When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy

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I. Introduction

Employee ownership of enterprise has become a prominent focus of public policy and private action both in the United States and abroad. This is the result, in considerable part, of an unusual convergence of economic thought from opposite ends of the political spectrum. On the left, recent years have brought the sudden and virtually complete collapse of state socialism as an economic ideal in both the East and the West. In the resulting ideological void, “workplace democracy” has emerged as the principal institutional reform that today commands widespread support among critics of capitalism; worker control of enterprise, it is hoped, will succeed where state control has failed in equalizing power and wealth and in decreasing worker alienation and exploitation. Reformers on the right, in turn, have become increasingly discouraged with the efficiency of traditional forms of labor-management relations. For an alternative, many have turned to employee ownership, hoping that it will improve productivity and increase worker identification with the interests of capital.

1. I refer here principally to the remarkable events of the last decade, during which Western European socialist parties have largely abandoned nationalization of industry as a plank in their platforms, communist Cuba and China have been eclipsed by capitalist Japan, Taiwan, Singapore, and South Korea as popular models for development throughout most of the Third World, the governments of the Soviet Union and China have effectively declared that state ownership of enterprise must be abandoned as a failure, and—most recently and spectacularly—the countries of Eastern Europe have begun to shift rapidly toward market economies.


3. The most influential proponent on the right in the U.S. has been Louis Kelso. See L. Kelso & M. Adler, The Capitalist Manifesto (1958); L. Kelso & P. Hetter, How To Turn Eighty Million Workers into Capitalists on Borrowed Money (1967); L. Kelso & P. Hetter, Two-Factor Theory: The Economics of Reality (1967). Kelso’s appeal to the populist right, particularly in the person of the late Senator Russell Long, has played an important role in the enactment of the substantial preferences for employee stock ownership plans that have been incorporated into Federal tax and pension law.

Whether out of principle or opportunism, many in the financial community now extol the virtues of
In the United States, current efforts to promote worker ownership have focused heavily on employee stock ownership plans (ESOPs) through which workers invest in their own company’s stock. There are now roughly 10,000 companies with such plans, including perhaps 1000 or more in which the ESOP holds a majority of the firm’s stock, and their numbers continue to grow rapidly. The ESOP movement has been strongly fueled by a variety of Federal and state legislative enactments. Most important among these is a series of large Federal tax subsidies created since the mid-1970’s. It is testimony to the popularity of the ESOP concept that these subsidies, almost alone among substantial tax preferences, survived the 1986 Tax Reform Act not only unscathed but strengthened. Yet ESOPs have also attracted strong critics, and the policies that support them are becoming the subject of increasing controversy.

Worker ownership in the United States has by no means been confined to ESOPs, however. Long before the advent of ESOPs, employee ownership was already the prevailing form of organization in a number of significant U.S. industries. Most conspicuous among these are the service professions, including law, accounting, investment banking, management consulting, advertising, architecture, engineering, and medicine. Although discussions of worker ownership commonly focus on industrial firms and rarely make reference to the partnerships and professional corporations that populate the service professions, such firms are among the world’s

worker ownership. For example, commenting on the conversion of a tugboat manufacturer to worker ownership with union management, Michael Milken of Drexel Burnham Lambert, Inc.—then at the peak of his influence—said:

The movement to ownership by the unions is the latest step in the progression from management ownership to employee ownership. It is part of what I call the democratization of capital. . . . When the employees own the company, productivity is higher, investment is higher and the chances of the company being successful are greater.

N.Y. Times, Aug. 28, 1988, § 3, at 1, col. 1.

4. I shall use the terms “worker ownership” and “employee ownership” interchangeably here. This means, in particular, that I shall not use the term “worker” to refer only to blue-collar workers, nor shall I use the term “employee” to suggest that the individuals involved necessarily have a contractual relationship with the firm that provides them with a salary in addition to whatever share they have in earnings as owners.

5. See infra Section VII(A).

6. At the Federal level, in addition to the tax subsidies discussed immediately below and infra at text accompanying note 157, these include the partial exemptions from diversification requirements and self-dealing prohibitions contained in Federal pension regulation. See Doernberg & Macey, ESOPs and Economic Distortion, 23 HARV. J. ON LEGIS. 103, 107-08 (1986). In addition, at least 19 states have passed legislation encouraging employee ownership, including tax preferences, loans and loan guarantees, and special employee cooperative corporation statutes. See Employee Benefit Research Institute, Issue Brief, Jan. 1988, at 25.

7. For analyses critical of the ESOP concept, see Levin, The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan, 95 YALE L.J. 148 (1985); Doernberg & Macey, supra note 6. Both these analyses, though thoughtful, are conventional in emphasizing the problems of illiquidity and risk discussed infra Section IV—problems which, as noted in that Section, are perhaps not so serious as these and other authors suggest—and largely ignore both the benefits of worker ownership discussed infra Section III and the costs of control discussed infra Sections V and VI.

ESOPs recently have become the subject of increasing critical scrutiny in the popular press as well. See, e.g., ESOPs: Are They Good For You?, Bus. Wk., May 15, 1989, at 116-23.
purest examples of worker ownership. Moreover, the industries in which they are found are virtually the only industries, not just in the U.S. but in any country, that are dominated by worker-owned firms. Yet recent increases in the scale and scope of the services provided by the firms in these industries, together with alterations in the market environment in which those firms operate, have caused investor ownership to begin to replace employee ownership. In the legal profession, in particular, there is increasing pressure to abandon the rules, which currently have the force of law in every state, that require all law firms to be owned exclusively by the lawyers that practice in them—that is, to be worker-owned.8

Worker ownership has also been a prominent focus of attention outside the United States.9 France and Italy both have substantial and growing numbers of worker cooperatives in their industrial sectors, encouraged in both countries by special governmental benefits. Britain has recently experimented actively, through both public and private action, with industrial worker cooperatives. And the large complex of prosperous worker cooperatives at Mondragon in Spain is now widely considered the textbook model for successful employee ownership of industrial enterprise. Accompanying these efforts at full worker ownership have been important steps to expand employee participation in corporate control in general through legislation that grants workers rights that verge on co-ownership. Most conspicuous in this regard is Germany, which has adopted a system of codetermination under which workers in all large corporations are entitled to elect up to half of the company’s board of directors. A similar regime has been proposed for the European Economic Community as a whole, to become part of the corporation law of all member states, and remains the subject of active debate.

