5

The Benefits and Costs of Employee Ownership

Despite the widespread attention given to employee ownership, it is still poorly understood. We begin our analysis with a survey of the pattern of employee ownership actually observed in modern economies. Then, with this pattern as a guide, we examine systematically the form's strengths and weaknesses. The conclusions that emerge, pointing to governance problems as the critical factor, are sharply at odds with most preceding analyses.

The Distribution of Employee-Owned Firms

The United States

Employee-owned firms are rare in the industrial sector of the American economy. If we exclude companies that have adopted employee stock ownership plans in recent years (to which we shall return shortly), employee-owned manufacturing firms have seldom proved viable over the long run. Among contemporary industries, the unique exception is plywood manufacturing, in which worker cooperatives in the Pacific Northwest have maintained substantial market share since the first cooperative was formed in the 1920s.[1] As of 1984 there were fourteen such firms, each with between 80 and 350 members, most of which had been in business for more than twenty years. Together they accounted for more than 10 percent of all plywood produced.[2] In the nineteenth century, there were a few hundred worker cooperatives—whose mem-

bers were generally skilled artisans—in other industries such as barrel making, shoe manufacturing, and shingle weaving. But those firms largely disappeared early in the twentieth century.[3]

In sharp contrast, employee-owned firms are common in the service sector. In particular, employee ownership has long been the prevailing mode of organization in the service professions, including law, accounting, investment banking, management consulting, advertising, architecture, engineering, and medicine. Although discussions of employee ownership usually focus on industrial firms and rarely make reference to the partnerships and professional corporations common in the service professions, the latter are among the world's purest examples of employee ownership. Moreover, the service professions are virtually the only industries that are dominated by employee-owned firms. Yet this dominance may be nearing its end. In advertising, investment banking, and primary medical care, for example, investor-owned firms have recently come to occupy large shares of the market.

Employee-owned service firms also appear occasionally where the employees involved are not professionals. For example, taxicab companies in large cities are quite frequently employee-owned,[4] and there has long been a group of employee-owned refuse collection companies in the San Francisco Bay Area.[5]

Employee Ownership Abroad

The pattern of employee ownership observed in the United States is roughly duplicated in other market economies: the types of industries in which employee-owned firms are found and the structures those firms assume are remarkably similar everywhere.[6]

Italy and France are the two Western European countries generally regarded as having the largest numbers of successful worker cooperatives.[7] Available estimates (which, however, are dated and apparently do not include partnerships of service professionals such as lawyers) indicate that as of 1983 there were in France several hundred firms organized as worker cooperatives employing a total of roughly 40,000 persons, of whom 61 percent were members;[8] in Italy, as of 1980, there were several thousand worker cooperatives employing a total of roughly 215,000 persons.[9] The average size of these firms is small (in each country around fifty-five workers) and the median size is much smaller still—perhaps no more than a dozen workers.[10] In France

roughly half of these cooperatives, in terms of both numbers and aggregate income, are construction companies, and the fraction represented by construction firms is similarly high in Italy.[11] Many of the cooperatives that are not construction companies are firms of artisans, such as printers or locksmiths.[12] In both countries, there are apparently only a handful of manufacturing firms of substantial size organized as worker cooperatives.[13] In Italy, many of the manufacturing firms that are cooperatives were converted from failing investor-owned firms.[14]

The most prominent example of successful industrial worker cooperatives in a market economy is found not in France or Italy but, rather, in the well-established group of closely affiliated worker cooperatives in Mondragon, Spain. The Mondragon group has received considerable attention in recent years, and its success is frequently cited by advocates of employee ownership as the best evidence that this form of organization offers a promising alternative to investor ownership.[15] The performance of the group has indeed been impressive. From a single small cooperative established in 1956, the Mondragon system has grown rapidly to comprise roughly one hundred affiliated firms with a total of approximately 20,000 employee-members.[16] These firms produce a broad range of goods, including home appliances, furniture, heavy machine tools, and agricultural products. They deserve special attention and will be examined more closely in Chapter 6.

Throughout the world, transportation companies are among the types of firms most often organized as worker cooperatives—and it is generally the drivers who are the owners. In Sweden, for example, all taxicab services and 50 percent of truck transport services are provided by worker cooperatives.[17] This is in contrast to the Swedish manufacturing sector, where worker cooperatives account for only 1 percent of all firms and presumably a much smaller percentage of output.[18] Similarly, in Israel, drivers' cooperatives provide nearly all bus transportation[19] and 50 percent of truck transport,[20] while at the same time—and despite strong cultural and institutional support of cooperativism—worker cooperatives have never become well established in manufacturing. In fact, as of 1972 employment in the Israeli bus and truck transportation cooperatives alone was more than four times that in all manufacturing cooperatives combined.[21] More recently, this widespread pattern of driver-owned transportation cooperatives has been extended to airlines: in 1994, the 7,000 pilots of United Air Lines, the world's largest airline company, finally succeeded in their seven-

year effort to acquire a majority of the company's stock. Unlike the typical transportation cooperative, however, United is not purely a driver-owned company; to succeed in their acquisition, United's pilots were ultimately led to bring members of the airline's machinists' union into the transaction as well, extending a share in ownership to 54,000 of the firm's 76,000 employees[22]—an important fact that we shall say more about in Chapter 6.

