agenda and where trade unions are active, such as in the metal, chemical, energy, mining and building sectors.

Finally, the study concludes that, despite the trade union tradition of linking environmental issues to OHS, there is a trend towards their differentiation. The significance of environmental policies in MNE strategies is increasing, including the use of natural resources and the impact of MNE activities on the environment. In parallel, trade unions and workers are building up their capacities for dealing with environmental issues under the umbrella of sustainable development strategies. As a result they are increasingly taking part in the development and monitoring of environmental policies. These developments might lead to greater emphasis being put on environmental issues in IFAs and encourage MNEs to look more favourably on trade union involvement in environmental issues.

5. Conclusion

Trade unions and employers both welcome the inclusion of CSR and sustainable development related issues in IFAs, particularly with regard to OHS and environmental issues. While OHS falls within the competence of trade unions, thus rooting it in national legal traditions in the EU member states, and OHS committees play a decisive role, environmental issues have yet to become established in IFAs for a number of reasons. These include the degree of awareness of the impact of MNEs’ activities on the environment, the recognition of trade unions as legitimate partners by MNE managements, the needs of a given sector, existing trade union strategies related to environmental issues and the significance of environmental issues within the sustainable development debate. Generally speaking, while IFA clauses on health and safety aim at promoting internationally recognised core labour standards, the new emphasis on environmental issues reveals a range of new spheres of action for trade unions. However, MNEs clearly still question the capacity of trade unions to deal with environmental issues and tend to choose other partners such as NGOs for their negotiations.
The primary function and role of IFAs is to reaffirm social rights and to initiate social dialogue on an international level. IFAs reference international and fundamental labour standards. The analysis of existing IFAs indicates that they principally aim at regulating labour relations within MNEs, even though they sometimes include broader issues.

CSR-related issues and other questions of business ethics are a new topic with regard to IFAs. IFAs can be described as an instrument for promoting respect for fundamental social rights among MNEs and their economic partners. Consequently, IFAs represent an emerging form of social dialogue at the international level. By establishing rules for social dialogue and reinforcing core labour rights IFAs can be a starting point for a broader debate and further reaching agreements on the concept of the Sustainable Company. However, although IFAs address CSR and sustainable development and lay down certain framework standards with regard to information, consultation and social dialogue, they are not the main contents. IFAs have to be developed further to include more topics, better rights for employee representatives in an international dialogue and concrete mechanisms for enforcement if they want to be constitutive elements for the Sustainable Company. IFAs are growing in importance as conflict resolution mechanisms in labour issues at international and European level, thus filling legal gaps.

We can see that the significance of CSR in international framework agreements is growing and the number of IFAs is increasing. Several developments are contributing to this:

— Accelerated internationalisation of corporate structures and transnational restructuring operations and growing public awareness of sustainability and CSR clearly underline the importance of these topics for MNEs.

— Recent IFAs concluded by MNEs have started to address CSR and sustainability more prominently.

— Furthermore, the increasing involvement of EWCs and European trade union federations, such as the EMF, in social dialogue and the development of clear framework conditions is a step to encourage MNEs to act in a socially responsible manner. We assume that the number of IFAs will grow during the next decade and more agreements will cover the question of sustainable development.
It would however be naïve to assume that better and more far reaching international agreements will be signed by MNEs without any pressure and active policy by employees and trade unions. Therefore international and European trade union federations have to increase their capacities and competence to handle more company based agreements. Currently IFAs develop in a legal no man’s land in Europe as well as at the international level. Since 2006 the European Commission has been working on a legal proposal for an optional framework for transnational company agreements (Ales et al. 2006, Van Hoek and Hendrickx 2009) without much success for the time being.

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Chapter 10
Strengthening cooperation between NGOs and trade unions in the interests of sustainability

Katrin Vitols

1. Introduction

An essential aspect of the Sustainable Company is the participation of key stakeholders in the corporate decision-making process. However, the task of coordinating the actions and demands of different stakeholder groups may not be easy or harmonious. One form of stakeholder cooperation which is receiving increasing attention is the relationship between trade unions and non-governmental organizations (hereafter NGOs). Some observers have claimed that these two types of organizations have fundamentally different interests which frequently lead them to be in competition with each other. Other observers see trade unions and NGOs as natural allies whose interests for the most part overlap and whose cooperation is needed to counteract strong pressures from the stock market for short-term behaviour. Many have demanded that these two groups should work together more closely (Beaujolin 2004: 19 and 34-35; Gallin 2000; Schmidt 2006). The reasons for this are the increasing importance of sustainability and Corporate Social Responsibility (CSR) and the reduced effectiveness of national regulation in the context of increasing globalization and power of transnational corporations (TNCs). Difficulties in implementing binding international agreements create room for manoeuvre for companies with regard to voluntary commitments to sustainability. For exactly this reason it is important to strengthen the discussion of the negative consequences of globalization and of the environmental and social responsibility of companies. At the same time recognition is growing that the influence of trade unions is decreasing as a result of globalization and decreasing membership. NGOs in contrast are faced with the problem of continually legitimating themselves, for example through permanent campaigns aimed at the public. Alliances between these two groups could potentially increase their power and improve their image vis-à-vis the public and government.
This chapter explores the potential strengthening cooperation between trade unions and NGOs. It argues that, although unions and NGOs have not often worked together, there are examples where the goals of trade unions and NGOs overlap significantly and alliance building has increased the ability to exert influence on companies. The chapter examines the factors that influence cooperation between NGOs and unions. Different interests and logics of action can be obstacles leading to competition but can also turn into vehicles for cooperation enhancing the role of both actors in sustainability. The chapter concludes by making recommendations on how cooperation could be strengthened in order to increase the voice of stakeholders on the path to the Sustainable Company.

2. Overview of the actors

NGOs are defined as ‘private, not-for-profit organizations that aim to serve particular societal interests by focusing advocacy and/or operational efforts on social, political and economic goals, including equity, education, health, environmental protection and human rights’ (Teegen et al. 2004: 466). They intervene frequently in political processes and, with regard to global sustainability, increasingly articulate high moral expectations of good business conduct (Curbach 2010).1 Although the first NGOs were founded more than 150 years ago, many of today’s over 7,600 NGOs worldwide were created by participants in the environmental movement in the 1960s and 1970s. While most of the NGOs active in the CSR area pursue environmental goals (e.g. Greenpeace and WWF), there are also some that are primarily concerned with social issues (e.g. Amnesty International and Action by Churches Together (ACT) Alliance). Few NGOs are concerned with both dimensions (e.g. Germanwatch) pursuing a mix of environmental and social goals. All in all NGOs are a ‘motley crew’ (Unmüßig 2003) and differ significantly regarding goals, targeted actors, financing, strategy and project design (Curbach 2008).

Trade unions on the national level in contrast have for the most part only recently been significantly concerned with sustainability issues. They see

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1. With regard to their political influence NGOs were once even labelled the ‘second superpower’ by the Financial Times (Brunnengräber 2008: 7).
2. In 2007 there were an estimated 7,628 NGOs worldwide (Union of International Associations 2009).
their primary duties as the representation of the interests of employees in their countries. Specifically, trade unions try to protect their members and promote their interests through mechanisms such as participation and collective bargaining. The aspects of sustainability that they are concerned with thus generally have a social or workplace-based nature and take the welfare of the worker as the main reference point for the CSR commitment of the company. Internal company social sustainability issues – which in many European countries are dealt with by works councils – for the most part revolve around discrimination, promotion of family and work/gender, remuneration and training. Many trade unions also have environmental interests, but these are mainly concentrated on resolutions or demands placed on other actors, rather than on activities by the trade unions themselves.³ On the whole there are also great differences in the extent of trade union activities between countries, as shown for example by one comparative study examining different European countries (Beaujolin 2004: 35-36).

The international trade union federations in contrast have been quite active in this area for some time. With regard to environmental sustainability all of the large international trade union federations issued statements for the Copenhagen Climate Conference. These statements supported environmentally-friendly policy changes and in particular the creation of green and decent jobs (ETUC 2009; ITUC 2009; Sustainlabour 2008). Sustainability has also been stressed for some time by these organizations at the international level. The ILO core labour standards for example were jointly formulated and approved by employers’ associations and trade unions. Trade unions also gave input into the formulation of the OECD Guidelines for Multinational Enterprises through the Trade Union Advisory Committee to the OECD (TUAC). In the past few years national trade union organizations have also started to take positions and issue publications on global standards such as the ILO core labour standards, OECD Guidelines and the ‘Norms on the responsibilities of transnational corporations and other business enterprises with regard to human rights’ of the United Nations.

³ An exception here is trade unions with members in the ‘green’ sectors, such as agriculture and forestry, which have undertaken more activities with regard to the environment.
3. Cooperation between trade unions and NGOs

Contacts and cooperation between NGOs and trade unions in the area of corporate sustainability are relatively rare. Examples of these include attempts of coordination by governments or other institutions, participation in dialogue in stakeholder forums at large companies and also joint actions between the two groups (such as the introduction and implementation of seals of approval). In this section the different types of interaction between NGOs and trade unions will be discussed briefly.

At the political level, where frameworks for corporate sustainability are defined, trade unions and NGOs are sometimes included. Governments frequently organize initiatives to encourage dialogue between different interest groups in order to increase the legitimacy of and ability to implement negotiated solutions in the area of corporate sustainability. For example, on the EU level a green paper on CSR entitled Promoting a European framework for Corporate Social Responsibility (European Commission 2001) was submitted, which both NGOs and trade unions responded to. Subsequently a Multi-Stakeholder Forum was organized which also included representatives of these two groups (European Multi-Stakeholder Forum on CSR 2004; Hiß 2005: 34).

On the national level both groups have in many cases been included in ‘round tables’ organized by governments. Examples of these in the process of developing a national sustainability strategy include the German Council for Sustainable Development (Rat für nachhaltige Entwicklung or RNE) and the French Grenelle de l'Environnement Roundtable.

Trade unions and NGOs are also both involved in international standard-setting in the corporate sustainability area and have actively taken positions on proposals. One example is the Global Reporting Initiative (GRI), which has developed a set of standards and a framework for sustainability reporting which is transparent and allows comparisons between companies and across time. GRI was founded in 1998 by a US

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4. Fundamentally different positions were taken on the green paper by trade unions and NGOs, who supported stronger regulation of CSR, and employers, who opposed more regulation. An attempt to mediate these differences in the framework of the European Multi-Stakeholder Forum on CSR was unsuccessful. Between September 2009 and February 2010 six workshops on CSR were organized by the European Commission to try to reconcile the social partners, in which however NGOs did not participate (European Commission 2009).
environmental organization. The Council of Global Unions (CGU)\textsuperscript{5} nominates trade union representatives to each of the top three decision-making bodies in the GRI. Furthermore, the ISO Norm on Social Responsibility (ISO 26000), which is an additional guideline for corporate responsibility, was developed with the input of organizations from 91 countries and 42 affiliated organizations including trade unions and NGOs (ISO 2009).

Some companies have also long discovered the advantages of involving stakeholders in their corporate sustainability management. They organize dialogues in the context of multi-stakeholder forums, which include NGOs and trade unions. The purpose of these dialogues is to help bundle together different and frequently partially contradictory expectations and interests into a manageable concept for the company (Hilgenstock 2007). Here companies hope to help find a future oriented, comprehensive CSR strategy, to identify potential for innovation and improvement and to minimize risk by helping stakeholders understand the company’s sustainability strategy. However, to date these dialogues have been rare and have not lived up to the expectations of the different participants. Conspicuous is the fact that, as a rule, trade unions and NGOs have voiced their opinions separately without previously coordinating their positions.

Good examples of actual cooperation between trade unions and NGOs on the international and national level are above all the creation of many labels and seals of approval, which companies can use to show their commitment to social and environmental responsibility and sustainability. This is particularly effective in consumer goods industries. One of the most famous and most successful seals is the certificate of the Forest Stewardship Council (or FSC) for the sustainable usage of wood (Forest Stewardship Council Arbeitsgruppe Deutschland e.V. 2004). FSC is a non-profit organization which was founded after the 1992 Rio climate conference by environmental groups, trade unions and companies from the wood industry. It is organized on the basis of a three chamber system (companies, unions and NGOs) in which all three interest groups have a say. No changes in standards can be made against the opposition of any one chamber. Both social and ecological factors are taken into account in the certification process for the FSC seal.

\textsuperscript{5} The Council of Global Unions includes the International Trade Union Confederation (ITUC), TUAC and the Global Union Federations (GUFs).
Another example is the Dutch Clean Clothes Campaign (CCC), an international network of over 250 NGOs and trade unions from twelve European countries. The CCC, which was founded in 1990, attempts to inform the public about decent working conditions in parts of the clothing and sport footwear industry (Kampagne für saubere Kleidung 2010). A further example on the sectoral level is the Flower Label Program (FLP), which strives for social and ecological standards in the cut flower industry and which is also organized on the basis of a chamber system.

The European Coalition for Corporate Justice (ECCJ) promotes corporate accountability by bringing together national platforms of NGOs, trade unions, consumer advocacy groups and academic institutions from 15 European countries. The coalition aims at increasing co-operation among groups working on corporate accountability and seeks to introduce internationally agreed and legally binding standards and principles for corporate behaviour regards human rights and social, labour, environmental and economic impacts. So far action has been taken in the areas of agenda setting, coalition building and policy advocacy.

Above and beyond these examples there are relatively few cases of joint publications or cooperative projects in individual countries between trade unions and NGOs.

4. Understanding NGO and trade union action on corporate sustainability

In the following section the factors for why there has been relatively little cooperation between NGOs and trade unions are explained. Trade unions and NGOs are based on fundamentally different organizational principles (Ammon et al. 2006: 145 and 148; Krüger 2002: 100-118). Trade unions are organizations with constitutions and elected leaders. They have a stable membership and organizational structure. In NGOs responsibilities are for the most part informally allocated and expertise is based on a small number of experts at the chapter or country level. There is typically high fluctuation in personnel and financing, so that topics can frequently be dealt with for only a limited period of time. In trade unions the choice of topics is overwhelmingly dependent upon the interests of their membership. Trade unions bind their membership through internal decision-making processes and loyalty. Thus their strength is dependent upon their organizational and mobilization
capacity. NGOs in contrast use scandalization and campaigns as means for mobilization, and support for their actions has to be constantly renewed.

To summarize, the following factors are relevant for differences and similarities: interests, logics of action and also competition between the two groups.

4.1 Convergent and divergent interests

One point which is frequently mentioned when comparing trade unions and NGOs is the divergence in interests between these two groups, specifically regarding ecological and social goals and sometimes also between national and international social goals. According to this perception employee organizations focus on national or even company level social goals such as the improvement of working conditions and the preservation of jobs. The NGOs in contrast focus on ecological topics or global social goals, such as the implementation of basic human rights (Ammon et al. 2006: 145-148; Krüger 2000: 23-25 and 2002). Each type of organization serves their membership. Whereas trade unions orient themselves towards their membership among workers, NGOs are characterized as voluntary, highly independent organizations focused on the general welfare and not bound by any particular interest. The different sets of interests can come into conflict when there is a tradeoff between environmental goals and job preservation, e.g. when environmental protection requires massive restructuring which threatens entire sectors and the jobs in them.