Nor has interest in worker ownership been confined to capitalist countries. Both the Soviet Union and China are focusing on worker ownership as a first step in their astonishing efforts to privatize their economies.10 In several Eastern European countries, reform movements have long been pressing for worker control of enterprise.11 And at the same time, Yugoslavia, which has mandated worker management as the norm in its economy for several decades, is beginning to subject that form of organization to increasingly critical scrutiny.12

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8. See infra Section X(D).
9. See infra Section II(B).
11. See, e.g., Norr, Self-Management and the Politics of Solidarity in Poland, in WORKER PARTICIPATION AND THE POLITICS OF REFORM 267 (C. Sirianni ed. 1987). Solidarity’s commitment to worker control has become less apparent, however, now that it has backed the effort to transform Poland overnight into a market economy.
12. Protests Swell as Yugoslav Economy Stalls: Painful Cure Promised for Tito’s Unworkable
For all of the interest and controversy that worker ownership has stimulated, and for all of the legislation that has been enacted to promote it, current scholarship does not provide a satisfactory account of the existing distribution of worker-owned firms across industries, much less of the relative strengths and weaknesses of employee ownership in general. I believe that an important reason for this is that previous analyses have been mistaken in their assessment of the most significant costs and benefits of worker ownership, and in particular have largely neglected a critical consideration: the costs of collective decision-making, or what we might term the internal politics of the firm. In this article I develop these themes and explore their implications, not just for worker ownership and the policies that promote it, but for the full range of means by which workers can participate in earnings or control, including ESOPs, codetermination, labor representation on corporate boards, and collective bargaining. In the course of the analysis I seek to shed particular light on the evolving structure of the sector in which worker ownership is most heavily concentrated, namely the service professions. In this connection I try not only to illuminate the reasons for recent changes in patterns of ownership, but also to provide a better explanation than has previously been given for some important aspects of the internal organization of firms, such as why it is that law firms so often share earnings equally among partners of a given age, or why they have so much difficulty accommodating as partners women who wish to have children.

The analysis begins in Section II with a description of the various forms that worker ownership takes and the frequency with which those forms appear in different industries and different countries. The following Sections then offer a systematic assessment of the benefits and costs of worker ownership, and of the degree to which those benefits and costs can explain the observed distribution of worker-owned firms. Section III begins by examining the benefits of worker ownership. It argues that worker ownership offers a number of important efficiency advantages vis-à-vis investor ownership—advantages that have often been ignored or underemphasized in the existing literature. However, these advantages correlate poorly with the observed distribution of worker ownership: the types of industries in which the advantages offered by worker ownership seem most important are not the industries in which worker ownership is most common. Section IV surveys the principal costs that have most commonly been imputed to worker ownership vis-à-vis investor owner-

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ship—including the costs of raising capital and of risk-bearing—and argues that these costs, while clearly significant in explaining the observed distribution of worker ownership, are less important than has commonly been supposed and, in any case, are insufficient to explain the existing distribution of worker-owned firms. Sections V through VII focus on other costs of worker ownership that have previously been overlooked or underemphasized, namely the costs associated with collective worker governance. The accumulated experience with worker ownership, it is argued, strongly suggests that these governance costs—which involve both the costs of the decision-making process and the costs of inefficient decisions—are quite high when the workforce exhibits any substantial degree of heterogeneity. Indeed, it appears that the most important obstacle to more widespread development of worker-owned firms is not risk-bearing or the cost of capital, but rather the difficulty of establishing an efficient collective governance mechanism for a heterogeneous population of workers. Sections VIII and IX proceed to survey, and reject, several competing explanations for the limited development of worker ownership to date. Finally, Section X discusses implications of the analysis for policy, including ESOPs, codetermination, the new employee cooperative corporation statutes, and the prohibition on investor-owned law firms.

The main themes developed here have interest well beyond law and policy concerning worker participation in the control of enterprise. Whenever ownership is widely shared—as it is in most large firms, whether they are owned by investors, workers, other suppliers, or consumers—some form of intra-firm political mechanism must be employed to permit the owners to act collectively. The characteristics of such mechanisms play an important role in determining which classes of individuals assume ownership of a firm, how the firm is organized internally, and how it behaves. Consequently, an understanding of politics is essential if we are to understand the organization of enterprise. Conversely, by studying the organization of enterprise we can gain valuable perspective on the characteristics of political institutions and on the relative virtues of politics and markets. The existing literature in political science and industrial organization has largely neglected these important points. Worker ownership is a particularly fruitful setting in which to begin exploring them.

II. THE EXISTING PATTERN OF WORKER OWNERSHIP

In a free enterprise economy, the market should tend to select for relatively efficient organizational forms. Two forces push in this direction. First, entrepreneurs and owners have a financial incentive to organize and reorganize firms in ways that are relatively efficient. Second, competition in the market will put less efficient organizational forms at a disadvantage and those forms will consequently have a smaller chance of surviving. In
the analysis that follows, survivorship will therefore be employed as an important index of the relative efficiency of alternative organizational forms and of worker ownership in particular.

To be sure, we should not exaggerate the effectiveness of market selection. Self-conscious invention and diffusion of new organizational forms can be a very gradual process; relatively inefficient firms may be weeded out by market forces only slowly; organizational, tax, and regulatory law may inhibit or promote particular organizational forms in particular sectors without regard to their efficiency; and various cultural and ideological factors may have a strong influence on the structure of organizations. We shall return below to consider these limitations on market selection more carefully and to assess how important they may be in explaining the current distribution of worker-owned enterprise. Nevertheless, it is reasonable to believe that market selection works with sufficient power to enable us to draw useful inferences about the efficiency of worker ownership as an organizational form by examining the circumstances under which it thrives and the particular configurations it takes.