Partial Employee Ownership

The firms just described are, in general, fully employee-owned in the sense that the firm's employees, or some subset of them, share among themselves full rights to control the firm and to appropriate its net earnings. In addition to these instances of full employee ownership, there are many firms that are organized so that employees have a *partial* share in control or earnings. For example, under German codetermination, employees elect half of a corporation's (supervisory) board of directors and have, at least formally, an important but partial share in control. Yet since they remain salaried employees, they do not participate directly in net earnings. Conversely, in most American firms with employee stock ownership plans (ESOPs), employees (through the ESOP) have a claim on some or even all of the firm's residual earnings and assets, yet control over the firm generally remains in other hands. In order to keep the inquiry sharply focused, this chapter will concentrate principally on firms that are fully owned by their employees. We will explore various partial forms of employee participation (including codetermination and ESOPs) in Chapter 6. As that chapter illustrates, an understanding of the strengths and weaknesses of full employee ownership also provides useful perspective on the efficiency of partial forms of employee participation, and vice versa.

The Costs of Market Contracting

A survey of the costs of hiring labor on the market leads to two broad conclusions. First, those costs can be substantial and provide an important incentive for employee ownership. Second, paradoxically, the magnitude of those costs correlates quite poorly with the pattern of employee ownership that we observe, which strongly suggests that they are not decisive in determining the overall efficacy of employee ownership.

Asymmetric Information

Because of the difficulty of monitoring individual employees, a degree of moral hazard necessarily infects market contracting for all but the simplest types of labor. One of the strong attractions of employee ownership is the prospect of mitigating this problem and hence improving the productivity of the firm. To be sure, if there are many employees, each individual employee bears only a small fraction of the costs of her own shirking even with employee ownership. But employee ownership also gives each employee an incentive to monitor her fellow employees and to apply pressure on them not to shirk, an incentive largely lacking in an investor-owned firm.

This logic has led many to argue—most conspicuously Alchian and Demsetz, in a well-known article[23]—that employee-owned firms are particularly likely to arise when monitoring employees is unusually difficult. Alchian and Demsetz, for example, say that "[w]hile it is relatively easy to manage or direct the loading of trucks by a team of dock workers where input activity is so highly related in an obvious way to output, it is more difficult to manage and direct a lawyer in the preparation and presentation of a case."[24] This explains, they claim, why the partnership form is so common among lawyers and other groups of individuals with artistic or professional skills.[25]

In fact, however, Alchian and Demsetz are mistaken about the difficulty of monitoring service professionals, and, more generally, the existing pattern of employee ownership is just the reverse of what one would expect if it were primarily a response to the difficulty of monitoring employees. In the service professions, where employee ownership is the norm, the productivity of individual employees can be, and generally is, monitored remarkably closely, because the quantity and quality of each individual's inputs and outputs can be observed with relative ease. Lawyers in corporate law firms, for example, commonly document the use of their time in intervals of six or ten minutes, indicating whether and to which client the time can be billed and the precise nature of the work done for the client in that interval.[26] Such records yield a close measure of the kind and quantity of work produced by an individual lawyer over the year and of the client revenue that this work has produced for the firm. Moreover, it is relatively easy to assess the quality of a lawyer's work, in part because the work product frequently consists of written documents produced by that lawyer alone.

In contrast, investor ownership is the dominant mode of organization in most firms in which employees commonly work in large teams or have extensive supervisory or managerial tasks—settings in which an individual's productivity is extremely difficult to measure. Thus while it is relatively easy, and in fact a common practice, to compute with some accuracy the marginal contribution to a law firm's net earnings that a given individual lawyer makes each year, it is inconceivable to think of undertaking such a calculation for an assistant vice president, or even a shop foreman, at General Motors.

This is not to say that monitoring can be done perfectly in law firms or in other firms of service professionals. Nor is it to deny that employee ownership improves productivity in such firms by helping to cope with monitoring problems. In fact, improved incentives for productivity are probably a significant reason why employee ownership is so common among these firms (although efforts to establish an empirical correlation between worker ownership and improved productivity have so far offered ambiguous results).[27] The point is simply that there must be other factors that are much more important in determining the distribution of employee ownership, since the types of firms in which employee ownership is most common seem to be firms in which employee monitoring is relatively easy.

Lock-In

Firms rarely occupy a position of monopsony in the labor market. Consequently, simple market power does not provide an important motivation for the formation of employee-owned firms. As we observed in Chapter 2, however, for many employees there may be a substantial problem of ex post market power, or lock-in. After working for a given firm for a number of years, an employee's skills may become specialized to that firm and he may be firmly rooted in the local community. One might expect employee ownership to arise where this type of lock-in is particularly severe.