But both actors also have common goals. Sustainability offers a common reference point with general principles such as protection and preservation of natural resources necessary for survival, justice, social protection, participation and democracy (Krüger 2002: 11). These are basic principles which trade unions and NGOs can agree on, even if there is disagreement on some of the content and implementation. There already is a common basis in the joint support of NGOs and trade unions for clear and binding rules in the field of corporate sustainability. There are many shared demands for regulation, for example the inclusion of CSR criteria in public procurement and funding, sustainability reporting requirements and independent monitoring of voluntary agreements, especially Codes of Conduct (CoCs) (DGB Bildungswerk et al. 2006;
ETUC 2006; Heydenreich 2008). Furthermore, NGOs in the environmental area have recognized that ecological problems frequently can only be solved when social aspects are taken into account. They have therefore become more concerned with the social dimension of CSR in recent years. For example, in the UK the Friends of the Earth and Greenpeace have examined the effect of climate change on jobs (Bird 2009; Jenkins 1997). At the same time it can also be observed that trade unions are becoming more active in the environmental area (see e.g. Arlt et al. 2007 for Germany; Broughton 2009).

4.2 Cooperative and conflict-oriented logics of action

The primary concerns of trade unions are the protection of their members, the distribution of income and participation. The easiest path for trade unions to follow is to focus their resources on implementing demands made by the bulk of their membership. The logic of action of trade unions however is influenced by different levels. Some political systems include trade unions in formal or informal bodies for interest representation at the national level. Employee representatives may also be included in regulation at the macro level (e.g. the Dutch polder model), at the sectoral level (mainly through collective bargaining agreements) and at the company level (e.g. through works councils and board level employee representation). The inclusion of trade unions in these frameworks creates pressures for a certain degree of cooperative behaviour. Because of the need for trade unions to intermediate between these levels it is clear that the membership will not always be 100 percent in agreement with compromises that are made, so that the ability to commit to obligations must be generated. The power of trade unions therefore dependents for the most part on internal decision-making processes, solidarity, incentives and pressure. The procedures that can be followed in conflict situations like strikes are (at least in corporatist countries) frequently legally defined.

In addition to political actors and the public, targets for influence by NGOs in the area of sustainability are companies. The corporate strategies that the NGOs follow can be divided into two types of logics: a radical-

6. Trade unions must therefore balance as best as they can the interests of their members (logic of membership) and their strategic goals vis-à-vis external actors (logic of influence) (Streeck 1987).
confrontative approach and a reformist-cooperative approach. The second approach, which is followed by the ‘moderate’ camp, has been relatively rare up to now (Curbach 2008; Den Hond and De Bakker 2007).

The radical-confrontative approach is based on a conflictual strategy characterized by a public confrontation with companies which focuses on their deficits in the area of corporate responsibility. Generally an attempt is made to influence the public or investors by scandalizing companies or calling for a boycott. This strategy represents a ‘reputation risk’ for companies, since the NGOs threaten their legitimacy in the area of sustainability (Curbach 2008: 381). Examples of prominent NGOs that follow this strategy are Greenpeace and Attac.

The reformist-cooperative logic of action is in contrast characterized by a strategy of cooperation. This moderate strategy focuses on persuasion and communication between NGOs and companies. The types of actions falling under this strategy include dialogues, information and education campaigns, joint projects (in areas such as education, culture and science) as well as the provision of services (e.g. consulting, marketing and sales of certificates).

NGOs can contribute here through the further development of company CSR policies and also as a legitimator for sustainability concepts. For NGOs this strategy also opens up the potential for fundraising. Prominent examples of NGOs with cooperative strategies are Transparency International and the World Wide Fund for Nature (WWF). Both NGOs and companies believe that cooperation between themselves will increase in the future (Medienfabrik Gütersloh and credibility.wegewerk 2010: 15-19 and 27).

4.3. Competition in influence on sustainability

However, conflicts are also possible in areas where both trade unions and NGOs have an interest in being involved. For example, a Code of Conduct or a certification system can be developed by or negotiated with either trade unions or NGOs, even in the area of labour standards. This is especially the case in countries where the social partners are less active and policy statements or the organization of conferences in the sustainability area are led by NGOs (Broughton 2009). This can also lead to problems in countries where trade unions want to get actively involved
but participation is not institutionalized and where the ‘independent monitor’ is an NGO presenting itself as an alternative to trade unions (Frege et al. 2004: 152; Justice 2005: 6). In such cases companies may explicitly choose to work with NGOs as a way of getting around employee representatives.

5. How to build new alliances

As this chapter has shown, there are examples of cooperation between NGOs and trade unions at the company level and in different governmental, institutional and corporate forums. However, for the most part these two types of organizations provide parallel inputs into these processes, rather than coordinating their positions and actions. Some of the reasons for the relatively small amount of cooperation in the CSR area are the different logics of action, different interests and (to some extent) competition. But problems should not block efforts by unions and NGOs to collaborate on corporate sustainability issues in the global economy. The two communities still have more in common with each other than either has with corporations or most governments (Compa 2005). Since the area of corporate sustainability is characterized by voluntary action by a plurality of actors, the capacity of both groups to increase their influence in the future will be decisively determined by their ability to cooperate and bundle together their power. An important question is how cooperation between both groups can be supported and how this might look like in the future. A few ideas about this are presented below.

When examining the different factors influencing cooperation in section 4 above, one conclusion could be that the logics of action of the two groups diverge, the interests however are becoming more similar and that competitive situations should be avoided. At the same time there are positive examples regarding the regulation of corporate sustainability, e.g. seals of approval. In order to reach agreement on common goals and actions, one promising way would be to formulate common demands regarding the governance and regulation of corporate sustainability. Potential common demands could be mandatory sustainability reporting, inclusion of sustainability criteria in public procurement and monitoring of voluntary agreements. Here the differences in the logics of action of the two groups must be taken into consideration in such arrangements as well as the autonomy of each partner, for example in a chamber system in the case of seals of approval.
However, there are also barriers in the way of such cooperation which should also be mentioned here. One problem is the frequent lack of sufficient interest in cooperation. Some trade unions do not assign much priority to the topic of corporate sustainability. They are primarily concerned with national production locations and sometimes the membership in some of these companies are in opposition to general sustainability goals (Bormann n.d.). NGOs frequently accuse the trade unions of conservatism regarding preservation of privileges and the status quo of increasing consumption and traditional work. Some NGOs also do not distinguish between the views of management and the employees of a company and their representatives and instead see them as unified. Stereotypes on both sides frequently hinder interaction, since it is assumed that differences of interest and competition exist, although this is not necessarily the case.

It is important to support communication between the trade unions and NGOs. Frequently, getting to know each other’s representatives can be seen as a positive step, in the sense of creating a trust basis for potential future cooperation. A further recommendation is the foundation of a loosely institutionalized internet-based network in which topic- and sector-wide demands and actions could be discussed and formulated for cooperation in corporate sustainability. The network could be founded and organized jointly by NGOs and trade unions.

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Chapter 11
How does corporate governance lead to short-termism?¹

Gregory Jackson and Anastasia Petraki

1. Introduction

The explosion of managerial pay, the crisis of Enron and the arrival of new players on financial markets have brought the topic of short-termism back into the limelight (see Tonello 2006). Now in the midst of an unprecedented global financial and economic crisis, the time is right to ask a fundamental question regarding the corporate economy: do managers and investors tend to pursue short-term gains in ways that have detrimental effects on the long-term prospects of companies or even national economies?

Social scientific approaches to short-termism have been hindered by a number of conceptual, methodological and empirical barriers. This chapter will seek to reinterpret debates over short-termism within the context of corporate governance. Managers, shareholders and other stakeholders may have different and sometimes conflicting time horizons for making economic decisions. This chapter suggests that short-termism is caused by a self-reinforcing and dynamic calibration (shortening) of time horizons produced through the interactions between shareholders and managers, and amplified by the roles played by gatekeepers in mediating these relationships. This relational character of the short-termism phenomenon helps explain why it is both hard to measure, and difficult to address through simple policy instruments aimed exclusively at one stakeholder group. Reforms aimed at supporting alternatives to shareholder value such as the Sustainable Company will therefore have to address a wide range of institutions and policy areas.

¹ This chapter is a summary of research made possible by the generous support of the Glasshouse Forum. For the full version of this report see Jackson and Petraki (2010).
2. What is short-termism?

Short-termism involves situations where corporate stakeholders (e.g. investors, managers, board members, auditors, employees, etc.) show a preference for strategies that add less value but have an earlier payoff relative to strategies that would add more value but have a later payoff. Short-termism arises in the context of intertemporal choice, where the timing of costs and benefits from a decision are spread out over time (Loewenstein and Thaler 1989). The survival of a firm often depends on achieving short-term results (Merchant and Van der Stede 2003), and ideally these actions will extrapolate into positive long-term performance. However, in many situations, the course of action that is best in the short-term is not the same as the course of action that is best in the long run. Actors may suffer from myopia when they have difficulty in assessing the long-term consequences of their actions (Marginson and McAulay 2008). But arguments regarding short-termism go a step further in claiming that decision making or behaviour of certain actors are demonstrably suboptimal. Different authors have applied the idea in relation to different sets of actors, such as managers (Narayanan 1985) or investors (Miles 1993; Dickerson et al. 1995).

While the definition of short-termism is intuitively clear, finding the ‘right’ model to demonstrate short-termism is not straightforward due to a number of fundamental conceptual challenges. Economists have usually conceptualized short-termism in relation to models of discounted utility (DU). Here economic actors face an optimization or maximization problem, but choose a project that is demonstrably ‘wrong’ in relation to a baseline model. Actually defining such a baseline has proven quite difficult for at least four reasons:

Time preference: Economic models of decision making rightly assume discounted utility of future rewards. But no theoretical criteria have been established for assessing whether a particular actor discounts the future ‘too much’ and thus give some proportionately greater weight to cash flows that occur closer to the present (Dobbs 2009, p.127).

Time horizon: Most studies assume that actors’ preferences are consistent over time, and thereby do not look at how actors define their own time horizons. While some studies consider two years as an empirically useful rule of thumb for distinguishing the short-term from the long-term (Tonello 2006), this benchmark is somewhat arbitrary. Time horizons
for assessing future returns may be different between managers and investors, or between different groups of investors (Hasty and Fielitz 1975).

Model of valuation: Many studies criticize project assessment methods based on net present value, where expected cash flows are discounted by the opportunity cost of holding capital from now (year 0) until the year when income is received or the outgo is spent (Demirag 1998). While the DU model assumes that the discount rate should be the same for all types of goods and categories of intertemporal decisions, new findings in behavioural economics show that gains are discounted more than losses, small outcomes more than large ones, and improving sequences over declining ones (Kahneman and Tversky 1979).

Uncertainty: Actors may behave myopically or make risk-averse decisions to avoid uncertainty about the future. As the time horizon for decision making extends into the future, the scope of uncertainty increases. The interdependence between uncertainty and time horizons leads actors to care about when events occur – hence, these two factors are nearly impossible to separate outside of controlled experimental settings.

Depending on how one specifies a baseline model, short-termism may be perfectly rational within the framework of economics, provided that we assume an ‘appropriate’ discount rate. This approach has come under growing criticism within economics (Frederick et al. 2002; Loewenstein et al. 2001) and by emerging approaches to decision making in other fields of study (Gigerenzer 2007; Todd and Gigerenzer 2007).

Given these challenges, empirical studies of short-termism remain surprisingly scarce. Policy makers often cite the increase in stock market turnover or shortening tenures of managers as evidence of a trend toward more short-term decision making. These measures are however indirect at best. Other approaches rely on survey evidence, where managers give information on their orientations on a self-reporting basis. Interestingly, these studies tend to find very strong evidence of short-term bias.

The harder issue remains establishing whether short-term decisions are actually detrimental to long-term value creation. This question is counterfactual - once a short-term decision is taken, we cannot know the possible effect of a different, longer-term decision. Thus, most studies adopt indirect proxies of either short-term or long-term decisions. Short-
term orientations have been measured by the earnings restatements by corporations, which reflect overly aggressive accounting practices and overestimation of short-term profitability. However, this measure does not capture all forms of short-term behaviour. Conversely, long-term orientations are usually studied by examining the rate of investment in R&D under the assumption that this expenditure is long-term in nature, imposing a short-term cost but enhancing profitability years later. However, this measure may miss other long-term drivers of value (e.g. employee skills, corporate reputation, etc.), and the salience of R&D as a key measure may differ across different types of firms and industries.

3. Short-termism as a problem of corporate governance

Our analysis attempts to overcome these obstacles in understanding ‘how short is too short’ by asking a related but distinct question: why do corporate stakeholders favour the short or long-term? Our focus shifts away from the question of optimization to the dynamics of corporate governance. By examining the interaction between stakeholders with distinct time preferences, we do not claim to have resolved the debates over existence of short-termism. Rather, we hope to identify the mechanisms that trigger changes in time horizons of key players from the perspective of corporate governance.

Myopic decisions compound into ‘short-termism’ if such decisions are taken repeatedly and become institutionalized. Short-termism thus reflects a systematic character of decision making within an organization shaped by organizational culture, processes, or routines. Our focus is accordingly on how corporate governance shapes intertemporal choices within the organization. Corporate governance involves the rights and responsibilities of actors with a stake in the firm (Aguilera et al. 2008; Aguilera and Jackson 2003) and is discussed here with reference to managers, various types of shareholders and gatekeepers.

3.1 Professional managers

Managers may make myopic decisions for a variety of reasons. Miller (2002: 690) explains that ‘managerial myopia indicates cognitive limitations in relation to the temporal dimension of decision making, and, at the extreme, analyzes the implications that arise when decision makers
find themselves without the necessary information to assess even the present state.’ The discussion of ‘faulty decisions’ by managers (Laverty), ‘cognitive limitations’ (Miller), and the ‘difficulty in assessing’ (Marginson and McAulay) stress the informational aspects of decision making – managers may be unable to correctly assess and appraise investment projects. Indeed, Laverty (2004) shows that managers are less short-term oriented when they have better information about the tradeoffs between short- and long-term results. While managers may be myopic and make faulty project evaluations, our framework seeks to specify organizational mechanisms that shape the identities and interests of managers toward a short-term orientation in a systematic way.

Borrowing from stewardship theory, we examine whether managers’ professional orientations reinforce short- or long-term time horizons by influencing their relative autonomy or commitment to the firm (Davis, Schoorman, and Donaldson 1997). Professional orientations are an element of wider managerial ideologies, as ‘the major beliefs and values expressed by top managers that provide organizational members with a frame of reference for action’ (Goll and Zeitz 1991: 191). Ideologies allow managers to legitimate their authority and decisions toward other stakeholders. But ideologies also shape the perception and framing of organizational problems through taken-for-granted cognitive templates and toolkits for decision making. Ideologies may become institutionalized through mimetic processes of diffusion (e.g. managerial education), normative processes (e.g. establishment of professional groups), or coercion (e.g. state regulation).