It should be emphasized that the concept of "efficiency" is used here in the broad sense, conventional in economic analysis, to encompass not only pecuniary but also nonpecuniary interests and values. For example, if participation in the governance of the firm is valuable to workers as an end in itself, then that preference must be given weight in evaluating the relative efficiency of alternative organizational forms. In contractual settings, such as the relationship between a firm and its workers, market selection can generally be expected to take such nonpecuniary values into account. For example, workers who value participation in governance for its own sake are presumably prepared to accept lower financial compensation from a firm that permits such participation than from one that does not, and thus, ceteris paribus, the participatory firm will have lower costs of labor than other types of firms and will be at a competitive advantage in the market for its products or services.

A. The Meaning of "Ownership"

The term "ownership," as it is generally used and as it will be used here, refers to possession of two rights: the right to control the firm and the right to appropriate the firm's residual earnings (that is, the net earn-

16. In broad terms, an organizational form is efficient only if there is no alternative form that could potentially make at least one person better off, in terms of her own subjective value system, without making anyone else worse off. (In general, I shall use the term "efficient" here more narrowly to mean "Kaldor-Hicks optimal." Because of the contractual character of worker-firm relationships, we need not be much concerned with the distributional considerations that distinguish Pareto optimality from Kaldor-Hicks optimality as definitions of efficiency.)
17. In particular, ignoring any other influence that worker participation might have on the performance of the firm, such as increasing or decreasing productivity.
ings remaining after all contractually fixed payments have been made). Control may be exercised either directly, as in the form of direct democracy that characterizes many small partnerships, or indirectly, as in those large firms in which the workers (like the shareholders in publicly-held business corporations) simply vote periodically to elect the firm’s directors, to whom most of the important decision-making powers are delegated.

There are many firms in which the workers receive some or even all of the firm’s residual earnings but have no right to participate in control of the firm. For example, in many firms with ESOPs the workers, through the ESOP, have a claim on most, or sometimes all, of the firm’s net earnings while control over the firm remains in other hands. These firms are often described as “worker-owned,” but this is a bit of a misnomer. In such firms control is often in the hands of investors of equity capital, who also receive a share of the firm’s residual earnings; firms of this type are essentially investor-owned firms with incentive compensation schemes. In other cases, control is in the hands of fiduciaries who do not participate in residual earnings and who, although not selected by the workers, are charged with managing the firm on the workers’ behalf. Such firms are best described as being beneficially rather than directly owned by their workers.

There are also firms in which workers have at least a partial share in control but do not participate directly in residual earnings. For example, under German codetermination, workers elect half of a corporation’s (supervisory) board of directors and thus, at least formally, participate importantly in control. The workers in these firms, however, are commonly salaried rather than compensated with a share of net earnings—although arguably their salaries can be adjusted over time to reflect changes in profitability.

In seeking to understand the viability of worker-owned enterprise, it is helpful to study both firms that are fully worker-owned and firms in which workers share only partially in earnings or control. As an introduction to such a study, it is useful to begin with a brief overview of the incidence of worker ownership both in the United States and abroad.

B. The Distribution of Worker-Owned Firms

1. The United States

Taking the American economy as an example, we find that worker-owned firms are rare in the industrial sector. If we exclude firms that have adopted ESOPs in recent years (to which we shall return below), there have been very few industries in which worker-owned industrial firms have proven themselves viable over the long run. The most conspicuous example is the plywood industry, in which a number of worker cooperatives, situated in the Pacific Northwest, have maintained substantial
market share since the first cooperative was formed in the 1920s.\textsuperscript{18} As of 1984, there were fourteen such firms, each with between eighty and 350 members, most of which had been in business for more than twenty years. Together they accounted for more than ten percent of all plywood produced.\textsuperscript{19} But plywood is unique among contemporary manufacturing industries in having a substantial number of stable worker-owned firms. In the nineteenth century there were a few hundred worker cooperatives, whose members were generally skilled artisans, in such craft industries as barrel making, shoe manufacturing, and shingle weaving. Such firms largely disappeared early in this century, however.\textsuperscript{20}

In the service sector, in contrast, worker-owned firms are common and are the dominant mode of organization among firms of service professionals. Outside of law, however, worker ownership is not the exclusive mode of organization in such fields. In advertising, investment banking, and prepaid group medical practice, for example, investor-owned firms have large and increasing market shares.\textsuperscript{21} Worker-owned service firms also appear occasionally where the workers involved are not professionals. For example, taxicab companies in large cities are quite frequently worker-owned,\textsuperscript{22} and there has long been a group of worker-owned refuse collection companies in the San Francisco Bay Area.\textsuperscript{23}

In addition to these instances of full worker ownership, large numbers of formerly investor-owned business corporations began in the mid-1970s to adopt ESOPs under which most or all of the firm's employees receive a portion of their compensation in the form of stock in the firm. Typically ESOPs are structured as deferred compensation plans in which the employer deposits stock in a trust fund that holds the stock for the benefit of the participating employees, often as the reserve for the employees' pensions. By 1986, approximately 4700 companies had adopted such plans. Roughly twenty-five percent of these plans owned more than twenty-five percent of the stock in their firms, and something less than two percent owned all of the stock.\textsuperscript{24} Today roughly 10,000 companies have ESOPs,\textsuperscript{25}

\begin{flushright}
\begin{enumerate}
\item See generally K. Berman, Worker-Owned Plywood Companies (1967); Greenberg, Producer Cooperatives and Democratic Theory: The Case of the Plywood Cooperatives, in Worker Cooperatives in America, supra note 2, at 175.
\item Greenberg, supra note 18, at 175–76.
\item See Jackall & Levin, Historical Perspectives on Worker Cooperatives, in Worker Cooperatives in America, supra note 2, at 35; Jones, American Producer Cooperatives and Employee-Owned Firms: A Historical Perspective, in id. at 37.
\item See infra text accompanying note 123–25.
\item “Taxi cooperatives are currently operating in virtually every large American city in which local authorities permit these organizations to be formed. They are absent only from cities in which cooperatives are illegal, because local governments have granted monopolies to competing ownership forms.” R. Russell, Sharing Ownership in the Workplace 141 (1985).
\item Id. ch. 3.
\item ESOPs: Are They Good For You?, supra note 7, at 118.
\end{enumerate}
\end{flushright}
and estimates indicate that the ESOP owns a majority of the stock in more than 1000 of these companies.\textsuperscript{26}