Yet the distribution of employee-owned firms appears to correlate poorly with the degree of employee lock-in. Although clear data are lacking, it seems a reasonable inference that, in large industrial and service firms, middle- and upper-level managers (and perhaps blue-collar employees as well) often become specialized to their current employer over time and are therefore considerably more productive in that firm than they would be in any alternative employment.[28] These

firms also accumulate information about the productivity of their employees that is unavailable to other prospective employers, and this should also reduce the wages the employees can obtain elsewhere. Nevertheless, such firms are rarely employee-owned. Rather, in the types of firms that are employee-owned, the employees appear unusually mobile. This is evidently true for the blue-collar employees who most commonly form worker cooperatives, such as taxicab drivers,[29] refuse collectors, and the semi-skilled laborers in the plywood cooperatives. And it is arguably true as well for service professionals such as lawyers and accountants.

To be sure, a professional such as a lawyer develops a special familiarity with her firm's personnel, procedures, and clients that is considerably more valuable within that firm than in another firm. Yet in part because service professionals typically provide services directly to their firm's clients rather than providing intermediate services to the firm itself, such professionals have mobility advantages that other types of employees lack: their skills are generally highly transferable; they have the option—largely unavailable to other types of skilled individuals—not only of taking a position with another established firm but also of forming a new firm of their own; and they can often take some of their clients with them when they leave their current employer.[30]

The types of employees who are found in employee-owned firms thus appear, if anything, to be less subject to lock-in than are employees in typical investor-owned firms. Again, this is not to say that lock-in does not provide an important incentive for employee ownership. But there must be other considerations that are more important in determining where employee ownership is most viable.

Strategic Bargaining Behavior

With investor ownership, management often has information that labor lacks about the firm's future prospects, including profitability, employment needs, and plant closings or relocations. Similarly, employees have knowledge that management lacks concerning the employees' own opportunities and preferences, including the minimum wages they would find acceptable, the ease with which they can increase their productivity, and changes in workplace organization that will improve productivity but require fewer employees or greater employee effort. The resulting asymmetries in information provide the incentive for both labor and management to adopt bargaining strategies, such as

strikes and lockouts, that significantly raise the transaction costs of reaching agreement.[31] One of the strong advantages of employee ownership is its potential to reduce or eliminate these costs.

In the types of firms in which employee ownership is common, however, the potential asymmetry of information between management and employees seems comparatively low. Consider, for example, partnerships of professionals such as law firms. The smallness of such firms and the shallowness of the hierarchy between management and the firm's professionals (indeed, the senior professionals in these firms *are* the firm's management) suggest that the professionals in these firms, even if they were not partners, would among themselves have most of the information available to management and vice versa. It is in large firms with substantial hierarchy and division of labor between management and the rest of the labor force that information asymmetries are likely to be most pronounced. But such firms are rarely employee-owned.

Communication of Employee Preferences

We also observed in Chapter 2 that, because employees in investor-owned firms may have information concerning their preferences that they cannot credibly communicate to management, investor-owned firms may be handicapped relative to employee-owned firms in fashioning the most efficient package of financial compensation and working conditions for their employees. Yet this advantage also fails to explain the existing distribution of employee ownership since, as just noted, employee ownership tends to appear in precisely those settings in which management is likely to have relatively little difficulty understanding employees' preferences.

Responsiveness to Average versus Marginal Employee Preferences

There are many situations in which the preferences of the marginal employee are likely to be different from those of the average employee. Workplace safety is an example considered in Chapter 2. Job security is another, and for similar reasons: the marginal employee may well be a young person who does not have a family and who is easily retrainable, and therefore is less averse to the possibility of layoff than an older employee might be. The organization of work, workplace aesthetics, and employee benefits are also areas in which the interests of

the marginal and the average employee may diverge. Thus employee ownership, which should tend to emphasize the preferences of the average employee, may often be more efficient in aggregating employees' preferences than is the hiring of employees through market contracting, which emphasizes the preferences of the marginal employee.

The actual importance of this problem in investor-owned firms is difficult to assess. Collective bargaining presumably mitigates its effects wherever there are unions. In any event, it does not seem important in explaining the distribution of employee-owned firms. As will be discussed at much greater length below, ownership in employee-owned firms is generally shared only among employees who have unusually homogeneous interests, which means that the difference between marginal and average preferences among the employee-owners is unusually small.

Alienation

Finally, it is a familiar argument that market contracting for labor leads to worker alienation. And indeed labor contracting is prototypically the type of setting in which, if anywhere, one would expect to find the problems described under this heading in Chapter 2.

Once again, however, the distribution of employee ownership is arguably the reverse of what one would expect if problems of worker alienation were important. Employee-owned firms tend to arise in industries in which most firms, whether capitalist or employee-owned, are small and have relatively homogeneous work forces with little hierarchy, which is precisely the setting in which one would expect relatively little worker alienation. Moreover, concern about worker alienation generally focuses on blue-collar employees, while it is service professionals that are most commonly employee-owners. (To be sure, the focus on blue-collar workers may simply reflect the strong concern with social class in much of the relevant literature. Whether in fact blue-collar employees resent selling their services through market relationships more or less than do professionals is not obvious a priori.)

