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History shows forcing companies to put workers on boards is a bad idea

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A quiet revolution in Left-wing economic thinking is bubbling on both sides of the Atlantic.

The Labour Party here and Democrats in America are embracing the Continental view that the "Anglo-Saxon" economic model is just too short-termist, and too obsessed with maximising near-term share prices. To "transform capitalism," both parties are considering legislating for "workers on boards" – a variant of Germany's co-determination laws.

If elected, Labour has said companies with more than 250 employees would be required to set aside a third of boardroom seats for "worker representatives". In America, Democratic firebrand senator Elizabeth Warren would go further, committing corporations with $1bn (£790m) or more revenue to at least 40pc of directors being selected by workers.

The thinking underpinning both is that workers often have longer and deeper attachments to companies than transient or disinterested shareholders. Direct representation for workers is therefore said to better represent the long-term interests of the company. Such representatives would vote against perceived irresponsible CEO remuneration packages or share buybacks, and prioritise sustainable value creation and investment.

Is such a romantic, abstract view of workers and their interests justified? It is certainly not borne out by evidence.

Research in 2000 by Gary Gorton, a University of Pennsylvania economist at the time, and Federal Reserve Bank of St Louis economist Frank Schmid found German companies were 27pc less valuable due to co-determination laws. This did not represent some pure redistribution from shareholders to workers either. In part, it is because German companies are generally less efficient, finding it more difficult to adapt to changing market conditions.

Indeed, a 1995-96 analysis of 46 studies on worker participation by economist Chris Doucouliagos found that while profit sharing and worker ownership can have positive effects on productivity, laws mandating worker representation on boards were actually a drag. Co-determination, in other words, leads to less productive companies and losses for pension funds and other shareholders.

This should not surprise us. If workers on boards were beneficial to delivering long-term value, then we would surely already see more of them. There are no restrictions on such corporate governance structures arising in the US or UK. Their rarity implies companies see the prospect of worker representation as restrictive on beneficial decision making.

And it's easy to think why. Who represents workers under such legislation would be decided through some form of electoral process. At that stage, all the perverse incentives that arise using electoral politics as a means of decision making come into play.

A major driver for self-interested worker representatives would be maximising their chances of re-election. That could bite when votes must be delivered on how cash flow is used. Employee-elected directors may opt to assure those worried about the solvency of the company pension plan that they will vote to shore it up, for example, rather than commit to investment in longer-term capital projects. They may choose to side with workers whose jobs are at risk should a plant be closed rather than commit to voting for broader pay rises elsewhere. Clearly, such decisions, though potentially bringing electoral support for the representative, may not be in the company's long-term interest.

Even if one could define a general interest for all workers for representatives to pursue, pursuing those decisions could hit the broader economy. Elected employee-directors would prioritise employee remuneration over share buybacks or dividend payments, for example. But, as my Cato colleague Derek Bonnet has explained, that would mean a smaller pool of capital available for other companies with profitable opportunities to grow.

It is highly probable too that workers on boards would be far less likely to vote to invest in labour-saving technologies or R&D projects, particularly when the returns for such investment are highly uncertain or will occur far into the future. That is to say nothing of consumers – who are very unlikely to benefit from price reductions when other uses of cash flow are available for workers. Again, all this is not merely theoretical. In the former Yugoslavia, industrial democracy resulted in under-investment and slow growth. Worker representatives pushed for maximum pay, rather than new projects. When investment did take place, it tended to be to grow existing companies, rather than in new, more productive ventures.

Germany has not obviously suffered from such damaging consequences. It is a rich, productive country. But total factor and labour productivity growth has been slower there than in the US in the past two decades. Germany does not seem to produce rapidly growing firms in new industries, such as the technology sector, which often requires corporate ruthlessness. Instead, it is dominated by a combination of old giants and many small and medium "Mittelstand" firms, with the trade-off of more job security.

Worker representation on boards has been identified as exacerbating the problems seen at Volkswagen too. There, a CEO teamed up with worker representatives to protect jobs in inefficient plants, as a quid pro quo for support on other issues. The board ultimately failed to hold management accountable for the emissions scandal.

Of course, scandals occur under all corporate governance systems. But this is indicative of the main impact of co-determination laws: they can prevent CEOs from making difficult, unpopular decisions for the company's long-term benefit, while creating a new interest group resistant to reallocating capital to its most productive uses.

Proponents of co-determination may talk in the abstract about employee-directors counteracting shareholder power for the public good. But the reality is that worker representatives become an interest group resistant to the innovation necessary for a dynamic economy. Given constant disruptive change drives improvements in living standards, worker representation on boards can actually dampen consideration of the long term, the opposite of the policy's intention.

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