2. Other Countries

The pattern of worker ownership seen in the United States is roughly duplicated in other market economies: The types of industries in which worker-owned firms are found, and the structures those firms assume, are remarkably similar everywhere.\textsuperscript{27}

Italy and France, for example, are the two Western European countries generally regarded as having the largest numbers of successful worker cooperatives.\textsuperscript{28} Available estimates (which evidently omit partnerships of service professionals such as lawyers) indicate that as of 1975 there were in France over 500 firms organized as worker cooperatives employing a total of roughly 30,000 persons\textsuperscript{29} while in Italy, as of 1977, there were around 2700 worker cooperatives employing a total of roughly 147,500 persons.\textsuperscript{30} The average size of these firms is small (in each country about 55 workers) and the median size is much smaller still—perhaps no more than a dozen workers.\textsuperscript{31} 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 even higher in Italy.\textsuperscript{32} Many of the cooperatives that are not construction companies are firms of artisans, such as printers or locksmiths.\textsuperscript{33} In the two countries there are only a handful of manufacturing firms of substantial size organized as worker cooperatives.\textsuperscript{34} And in Italy nearly all of the manufacturing firms that are cooperatives were converted relatively recently from failing investor-owned firms.\textsuperscript{35}

\textsuperscript{26} See J. Blasi, Employee Ownership: Revolution or Ripoff? 4 (1988) (estimating that as of his writing there were approximately 1000 to 1500 companies, with total of one million workers, in which an ESOP holds at least 51 percent of company's stock).

\textsuperscript{27} Because a survivorship test can plausibly be employed only in free-enterprise market economies, the discussion below largely ignores the experience with worker control of enterprise in those countries—such as the communist countries of Asia and Eastern Europe—in which the state precludes meaningful choice among organizational forms. In particular, we shall not examine Yugoslavia's extensive experience with worker-managed enterprise. The themes developed here nevertheless provide a useful framework with which to analyze the Yugoslavian experiment.


\textsuperscript{29} R. Oakeshott, supra, at 123.

\textsuperscript{30} Id. at 146. Estrin, Jones, & Svejnar, supra note 28, at 45, state that in 1981 there were "almost 20,000 registered" worker cooperatives in Italy. But this figure is evidently based on official records which, as Oakeshott explains, appear substantially inflated.

\textsuperscript{31} R. Oakeshott, supra note 28, at 129, 146.

\textsuperscript{32} Id. at 124, 146; Zevi, The Performance of Italian Producer Cooperatives, in Participatory and Self-Managed Firms: Evaluative Economic Experience 239, 241 (D. Jones & J. Svejnar eds. 1982).

\textsuperscript{33} R. Oakeshott, supra note 28, at 129, 150, 157.

\textsuperscript{34} See id. at 130, 160.

\textsuperscript{35} Zevi, supra note 32, at 243.
The most prominent example of successful industrial worker cooperatives in a market economy is not found in France or Italy, however, but rather in the well-established group of closely affiliated worker cooperatives at Mondragon, Spain. The Mondragon group has received considerable attention in recent years, and its success is regularly cited by advocates of worker ownership as the best evidence that this form of organization offers a promising alternative to investor ownership. 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 worker-members. These firms produce a broad range of goods including home appliances, furniture, heavy machine tools, and agricultural products. They obviously deserve special attention, and we shall examine them much more closely below.

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. For example, in Sweden worker cooperatives account for one hundred percent of all taxicab services and fifty percent of all truck transport services. This is in contrast to the Swedish manufacturing sector where, although cultural conditions in Sweden appear favorable for cooperativism and consumer cooperatives are common, worker cooperatives account for only one percent of all firms and presumably a much smaller percentage of output. Indeed, there is only one Swedish manufacturing industry, fur and leather goods, in which more than five percent of the firms are worker cooperatives, and even there they account for only 6.5% of all firms. Similarly, in Israel, drivers’ cooperatives provide nearly one hundred percent of bus transportation and fifty percent of truck transport, while at the same time—again 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. This pattern of driver-owned

38. Id. Section VI(C).
40. In 1970 consumer cooperatives accounted for 18% of Swedish retail trade. Id. at 8.
42. Moreover, this has been the case in the territory that is now the state of Israel since the 1920's. Over the intervening decades, the various separate bus transport cooperatives have gradually merged into a single monopoly, Egged. A. Daniel, Labor Enterprises in Israel 235–54 (1976).
43. Id. at 220.
44. Id. at 219–20.
transportation cooperatives will be extended to airlines if United Air Lines' 7000 pilots ultimately succeed in their recent efforts to acquire United by purchasing a controlling interest in its stock, thus creating the largest worker-owned enterprise in the world.

C. Costs and Benefits

To understand the reasons worker ownership has developed in the pattern just described, and to see more clearly that pattern's salient characteristics, it helps to survey systematically the costs and benefits that worker ownership can bring. We begin with the benefits.

III. THE POTENTIAL BENEFITS OF WORKER OWNERSHIP

Compared with the standard investor-owned firm, in which investors have control and workers transact with the firm simply through market contracting, worker ownership offers a number of potentially important efficiencies—efficiencies that have commonly been overlooked or underestimated in the existing literature. Yet the types of firms in which these potential efficiencies seem greatest are not the types of firms in which worker ownership is most common.

A. Monitoring Workers

Because of the difficulty of monitoring individual workers, a degree of moral hazard (more simply put, shirking) necessarily infects market contracting for all but the simplest types of labor. The greater the difficulty of monitoring workers, the worse this problem is likely to be.

45. Originally, United's pilots sought to purchase the airline by themselves. See, e.g., Pilots Renew Bid to Buy Out Parent Company of United, AVIATION WEEK & SPACE TECH., May 9, 1988, at 95; United's Pilots Are Inching Closer to a Coup, BUS. WK., Aug. 31, 1987, at 32. That bid collapsed in October 1989. Since then, the pilots' union has joined with United's machinists' union and flight attendants' union in another effort to purchase the airline. See 3 Unions Plan New Bid for United Airlines, N.Y. TIMES, March 29, 1990, at D1, col. 3.