Summary

When compared with contracting for labor on the market, employee ownership holds the promise of significant efficiency advantages, including improved employee productivity, avoidance of opportunism

associated with employee lock-in, less strategic behavior in bargaining, better communication of employee preferences, and reduction in worker alienation. These advantages presumably explain the success of employee ownership in those industries where it is commonly found. But the magnitude of the potential efficiency gains from these sources correlates poorly with the actual pattern of employee ownership. In general, these potential gains seem greatest in large-scale hierarchical firms, which are typically investor-owned, and comparatively much more modest in the small-scale professional service firms where employee ownership is most common. We must look elsewhere for an explanation of the existing distribution of employee-owned enterprise.

Raising Capital

It is conventional wisdom that employee ownership is poorly suited to capital-intensive industries. While there is some truth in this view, the importance of capital intensity is often exaggerated.

If an employee-owned firm needs capital primarily to purchase assets that are not firm-specific, the firm can usually borrow the capital on reasonable terms. The resulting leverage may impose substantial risk on the employee-owners. But employees are often prepared to bear a relatively large amount of risk. In fact, employee-owned firms are surprisingly common in relatively capital-intensive industries that employ fungible assets. Transportation companies, much of whose capital is invested in vehicles that are easily resold, are among the types of firms in which employee ownership most commonly appears. Investment banking also requires substantial capital per employee, but again, the firms' assets are highly fungible.

The family farms that dominate American agriculture provide yet another example. They are employee-owned firms owned by a single individual or family. And they are often quite capital intensive. But, because the land and equipment are not firm-specific and thus provide good security, individual farmers can borrow extensively to obtain the capital necessary to permit them to be owners.

In contrast, if capital is needed to purchase assets that are firm-specific, the costs of contracting for capital on the market can be heavy, as described in Chapter 4. Where the amount of firm-specific capital per employee is modest, or where the employees are prosperous, these costs can be avoided by having the employees themselves supply the capital. For example, under the ESOP approach to employee owner-

ship, the employees invest their pension savings in their employer's stock. Then both labor and capital are provided by owners, avoiding the costs of market contracting for each factor. But this solution creates two problems of its own.

The first and most familiar problem is that, when employees invest any significant portion of their wealth in the firm that employs them, they increase significantly the amount of risk that they bear. They not only reduce the diversification of their investment portfolio, but also reduce the diversification between their investment portfolio and their source of earned income—that is, their human capital. If the firm goes bankrupt, they lose not only their jobs but their savings as well.

The second problem is that, when the firm's owners are suppliers of capital as well as labor, the opportunities for divergence of interest among them is likely to increase. Generally some employees—often the older employees—will have proportionately more capital invested than others, with the result that the balance between individuals' interests as investors and as employees will vary. This imbalance threatens, in turn, to increase the costs of collective decision making.

In short, if an employee-owned firm requires large amounts of firm-specific capital per employee, the firm may incur substantial costs whether the capital is borrowed or supplied by the employees themselves. This presumably helps explain why employee ownership seldom appears without subsidy in the industrial sector. For those industries, ownership by the lenders of capital has the strong advantages described in Chapter 4.[32]

This point should not be overstated. As we observed before, the success of leveraged buyouts with high debt-equity ratios suggests that today sufficient debt can often be obtained to cover a large fraction of a firm's capital needs. The proliferation of ESOPs in the manufacturing sector indicates that a firm's employees can themselves provide substantial equity capital without crippling costs. The employee-owned firms at Mondragon have not had difficulty obtaining capital even though they are in moderately capital-intensive industries; indeed, by the early 1990s the firms in that group, together with their affiliated bank, had become net lenders.[33] Finally, other types of non-investor-owned firms have had significant success in capital-intensive industries. Consequently there is good reason to believe that capital accumulation is not an insuperable obstacle to employee ownership in most industries.

Conversely, although a relatively low level of firm-specific capital per employee is helpful in making employee ownership viable, it is apparently not sufficient. There are many industries in the service sector that involve low amounts of firm-specific capital but in which employee ownership has remained rare, such as hotel and restaurant services, retailing, and (at least in the United States) the construction trades.

It seems, then, that the costs of obtaining capital cannot by themselves explain prevailing patterns of employee ownership either within or without the industrial sector.[34]

Costs of Ownership

The existing distribution of employee-owned firms clearly cannot be explained just in terms of the costs of market contracting. More particularly, employee-owned firms do not, as one might at first suppose, simply arise where the costs of hiring labor on the market are unusually high and the costs of hiring capital are low. For an explanation we must turn to the costs of ownership.