First, different time horizons are embodied in the decision heuristics or investment appraisal practices adopted by managers. Short-termism may result from the application of faulty or biased methods for assessing investment projects (Laverty 1996). Most measures that rely solely on financial data lead to underestimating the intangible payoffs, such as from trained employees or reputation (Atherton, Lewis, and Plant 2007). The use of certain valuation practices like net present value models may lead to short-termism, not only due to the omission of non-financial returns but also through the use of excessive discounting, which undervalues cash flows that accrue further in the future (Lefley and Sarkis 1997).

Second, these decision heuristics are cultural artefacts linked to managerial experience and education. Different forms of managerial expertise may influence the ability or willingness to assess a long-term
investment and avoid managerial myopia (Marginson and McAaulay 2008; Miller 2002). In particular, managers’ understanding of ‘extra-financial’ assets and risk factors is likely to influence their propensity to be myopic (Atherton, Lewis, and Plant 2007). Conversely, to the extent that managers are oriented to stock prices, Liu (2005) finds that they may behave myopically due to managers’ ‘effort to achieve a high stock price by inflating current earnings at the expense of the firm’s long term interest, or intrinsic value. Managers can inflate current earnings by under-investing in long-term intangible assets.’ Managers are also likely to perceive that investors are focused largely on short-term (quarterly) earnings estimates and adjust their time horizons to these perceptions (Demirag 1998; Grinyer et al. 1998; Marston and Craven 1998). In the USA and Britain, the spread of shareholder-value as ideology (Lazonick and O’Sullivan 2000) is related to the focus on education in ‘general’ management, with a strong emphasis on finance. In particular, the rise and expansion of MBA education has been linked to the dominance of the ‘financial conception of the firm’ and its focus on shareholder returns (Khurana 2007; Fligstein 2001). The diffusion of shareholder value as management ideology in the last decade is widely considered to have reinforced the short-term focus of managers on quarterly earnings and associated practices such as share buy-backs that aim at changing short-term stock prices (Lazonick 2007).

Finally, a growing trend in board composition around the world regards the role of independent or outside directors. This shift from an ‘advising’ to a ‘monitoring’ board has been part of a long-term shift in corporate governance toward shareholder value as a dominant corporate ideology (Gordon 2007). While independent directors are encouraged to increase the accountability of managers, outside directors may simply lack the amount and quality of information that insiders have. The information available may be too dependent on formal disclosure, too focused on finance rather than strategy and operations, and hence prone to undervalue long-term future projects. Conversely, other studies have found effective evaluation of top managers may be associated with a majority of inside directors (Hoskisson et al. 1994; Hill and Snell 1988) or participation of other stakeholders such as employees in the board (Addison et al. 2004). For example, some studies on Germany suggest that employee representation on boards results in higher capital market valuations due to the fact that employees have strong inside knowledge of company operations that aid in the monitoring of management (Fauver and Fuerst 2006).
Another set of factors influencing time horizons related to the financial and career incentives of managers. Such incentives are shaped by executive compensation practices and labour markets for top executives. Managers have their own objectives and ambitions as individuals. In particular, the time horizons attached to incentives (or lack thereof) through executive compensation schemes or within managerial labour markets shape the extent to which short- or long-term corporate strategies will translate into higher individual income. For example, opportunistic managers may reject long-term investment projects, crucial for the future welfare of the firm, in order to concentrate on other short-term alternatives whose earlier payoff boosts allows them to maximize their own monetary incentives (Laverty 1996). Managers may also exhibit moral hazard, pursuing investments with faster payoff, either because it was a less risky option in the short-term or due to insufficient long-term incentives.

The adoption of more sophisticated, variable or equity-based executive remuneration schemes has been advocated as a means to solve such agency problems by giving managers proper incentives to improve good corporate performance. However, the nature of the reward can influence a manager to follow a short-term investment strategy by creating excessive incentives on short-term results or failing to focus on performance metrics reflecting long-term value creation or sustainable strategies of growth. For example, a survey of UK, US and German manufacturing firms show that packages that include shares, option and any kind of profit-related scheme are connected with a higher probability of short-term orientation relative to other types of schemes (Coates et al. 1995).

Criticism of executive pay is not new in itself, but a new wealth of evidence has accumulated to suggest that executive pay is itself a core problem of contemporary corporate governance (for the most comprehensive critical assessment, see Bebchuk and Fried 2004). The core argument is that executives have a substantial influence over their own salaries, and have used this power to weaken the link between pay and performance. For example, recent studies have shown the size of stock options outstanding had a very strong influence on the prevalence of earnings restatements (Denis et al. 2006; Efendi et al. 2004). Other recent studies of earnings management suggests that executives with unexercised stock options were more likely to manage real earnings management through abnormal changes in cash from operations, production costs, or discretionary expenses such as R&D (Cohen et al.
Thus, even advocates of share options, such as Michael Jensen, have started telling executives to ‘just say no’ to Wall Street, and criticized managers’ focus on short-term earnings games (Fuller and Jensen 2002). Other studies show that the relative talents of CEOs have little influence of stock market capitalization, which are driven by firm size and market sentiment (Tervio 2008; Kolev 2008). The money paid to attract ‘top’ executives doesn’t improve market returns relative to the ‘less talented’ and cheaper executives (Wyld and Maurin 2008).

The career patterns of managers also shape the time-horizon of decision-making. One aspect concerns the prospect of job turnover. High turnover may prevent the building of long-term trust relationships and weaken social bonds (Webb 2004), thus undermining the importance of reputation, norms of collegiality, and other social devices for increasing commitment of people to the long-term future of the firm. For example, Palley (1997) found that high turnover leads managers to invest only in short-term projects in order ensure that the rewards take place while they are still in the firm. This strategy discounts the risk of having lower or even no return in the long-term, should they have stayed at the same company. Conversely, if managers have the possibility of longer job tenure, they are more likely to pursue some long-term projects, possibly to diversify against this risk.

3.2 Shareholders

Many studies suggest that shareholders may put too much value on short-term firm performance and push managers to inflate performance measures or alter strategy even if it is harmful for the company in the long run (Chaganti and Damanpour 1991; Hansen and Hill 1991; Kochhar and David 1996; Samuel 2000). Studies of institutional investor myopia typically examine whether higher levels of institutional investor ownership are associated with outcomes such as corporate R&D investment, which act as a proxy for long-term investment (Bushee 1998; Hansen and Hill 1991). Yet while some studies find evidence of short-termism, other studies find that institutional investors promote R&D, engage in monitoring, or improve the market value of firms with good future prospects but low current profitability (Davis 2002).

These mixed results suggest the need to differentiate between different categories of shareholders and develop a more complex understanding
of investor behaviour (Aguilera et al. 2008; Aguilera and Jackson 2003). While some institutional investors are quite sophisticated and potentially long-term, other transient investors with high turnover are associated with lower R&D and focus on short-term earnings (Bushee 1998, 2001; Liu 2006). Looking at the equity portfolios of various UK based investors in the year 2007 substantial variation in the average holding periods of different investor types is apparent (Jackson and Petraki 2010). However, despite this variation, the long-term trend suggests a very strong rise in overall stock market turnover. Looking at the New York Stock Exchange, levels of turnover have expended from around 30 per cent to nearly 100 per cent of stock market capitalization during the same period (Windolf 2009).

What factors shape the orientation of investors to the short vs. long term? A first dimension of investor orientation concerns whether shareholders engage with the firm as owners, or whether they are essentially traders of stock (Hendry et al. 2006). Traders may pursue a variety of investment strategies and have heterogeneous portfolios, but they have in common the focus on predominately financial criteria for their investment and aim to make gains on the trading of stock. Meanwhile, owners refer to shareholders having some strategic motivations in exercising control over company decision making, such as in the context of restructuring, family control, inter-firm business networks, and so on. Trading thus represents a preference for exit as a response to organizational decline, whereas ownership suggests the exercise of voice as a way to alter the course of the organization and thus share in the responsibility for future outcomes (Hirschman 1972).

These differences are manifest in shareholders’ involvement in corporate governance. Black (1992) suggests that a ‘concern related to institutional competence [in corporate governance] involves the institutions’ time horizon... short-sighted institutions won’t do much monitoring because the payoff from oversight is long-term.’ Most research assumes or implies that more involvement in corporate governance issues and longer holding periods characterize ‘better’ policies and may limit short-termism.

Investor orientation is also shaped by the organizational capacity of investors to evaluate and monitor firms. Kochhar and David (1996) find

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2. Elsewhere, a similar distinction is used between the strategic and financial interests of owners (Aguilera and Jackson 2003).
that ‘[short-term] investors may lack access to proprietary firm-specific information, and therefore find it difficult to evaluate the long-term value of a firm. Instead, they may focus on performance measures, like current earnings, that are easily quantifiable. Thus, they behave like arbitragers to ‘churn’ or frequently turn over their portfolio of stocks in order to capitalize on all possible short-term gains.’ Shareholders may focus only on short-term benefits to the extent that they lack information or have troubles quantifying intangible (human and other) assets, thus giving too much weight to measures of return that refer to a relatively short-period of time. If the reported return is low, they reshuffle their portfolio. Bushee (1998) identifies a group of ‘transient” investors who hold a diversified portfolio and high trading turnover, who exhibit this behavior. Likewise, the lack of long-term engagement of shareholders may be related to conflicts of interest, as in case of corporate pension funds (Davis and Kim 2007).

Investors also face economic incentives to engage in short or long-term trading. What situations create incentives for investors to realize short-term gains and externalize the costs of sacrificing longer-term gains? Incentive problems may arise because the delegation of investment decisions results in conflicts between principles and the personal incentives of agents. Even if an investor prefers a long-term orientation, actual investment decisions may be made by fund managers within the organization or contracted out to external fund managers in different organizations. Incentives may be given to fund managers that shorten time horizons or fail to reward long-term investments in an effort to control or monitor these managers. In studying institutional investors, Hansen and Hill (1991) argue that the myopic institutions behaviour arises because ‘institutional fund managers are under considerable pressures from their superiors to perform. When they make decisions they respond to organizational pressures and their own desires for job security and advancement. This translates into risk aversion and short-run focus.’ Similarly, Chaganti and Damanpour (1991) find that ‘institutional money managers cannot afford to take a long-term view because their performance is evaluated frequently.’

Intermediation of investment also leads to agency problems between the principles bearing ultimate risks for an investment and the organizational incentives of agents. The rise of financial services has led to a growing amount of intermediation, where investment advisors manage ‘other people’s money’ and has become detached from risk taking.
(Windolf 2008). Fund managers chase high rates of return due to the competition with other fund managers to gain and retain clients’ business. With high returns also comes greater risk, and hence the long-term value creation of the firm is likely to be undervalued. While beyond the scope of this report, the growth of derivatives and options market have increased the ability of financial institutions to originate and distribute liabilities without bearing the ultimate risks, thereby raising new questions about the relationship between new financial instruments and short-termism.

In sum, the different organizational orientations and incentives shaping time horizons differ widely across different types of shareholders (see a detailed discussion in Jackson and Petraki 2010).

### 3.3 Gatekeepers

Gatekeepers play a hitherto neglected role within corporate governance (Coffee 2006). They occupy a boundary role that serves principally information and advisory functions. Yet due to the importance that markets place on this information, gatekeepers play a powerful role by shaping the perceptions and interactions between market actors – managers, shareholders, investors and the public. For example, Healy (2001) finds that gatekeepers, including financial analysts, the business press and rating agencies, significantly affect stock prices by shaping the flow and evaluation of information from corporate disclosure. In the context of short-termism, information asymmetry and uncertainty are key triggers of myopic behaviour and hence short-termism. Gatekeepers have a particular role as informational intermediaries since managers’ private information can be unavailable to the shareholders (Narayanan 1985) and their actions may be partially unobservable (Laverty 1996). Overcoming such asymmetric information problems is important for stakeholders to avoid making suboptimal investments (Dickerson et al. 1995).

Gatekeepers came under negative criticism through the Enron case. Apreda (2002) writes: ‘this disgraceful tale of malfeasance uncovered the ultimate actors that should be blamed for: the gatekeepers. They neglected their fiduciary role and damaged the credibility of many institutions and practices either in corporate or global governance.’ Bruner (2008) thus stressed the importance of gatekeepers as part of the...
regulatory framework for financial markets. Windolf (2005) also focused on gatekeepers’ ability to transform uncertainty into risk and thereby provide essential support the operation of financial markets. Whereas entrepreneurial decisions are truly uncertain, analysts and others look at these strategies in terms of risks for investors. However, this can only be done in the very short-term perspective – such as forecasting the profitability of those investments next year and then comparing the results. This ‘framing’ of corporate activity in terms of its short-term risks is one of the major constraining factors whereby financial markets encourage short-termism.

Here we note the example of securities analysts. Securities analysts collect information, evaluate performance, make forecasts and recommend that investors buy, hold or sell the stock of the firms they cover. Security analysts are not only passive players within the marketplace, but exert strong power by setting agendas and influencing the cognitive frameworks through which investors evaluate firms. In his pioneering study of U.S. firms, Zuckerman (1999) has shown how low coverage by analysts led to a substantially lower valuation of company stock prices and discounting of expected dividend payments. Francis et al (1997) indicate that quarterly earnings are indeed more important than other company features for analysts. Analysts tend to ignore ‘extra-financial’ features like human resources, which are very important for the long-term wellbeing of the firm (Atherton et al. 2007). Conversely, based on a case study of analyst ratings during the ‘new economy’ boom, Beunza and Garud (2004) show how analysts shape the cognitive frames used by investors to overcome uncertainty and justify taking on excessive investment risks based on new and different models of valuation of IT firms. Several studies have thus found that the use of quarterly earnings reports increases stock return volatility and is more likely to undervalue long-term strategies and assets (Bhojraj and Libby 2005; Rahman et al. 2007). So managers are under pressure to present good short-term quantifiable results or conform with the expected features of analysts’ models, sometimes at cost of long-term investments.

Similar arguments can also be made with regard to credit ratings agencies or auditors. Many of these gatekeepers are also riddled with various conflicts of interest (Palazzo and Rethel 2007). Auditors are of special interest because of their exposure to conflicts of interest. Although auditors enhance the credibility of accounting reports, audit firms face an incentive problem: they are more likely to act in the interests of
managers who hire them and not in those of the firm’s investors. This conflict of interest is one of the factors that made in the Enron case possible (Healy and Palepu 2001, 2003). In his influential account of ‘control fraud’, Black (2005) has focused on the crucial position of auditors and how the recognition of accounting reports by auditors can permit fraud by corrupt companies.