46. It is generally acknowledged that the transaction would create the largest employee-owned firm in the United States. See, e.g., UAL Stern Accepting Buyout Bid, N.Y. TIMES, Sept. 15, 1989, at D1, col. 3; 3 Unions Plan New Bid for United Airlines, supra note 45. Outside the U.S., the largest worker-owned enterprise appears to be the complex of cooperatives at Mondragon, Spain, discussed infra Section VII(C). The Mondragon cooperatives have in total only a third as many employees as United, and, although it is hard to obtain current estimates of assets for Mondragon, the value of those cooperatives is clearly far less than the $6.75 billion that the pilots offered in 1989 to acquire United. See, e.g., H. THOMAS & C. LOGAN, MONDRAGON: AN ECONOMIC ANALYSIS 96-130 (1982) (giving statistics on assets and income of Mondragon system as of 1979).

47. That is, simply through individual labor contracts with the firm (perhaps supplemented by a collective bargaining agreement) under which workers' only leverage over firm policy is the threat to withdraw their services from the firm and take whatever other alternative the labor market offers.

48. If management cannot determine the difference between a high level of effort and a low one, workers in an investor-owned firm have an incentive to expend only a low level of effort whatever their contract calls for. The owners of the firm, in turn, have an incentive to compensate the workers only for the low level of effort that is to be expected from them. This outcome will result, moreover, even if both workers and the owners of the firm would prefer an arrangement whereby workers received greater compensation and expended a higher level of effort. The classic model of this phe-
Making the workers the owners of the firm may solve this problem to some degree. As owners, the workers will (at least collectively) bear all of the costs of their shirking and thus will have an incentive to expend a level of effort closer to that which is efficient. To be sure, so long as any substantial number of workers share ownership, each individual worker will bear only a small fraction of the costs of her own shirking. But each worker/owner also has an incentive to monitor her fellow workers and to apply pressure to them not to shirk, an incentive that is largely lacking in an investor-owned firm. In short, by encouraging both self-monitoring and mutual monitoring, worker ownership may offer an important efficiency advantage over investor ownership where monitoring workers is difficult.

Following this logic, it has sometimes been argued—most prominently in a famous article by Alchian and Demsetz, though the argument has often been repeated since—that worker ownership can be understood largely as a response to moral hazard in labor contracting and that worker ownership therefore tends to arise in those situations in which workers are unusually hard to monitor. Thus, Alchian and Demsetz argue 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.” This explains, they claim, why the partnership form is to be found among lawyers and other groups of individuals with artistic or professional skills.

As it is, however, the existing pattern of worker ownership is just the reverse of what one would expect if it were primarily a response to the difficulty of monitoring workers. In the service professions, where worker ownership is the norm, the productivity of individual workers can be, and generally is, monitored remarkably closely, since 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. Such records yield a close measure of

52. Id. at 790.
53. McChesney, Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis, 11 J. LEGAL STUD. 379 (1982), makes a similar argument regarding the Alchian and
the kind and quantity of work produced by an individual lawyer over the year, and of the client revenue that this work has yielded the firm. Moreover, it is relatively easy to assess the quality of a lawyer's work over time, in part because the work product is frequently embodied in 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 relative 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 worker 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 worker ownership is so common among these firms. The point is simply that there must be other factors that are much more important in determining the distribution of worker ownership, since the types of firms in which worker ownership is most common seem to be firms in which worker monitoring is relatively easy.

Demsetz monitoring theory. McChesney offers the alternative theory that lawyer ownership of law firms provides a necessary incentive for senior lawyers to undertake the promotional efforts necessary to attract business to the firm. "Profit sharing in law firms might be explained as akin to a salesman's commission in rewarding promotional factors in professional firms." Id. at 390. In essence, however, this is just a special case of the high-cost-of-monitoring theory. Undoubtedly worker ownership improves incentives for promotion. Yet this factor seems inadequate in itself to explain the prevalence of worker ownership among law firms as opposed to other types of firms. It is not difficult to determine which clients were brought to the firm by which lawyers and thus to reward the lawyers simply by salary for their promotional efforts. Moreover, not all partners play an important role in attracting business. And finally, there are many other industries in which attracting new clients is a major part of the job, but the employees responsible for this are not made owners.

54. There is some anecdotal evidence—for example, from the plywood industry—that worker ownership improves productivity. See, e.g., Greenberg, supra note 18, at 175-76. Efforts to obtain explicit empirical measures of the effect of worker ownership on worker productivity have so far been inconclusive, however. The evidence available to date, taken as a whole, suggests that profit-sharing alone has a weak positive effect on productivity. M. Wetzman & D. Kruse, Profit Sharing and Productivity (June 1989) (unpublished manuscript; on file with author). Some studies suggest further that worker control has a positive effect on productivity beyond that which can be obtained simply with profit-sharing, although the results are ambiguous and are clouded by the absence of a straightforward comparison between worker-controlled and investor-controlled firms. See, e.g., Jones & Svejnar, Participation, Profit Sharing, Worker Ownership and Efficiency in Italian Producer Cooperatives, 52 Economica 449 (1985); Jones, British Producer Cooperatives, 1948-1968: Productivity and Organizational Structure, in Participatory and Self-Managed Firms, supra note 32, at 175.
B. Worker Lock-In

After an individual has worked for a given firm for a number of years, his skills often become specialized to that firm. Consequently, he is substantially more productive there than he would be if he were to work elsewhere. Moreover, a worker must often make important personal investments in the community where his employer is located, investments that cannot be recouped if he leaves that community. His spouse may be employed there, his children may be accustomed to the local school system, and his entire family may have developed strong personal ties with other members of the community. Consequently, as time passes it often becomes increasingly costly for an individual to change employers; to a degree he becomes "locked in" to the firm. In such circumstances, the individual’s value to the firm may substantially exceed his potential return from employment elsewhere. Such an individual’s employer has an incentive to act opportunistically toward him, compensating him only near the level of his next best alternative and taking the surplus for itself. Workers who perceive this possibility for exploitation may insist on higher initial wages, resist making otherwise efficient firm-specific investments, or insist on extensive job and wage guaranties, thus making labor contracting more costly. 55

Worker ownership reduces the incentive for such opportunism: presumably workers would not generally vote collectively to exploit themselves as individuals. Consequently, worker-owned firms may have an efficiency advantage over investor-owned firms where other contractual devices are inadequate to control such opportunism. 56 Indeed, vertical integration often arises to deal with lock-in problems in other industrial settings, 57 and worker ownership is a form of vertical integration. This might lead one to expect worker ownership to arise where the problem of lock-in is particularly severe.