Agency Costs of Delegation to Management

The problem of the separation of ownership and control—that is, the agency cost of policing management—is potentially much less acute in employee-owned firms than it is in investor-owned firms. Investors of capital are often widely dispersed, have no sources of information about the firm beyond publications, and hold the firm's securities as only one of a number of investments. As a result they are in a poor position to police the firm's management. In contrast, employees know a great deal about the firm simply as a by-product of their employment and are in a good position to learn more; they have a large personal stake in the fortunes of the firm, since most of their income comes from it; and they can be easily assembled for collective action. They have both the opportunity and the incentive to acquire information about the effectiveness of management—or to appoint and hold accountable representatives who will do this for them—and then to act collectively to hold management accountable to their will.

To be sure, investor-owned firms have the benefit of the market for corporate control as an aid in policing management. Yet it is not

necessary to forgo the benefits of this market when a firm is employee-owned. The employees can sell the firm to outside investors at any point they wish.[35] In fact, such transactions have occurred frequently (for example, among plywood cooperatives,[36] advertising firms, and investment banking firms).

It follows that one might expect to find employee ownership in those circumstances where investors would be in a particularly poor position to monitor the firm's management. Yet successful employee-owned firms are in most cases sufficiently small that, if investor-owned, they would be closely held firms. They would not experience a significant separation of ownership and control, nor the agency costs associated with such a separation.[37] The potentially high agency costs of investor ownership therefore fail to explain why employee ownership appears where it does.

Risk Bearing

Poor risk sharing is a commonly cited disadvantage of employee ownership. Workers, lacking the ability to diversify risk by taking jobs in a number of different firms simultaneously, are in a worse position than investors to bear the risks of fluctuating residual earnings.

It would be reasonable to conclude from this that risk bearing is a major obstacle to employee ownership in all forms of enterprise, and particularly in capital-intensive enterprise where the risks borne by employee-owners are amplified. Interestingly, however, the observed distribution of employee ownership does not provide much support for this conclusion. The plywood industry is both moderately capital intensive and relatively volatile.[38] Investment banking is highly capital intensive and highly volatile. And farming is often highly capital intensive, as already noted, and also highly volatile. Indeed, the inability of investor-owned firms to gain an appreciable market share in most important crops is dramatic evidence of the relative unimportance of risk bearing in assignments of ownership: farms continue to be owned overwhelmingly by the individuals who work them, despite the large amounts of risk those individuals must consequently bear. Clearly there is a substantial segment of the working population that is quite willing to bear substantial risk in return for other efficiencies.

Moreover, we should not underestimate the amount of risk that employees bear even in investor-owned firms. It would be efficient, if

an enterprise were viewed simply in terms of risk bearing, for the investor-owners of an industrial firm to bear the overwhelming share of the risk of the enterprise and to insure employees against the vagaries of the market by providing substantial job security. Yet in the United States, industrial workers have traditionally been hired as employees at will who can be laid off on a day's notice whenever the firm's fortunes take a turn for the worse—and this has been true even in unionized firms.[39] There are presumably several explanations for this seeming anomaly, including the incentives created by the prevailing system of collective bargaining,[40] the reduction in productivity that might accompany greater job security,[41] and the limitation on employees' prospective downside losses resulting from unemployment insurance, social welfare programs, and the prospect of reemployment. But whatever the reason, job security in many industries has traditionally been very low, with the result that a shift to employee-owned enterprise might not cause employees to bear substantially more risk than they do already.

In short, there is good reason to believe that risk bearing is not in itself a major obstacle to employee ownership, and that it plays at best a modest role in explaining the distribution of employee ownership that we observe.

Collective Decision Making

This leaves us to assess the third and final principal cost of ownership, the cost of collective decision making. In fact, this factor seems to play a surprisingly strong role in determining where employee ownership is viable. The next chapter is devoted in large part to exploring this issue. First, however, we must turn to several other considerations that, though not included among the basic costs of contracting and of ownership surveyed in Chapters 2 and 3, are often said to present major obstacles to the success of employee-owned enterprise.

The Horizon Problem

It has been argued that employee-owned firms have too little incentive to invest in projects that will pay off only over long periods of time (the "horizon problem").[42] The source of the problem, it is said, is the employees' lack of transferable residual claims. Because employee-

owners freely sell their ownership rights on the capital market, they lack the ability that investor-owners have to realize, in the present, the value of the future returns that their investments will bring.

There may well be a horizon problem in firms, such as those formed in Yugoslavia during the decades of communist rule, in which employees have control but only a limited right to appropriate net earnings and assets—that is, in which firms are employee-managed but not employee-owned. In free enterprise economies, however, most employee-owned firms with any significant amount of invested capital are organized to provide their employees with residual claims that are transferable. In some firms these claims are transferable at all times and in others they are transferable only when the employee leaves the firm. For example, shares in the plywood cooperatives can be freely sold to new employees by departing ones, subject only to a right of first refusal by the firm.[43]

Even if employees could never withdraw capital from the firm, they should have a relatively long time horizon. The median employee's expected tenure with a firm may well be as long as fifteen or twenty years, or even longer if pension payoff periods are included.[44] And a fifteen-year investment horizon is quite long by contemporary industrial standards.