During the 1990s in the USA, the quality of audits declined, while the marketing of non-audit services by auditing firms increased in parallel. For example, the number of earnings restatements issued by listed corporations more than tripled since 1990 (Coffee Jr. 2003: 17), and has continued to climb through 2002. More worrying was the fact that the size of earnings restatements increased greatly, revealing that income smoothing had given way to much more aggressive accounting practices aimed at the earlier realization of income. A key explanation here is the explosion of non-audit income through consulting services (Coffee Jr. 2003). The main issue here is not necessarily the desire of auditors to retain the larger share of consulting-related income, but the fact that mixing these two services give client firms a low visibility way of firing (or reducing the income) to auditing firms (Gordon 2002). It seems clear that auditing firms were prone to avoid these short-term losses by adopting more critical appraisals, but ultimately undermined long-term benefits – most spectacularly in the case of Arthur Anderson.

4. Short-termism as a social process

Figure 1 summarizes the key mechanisms leading actors to adopt short-term orientations. Yet corporate decision making is not the sole result of any single group of stakeholders. Corporate governance involves a sociological ‘double contingency’ in the sense of Parsons and Shils, who describe this as follows:

...since the outcome of ego’s action (e.g. success in the attainment of a goal) is contingent on alter’s reaction to what ego does, ego becomes oriented not only to alter’s probable overt behaviour but also to what ego interprets to be alter’s expectations relative to ego’s behavior, since ego expects that alter’s expectations will influence alter’s behavior... (Parsons and Shils 1951: 105).
## Figure 1  Mechanisms promoting short-termism

<table>
<thead>
<tr>
<th>Actors</th>
<th>Triggers</th>
<th>Specific mechanisms</th>
<th>Potential policies/practices as remedy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managers</td>
<td>Professional orientations</td>
<td>Decision heuristics</td>
<td>Wider information dissemination and less use of short-term measures for share evaluation (Demirag 1998)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Experience and knowledge of “extra-financial” assets and risks</td>
<td>Less focus on investment appraisal methods like NPV and more training about including non-financial factors (Leffey and Sarkis 1997, AccountAbility 2005, Atherton et al 2007)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Education</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Role of independent directors</td>
<td>Strengthen accountability to external stakeholders, including investors and employees</td>
</tr>
<tr>
<td>Shareholders</td>
<td>Organizational orientations</td>
<td>Engagement in corporate governance</td>
<td>Encourage patient capital by linking shareholder rights to holding period (Aspen 2009 report)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Organizational capabilities for monitoring</td>
<td>Increase communication and transparency (Aspen 2009 report; CFA Report)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Decision heuristics</td>
<td>Assess performance using long-term strategic plans by managers (CED Report)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Intermediation relative to ultimate risk bearers</td>
<td>Apply a higher degree of accountability and enhanced fiduciary duties to financial intermediaries (Aspen 2009 report)</td>
</tr>
<tr>
<td>Gatekeepers</td>
<td>(absence of) professions</td>
<td>Agency problems along the investment chain</td>
<td>Align asset manager compensation with long-term client interests (CFA report). Speculation tax.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Exposure to ultimate risks</td>
<td>Employ one advisor for each different “gatekeeper” service</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Personal and impersonal conflicts of interest</td>
<td>Clearly separate gatekeeper function from corporate operations to ensure impartiality</td>
</tr>
</tbody>
</table>

Both investors and managers know that both know that each could individually pursue a different strategy depending on the reaction of the other. This process of contingency and expectation adds a temporal dimension to the standard agency theory model.

Figure 2 presents a stylized model of possible interactions between managers and shareholders. Ideally, managers and investors would perceive each other as having long-term orientations. This scenario could be described as the Sustainable Company, wherein all stakeholders share a long-term vision of the firm (bottom right cell). While agency problems may still exist with regard to the distribution of value among stakeholders, both investors and managers share a long-term orientation and commitment to the firm. Neither party will prematurely exit the relationship and thereby be able to externalize the long-term consequences of strategic decisions onto third parties (Dobbs 2009). Without a mutual commitment to long-term objectives, the time horizon will be inherently subject to conflicts among stakeholders and remain unstable and open to opportunist short-term behaviour.

Figure 2  Intertemporal agency conflicts: a simple framework

<table>
<thead>
<tr>
<th>Managers' preferences</th>
<th>Long-term managers pressured by short-term investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-termism</td>
<td></td>
</tr>
<tr>
<td>Agency conflict - long-term investors undermined by short-term opportunism of managers</td>
<td>The Sustainable company</td>
</tr>
</tbody>
</table>

While this type of long-term outcome is likely to be desirable, it is important to recall the limiting case of over-commitment to the long-term. Stakeholders may become over-committed to the organization, postponing short-term gain inevitably or failing to preserve options for creating value by pursuing outside alternatives (e.g. exiting the firm, liquidation, merger, etc.). For example, the hazards of over-commitment in risky or uncertain ventures help explain the incremental or tournament-like pattern of investment in venture capital firms or joint
ventures, as well as the corresponding governance structure (Folta 1998). Corporate governance mechanisms supporting exit, such as golden parachutes as a form of executive compensation, may create long-term value for all stakeholders by reducing vested interests or over-commitment of managers to particular strategies (Evans and Hefner 2009).

A conflictual scenario arises when managers prefer long-term strategies, but perceive shareholders to be interested in short-term results (top right cell). For example, stakeholder models of corporate governance have come under growing pressure as the long-term orientations of company insiders have come under pressure from capital markets (Vitols 2004; Jackson 2005). Institutional investors often call for more rapid company downsizing, and fail to fully value the contribution of essential human assets to the competitive success of the firm (Aoki and Jackson 2008). One example of this is when Moody’s famously downgraded Toyota’s bond rating in 1998 citing its policy of lifetime employment. However, short-term orientations of investors are not sufficient to produce short-termism without additional governance mechanisms to influence managers. Shareholders may lack power to assert their agenda on managers (e.g. the absence of a takeover market). Alternatively, managers may be able to shield themselves from influence from short-term shareholders by forming coalitions with other long-term shareholders, such as family owners, banks, or cross-shareholdings with other firms. This point is extremely important, since it suggests that the short-term investment horizons of traders in secondary markets are not necessarily a problem. Indeed, investors only cause short-termism when their time horizons begin to influence the time horizons of managers and hence spill over from financial markets to the ‘real’ economy.

An inverse scenario arises when investors pursue long-term strategies, but these are threatened by short-term and opportunistic behaviour of managers (bottom left cell). This scenario is a classic agency theory situation. To the extent that agency problems cannot be sufficiently resolved by other institutional mechanisms (e.g. independent directors), investors may react by pursuing short-term strategies that do not require them to trust managers, such as demanding higher short-term dividend payments and lower levels of reinvestment. Indeed, agency theory suggests that shareholders may prefer short-term payouts in order to limit the scope for managerial opportunism. If a surplus exists at the end of a financial year, shareholders may prefer higher dividends now rather
reinvestment into the firm, because shareholders fear that managers may consume this extra amount (Dickerson et al. 1995). This constellation may also gravitate toward short-termism to the extent that shareholders re-calibrate their time horizons to those of short-term oriented managers.

Agency conflicts arising from the misalignment of managerial and investor time horizons in these scenarios may therefore potentially lead to short-termism. But this is not always the case. To the extent that one set of actors has limited power or can hedge against the influence of the other, these situations may lead to isolated cases of myopia rather than systematic processes of short-termism. However, each scenario raises the possibility that one group (ego) may adapt their behaviour to the expectations of the other (alter). For example, managers may begin to re-orient themselves to the short-term horizons of investors trading in financial markets. Mutually reinforcing short-term orientations are likely to create externalities vis-à-vis future managers and shareholders, as well as other stakeholders.

The concept of *temporal calibration* is used to describe how actors with different time horizons engage in mutual or one-sided adjustment to the horizons of other actors (Noyes 1980). One interesting aspect of this process is its asymmetrical nature. If ego has a longer time horizon than alter, ego has the capacity to adjust herself by shortening her time horizon – but not necessarily vice versa:

Temporal calibration, by the adjustment of one’s time horizon for purposes of improved communications, or even for purposes of bringing about social reform, does not imply the abandonment of that longer time horizon which makes either concept or early support possible. One does not, simply by stressing the short term advantages, diminish such inherent long-term or moral gains as justice, economic liberty and the security of a society in which no one need be poor. It is simply that the short term advantages are ‘easier to sell’ (Noyes 1980: 269).

Managers facing short-term pressures may adjust their strategy in alignment with the perceived expectations of shareholders (Chaganti and Damanpour 1991), thus pushing toward a more systematic and self-reinforcing pattern of short-termism (top left cell). In this case, managers may try to inflate earnings, but do so by cutting down investment in long-term assets that are important for the future of the organization, like R&D.
and employee training. In fact, one reason why managers would deliberately sacrifice long-term in favour of short-term investments might be in order to inflate reported earnings, even if this is not in the best long-term interests of the shareholders. Conversely, investors may shorten their time horizons if they lack trust in management or perceive managers to be driven by short-term considerations. To the extent that investors feel unable to monitor managers effectively or derive long-term expectations about company performance, risk-averse investors may demand greater results in the short-term, thereby placing further pressure on managers.

In cases where both managers and shareholders are focused on the short-term, intertemporal agency conflict may not manifest itself, since both actors have calibrated their time horizon to the short-term. Samuel (2000) described this as a self-reinforcing pattern, whereby shareholders focus on the behaviour of stock prices in the short term and managers similarly focus on improving earnings in the short-term. The absence of agency conflicts may help to explain the fact that advocates of the stakeholder model often frame their criticisms of the shareholder value model of the firm in terms of short-termism – here both current managers and shareholders externalize adverse effects on third parties, such as employees or future managers and investors. The same fact may also explain why the very issue of short-termism remains so disputed in Anglo-Saxon countries, where the normative ideal of corporate governance is centred on shareholder value maximization.

The interactions between shareholders and managers are also influenced by gatekeepers. Gatekeepers may help resolve conflicts in ways that may help calibrate the expectations and orientations of actors toward long-term evaluations of company value. As such, gatekeepers do not strongly influence the incentives of managers and shareholders, but have a strong role in shaping and legitimating particular orientations of other stakeholders. Consequently, gatekeepers may bias interactions among these stakeholders toward the pattern of short-termism. If gatekeepers focus only on easily quantifiable financial measures to assess the potential of a firm, they may undervalue the ever-important benefits of long-term investments with intangible payoffs (Atherton, Lewis, and Plant 2007). If gatekeepers focus on short-term figures like quarterly profits, this pushes managers to inflate those figures in expense of long-term investments.

If managers perceive capital markets (and the participants in them) to be short-term in their share price evaluation, they will pursue short-term
investment strategies (Demirag 1998; Grinyer et al. 1998; Marston and Craven 1998; Samuel 2000). Interestingly, a two-country comparison showed that managers in Sweden seem to be far less influenced by their perceptions of capital markets’ reaction than in the US (Segelod 2000), which may be due to differences in managerial orientations (Section 3.1) in these two institutional environments.

The more interesting theoretical implication of these interactions may create self-reinforcing dynamics, creating path dependent lock-in on short-term orientations. Here initial orientations of ego are reinforced by the orientations of alter. While third party gatekeepers, regulators, or other institutional factors may help mitigate such interactions, these factors can equally serve to amplify such effects. Once such a cycle is in place, it may be impossible for actors to unilaterally change their strategies – even if both actors would in principle prefer to shift to a different long-term pattern. This process aspect of short-termism may help explain why managers, investors and analysis often feel trapped into playing the ‘earnings game’, despite the fact that everyone involved is critical of the process (Tonello 2006).

5. Conclusion: implications for policy, practice and future research

This chapter has stressed that short-termism is not an isolated phenomenon. Rather it reflects the complex interactions between the incentives and orientations of different stakeholders. While it remains difficult to demonstrate empirically that particular stakeholders’ orientations are ‘too short’ from an economic perspective, we can find substantial support for the idea that stakeholder orientations reinforce each other in ways leading to a shortening of time horizons. Key triggers here are the mechanisms whereby the short-orientations of managers and investors become self-reinforcing. For example, stock-options help managers internalize the short-term focus of investors and quarterly earnings statements by managers help focus investors on short-term targets.

Given the systemic nature of the problem, the authors of the 2009 Aspen Institute paper on ‘Overcoming Short-Termism’ argued that ‘effective change will result from a comprehensive rather than piecemeal approach.’ No single policy in isolation is likely to address short-termistic
behaviour among managers, shareholders and gatekeepers at the same time. Indeed, Figure 4 shows how various past reports on policies against short-termism have in common their stress on systemic policies and recommendations that address different levels of the problem. New policies and practices are needed that shift the incentives of key stakeholders toward more long-term goals, either through adoption of best practices, regulation or taxation policies. But the complex nature of short-termism also relates to ‘softer’ factors related to the professional and organizational orientations of those stakeholders – that is, their self-understanding, social norms, and formal rights and responsibilities. These issues go to the heart of corporate governance itself, affecting the checks and balances between corporate stakeholders in ways to assure that stakeholders with long-term interests are given sufficient voice in decision making. The successful institutionalization of long-term behaviour is only likely when adopting such practices increases their legitimacy in the eyes of other stakeholders.

It goes beyond the remit of this chapter to discuss the prospects or problems with specific policies. Indeed, these touch upon a wide array of technically complex areas of corporate law, business practice, and financial market regulations. However, a good starting point would be to develop a detailed review of such existing policies in these areas. Future research might compile an overview of existing policies in different countries, thereby identifying the range of available policy instruments and examining evidence on their relative effectiveness. To our knowledge, no country has consciously undertaken a set of coordinated policies to specifically counteract short-termism. Yet a large number of relevant, yet little known policies exist already. For example, French shareholders receive double voting rights after holding their shares in excess of two years (Schmidt 2004). Likewise, Germany passed a new law on executive compensation in 2009 calling for limits of total compensation to ‘reasonable’ levels and tightened the criteria applied to performance-related pay.

Despite the complexity of the task, the time is ripe to rethink corporate governance with a view to the long-term. Many of the current ‘best practices’ in corporate governance seem are geared toward institutionalizing decision making based around the idea of maximizing value for shareholders, as viewed in the moment. Still, in looking to the future, open questions remain about whether or not short-term value maximization leads to long-term sustainable advantages. Indeed, short-
termism is most likely to occur precisely in that moment when we feel that little may be gained from waiting.

References


How does corporate governance lead to short-termism?


Chapter 12
Enhancing governance of financial markets through regulation: a ten point agenda

Andreas Botsch

1. Introduction

Since the start of the financial crisis there has been no shortage of bold declarations from top leaders in the G20 and the EU to re-regulate the global financial market internationally and to keep in check the devastating effects of its ‘weapons of mass destruction’. At the G20 summit in Pittsburgh in September 2009 heads of state and government declared they would ‘make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis. Where reckless behaviour and a lack of responsibility led to crisis, we will not allow a return to banking as usual.’