Yet the distribution of worker-owned firms appears to correlate poorly with the degree of worker lock-in. While clear data are lacking, it seems a reasonable inference that, in large industrial and service firms, middle and upper-level managers (and perhaps many blue-collar employees as well) often become specialized to their current employer over time and thus con-

55. Sometimes the employer also has a transaction-specific investment in the worker—for example, where the worker’s accumulated experience on the job makes him much more valuable to the firm than a new employee would be. In that case, the worker has a countervailing threat to use in bargaining and may not need to fear serious exploitation. Even in this situation, however, there is the possibility that bargaining will be costly, since the parties stand in a relationship of bilateral monopoly.

56. The types of contractual devices that are required are ones that bond the employer not to behave opportunistically. For example, the employer might supply a hostage of some sort. See, e.g., O. Williamson, supra note 13, at 163–205. In labor contracting the employing firm’s reputation may often be the only effective hostage it can supply, and this may sometimes be inadequate—for example, where there is a possibility of endgame behavior.

57. Id. at 85–130.
siderably more productive in that firm than they would be in any alternative employment.\textsuperscript{58} Nevertheless, such firms are rarely worker-owned. Conversely, the types of workers found in worker-owned firms appear unusually mobile. This appears to be true of the types of blue-collar workers who most commonly form worker cooperatives, such as taxicab drivers,\textsuperscript{59} refuse collectors, and the semi-skilled laborers in the plywood cooperatives. It is arguably true as well for service professionals such as lawyers and accountants.

To be sure, a professional such as a lawyer will develop a special familiarity with his firm's personnel, procedures, and clients that will be 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 lacking for other types of highly 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.\textsuperscript{60}

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

C. \textit{Strategic Behavior in Bargaining}

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, workers have knowledge that management lacks concerning the workers' own opportunities and preferences, including the minimum wages they would find ac-

\textsuperscript{58} This does not necessarily mean that they become much more productive and thus much harder for their employer to replace. It could equally well result if over time employees lose some of the general skills and the flexibility for retraining that they had at the beginning of their work careers.

\textsuperscript{59} Taxicab drivers may, however, experience some degree of lock-in. In many towns taxicab companies have substantial monopoly power. Thus a taxi driver may be forced to move to another town if he wishes to seek alternative employment. Such a move will not only cost him whatever investment he and his family have made in personal relationships in the community, but will also cost him his accumulated experience with the community's streets and traffic patterns.

\textsuperscript{60} Gilson and Mnookin note that lawyers who are insufficiently prominent to achieve substantial individual reputations outside their firms may experience a degree of lock-in owing to the fact that their present firm has much better information about their productivity than does any prospective new employer. Gilson & Mnookin, \textit{Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns}, 41 STAN. L. REV. 567, 576–78 (1989). But even if this were true, it would seem much easier for a lawyer to demonstrate her competence to a prospective new employer than it would be for a manager in a large industrial firm.
ceptable, 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 increase 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. Worker ownership can reduce or eliminate these costs: By merging labor and management, it removes their conflict of interest and assures that they share the same information.

In the types of firms in which worker ownership is common, however, the potential asymmetry of information between management and workers seems relatively low. Consider, for example, partnerships of professionals such as law firms. The smallness of such firms, together with the shallowness of the hierarchy between management and the firm's professionals (reflecting the fact that the professionals in these firms in many respects effectively are the firm's management), suggest that the senior professionals in these firms, even if they were not partners, would among themselves have most 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 seem likely to be most pronounced.

D. Communication of Worker Preferences

When workers have information concerning their preferences that they cannot credibly communicate to management, inefficiencies may arise beyond the costs of strategic bargaining behavior. In particular, management may find it difficult to select the least-cost package of financial compensation and working conditions that will yield workers a given level of satisfaction. What, for example, are the workers' preferences concerning tradeoffs between compensation and working conditions? Among different compensation packages, what is the workers' preferred tradeoff between current and deferred compensation, or between job security and increased wage levels? With respect to working conditions, what is the workers' preferred tradeoff among job safety, workplace aesthetics, speed of production, and variety of work? When there is a conflict of interest between workers and management, as in an investor-owned firm, there may be no credible way for workers to convey their preferences on these matters even where both management and workers would be better off if these prefer-

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61. For a survey of theoretical models and their fit with empirical data, see Kennan & Wilson, Strategic Bargaining Models and Interpretation of Strike Data, J. APPLIED ECONOMETRICS (forthcoming).

62. Elected representatives can, of course, have a conflict of interest with their constituents or have information that their constituents lack. Consequently, strikes in fact sometimes occur in worker-owned firms, as at Mondragon in 1974. See infra note 134.
ences could be conveyed; workers will have an incentive to misrepresent their preferences and, knowing this, management will disbelieve them.

Joining the interests of management and workers through worker ownership can mitigate this problem. Yet this advantage also fails to explain the existing distribution of worker ownership since, as just noted in the discussion of strategic bargaining behavior, worker ownership tends to appear in precisely those settings in which management is likely to have relatively little difficulty achieving an accurate understanding of workers' preferences.

E. Responsiveness to Average Versus Marginal Worker Preferences

Even if an investor-owned firm has accurate information about worker preferences, the firm may choose an inefficient combination of financial remuneration and working conditions for its workers. A firm that simply hires workers on the labor market, as an investor-owned firm does, has an incentive to adjust pay and working conditions to the preferences of the marginal participant in the market. Yet efficiency requires that the firm adjust its policies to the preferences of the average worker, and the preferences of the marginal individual may differ from those of the average individual.63

Consider, for example, a firm's choice of the appropriate level of safety for its workers. The firm has an incentive to choose the least-cost combination of pay and investment in safety that satisfies the marginal workers—that is, the combination that just suffices to retain those workers who are most likely to leave the firm and seek employment elsewhere. But the preferences of the marginal worker—who may, for example, be young, single, and relatively unconcerned with safety—may not be those of the average worker. Consequently, the level of workplace safety chosen by the firm may not be that which most efficiently satisfies the preferences of the workers as a whole.