There is thus little reason to believe that the horizon problem has been a major obstacle to employee ownership.

Reversion to Investor Ownership

Successful employee-owned firms frequently convert (or, as advocates of employee ownership say, "degenerate") to investor ownership. For example, there has been gradual attrition from the ranks of the U.S. plywood cooperatives as their members have sold the firms to investors. Similarly, failing investor-owned firms that were bought out by their employees and subsequently succeeded (rather than going bankrupt) have sometimes reverted to investor ownership.[45] And in some of the service professions, such as advertising and investment banking, many firms formerly organized as partnerships have been acquired by outside investors in recent years. Noting this pattern, some scholars have argued that a tendency to convert to investor ownership is an inherent characteristic of employee-owned firms, and that this is an important explanation for the minuscule market share that employee-

owned firms occupy in the industrial sector.[46] At least two different mechanisms have been offered to explain this supposed tendency.

A Tendency toward Hired Labor

First, it has been argued that when a successful employee-owned firm takes on additional employees, it has a strong incentive to hire them on a salaried basis rather than to make them owners. For if the firm's net earnings per employee are higher than the market wage rate—which is what "successful" means in this analysis—the existing employee-owners will find it profitable to take on new workers only as mere salaried employees who receive the market wage rate rather than as co-owners who have a pro rata share in the firm's profits. Consequently, over time the ratio of employee-owners to hired employees will steadily decline until ownership is concentrated in the hands of a small number of individuals and the enterprise has essentially assumed the character of an investor-owned firm.[47]

The soundness of this argument, however, depends on the assumption that the productivity of a worker in the worker-owned firm is the same whether she is hired as a salaried employee or made an owner. But in that case worker ownership has no efficiency advantage over investor ownership, and there is no reason why the workers should own the firm. The success of the hypothetical employee-owned firm in this analysis must be due, not to the fact that it is employee-owned, but rather to some other factor such as market power, accumulated reputational goodwill, or possession of an important patent. The firm would then be just as successful, or perhaps even more so, if it were investor-owned, and a tendency to convert to investor ownership would be neither surprising nor inappropriate.

This case is in contrast to those in which the success of an employee-owned firm *is* due to employee ownership, perhaps because the employees are more productive when they are also owners, or because they derive other tangible or intangible rewards from ownership and are hence willing to work for lower cash compensation. In that case, it should be more profitable for the existing members of the firm to add new employees by giving them a share in ownership[48] than by taking them on only as salaried employees, and there should be no tendency toward investor ownership.

In some industries in which employee ownership is the dominant

mode of organization, there has been no conspicuous tendency to substitute hired labor for employee-owners. Large law firms, for example, have for generations almost universally followed an up-or-out system whereby an employee must leave the firm if she has not been made a partner within a period of six to eight years. This practice ensures that all but the most junior lawyers in the firm will always be owners. Continued adherence to this system arguably reflects a recognition by all involved that employee ownership is the most efficient system of organization for these firms and that deviation from that system would in the long run be costly. To be sure, in recent years it has been increasingly common for law firms to create a class of hired senior attorneys termed "permanent associates" and in the process abandon strict adherence to the up-or-out system. But, as we shall discuss in the next chapter, this phenomenon seems best explained by considerations other than the theory of inevitable degeneration just described.

Capital Accumulation

The second mechanism alleged to cause successful employee-owned firms to convert to investor ownership is that, owing to the firms' very success, their value per employee becomes so large over time that younger employees cannot afford to purchase a share in the firm from older employees who are retiring. As a result the older employees have a strong incentive to sell their shares to outside investors, thus converting the firm to investor ownership.

The problem with arguments of this type is that they rarely make it clear precisely why the firm's net worth per employee has increased over time. There are, broadly speaking, two possibilities. On the one hand, net worth may have increased because the firm has retained and accumulated net earnings over the years. In that case, the firm should be able to distribute the accumulated retained earnings to the retiring employees (by repurchasing their shares) and replace them with debt, bringing net assets per employee down closer to the original level so that new young employees can afford to purchase shares in the firm.

On the other hand, net assets per employee could have increased because the firm has adopted new technology that requires more firm-specific capital per employee than the technology employed when the employees first acquired ownership, and the firm has used retained or

forgone earnings over the years to acquire the required new technology. (Note that goodwill is among the common forms of firm-specific capital that a firm can accumulate over time.) The requisite amount of equity capital per employee may now be much higher than a new employee could or would contribute. Employee ownership is therefore less appropriate, and conversion to investor ownership may be efficient.

In short, financial success need not in itself make it more difficult for a new generation of employees to become owners of the firm than it was for previous generations of employees. If there have been no changes in the industry that make employee ownership less efficient, then it should be possible to rearrange the firm's financing—perhaps by increasing the firm's leverage—so that new employees can afford to purchase shares and the retiring generation of employees can realize the earnings accumulated during their tenure as owners.

Why Are There Conversions to Investor Ownership?