2011 marks the fourth year of the worst financial crisis since 1929, yet both financial market developments and the corresponding debate on how best to achieve a long lasting stabilisation through market regulation still stand on shaky ground. Markets have remained extremely volatile and sentiment is characterised by deep uncertainty on the short to medium-term outlook. The next menu of potential future crises comes with a wide variety of hazardous and hard to digest ingredients, including: a major crisis on sovereign debt markets (bond markets and credit default swaps in southern Europe and Ireland); further tensions within the euro zone with the risk of sovereign default and a possibly ensuing crash of ‘systemic’ banks in the big member states Germany, France, the UK and Italy; volatility in global foreign exchange markets and energy, commodity and food prices; a crisis in markets for commercial real estate in the US and Europe; risky private household debt securitization in the US, UK and Ireland; and a looming housing bubble in China. Each of the latter may be selected and none can be excluded.

   http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf
In stark contrast to this ‘menu’ are the 2010/2011 stock market rally and the rebound of banks reporting profits at almost pre-crisis levels, both of which weaken the policy resolve for financial market reform. The crisis seems to be over for banking institutions and their managers. The huge bail-out programmes have not resulted in more socially responsible behaviour in the banking sector but rather have added to moral hazard and a widespread self-service mentality. Among many policy makers and financial market experts in Europe and the US the view now prevails that the financial and economic crisis has resulted from a series of unfortunate (though interrelated) mishaps in allegedly efficient financial markets, comparable to a natural disaster (‘tsunami’) that no one had been able to predict. To overcome current drawbacks it would be sufficient to merely devise a few new rules and change some existing ones in order for the system to return to normality. Accordingly, those same people warn against the cumulative effects of tighter rules that would hamper financial innovation and future growth. To date, a huge armada of financial lobbyists has managed to successfully obstruct reforms of the financial sector that would genuinely overhaul its fundamental flaws and rebalance the world of finance with regard to the needs of sustainable growth in the real economy. Reforms undertaken so far have been shaky and hesitant. The preliminary assessment of them is mixed at best and the outlook for future progress rather bleak. Reform steps have remained incremental in nature.

Notwithstanding the latter, a consensus has emerged among progressive politicians, the European and international trade union movement and many academics and civil society organisations about the governance failures – both at macro and micro levels – that caused the crisis: growing income inequality, global and intra-European macro-economic imbalances, the absence of a stable exchange rate system at global level, the predominance of a short-termist model of shareholder value in board rooms, and the almost ubiquitous belief in laissez-faire and efficient financial market deregulation (Watt and Botsch 2010).

2. The most prominent example is the International Institute of Finance (IIF), the global association of financial institutions. See for example http://www.iif.com/press/press+releases+2010/press+141.php
2. Guiding principles

Tackling the fundamental flaws of an essentially finance-driven economic model implies having a set of guiding principles for financial sector reform and the right sequencing of a broad range of measures that need to be taken. The immediate rescue plan for financial institutions must be accompanied by bold measures for recovery to make up for the enormous losses – amounting to thousands of billions – incurred due to the financial crisis and followed by a rebalancing of the economy on a model of sustainable growth. As far as financial markets and institutions are concerned, rebalancing means first and foremost the reassignment of finance to a commensurate role in society and the economy towards a new and sustainable growth model of full employment and social justice. Another guiding principle for financial reform is the achievement of stable and cost-effective financing for the real economy, which should stabilize macro-economic volatility and allocate finance to socially beneficial uses. Finally, effective crisis prevention policies must restore the fundamental role of the financial system of intermediation, allocation and transfer of capital to productive use and roll back the transfer of credit risk to society at large. Finance must serve the real economy, not vice versa. The provision of finance constitutes a public good; therefore the future banking system should be characterized by the formula ‘5 S & 1 D’: a more stable financial landscape would have to be (1) smaller in size, (2) slower in speed, (3) simpler in structure, (4) functionally separated, (5) less short-term oriented, and last but not least, democratised.

Financial regulation for a new financial architecture must be comprehensive and leave no unregulated areas and loopholes in order to become less crisis-prone. The following sections attempt to set out an all-encompassing ten point agenda for financial regulation at EU level and beyond.

Supervision of financial markets

In September 2010 the EU institutions achieved a compromise deal in triilogue negotiations on a new European System of Financial Supervision (ESFS) architecture. They agreed to set up a pan-European...
regulator composed of three new European Supervisory Authorities (or ESAs) for micro-prudential supervision (ESAs for Banking, Insurance and Pensions and Securities and Markets – respectively the EBA, the EIOPA and the ESMA) and a European Systemic Risk Board (ESRB) for macro-prudential supervision. These have been set up and running since 1 January 2011. The new authorities were assigned binding rights to intervene in the markets and enabled to act vis-à-vis national supervisors. The legislation was approved by the Council and formally adopted by the Parliament on 22 September, and constitutes an important step forward, paving the way for a new EU financial architecture and strengthening the regulation of Europe’s financial markets.

In working closely with members of the European Parliament, the European Trade Union Confederation (ETUC) was able to achieve considerable progress on strengthening the terms of the Commission’s draft legislative acts and to establish a genuine European supervisory authority for banks, securities and markets as well as for insurance and occupational pensions. The objective has been to open up the closed shop mentality of central bankers and the financial community and to ensure trade union representation with voting rights on the General Board of the ESRB (Article 6 of the ESRB Regulation adopted by the EP). However, the final version of the compromise adopted in the trialogue no longer contains this provision, but confines trade union representation to the Advisory Scientific Committee (article 12a). The other three ESFS regulations have strengthened the role of trade unions and civil society organisations in the respective Stakeholder Groups of the European authorities.

The legislation will ensure that the new authorities will be more important than originally foreseen in proposals made by the high level group chaired by Jacques de Larosière (European Union 2009) or by the Commission and Council. The European Parliament has veto rights in appointing ESA chairpersons and may request the Council to declare an emergency. A revision clause stipulates that, in a few years, the effectiveness of the supervisory system needs to be assessed and accordingly reinforced. Key details of the supervision legislation are: the possibility to ban certain financial products; better consumer protection on financial markets; binding mediation of the ESAs in case of conflicts between national supervisors; the power of ESAs to directly address decisions to financial institutions and national authorities; and, in case of emergency, if national authorities do not act appropriately, the
European Authorities are able to address binding decisions to national authorities, and if they still do not act, directly to the financial institutions concerned. ESAs are furthermore represented in colleges of national supervisors to ensure a coherent and consistent functioning of supervisory colleges for cross-border institutions. The authorities will play a key role in designing a European system of deposit guarantee schemes and banking resolution funds to move towards an internalisation of costs. The ESAs will be in charge of monitoring systemic risk and developing adequate stress testing for institutes that may pose systemic risk – a crucial role will be the design of the future stress tests, since the first European tests in 2010 were so poorly designed that they were passed by the three major Irish banks just weeks before those banks collapsed. An enabling clause makes sure that ESAs can assume additional supervisory powers for derivate trading and credit rating agencies by making the transfer of tasks to the authorities in the future possible. Finally, the involvement of trade unions and the non-profit sector in the ESAs' advisory stakeholder groups, together with the provision of adequate financial compensation as well as external experts including trade unions as members in the ESRB in the Advisory Scientific Committee, will for the first time open up the closed shop of the European System of Central Banks.

Regulation of hedge funds and private equity

Among the measures intended to increase transparency in financial markets, the Alternative Investment Fund Managers Directive (AIFM), which was adopted in November 2010, regulates for the first time the highly speculative ‘shadow banking’ sector and intends to contribute to more market transparency. While hedge funds and private equity funds may not have been the root cause of the financial crisis, the € 2 trillion industry has nonetheless heavily aggravated it, inter alia through the use of high levels of leverage and techniques of naked short-selling of assets. Private equity portfolio companies’ high debt levels, inherited from the highly leverage deals attached to their purchases, make them especially vulnerable in periods of economic downturn; more than half of corporate defaults in 2009 involved former or current private equity portfolio companies. Although leverage used by fund managers will become more transparent, it is nonetheless a shortfall that the directive contains only weak provisions to restrict leverage levels for future transactions.
It is significant that the AIFM Directive at least to some extent addresses concerns that have been raised by trade unions about the impact of private equity buyouts on employment conditions for workers in portfolio companies. The European Parliament managed to strengthen substantially the obligations for AIFM. Limiting asset stripping, controlling leverage and consulting workers will help improve financial stability as well as limit social externalities such as bankruptcies and associated job losses in companies owned and controlled by private equity funds. The provisions in articles 26 to 30 specifically target private equity funds. In the version adopted by parliament, the latter would have given workers significant social rights vis-à-vis the owners/shareholders of the companies that are taken over by a fund by providing for direct consultations with the AIFM exercising controlling rights, and did not limit rights to consultation with the management. These provisions were strongly criticised in a joint letter from the French (MEDEF), British (CBI) and German (BDI) industry federations as allegedly contrary to the European system of corporate governance, and did not survive in the final compromise text adopted in the triologue between the Council, EP and Commission. However, minimum holding periods (‘lock-in’) for portfolio companies taken over by an AIF (article 27a) were introduced, and private (non-listed) companies are now subject to European Company Law.

The newly established European Securities and Markets Agency (ESMA) was assigned no less than 72 functions of supervising AIFMs, including the potential setting of limits to leverage, the establishment of a central register of hedge funds and their managers, as well as the contentious issue of the third country rule. The latter addresses the ‘footprint’ of hedge funds not being domiciled in the EU and the problem of offshore funds being used for tax and regulatory arbitrage reasons; this has caused considerable protest from fund managers outside the EU. It has also illustrates the difficulties for some Member States to endorse the internal market principle so as to achieve a level playing field in European financial market regulation. Even though the adopted AIFM Directive constitutes a minimum harmonisation of rules for speculative funds and their managers, it contains a revision clause which would allow further strengthening of its provisions in light of the practical experiences with these in the period up to 2017.
Regulation of credit rating agencies (CRAs)

Transparent rating of assets and liabilities is a public good in open and transparent markets. CRAs contributed significantly to the current problems in the financial markets. They clearly underestimated the risk that the issuers of complex structured financial instruments might not be able to repay their debts. The fact that CRAs advised bond issuers and subsequently gave the highest possible ratings to many of those complex instruments without assessing properly or at least publicly acknowledging the risks can be attributed largely to a conflict of interest. The main CRAs are US-based private for-profit companies with no public accountability or general welfare considerations. Their revenues came from the financial institutions seeking to sell their structured products, many of which were quickly revealed to be ‘toxic’. As market conditions worsened, CRAs failed to reflect this promptly in their ratings. As a result, credit was granted even if it would not be justified by economic fundamentals, adding pressure to the financial bubble. More recently, CRAs triggered the start of the first severe crisis within the euro zone by downgrading Greek sovereign debt by five top notches within the short time span of four months.

EU regulation of CRAs started in early 2009 and has remained piecemeal for the time being. According to the 2009 regulation, all CRAs now need to apply for registration with the ESMA. The problem of conflicts of interest have been addressed in that consultancy services are legally incompatible with rating of the same companies, and the 2010 revision has entrusted ESMA with centralised European oversight and exclusive supervisory powers over CRAs that are registered in the EU. The enhancement of the independence and transparency of credit rating agencies is a positive step forward. However in light of the experience made with sovereign debt rating in the euro zone and the purely speculative explosion of credit default swaps of sovereign debt, the ETUC has insisted on the creation of a public and independent European non-profit organization CRA, which would be funded by the European budget and supervised by the ESMA.

Abolishment of tax and regulatory havens

Almost no progress has been made in abolishing harmful tax competition and in achieving more transparency in cross-border financial reporting.
Up to now the economic governance agenda of the EU has restricted coordination of fiscal policies to the expenditure side, whereas the tax revenue side has remained a matter of competition among member states. The rescue plans for Ireland and some of the new member states contain no aid conditionality with regard to harmful tax competition. The result has been that, despite having a massive budget deficit of unknown proportions so far (reaching 32 per cent of GDP in 2010), the government of Ireland has insisted on and successfully managed to keep its low corporate tax rates of zero, five and twelve per cent. East European member states with flat tax regimes will also continue to maintain ‘competitive’ taxation, leaving doors wide open to companies for tax arbitrage and transfer pricing.

The sophisticated tax saving model that a majority of the private equity fund models provide is one of the main drivers for investors to put money in those funds. Yet this has not been a subject in the debate in regulating AIFs. The European institutions have not yet found sufficient answers to the problem that the liberalisation of financial markets and modern communication technologies have made it much easier for individuals and corporations, including from the financial sector, to go ‘off-shore’ to evade legally-due taxes. This, combined with the lack of transparency and effective cooperation between tax administrations, has made offshore non-compliance easier. At least the EP in 2010 achieved a small step towards more transparency in financial markets in obtaining a commitment by the Commission to adopt a communication on country-by-country reporting by September 2011. The current debate on economic governance in Europe and a European Pact for Competitiveness launched by the German and French government contains proposals to strive for an incremental harmonisation of corporate taxation in the medium term.

Taxation of financial transactions, at least at European level

Social justice and democracy is at risk if workers and their families are to bear the lion share of the crisis burden, whereas shareholders get a free ride and bank managers continue to enjoy high salaries and bonuses. Democratic societies cannot accept that financial institutions expropriate public budgets with impunity because of perverse incentives for excessive risk taking or because of the prevailing moral hazard problem. Taxing the financial sector has therefore come to the fore of the debate at European and G20 level.
On 7 October 2010, the European Commission published a Communication on Taxation of the Financial Sector. The paper sets out three main arguments for further taxes on the financial sector: to contribute to improving the stability of the financial sector and reducing the harmful effects of excessive risk-taking; to make a fair contribution in return for the bail-outs by helping to create conditions for more sustainable growth; and to make a fairer and more substantial contribution to government finances, which could help meet financial commitments to climate protection and development. The paper then analyses the merits and drawbacks of a Financial Transactions Tax (FTT) and a Financial Activities Tax (FAT), with the Commission coming down in favour of the latter at EU level, though supporting a global FTT. The FAT would be a tax on profits and remuneration. The Commission’s worries over tax evasion and market distortions do not stand up to scrutiny, nor does its position that the FTT must be implemented globally to work. The UK for example already has a successful transaction tax on shares.

In addition to advocating bank levies to repair a small part of the damage done, the ETUC in several communications has taken a strong view favouring a comprehensive FTT over a FAT, for two main reasons. The difference between the FTT and the FAT lies, firstly, in the revenue that is potentially raised at European level. A FAT would roughly amount to €24 billion, whereas a FTT could raise up to 12 times the revenue of FAT. A FAT can only be applied to banking and financial institutions, not to financial products being traded, whereas a FTT applies to all transactions, including those of the shadow banking sector and derivatives. A precondition for the latter is the existence of central trade repositories and the obligation for all OTC trades to go through central counterparty clearing. This is currently being debated in the EU legislation on OTC derivatives, in particular the proposed Regulation on OTC derivatives, central counterparties and trade repositories (see below).