Making the workers the owners of the firm might well lead to an efficiency improvement in this respect because, to the extent that the worker-owners vote to decide such matters, they will tend to choose policies that reflect the preferences of the median worker. Although the preferences of the median worker might not be the same as those of the mean, in general they seem likely to be much closer to the mean than are the preferences of the worker who is marginal in the market.

Direct evidence of the importance of this problem in investor-owned firms is difficult to find. Collective bargaining (discussed further below) presumably mitigates its effects considerably wherever there are unions. But in any event this problem does not seem to be particularly important

63. See Spence, Monopoly, Quality, and Regulation, 6 Bell. J. Econ. 417 (1975).
in explaining the distribution of worker-owned firms, since, as discussed at considerably greater length below, firms in which worker ownership appears generally have unusually homogeneous work forces. Moreover, they tend to confine ownership to an especially homogeneous subset of their workforce. Consequently, differences in preferences between marginal and average workers are probably unusually small among the workers who share ownership of worker-owned firms.

F. Agency Costs of Delegation to Management

The problem of the separation of ownership and control—or, as it is characterized in the economics literature today, the agency cost of policing management\(^{64}\)—is potentially much less acute in worker-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. Consequently, they are in a poor position to police the firm's management. In contrast, a firm's workers have substantial information about the firm simply as a byproduct of their employment and are in a good position to learn more; they have a large personal stake in the fortunes of the firm; and they can be easily assembled for collective action. In short, 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 make management responsible to their will.

To be sure, investor-owned firms benefit from 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 worker-owned. Workers can and generally do retain the right to sell the firm to outside investors\(^{65}\) at any point they wish.\(^{66}\) Such transactions have in fact been relatively common (for example, among plywood cooperatives,\(^{67}\) advertising firms, and investment banking firms\(^{68}\)).

One might therefore expect to find worker ownership appearing in

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65. A prominent example is the Vermont Asbestos Group, a failing subsidiary of GAF that was sold to its workers in lieu of closing in 1975 and then, because of a dramatic improvement in its product market, became highly profitable. In 1978 the workers sold enough of their stock to a local businessman to enable him to assume control of the firm. M. Carnoy & D. Shearer, *supra* note 2, at 152-57.

66. To be sure, if all of a firm's equity securities are held by its workers, those securities may no longer be evaluated and priced by the securities markets. Consequently, the firm will be subject to less monitoring by those markets than would be the case for a publicly held firm, and the market for corporate control may be less effective in policing the firm than if it were a publicly held, investor-owned firm.


68. See *infra* text accompanying notes 122-23.
those circumstances where investors would be in a particularly poor position to monitor the firm's management. Yet successful worker-owned firms are typically sufficiently small so that, if investor-owned, they would in most cases be closely held firms and thus not subject to particularly large agency costs resulting from separation of ownership and control. 69 Therefore, like the other advantages of worker ownership reviewed above, this consideration also fails to explain the existing distribution of worker ownership.

G. Participation

The voluminous literature advocating worker ownership—or, more broadly, "economic democracy," "worker participation," or "labor management"—is often vague about the virtues of this alternative form of organization. Sometimes that literature invokes, with greater or lesser clarity, one or more of the potential advantages of worker control described above, although usually in rather different language. For example, arguments to the effect that worker control reduces worker "alienation" or "exploitation" seem to be based at least in part on the possibility that worker control will prevent the firm from taking opportunistic advantage of worker lock-in, that it will eliminate strategic behavior in bargaining, or that it will result in more satisfying working conditions through better communication of worker preferences.

Sometimes, however, there is a suggestion of further values served by worker control. In particular, some discussions of workplace democracy imply that participation in control of the firm through democratic processes is a value in itself, distinct from any changes in the actual decisions made by the firm as a result. Although the nature or source of this value is seldom spelled out explicitly, 70 it is possible to speculate on some potential sources.

First, individual workers might enjoy the process of collective decision-making as a communal activity that is satisfying in itself quite apart from the character of the decisions reached. Second, worker control changes the psychological relationship between the workers and the firm. Market contracting establishes an adversarial relationship between the employee and the firm: the firm has an incentive to extract from the employee the most work for the least pay, while the employee has an incentive to seek the opposite. Workers might feel that having such an adversarial relationship with their employer is psychologically unpleasant, regardless of whether

69. This is not, however, universally true. For example, some of the advertising firms that have converted from partnership form to investor ownership in recent decades are now publicly held firms.
70. See, e.g., R. Dahl, supra note 2, at 153 ("self-government in work need not be justified entirely by its consequences, for, as in the state, it is justified as a matter of right"); cf. S. Bowles & H. Gintis, supra note 2, at 3–4 (stating that they "will not seek to justify" their "commitment" to democracy as a principle).
the working conditions and rate of pay established through this relationship are satisfactory in themselves (that is, are at least as good as those that the workers would establish if they were the owners). With worker ownership, the conflict of interest between workers and owners that creates this adversarial relationship is largely eliminated. Third, as is sometimes explicitly argued, individuals gain psychological satisfaction simply from the sense of being in control, and this may be enhanced by permitting workers to participate in firm decision-making. And fourth, as has also been argued, worker participation in collective decision-making within the firm may be useful training for participation in democratic political processes in the larger society and might be valued for this reason both by the workers themselves and by the rest of society.

Again, however, the distribution of ownership types is arguably the reverse of what one would expect if such considerations were important. Worker-owned firms tend to arise in industries in which typical firms (investor-owned as well as worker-owned) are small and have relatively homogeneous work forces with little hierarchy, which is precisely the setting in which one would expect worker alienation to be least pronounced.

H. Summary

In summary, worker ownership promises some conspicuous efficiency advantages over investor ownership, including improved worker productivity, avoidance of the problems of opportunism associated with worker lock-in, less strategic behavior in bargaining, better communication of worker preferences, improved monitoring of management, and the further satisfactions that may arise from participation in the process of collective decision-making. These advantages are presumably important in explaining the success of worker ownership in those industries where it is commonly found. But the magnitude of the potential efficiency gains from these sources does not correlate well with the observed pattern of worker ownership across industries. In general, these potential gains seem greatest in large-scale hierarchical firms and considerably smaller in the small-scale service firms where worker ownership is most common. To explain the existing pattern of worker ownership we must, therefore, examine the liabilities of worker ownership relative to investor ownership.