If, as just argued, there is no perverse mechanism that causes successful employee-owned firms to convert to investor ownership simply as a consequence of their very success, then why do conversions from employee ownership to investor ownership occur so frequently? The most likely explanation is simply that employee ownership is not an efficient mode of organization for the firms involved.

In some firms that convert from employee to investor ownership, employee ownership was probably an inefficient way to organize the firm from the start. For example, in some cases employee-owned firms are established out of miscalculation or excessive idealism; conversion to investor ownership is then simply a belated recognition of that fact. In other cases employee ownership, though in itself perhaps inefficient for the firm in the long run, is evidently adopted to facilitate an efficiency-enhancing one-time transaction that could not otherwise be arranged. A common situation of the latter type occurs in investor-owned firms that fall into severe financial difficulties. Selling such a firm in whole or in part to its employees has a variety of potential advantages. It offers a way for the employees, and especially their union, to accept the substantial concessions necessary for the firm to continue—such as layoffs, severe reductions in wages, and changes in work rules —without loss of face and without creating a precedent that

will compromise the union's bargaining strategy vis-à-vis other more successful firms. It gives employees a benefit (the stock in the reorganized firm) of uncertain value to set off against their specific reductions in wages and benefits, making the net magnitude of the employees' loss less specifically concrete and hence easier to accept psychologically. It is a credible way for the investor-owners of the firm and their managers to signal credibly to the workers the management's view of the seriousness of the firm's financial difficulties and the consequent necessity for employee concessions, thus averting costly bargaining. Finally, it is a credible way to assure the employees that, if the firm survives and prospers, the fruits of the employees' concessions will not go disproportionately to the firm's current investor-owners.[49] There remains the option that, if the firm succeeds, the employees can ultimately sell it back into investor ownership. This transactional use of employee ownership arguably characterizes the recent employee stock acquisitions in the airline industry, including United Air Lines, as well as the prominent employee buyout of the Weirton Steel Company described in the next chapter.

Finally, there are situations in which employee ownership was once efficient, but has ceased to be so, perhaps because the character of the industry has changed. This is arguably the situation in investment banking, for example, in which the capital required per employee and, perhaps more important, the size and internal complexity of individual firms have increased in recent years to the point where, for most firms, investor ownership may now be the most efficient mode of organization.

Perverse Supply Response

The economics literature on employee ownership shows an almost obsessive fascination with a simple theoretical model, originally developed in the 1950s by Ward, portraying the behavioral incentives facing a worker cooperative.[50] This fascination owes much to the model's prediction of "perverse supply response": when worker cooperatives experience an increase in demand for their product or a decrease in their costs of production, they have an incentive to reduce both the amount of their output and the size of their work force; conversely, when the price at which the cooperatives can sell their product declines, or the costs of their nonlabor inputs rise, they have an incentive

to add more workers and increase output. The model likewise predicts that worker cooperatives will be smaller than comparable investor-owned firms and will underemploy labor. The basic reason for this strange behavior is that the firms in the model maximize average profit per worker-member rather than total profit.

Despite the attention given to it, this model does little to explain the observed distribution of employee-owned enterprise. To begin with, the inefficient behavior predicted by the model depends on a variety of unrealistic assumptions—such as that the firm produces only a single product, that the number of hours worked per employee is fixed, that there can be no nonmember employees, and that new employee-owners will always be brought in on the same terms as their predecessors (without, in particular, having to pay anything to the existing members for the privilege of joining). Moreover, as has long been recognized, even if these restrictive assumptions are granted, entry by new cooperatives should ultimately lead to efficient levels of output and employment both for individual firms and for the industry as a whole. Presumably for these reasons, empirical work has failed to uncover clear evidence of the phenomena predicted by Ward's model.[51]

Legal Constraints

It is sometimes suggested that lack of a legal structure well adapted to employee ownership is heavily responsible for the general paucity of employee-owned enterprise in market economies. Yet in the United States, at least, it is hard to argue that the law has been a serious obstacle to the success of employee ownership.

There are no explicit legal prohibitions on employee ownership of enterprise in any industry. On the contrary, there is at least one business—the practice of law—in which employee ownership is explicitly required by law throughout the United States. The American Bar Association's Model Rules of Professional Conduct, like the Model Code of Professional Responsibility and the Canons of Professional Ethics that preceded them, explicitly proscribe any arrangement whereby a lawyer serves as an employee of a profit-seeking organization that sells legal services to the public if that organization is not wholly owned by lawyers who practice in it, as in the conventional law partnership or professional service corporation.[52] Because this provision of the Model Rules, or a close counterpart, has the force of law in

virtually very state,[53] employee-owned firms are presently the only available form for organizing the practice of law.[54] Analogous legal restrictions forbade the formation of investor-owned, rather than doctor-owned, medical practice firms in most states before those laws were overridden by the federal Health Maintenance Organization Act of 1973.