Secondly, James Tobin’s ‘sand in the wheels’ argument is still valid – although Tobin himself had never thought of the devastating character of derivatives and excluded them from his tax proposal. At the time of his proposal derivatives were mainly used for legitimate hedging rather than speculation. Now that the notional value of derivatives traded annually

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5. FTT revenue according to calculations by Schulmeister (2010).
exceeds global GNP by 900 per cent it is the speculative nature of innovative products that needs to be covered by taxation. A FTT at a low tax rate of 0.05% would significantly slow down the speed and volume of financial transactions. In a report to the G20, the International Monetary Fund in September 2010 confirmed: ‘The impact on financial markets from a low-rate (less than 5 basis points), broad-based STT [securities transaction tax] would likely be fairly modest, beyond its reduction of very short-term trading’ (Claessens et al. 2010: 177). The Commission has launched a comprehensive impact assessment examining each of the options, with a view to presenting policy proposals by the summer of 2011. It can be expected that lobbyists will continue to warn against an 'overburdening' of the financial industry, which would already be suffering from 'regulatory over-stretch'.

Sufficient capital reserves requirements and enhancing governance through stress tests

European legislation on improving capital requirements has continued as work in progress, leaving substantial work to the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). In the autumn of 2010 the G20 agreed on new rules on capital standards and the possible utilisation of capital for banks (‘Basel III accord’), which are expected to be transposed into European law in the upcoming fourth revision of the Capital Requirement Directive (CRD IV). Enhanced international capital and liquidity requirements are essential for countering excessive leverage and risk taking by banking institutions. Yet the banking sector, in particular the Institute of International Finance, has been fiercely opposed to any more tightening of capital requirements, putting the argument forward that this would risk stifling the recovery. The Basel III rules allegedly restrict the banks’ ability to function and curtail lending. Banking associations as well as industry federations such as MEDEF and BDI have been doing their utmost to fend off any potential profit reductions for the banking sector.

Over the course of 2010 the Basel institutions significantly watered down their initial reform proposals by lowering liquidity rules and allowing higher leverage. According to the Basel agreement of September, the minimum tier one capital ratio will be raised from the current level of 4 per cent to 8.5 per cent. The core tier one ratio, which is defined as the highest quality capital, is set to rise from 2 per cent to 4.5 per cent starting
in 2013. Up until 2019 banks will also have to build up so-called additional buffers of 2.5 percentage points of tier-one capital, with a further 2.5 percentage points required for those deemed systemically important by national regulators. From 2017 onwards the leverage ratio will be set at 3 per cent, meaning that the balance sheet total is restricted to 33 times the amount of tier one capital. A formal endorsement of the proposals including the timetable for the long phasing-in periods of the different measures was made by the G20 Summit meeting on 11-12 November 2010.

Expressing their discontent with the compromise found in the Basel Committee, national regulators such as the FSA in the UK and FINMA in Switzerland have announced their intention to further tighten capital requirement rules at national level (e.g. 10% core capital for Swiss banks), a move that subsequently was fiercely opposed by the international banking community represented by the IIF. The ETUC has welcomed tighter capital requirements and called on EU institutions to shorten the phasing-in period in implementing the Basel III accord in the European Union. The Commission is expected to adopt proposals for a CRD IV in the spring of 2011. Combined with tighter capital standards, a reversal of pro-cyclical accounting in banking will require changes in and better harmonisation of international accounting standards of the IFRS and US GAAP, which promote pro-cyclical mark-to-market accounting. However, a convergence of the two systems of accounting currently seems as unlikely as before the crisis.

Stress tests are normal measures that banks undertake to weigh their risk exposure and define future lending policy. In its October 2009 Executive Committee resolution the ETUC demanded an EU wide stress test of banks through a generalised and non-discriminatory examination of the books of banks, insurance companies and other financial institutions (ETUC 2009). This would support the objective of restructuring the financial sector and putting it back on a healthy basis. Because of the huge uncertainties resulting from the crisis, the ETUC demand was harshly resisted by the big private banks in question, until the ECB conducted the stress test for 91 major banks in Europe during the spring of 2010. The results sparked scepticism because only a few banks failed the stress test. In addition, it turned out that the highest risk exposure for banks (i.e. sovereign debt of Southern Europe and Ireland) was not properly taken account of. Only weeks after the test had ‘passed’ the three major Irish banks, the government of Ireland had to step in again with a rescue
package. In the future stress tests must be conducted on a regular basis by the European System of Financial Supervision, which should force banks to raise their tier one capital ratios if needed. Only then can confidence be restored.

Remuneration and bonus schemes which reflect long term and sustainable performance

Banks' executive pay and remuneration policies have been based on perverse incentives geared to short-term success at the expense of long-term profitability and, in some cases, rewarded outright failure. This has fostered a culture of excessive risk-taking by financial institutions, from banks to hedge funds. Banks are paying bonuses on the basis of expected profits from the deals that traders were making – the bigger the risk, the bigger the potential profit and the bigger the bonus. While governments have pumped billions of taxpayers' money into failing banks, a new record level of disbursed bonuses was reached in Europe and the US at the end of 2010.

By adopting the Capital Requirement Directive III (CRD III) on 7 July 2010, the European Parliament set new rules for bonuses and remuneration that would be the strictest in the world. When the CRD III is be implemented by national legislation bankers will be able to take only 30% of the total bonus in cash. For particularly large bonuses the upfront cash limit is set at 20%. Between 40% and 60% of any bonus must be deferred for at least three years and can be recovered if investments do not perform as expected. Moreover at least 50% of the total bonus will be paid as ‘contingent capital’, i.e. funds which are drawn upon first in case of bank difficulties and shares. With the CRD III supervisory authorities are enabled to impose capital 'sanctions' on financial institutions. However, as financial markets have recovered and returned to pre-crisis turn-over rates, remuneration committees of banks in the UK have engaged in haggling with the Financial Services Authority (FSA) that their record pay deals conform to the legal commitments.

Regulation of derivatives and short-selling

The sovereign debt crisis in the periphery states of Europe has once again highlighted the destabilizing power of derivatives, in particular credit
default swaps (CDS) and those derivatives that are traded over-the-counter (OTC). These customized contracts, in which two parties place bets on the movement of prices for other assets, brought Greece to the brink of insolvency by forcing the government to raise fresh money at prohibitive interest rates. The joint EU/IMF rescue plan for Greece, which amounts to €135bn, has also served as a wake-up call to the European institutions to announce the regulation of OTC derivatives. In September 2010 the Commission adopted a Regulation on OTC derivatives, central counterparties and trade repositories. The Regulation introduces a reporting obligation for OTC derivatives, a clearing obligation for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives and common rules for central counterparties (CCPs) and trade repositories. At the same time the Commission adopted proposals for a Regulation on short selling.

In two public consultations on derivative markets and short-selling in the spring of 2010 the ETUC, together with UNI Europa Finance, took the view that a clearing obligation should apply to all derivatives. Non-financial (corporate) counterparties may have a legitimate interest in building hedging positions which shield them from market volatility and large fluctuations in prices. However it has become the practice in many non-financial corporations, in particular in finance departments, to behave like financial institutions and engage in derivative trading at volumes greatly exceeding their hedging needs.

Intensive lobbying, inter alia by the European Association of Corporate Treasurers (EACT), which is composed of large industrial companies like Siemens, E.ON, Lufthansa and Rolls-Royce, has again paid off for vested interests, as European companies have managed to persuade the Commission not to force them to use clearing houses for over-the-counter derivatives trades. According to the Commission proposal they will be given exemptions through defining thresholds that will determine whether non-financial users of OTC derivatives need to use clearing. At

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the time of writing, the legislative process in the European Parliament is continuing.

Bank resolution and the problem of ‘too big and too interconnected to fail’ (TBTF)

In the US the proposed Volcker rules and the Kanjorski amendment to the enacted Dodd-Frank financial reform bill gives federal regulators the power and the responsibility to limit the activities or even break up big banks if they pose a ‘grave risk’ to the financial system. In Europe, in contrast, policy has remained largely silent about ‘too big to fail’ (TBTF). The argument frequently used is that European banks are not as big as those in the US, hence they pose less danger to systemic stability. By looking at the size of banks as measured by their total assets relative to GDP, we can see that this view misses reality. In the US the six biggest banks’ balance sheets (Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley and Wells Fargo) amounted to almost 70% of GDP at the end of 2009 (see Table 1).

![Table 1](image-url)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Assets as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>17.3%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>14.4%</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>6.6%</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>15.8%</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>6.0%</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>9.7%</td>
</tr>
<tr>
<td><strong>Total - Top 6 US Banks</strong></td>
<td><strong>69.7%</strong></td>
</tr>
</tbody>
</table>


In the UK the three biggest banks’ (RBS, HSBC and Barclays) total assets were 333% of GDP; in France, BNP Paribas, Crédit Agricole and Société Générale together amounted to 290% GDP; and in Germany, the Deutsche Bank, Commerzbank and the insolvent and fully nationalised Hypo Real Estate weighed in at 133% of GDP in 2009. The most striking case in the EU is Ireland, where the three main banks (Allied Irish, Bank of Ireland and Anglo Irish) totalled more than 280% GDP in assets in

7. Or rather, as Stiglitz (2009) put it, ‘to big to live’.
2008. After having received 14 billion Euros in state aid, the fully nationalised Anglo Irish Bank in August 2010 received a further 10 billion Euro rescue package. Allied Irish required another 3 billion Euros in September, raising state ownership to almost 90 per cent. With bail-out costs totalling nearly 50 billion the deficit in the Irish state budget has attained the vertiginous rate of 32% GDP in 2010. In Switzerland, the combined liabilities of UBS and Crédit Suisse exceed annual Swiss GDP by more than four times. The Swiss authorities have announced the acceleration of the phasing-in of the Basel III implementation and the earlier introduction of caps on leverage (in 2013).

Table 2  **EU banks’ assets under management as a % of home country GDP (2009)**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Assets as % of domestic GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Bank of Scotland</td>
<td>127.4%</td>
</tr>
<tr>
<td>HSBC</td>
<td>106.1%</td>
</tr>
<tr>
<td>Barclays</td>
<td>99.9%</td>
</tr>
<tr>
<td><strong>Total – Top 3 UK Banks</strong></td>
<td><strong>333.3%</strong></td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>128.7%</td>
</tr>
<tr>
<td>Crédit Agricole</td>
<td>97.4%</td>
</tr>
<tr>
<td>Société Générale</td>
<td>64.0%</td>
</tr>
<tr>
<td><strong>Total – Top 3 French Banks</strong></td>
<td><strong>290.1%</strong></td>
</tr>
<tr>
<td>Bank of Ireland</td>
<td>114.9%</td>
</tr>
<tr>
<td>Allied Irish</td>
<td>104.8%</td>
</tr>
<tr>
<td>Anglo Irish</td>
<td>60.9%</td>
</tr>
<tr>
<td><strong>Total – Top 3 Irish Banks</strong></td>
<td><strong>280.6%</strong></td>
</tr>
<tr>
<td>Santander</td>
<td>170.0%</td>
</tr>
<tr>
<td>BBVA</td>
<td>82.4%</td>
</tr>
<tr>
<td>Caixa</td>
<td>40.5%</td>
</tr>
<tr>
<td><strong>Total – Top 3 Spanish Banks</strong></td>
<td><strong>293.0%</strong></td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>77.0%</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>39.0%</td>
</tr>
<tr>
<td>Hypo Real Estate</td>
<td>16.6%</td>
</tr>
<tr>
<td><strong>Total – Top 3 German Banks</strong></td>
<td><strong>132.6%</strong></td>
</tr>
</tbody>
</table>

Source: Annual Reports 2010, own calculations.

Tables 1 and 2 demonstrate the power of coercion that big banks have used against democratically elected governments. Banks have become too big and thus manage to coerce governments into bailing them out. Most recently, this could be witnessed in the rescue package for Ireland,
which was nothing more than another bail-out of banks with exposure to Irish public and private assets. Caps on the size of banks relative to GDP, as proposed by Johnson and Kwak (2010), combined with a functional separation between investment banking branches and commercial and retail banking therefore seems vital and would enhance the diversity of the financial sector. This could also be realized by building ‘Chinese walls’ separating liability between the different branches and would counter the moral hazard of banks almost certainly being bailed-out due to their sheer size and prevent the financial system from taking the whole of society as hostage. The aim is to let the gamblers gamble on as they please, but at their own risk. Volcker’s proposal to limit banks’ size relative to total liabilities would, on the other hand, not prove ‘bubble-proof’ as long as relative prices in the real economy (e.g. for housing) vary markedly, thus influencing the value of nominal assets and liabilities. In any case, no deposit-taking bank should be allowed to engage in proprietary trading.

Democratisation of finance

Finance is much too important to be left to an expertocracy of the financial community. EU legislation on financial markets so far has shown the unbroken power of the financial lobby. This clearly calls for more transparency in policy making and for more civil society and trade union representation in advisory bodies of the Commission and the EP. Broad coalition-building among trade unions and civil society organisations for financial reform would also challenge the closed-shop mentality of the financial elites and shed light on the opacity of their business practices and institutions on the range of issues described above. Trade unions need to build public support for pushing their agenda forwards. The recent initiative of members of the European Parliament from the four main political parties to set up a ‘FinanceWatch’ organisation⁸ – a European centre for expertise, communication and lobbying to create a counter-expertise to the banks – provides a good opportunity in this regard. Opposing democratic governance to financial oligopolies would reflect Franklin D. Roosevelt’s famous phrase that ‘government by organised money is just as dangerous as government by organised mob.’

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3. Conclusions

In 2011 the EU agenda for financial market regulation will focus on financial sector taxation (point 5 above), improving capital requirements (point 6), regulating derivative markets (point 8) and bank resolution (point 9). But two years after the endorsement of the de Larosière recommendations by the Commission it has become increasingly evident that much of the original momentum for financial sector reform has been lost. Overshadowed by internal macro-economic imbalances and the ensuing crisis in the euro zone, the policy debate on coming to terms with the crisis is about to resurrect the zombie economics of the 1990’s Washington consensus in Europe⁹ – the very same deregulation agenda that has accelerated the financialisation and short-termism of the economy, as well as shareholder value in a large number of board rooms. Conversely, financial market regulation as described above would play an important role in curbing purely speculative, socially useless activities, and in turn contribute to bringing main street companies onto a pathway to the Sustainable Company.

References


Chapter 13
Signal change: environmentally sustainable corporate behaviour requires a change in incentives

Andrew Watt

1. Introduction

The founding book of economics is widely considered to be Adam Smith's *Wealth of Nations*. In the more than 230 years since its first publication in 1776, not only economists but social scientists of all stripes, politicians and, indeed, ordinary citizens, voters and workers have discussed – knowingly or not – the tome's central questions and its most important conclusion.

The main questions Smith posed were: What constitutes the wealth of a society? How is it produced and how is it distributed between the different social classes? Even if 'social class' has become a less used term – a preferred concept, also in this book, is 'stakeholder' – the questions are instantly recognisable as key issues, and bones of political contention, today. Beyond asking the right questions, however, Smith's seminal contribution was to provide a novel and persuasive answer, persuasive in particular to the then rising commercial and industrial bourgeoisie: markets, if left untrammeled by state interference and freed of feudal traditions and privileges, would coordinate the activities of countless individuals, each following his or her own self-interest, so as to produce the maximum material wealth possible and to distribute it according to the contribution made by each individual.

On this issue the debate has raged between its supporters ('liberals') and those convinced that markets are not (always) efficient instruments of social coordination, either because they do not in fact lead to maximum output or because the distribution of market outcomes is considered unacceptable from a normative point of view. In most democracies an uneasy compromise has ensued from these ideological and political struggles, under which 1) most goods and service production is left to 'the market' and thus privately-owned companies, but some goods and services are produced by the state, 2) private activity is constrained by a
whole set of general and specific rules, and 3) market (primary) distribution is 'corrected' by progressive taxation and the provision of non-market social transfers, bringing (secondary) income distribution closer to what is generally considered by voters to be socially acceptable.

For most of modern history there was, by contrast, little debate about what wealth was. Wealth was stuff, i.e. things, physical objects, wrought by human labour that could be consumed or used to produce other goods more efficiently. Also included, and of steadily increasing importance, were services that satisfied needs that one was unable or unwilling to provide for oneself. And there was little doubt that more was better. Two bushels of corn better than one. Two steam engines better than one. Eating out once a week better than once a month. Equally, qualitatively better was more: a bicycle than a scooter, a motorbike than a bicycle, a car than a motorbike, and a Mercedes S class than a Fiat Uno. The total amount produced in, say, a year was the gross domestic product (GDP), which was arrived at by summing up the market prices of all the (final) goods and services bought and sold. Given the seemingly-plausible assumption that people spent their money on things they wanted, the higher the GDP per capita, the higher the welfare of the population could be assumed to be, even if it was widely recognised that GDP does not actually measure welfare.¹

This only began to change in the 1970s, with the increasing recognition that the rise in GDP was, in theory, infinite, but the material resources, in particular fossil energy resources, of the planet are not. Continuously rising productivity of human labour came up against limited physical input. In addition the earth has a limited 'carrying capacity' for the unused, unusable and often toxic by-products of production.

The more recent discovery that emissions of carbon dioxide from the burning of fossil fuels and other so-called greenhouse gases (GHG) threaten to raise the temperature of the earth to such an extent that human life as we know it may, in the not so distant future, become no longer viable does not change this basic fact, but dramatically increases the urgency and intractability of the problem. Every act of using fossil energy, either by individuals in consumption or firms in production,

¹. Most obviously, ‘leisure’ is also seen as a good (or paid work as a ‘bad’): the longer the holiday, the better. Increased welfare can (and historically has) therefore also taken the form of shorter working hours.
constitutes a ‘part of the problem’ of planetary survival. Initially disputed by many, this recognition is now almost universally held to be a scientific fact; so-called climate deniers (or, more neutrally, sceptics) are a small minority.\textsuperscript{2} The debate is primarily about the size of the effects and here considerable uncertainty remains because of the complex interactions between the different variables that make up the natural environment. Two questions are critical: How much will further GHG emissions raise the earth’s temperature? And what are the costs of temperature increases of a given magnitude?

The precise answers are currently unknown. Still, whatever the room for debate, the clearly established and now almost universally accepted causal link between production and consumption and emissions and the threat to human survival raises the question of what a Sustainable Company might mean in this ecological sense.

It is not widely appreciated that recognition of this new ‘big fact’ also calls into question the fragile theoretical and also social compromise around the use of Smith’s invisible hand – the market – as the predominant means of social coordination for individual activities driven by individuals’ sense of self-interest. At heart, Smith’s claim is that social and individual rationality coincide. For this to be true, any negative impacts of individual behaviour on society must impact negatively (ideally proportionally so) on the perpetrator. The specific question of interest here is: How can a ‘self-interested’ (i.e. profit-maximising) company take into account the wider social interest, which is clearly to limit carbon emissions and avoid disastrous climate change, and thus, in ecological (or at least emissions’) terms, be considered sustainable?

This contribution draws out the implications of both these debates and recent economic and political developments for the idea of a Sustainable Company. The focus is on the issue of carbon emissions, partly because this appears at present to be the most pressing issue and partly because, \textit{mutatis mutandi}, similar considerations apply to other related ecological issues such as pollution.\textsuperscript{3} We examine the behaviour of a normal,

\textsuperscript{2} A milestone here was undoubtedly the publication in October 2006 of the Stern Review commissioned by the UK Treasury. A summary is available at: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/media/7/7/stern_summary_worldeconomics.pdf/.

\textsuperscript{3} There are other greenhouse gases than carbon-dioxide, such as methane, but to keep the analysis simple I abstract from them here.
privately owned and managed company in the absence of constraints regarding its emissions of carbon. From that starting point we consider the various ways in which it can be induced or forced to behave in an ecologically sustainable way (section 2). Taking the example of price incentives – widely considered to be the most effective and efficient single measure – section 3 discusses the differences between a carbon tax and a cap-and-trade (CAT) system and the experiences in Europe to date. Some data is then presented on the orders of magnitude of an effective tax and/or permit-based system in light of Europe’s climate commitments, which are taken as the benchmark for ensuring that, collectively, European companies can be considered ecologically sustainable (section 4). Section 5 concludes.

2. Visible hands needed to prevent climate change

Macroeconomic theorists and, more recently, business economics refined the insights of Smith and his followers – which were usually couched in the language of individuals making rational (and under certain assumptions 'optimal') decisions – and 'converted' them to the reality of a modern economy dominated by corporations (see also the first chapter in this volume). According to this dominant school of thought, all will be right with the world if the decision-makers in the firm – that is its owners or their hired representatives, top managers – seek one thing and one thing only: the highest possible share price (Jensen and Meckling 1976)\(^4\). This is because, by way of a number of more or less heroic assumptions, the share price measures the value of the firm – not just to its owner, but also to society, not just now but into an infinite (and uncertain) future. This is the ideology of shareholder value.

As Vitols shows in chapter one of this volume, this ideology suffers from serious theoretical and empirical weaknesses. Of special relevance to the ecological problematic, on which we focus here, is the issue of externalities: even if all other conditions are met, firm owners and managers will systematically fail to act in ways that conform to the wider social interest – in this case, preserving the environment for the use of future generations. This happens whenever and to the extent that a) they do not face negative repercussions for actions which have negative

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\(^4\) Owners are expected to do so out of self-interest. Managers need to be incentivised to act in this way, primarily by linking their pay to stock performance (notably through stock options).
impacts on the wider environment (negative externality) and b) they cannot reap private benefits from actions that have a beneficial impact (positive externality).

The former needs little explanation, carbon emissions being the case par excellence: in a ‘free market’ emitting carbon into the atmosphere costs polluters nothing as there is no private ‘owner’ of the atmosphere willing and able to charge for such pollution. The latter is equally important, though: investing in equipment that would reduce emissions has a private cost and a social benefit, namely lower emissions, but no comparable private benefit (or an infinitesimally small one for a single company). Common to both cases is that the pursuit of self-interest by decentralised entities (firms) will not generate optimal social outcomes because of a collective action problem. In such an environment companies will not be Sustainable Companies.

It is important to be clear just how serious a problem this is. Rarefied language such as 'optimal social outcomes' might suggest that firms might have scope to adjust their behaviour according to some moral insight into what is right, or to adopt some value-rational (Weber) form of behaviour, even if they incurred some limited costs in so doing. However, unlike a consumer, who can voluntarily sacrifice a proportion of his/her income in order to make an ethical choice, a firm in a perfectly competitive environment (at least in theory) has to play entirely by the rules of the market and has zero scope for such behaviour. In such an ‘ideal world’ (actually a nightmarish world) not a single euro or dollar cent would be spent by uncoerced private companies on reducing carbon emissions. In such an environment firms are constrained to behave ‘optimally' in the narrow sense of taking the ‘right’ decisions given the existing framework conditions and thus given the existence of externalities. Any firm that does not do so will earn lower profits than its peers. It will be driven out of the market or be subject to takeover by other operators who recognise the scope for ignoring or capitalising on the externality.

In practice there is some scope, precisely because the real world does not conform to the textbook model, and we will return to this below. But for now let us take as the starting point the finding that the invisible hand of the market threatens to lead, not just to innocuous sounding ‘sub-optimal social outcomes', but to the proximate heat death of the entire planet. What other visible hands could, and indeed must, be used to reduce carbon emissions if that fate is to be avoided?
We discuss in turn four basic options, indicating their scope to effect change, along with their possible limitations or drawbacks:

— *An environmental voice within the company.* An approach much discussed in other chapters of this book is to give a voice to other stakeholders beyond owners and their immediate hired representatives. To say the least, it is not immediately obvious, however, who might represent 'the environmental interest' or 'the interest of future generations' within the company. A greater say for workers' representatives is vital in many regards, and may well be important for specific environmentally related issues such as health and safety. For some issues, such as localised pollution, some form of voice by local authorities or citizens may be a useful corrective. In the case of carbon emissions, however, it is hard to see why, on the basis of self-interest, workers of a given plant or company would take a different view than owners or managers on the need for GHG emissions reduction. Such voice mechanisms, though, may well come into their own once the need for emissions reduction by the firm has been established and effective and efficient implementation tools need to be deployed.

— *Voluntary commitments to broader corporate success criteria.* Earlier it was pointed out that, in competitive ‘perfect’ markets there is no scope for an individual firm to voluntarily sign up to alternative corporate goals, such as adding an emissions-reduction goal to that of maximising shareholder value. We can turn this around and ask under what real-world conditions such commitments could be effective. Obviously commitments that do not ‘hit the bottom line’ (reduce share value) are not problematic from a competitiveness point of view. This may seem self-evident, but is worth emphasising in the context of carbon reduction. Energy consumption (causing emissions) costs money, so a ‘voluntary’ commitment to reduce the energy consumed in production is

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5. A World Future Council has been set up consisting of eminent persons precisely to perform this function (von Uexkull 2009). It is not immediately apparent to me, though, how such a Council will help in determining the day-to-day decisions of millions of companies in advanced, not to mention developing, economies.

6. A proposal along these lines was made by one of the ‘fathers’ of the environmental movement E.F. Schumacher in Small is beautiful. Given the NIMBY (not in my backyard) problem, a reverse problem of ensuring that such voice does not end up with environmental concerns trumping all others would also need to be addressed.
already 'rational' in a perfectly competitive world, provided the costs incurred by the conservation measures do not exceed those of the energy saved.\textsuperscript{7} The problem for climate-change policy, though, is that all such measures should have already been initiated by shareholder value-maximising firms. More relevant for needed future reductions are cases where the firm can safely pass on the costs of climate change mitigation measures onto customers.\textsuperscript{8} This could be the case for example if a certain commitment is entered into voluntarily at the level of a sector, ensuring a level playing field between domestic producers. A potential problem is that the writ of such an agreement does not extend beyond national borders: in a free trading regime import competition on the relevant goods markets will undermine such nationally based approaches. Some (large) companies may be able to commit to expensive measures even on an individual basis to the extent that they can convince customers (via 'branding' techniques) that this makes their products qualitatively 'better', justifying a higher price. Clearly, given how hard it is for consumers (even if one assumes a widespread willingness on their part to 'pay extra' for low carbon products) to assess products against this criterion and, on the other hand, the scope for 'smoke and mirrors' via misleading advertising campaigns, it would be naïve to expect too much from this mechanism.\textsuperscript{9}

— \textit{Government quantitative regulation.} A private firm operates in a legal space set by the government of the territory/ies in which it operates, and this is determined, in democratic societies, ultimately

\begin{itemize}
\item \textsuperscript{7} Strictly speaking, the bar is actually rather higher and should be expressed as follows: the measures must lower costs to such an extent as to earn an expected rate of return over the lifetime of the investment equal to or greater than that of other activities in which the firm could invest. Obviously, the expected cost of energy in the future is a crucial component of any such calculation, but it is not the only one. The discount (or interest) rate used is also vital. This issue was a key bone of contention in the debate following the publication of the Stern Review (see above).
\item \textsuperscript{8} It might be thought that here the firm is also 'externalising' costs, this time to customers rather than the environment. However, this externalisation is 'good' in the sense that, ultimately, it is consumers that decide what is produced and it is the cost of products to them that determines demand patterns.
\item \textsuperscript{9} It is worth noting that globalisation and financialisation have decisively narrowed the scope for firms to be able to pass on costs to consumers. In relatively closed national markets, many large firms had an oligopoly enabling them to earn 'super profits'. These 'rents' were shared partly with workers but could also take the form of various philanthropic and image-enhancing activities (which could include activities to mitigate climate change). Not only is there greater threat now of import competition, but even large companies in such an oligopolistic position are no longer immune from the threat of takeover if they do not rigorously exploit their market power to the full in generating 'shareholder value'.
\end{itemize}
by voters' preferences. The government can therefore stipulate quantitative regulations. If the aim is to reduce carbon emissions these could include outright bans on certain types of production (products or processes), or, more typically, minimum or maximum standards (again applying to products or production processes).\textsuperscript{10} The key advantage of such regulation (assuming it is reasonably well designed) is that, by creating a level playing-field, it forces all competing firms in the industry to adopt a certain pattern of behaviour. In so doing it removes the competitive constraint identified earlier and thus resolves the collective action problem of a competitive market. Clearly the import-competition problematic remains thorny here. An additional problem is that, depending on the precise form of the regulation, enforcement can be difficult and/or costly. More fundamentally, those measures that, for technical reasons, are most suitable to serve as a basis for the (enforceable) quantitative restrictions may not be the most effective or efficient (lowest cost) means of achieving a given volume of reductions (OECD 2011; 33f.).\textsuperscript{11}

— \textit{Economic incentives set by government.} Finally, governments can act to 'internalise the externality' by manipulating the price mechanism to ensure that it send the ‘right’ signals. If, as in the case of carbon emissions, the problem is that the price of fossil energy consumption is too low to incorporate the full social cost of emitting carbon, then the government should raise the price to that level. Conversely a subsidy may be provided to lower the price of goods or services whose production and consumption is deemed (relatively) desirable in environmental terms. The issues raised by this approach will be discussed in some detail in the next section, but at this point it is worth noting some key similarities and differences to some of the other measures discussed:

— Working through the price mechanism has the decisive advantage over direct regulation that firms (and also consumers) are left to choose the least costly (or least welfare-reducing) ways

\textsuperscript{10} A weaker form is compulsory product labelling (such as the energy efficiency ranking by letter on refrigerators and similar white goods); this measure does not actually constrain behaviour but relies on informed consumer choice.

\textsuperscript{11} To give a hypothetical example: it may be easier to impose limitations on the fuel efficiency of cars than, say, to insist on adequate house insulation (for example because there are only a small number of volume car producers, whereas the latter requires checks on millions of housing units), but that may be a more expensive way to reduce carbon emissions.
in which to reduce the emissions. The earth doesn't 'care' how the emissions are reduced, just that they fall. Put another way: the extent of the ‘trade-off’ between higher living standards (understood conventionally as higher production and consumption of goods and services) and reducing emissions is minimised. Emissions are ‘decoupled’ from output with the least negative impact on output itself.

- To the extent that lower-income households spend a greater proportion of their income on fossil energy, directly or indirectly, working through the price mechanism has per se negative distributional impacts.