More generally, existing organizational law—that is, corporation law and partnership law—is sufficiently flexible to permit the formation of nearly any type of worker cooperative. In some states the cooperative corporation statutes appear suitable for this purpose, and in theory these statutes provide the simplest and most direct approach.[55] In many jurisdictions, however, the business corporation statutes are more workable, owing largely to the rudimentary and sometimes narrowly constricting character of the cooperative statutes.[56] Using the business corporation statutes, to be sure, requires some manipulation to ensure that earnings are distributed according to work contributed. One can argue, therefore, that employee-owned firms have been disadvantaged vis-à-vis investor-owned firms in that statutes embodying a standard form have not been available for the former while they have been for the latter.

The new worker cooperative corporation statutes that have recently been enacted in some states are designed to provide the missing standard legal form. Those statutes do no more than this, however; even their promoters do not claim that they extend the range of available organizations beyond those that can be formed under the existing business corporation statutes. Nevertheless, such a standard form may offer significant advantages. It not only reduces the transaction costs of forming an employee-owned firm (for example, by making the form comprehensible to a broader range of attorneys), but also presumably gives the form a degree of visibility, recognizability, and legitimacy it might otherwise lack. A bank lending officer, for instance, might well feel more secure making a loan to a worker cooperative formed according to a standard pattern set forth in a special worker cooperative statute than to one formed under a business corporation statute by means of complex articles of incorporation, bylaws, and shareholder agreements.

That said, it is nevertheless highly unlikely that the inconvenience of the lack of a standard statutory form has in itself been an important obstacle to the development of employee-owned enterprise. The business corporation statutes generally serve as a standard form only for publicly held corporations, in any case; closely held business corporations, which represent the overwhelming majority of all firms, often require some special drafting. In addition, there have long been conspicuous examples of employee-owned corporations, such as the plywood cooperatives, that have been successful without the benefit of standard statutory forms and whose corporate charters and bylaws are available to serve as organizational models for other employee-owned firms. (Some of the plywood cooperatives are incorporated under cooperative corporation statutes and some under business corporation statutes.)[57] It would be surprising if the adoption of the new worker cooperative statutes were to increase significantly the popularity of employee ownership.

Moreover, tax law is probably more important than organizational law in determining which organizational forms prosper, and tax law has long been biased in favor of, rather than against, employee ownership. At least since 1931, net earnings distributed to members of a workers' cooperative have been able to escape (at least to a substantial degree) the corporate income tax that is levied on net earnings distributed to investors in investor-owned firms.[58] In addition, since 1964, worker cooperatives have qualified for the special regime established for all types of cooperatives in Subchapter T of the Internal Revenue Code—described in more detail in Chapter 7—under which all the net earnings of a worker cooperative, whether distributed or retained, are free from the corporate income tax.[59] Finally, since the early 1970s there has existed a generous package of tax subsidies for employee stock ownership plans.[60]

Ideological Hostility

It has been argued that, whatever the formal legal rules and institutions that bear on the matter, American society in general, or key actors such as bankers in particular, are hostile to employee ownership on ideological grounds and have used their authority to hamper its development and deprive it of cultural legitimacy.[61] Yet while some Americans undoubtedly see employee ownership as socialistic and therefore evil, the evidence makes it hard to argue that ideological resistance to employee ownership is strong or widespread. As was noted in the Introduction, employee ownership has shown broad ideological appeal to

the right as well as to the left in the United States, and the advocates of ESOPs have exploited this appeal quite successfully.

Moreover, lawyers, accountants, investment bankers, and management consultants—the actors in society principally responsible for the design of business organizations—have long organized themselves in employee-owned firms. They cannot be unaware of the benefits of employee ownership or opposed to it on principle. At most they can be accused, rather implausibly, of hoarding the benefits of employee ownership for themselves and—whether out of spite or just lack of imagination—denying those benefits to firms in other industries.

To understand the prevailing pattern of employee ownership, we must turn instead to the costs of governance that are the subject of the next chapter.

6

Governing Employee-Owned Firms

A recurrent theme in the voluminous literature advocating employee ownership (or, more broadly, "economic democracy," "worker participation," or "labor management") is that employee participation in control of the firm through democratic processes is of value in itself, quite apart from the quality of the substantive decisions reached by those processes. In Chapter 3 we speculated on three reasons why this might be so: that participation in governance is a consumption good; that it provides a valued sense of control; and that it stimulates and informs participation in political life beyond the boundaries of the firm. The last of these reasons might provide some justification for public subsidy to employee ownership as a means of making workers more responsible citizens in a democratic society. Unfortunately, the available empirical evidence provides little support for it.[1] The employees themselves enjoy the other two potential benefits of employee participation. If those benefits are actually important, they should influence employees' choices about the types of firms in which to work. That is, they should give employee-owned firms a survivorship advantage.

Participation is not free, however. It brings with it all the costs of collective decision making. And there is substantial evidence that these costs can be large.

The Costs of Collective Decision Making

In many respects a firm's employees are often better situated than its investors to oversee management effectively, as we observed in Chapter 5. But there is a compensating disadvantage: employees are far