- If changes in the price structure can be enforced that bring carbon emissions down to acceptable levels, they would avoid the necessity of further-reaching changes in corporate governance structures as far as the one goal of carbon emission reduction is concerned. This can be considered an advantage politically to the extent that the climate goal is considered paramount and stiff political resistance to other constraints on the decision-making prerogatives of capital owners and senior managers is anticipated. It can equally be considered a disadvantage given that – as also suggested in other chapters of this volume – there are a variety of other reasons why it is necessary to change those prerogatives.¹²

- Lastly, like many of the other options, the problem of import competition is not resolved, unless the measure can be extended internationally by agreement and/or compensatory mechanisms can be introduced.

The main conclusion that can be drawn from this section is that, in the specific case of carbon emissions reduction, externally imposed economic incentives – more particularly government-mandated increases in the price of fossil energy consumption – have a number of advantages in bringing about the needed transition to the Sustainable Companies. They are likely to be more economically efficient than external quantitative restrictions and more effective than ‘internal’ reforms within

¹². This chapter is about the possible ways to make companies contribute to ecological sustainability, so I do not need to take a position in this debate.
corporations. A notable drawback – alongside that of import competition which affects all measures – is the likely regressive distributional effect.\textsuperscript{13} Model simulations have shown the effectiveness of carbon-price increases in influencing behaviour, although they have to be substantial – in excess of EUR 50 per tonne – to achieve needed reductions in emissions (Ekins 2009; Cottrell et al. 2010: 2). This analysis does not at all mean that governments, and other actors such as trade unions, should refrain from implementing measures that come under the three other types, which may well be suited to addressing particular emissions-related issues, not to mention their important role in other aspects of the Sustainable Company. However it justifies focussing on externally imposed economic incentives in the remainder of this chapter.

3. Set the price or the quantity: tax or CAT

There are two basic approaches to reducing carbon emissions by ‘artificially’ changing price incentives. They are functional equivalents and, in terms of abstract economic theory, in fact perfect equivalents, a sort of tautology.\textsuperscript{14} One is to levy a tax that raises the price of fossil energy proportionally to the amount of carbon emitted in its combustion – a carbon tax. This causes firms to use less energy as inputs and customers to buy fewer products with a high energy content. The 'output' of fossil energy falls and – with it – emissions. The amount of the tax (i.e. the price increase) determines the amount by which emissions fall, given consumers’ sensitivity to price changes (the so-called price elasticity of demand). Firms have a direct incentive to reduce their consumption of energy in production – making them more sustainable, narrowing the gap between individual and social rationality – and, importantly, also to choose the most efficient, lowest-cost ways to do so. With the higher tax-induced price the market enforces emissions-reduction; it does not prevent it as was the case in the absence of intervention.

The other approach is quantity based. It starts by setting a cap on the total emissions that are considered acceptable. An equivalent number of emissions permits are created. To consume fossil energy (and thus emit

\textsuperscript{13}. Obviously this is a normative position.

\textsuperscript{14}. For an informative discussion that also considers some of the ‘real world’ problems addressed below see Willem Buiter’s blog at: http://blogs.ft.com/maverecon/2008/06/cap-trade-is-a-tax-on-carbon-emissions-fortunately/.
a certain amount of CO2) the final consumer or goods producer must buy an equivalent number of permits. The permits are tradable on markets, hence 'CAT' – cap and trade. A price is formed on the market for trading permits. Those who can save energy cheaply will sell surplus permits to those for whom this is more difficult or expensive. The initial allocation of permits can take various forms: typically they are allocated to large emissions-producing firms (which reduces the competitive pressure they face) or are auctioned. In principle, however, the permits can be allocated in any way to whatever parts of society the government sees fit. The only condition is an efficient market on which they are subsequently traded. Again, in theory, the CAT system ensures that a given volume of emissions reductions is achieved at the lowest possible cost.

Figure 1  The equivalence of carbon tax and CAT

That these two methods are theoretical equivalents is easily shown using the downward-sloping demand curve diagram familiar to all first year economics students (Figure 1). The demand for energy (and thus indirectly for carbon) depends on price; the higher the price, the less is demanded. If policymakers want to depress the quantity demanded from Q to Q*, they can impose a cap at this level, directly driving down the quantity (the arrow on the x-axis). Permit trading will then drive the price up from P to P*, whereby the cost of the permit will be P*- P. The extent of this price increase depends on how price sensitive firms and consumers of carbon are (represented graphically by the slope of the demand schedule). Alternatively a tax can be imposed, whose value would be equal to P*- P: this higher price then drives down the quantity
demanded from Q to Q*, again in accordance with the demand pattern exhibited by energy consumers.

Although the two approaches are equivalents at the theoretical level, in practice there has been a long-standing and at time acrimonious debate between partisans of each approach (OECD 2011; Nordhaus 2009).

The main theoretical attraction of the CAT approach is that the desired quantitative reduction in emissions can be set politically and then directly instrumented by issuing the requisite number of permits, e.g. on a declining trajectory. The trading ‘market’ then determines the prices of the permits. To the extent that the CAT regime does not face enforcement problems, the system can therefore guarantee to deliver a pre-determined amount of cuts in emissions. This is not the case with a carbon tax: the quantitative downward effect on carbon demand and thus emissions of a price increase induced by a tax of a politically determined magnitude – the slope of the gradient in Figure 1 – is not known in advance. Experience can be gained through implementation, of course, but the sensitivity to price can be expected to vary both over time and also between countries and be non-linear (the gradient is different at different levels of tax/permit price).

This argument may be less important, however, if the science is such that we do not in any case know the ‘desired’ level of emissions. In such a case there will likely be a premium on a steady medium-to-long-run trajectory along which the carbon price predictably increases. During this period the impact of higher prices on carbon demand will emerge and our knowledge of the impacts of emissions on the climate will deepen, in response to which the pace of price increases can be accelerated or decelerated (and conceivably at some point halted).

In addition a range of more practical arguments have been raised in favour of taxing carbon over CAT schemes. Countries have experience in imposing taxes. They are simple and less open to manipulation than complex cap-and-trade systems. They are transparent and generate greater price predictability. They also affect all consumers of energy, down to the very smallest, giving them price incentives to reduce fossil fuel consumption, whereas CAT schemes focus on the big players.

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An important political-economy argument against carbon taxes, on the other hand, may be that voters are allergic to the idea of higher taxes, especially those perceived to hit broad swathes of the population, whereas cap-and-trade is seen as a matter for the (big) businesses on which it is imposed via the permit system. In fact economically these differences are minor or indeed, given efficient markets for trading the permits, non-existent (see the Buiter blog entry reference above), but – a point Buiter ignores – the fact that political opposition may be greater to a carbon tax can be considered an argument in favour of cap and trade, even if it is in economic terms a matter of smoke and mirrors.

4. European experiences in practice

The EU Emissions Trading Scheme (ETS) was launched in 2005. Based on the CAT principle, it is the biggest scheme of its kind in the world. (Schemes also exist in New Zealand, in some US states, in Tokyo and elsewhere.) Originally limited to power stations and a small number of heavy industrial plants, the aim is to steadily expand coverage of the scheme, e.g. to airlines in 2012. To date emissions permits have been allocated free of charge to companies. If they want to emit more CO2 than foreseen, they have to purchase permits from other companies who emit less than their quota; a number of companies have made substantial amounts of money by selling permits that were surplus to their requirements. For the first two trading periods (2005-2007 and 2008-2012) the caps were set at national level. This exacerbated fears of national losses of competitiveness and encouraged governments to distribute generously sized quotas to domestic firms. From 2013 this will be done directly at EU level, accompanied by a progressive move to auctioning permits. Sectors threatened by carbon leakage – the transfer of production abroad and subsequent import of goods – will continue to receive free allocations of permits. Each year the total cap will decline by about 1.75% in order to bring about the desired decline in emissions.

Early experience with the ETS showed up a number of major flaws. Member States, presumably worried about competitiveness issues for ‘their’ companies, made excessively generous permit allocations. This in turn meant that the carbon price determined by the trading market

1. For details see the relevant Commission website: http://ec.europa.eu/clima/policies/ets/index_en.htm/.
proved to be very low, drastically limiting the incentive to change. Linked to this, the price also experienced very severe volatility as expectations suddenly shifted. The price initially rose to about EUR 30/tonne only to decline to virtually zero once the extent of over-allocation became apparent.17 This generated windfall gains and losses and, more importantly, undermined the steady price signals that are needed to lead to changes in investment behaviour. Importantly, the ETS only covered around 40% of GHG emissions in its first phase. Last but by no means least, emissions actually rose during the first phase of the scheme. The scheme was tightened in the second phase, but more recently the recession has reduced fossil fuel demand. This in turn makes carbon permits less attractive and has consequently led to a fall in their price. A modest reduction in emissions only is forecast for phase two.

Not until the third phase can the ETS really be said to be imposing an effective constraint in the sense of exerting a decisive influence on firms’ behaviour. This assessment, obviously, is conditional on its being implemented from 2013 as currently envisaged.

By contrast Europe has to date no coordinated policy to introduce national carbon taxes, not to mention a European-level carbon tax comparable with the ETS. The 2003 Energy Tax Directive does provide for minimum levels of taxation on mineral oil and other energy products; this constitutes a limitation on the ability of countries to ‘poach’ tax revenue through lower fuel taxes, and thus reduces the risk of a race to the bottom. Discussions are currently under way to revise the directive. The Commission is proposing for the first time something approximating to a carbon tax; however at the time of writing it is unclear precisely in what form the directive will be adopted.18 As part of the EU2020 strategy the EU has launched a so-called flagship initiative – one of seven – for a ‘resource-efficient Europe’. According to the corresponding Communication from the European Commission,19 however, little is planned concretely in the area of taxation beyond the above-mentioned revision of the Energy Tax Directive: the phrase ‘carbon tax’ does not appear once in the document.

17. For this and the following empirical facts see: http://en.wikipedia.org/wiki/European_Union_Emission_Trading_Scheme/.
18. See http://www.eeb.org/?LinkServID=6EABD79F-0127-A4FC-739142F4206342F4&amp;showMeta=0/.
A number of EU Member States have introduced environmental fiscal reforms at national level. These take various forms, ranging from pure carbon taxes to very specific measures such as a tax on airline tickets. An overview is provided by Cottrell et al. 2010. The need for fiscal consolidation is leading to renewed interest by many governments in such tax-based policies – whereby the ecological effect appears of secondary concern – as an element in austerity packages. Crisis-hit Ireland has announced the introduction of a carbon tax (for an overview of responses in the context of the austerity packages see Theodoropoulou and Watt 2011). The existence of such measures on a piecemeal basis across Europe does show that national measures can be introduced in the face of arguments that competitiveness concerns make them unviable. Equally, it remains the case that a European-level initiative to introduce a European-wide carbon tax – or at least to insist on binding minimum standards for national-level carbon (or equivalent) tax measures – would be highly desirable (Le Cacheux 2010) and almost certainly a necessary condition for meaningful price signals. Currently, revenues from environmentally related taxation constitute only about 6% of total tax revenues in European countries (OECD 2011: 26).

5. Conclusion

Changing the behaviour of European firms to make them ecologically sustainable – here with a focus on carbon emissions – requires a package of measures. The central argument in this article though is that, without a sustained rise in the price of carbon, there can be no sustainability. Other ways of influencing corporate behaviour exist but they are unlikely to cut much ice, to use an incongruous metaphor, or are likely to be highly inefficient. Europe urgently needs an effective cap-and-trade system and/or an effective carbon tax. Estimates are very provisional but it is widely thought that an increase of at least EUR 50 per tonne of CO2 equivalent is needed to substantially reduce emissions (Ekins 2009: 5) Until now the ETS, the mainstay of Europe’s climate change policy, has not come close to delivering this. The regime will be tightened substantially from 2013, but it remains to be seen whether it can really deliver. Meanwhile carbon taxation remains piecemeal and woefully inadequate overall.

Europe needs an effective coordinated system of carbon taxation to supplement the ETS, extending its coverage and ensuring a predictable
and steady rise in the price of carbon. Effective measures against carbon leakage are needed. At a time when governments are engaging in austerity packages in an attempt to balance their books after the fiscal ravages of the crisis, they should surely sit up and pay attention to calculations showing that a USD 50 per tonne CO2 equivalent tax (or CAT revenue) would generate more than 1% of GDP in tax revenues in Europe (OECD 2011: 27).

In order to address the problem of carbon leakage outside the EU (i.e. production being forced abroad by the higher production costs due to the tax, with the products subsequently imported) two basic solutions offer themselves. The first is a border levy on all goods produced outside the EU unless they come from countries imposing comparable tax or CAT burden. Alternatively a ‘European carbon-added tax’ – in analogy to value-added tax – would be imposed on all goods and services marketed in the EU, irrespective of where they are produced (Laurent and Le Cacheux 2010).

A serious attempt to signal change to enterprises (and consumers) through the price mechanism needs two vital supports. The first is to address distributional issues: price tools have regressive effects that need to be (at least) offset via the way in which the revenues are redistributed. The popular proposal of using carbon tax revenues to cut income tax rates would be a double whammy for distribution (raising a regressive and cutting a progressive tax). Secondly, the real-world restructuring engendered by the price signals needs to be actively managed. These changes will be massive – if climate change policy really starts to bite – and are currently underestimated by policymakers (Galgoczi 2010). Such restructuring will not be a painless process and will require negotiation and dialogue and active government intervention if it is to proceed smoothly and equitably (the two are linked). It is here that some of the other elements of a Sustainable Company discussed in this volume, and in particular the various means of ensuring employee voice in the enterprise, take on a critical importance also for the environmental sustainability issue.

The EU2020 strategy has set Europe ambitious targets for preventing climate change. Emissions are to be reduced by 20% by 2020 (and by 30% if other countries match this ambition). According to agreement at the G8, industrialised countries are to reduce emissions by a massive 80% (compared with 1990 levels) by 2050. Europe can consider itself a
pioneer in comparison with some other countries, notably the USA. At the same time, it is clear that current policies are in no way adequate to achieve the sort of huge behavioural changes needed to bring about such reductions. In the language of this volume: European companies, as a whole, are ecologically unsustainable and risk remaining so. For them to become sustainable in terms of emissions a whole range of measures will be needed – some national, some European in origin. Regulatory measures have a role to play. The most important measure, though, is to raise the price of carbon through some combination of a carbon tax and CAT. Disagreements between partisans of these two approaches cannot be allowed to result in stand-off in which, ultimately, neither measure is introduced in an effective way.

Realigning the incentives of firms’ decision makers so as to bring individual (firm-level) rationality and social rationality closer together – adding a visible to Smith’s invisible hand – is a necessary condition for making European companies ecological and sustainable. But it is not sufficient. Actual change in corporate behaviour and production processes will be needed, and those changes will be sweeping. Such changes cannot effectively be realised in a top-down command-and-control way. For them to occur smoothly, at a low cost and equitably, the voices of additional actors besides capital owners and their hired representatives, and particularly that of workers, will need to be heard inside Europe’s Sustainable Companies.

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