71. See Blumberg, Alienation and Participation: Conclusions, in Self-Management: Economic Liberation of Man, supra note 2, at 524.
72. E.g., M. Carney & D. Shearer, supra note 2, at 126-27; R. Dahl, supra note 2, at 94-98; C. Pateman, Participation and Democratic Theory 45-66 (1970); J. Rothschild & J. Whitt, The Cooperative Workplace 13 (1986). As Dahl notes, the available empirical evidence fails to confirm the theory that workplace democracy promotes greater participation in democratic institutions in the larger society.
IV. SOME BASIC COSTS OF WORKER OWNERSHIP

Worker ownership can, of course, often be a costlier form of organization than investor ownership. If this were not so, then the advantages of worker ownership just surveyed would presumably lead to the complete dominance of worker-owned over investor-owned firms in all industries.

In this Section we shall survey several potentially costly disadvantages commonly imputed to worker ownership and offered as explanations for the relative paucity of worker-owned firms. Most of these disadvantages are related in some way to capital. Although some of these disadvantages are real, their significance is frequently exaggerated. While they clearly help to account for the observed distribution of worker-owned firms, they also leave much of that distribution unexplained.

A. Raising Capital

An obvious obstacle to worker ownership is the problem of raising capital. To the extent that the capital needs of a worker-owned firm exceed the combined liquid wealth of the workers, the required capital must be borrowed on the market. If the capital is needed to purchase physical assets that can be easily resold for a price close to their purchase price—that is, to purchase assets that are not "firm-specific"—then borrowing (or even leasing) on reasonable terms may be quite feasible since the assets can simply be pledged as security for the funds borrowed. In fact, worker-owned firms are not uncommon in relatively capital-intensive industries in which assets are not highly firm-specific. Thus, as we have seen, transportation companies, much of whose capital is invested in vehicles that are easily resold, are among the types of firms in which worker ownership most frequently appears. Investment banking also requires substantial capital per worker, but again the firms' assets are highly fungible.

Family farms provide another illustrative example. In a sense, they are reductive examples of worker-owned firms in which ownership is confined to a single individual or family. And they are 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.

On the other hand, where capital is needed to purchase firm-specific assets it may be very costly or impossible for a worker-owned firm to obtain the necessary capital by borrowing it on the market. The problem is that persons who lend capital to such a firm expose themselves to the threat of opportunistic behavior by the worker-owners, who have an incentive to appropriate for themselves the amounts that are borrowed. The

73. See supra text accompanying notes 39–46. A related industry is car rental, in which Avis, the second largest firm, is employee-owned through an ESOP. With an ESOP, Avis Tries Even Harder, Bus. Wk., May 15, 1989, at 122.
workers can accomplish this appropriation either by diverting the firm’s earnings to themselves (for example, through inflated wages) and leaving too little to pay off the loans or by investing the amounts borrowed in inefficiently speculative projects whose potential upside gains will accrue principally to the owners and whose potential downside losses will accrue principally to the lenders. Without physical assets that can be pledged as security to the lenders, there may in fact be no feasible way in which the owners can commit themselves not to behave in such an opportunistic fashion.

This consideration is probably important in explaining the existing distribution of worker ownership, which seldom appears without subsidy in firms, such as those in the industrial sector, that require large amounts of firm-specific capital per worker. In such firms, ownership by the lenders of capital is the obvious solution to the problem of opportunism just described.74 On the other hand, the importance of this factor should not be overstated.75 The recent success of leveraged buyouts with very high debt/equity ratios suggests that today debt can be obtained to cover a large fraction of a firm’s capital needs, including firm-specific capital. And the success of ESOPs in the industrial sector, discussed below, supports the same conclusion.

Moreover, even if a relatively low intensity of firm-specific capital per worker is generally necessary for worker ownership to be viable without subsidy, it is not sufficient. There are many industries in the service sector that involve low amounts of firm-specific capital but in which worker ownership has remained rare, such as hotel and restaurant services, retailing, and (at least in the United States) the construction trades.76

B. Risk-Bearing

Another commonly cited disadvantage of worker ownership is poor risk-sharing. And the more capital-intensive the firm, the worse the problems of risk-sharing will be.

If the workers supply the required capital themselves—for example, by investing their pension plan assets or other forms of personal wealth in the firm—they will be badly underdiversified: If the firm goes bankrupt, they will lose not only their jobs but their savings as well. And if the workers borrow to finance the firm’s capital needs, the resulting leverage

75. For example, Williamson, Corporate Governance, 93 Yale L.J. 1197, 1226–27 (1984), offers this consideration as the principal reason for the absence of worker cooperatives in the corporate sector. Although his analysis is sound as far as it goes, as discussed below there are other considerations that seem equally important in explaining the distribution of worker ownership.
76. In Italy and France, as discussed infra Section VI(D), there are a number of construction companies organized as worker cooperatives.
will amplify the fluctuations in net earnings going to the workers, leaving them with highly unpredictable incomes.

Problems of risk-bearing might therefore appear to be a major obstacle to worker ownership in capital-intensive enterprise even when workers are able to obtain the necessary capital. Interestingly, however, the observed distribution of worker ownership does not entirely support such a conclusion. The plywood industry, for example, is both moderately capital-intensive and relatively volatile, and investment banking is highly capital-intensive and highly volatile. Family farms provide another illustration. Farming is relatively capital-intensive and also highly volatile. Yet investor-owned firms have never been able to gain any appreciable market share in most staple grain crops; farms continue to be owned overwhelmingly by the individuals who work them, despite the large amounts of risk those individuals must bear.

Moreover, we should not underestimate the amount of risk that workers bear in investor-owned firms. From a risk-bearing perspective, it would seem that the efficient arrangement would be for the investor-owners of an industrial firm to bear the overwhelming share of the risk of the enterprise and insure workers 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. There are presumably several explanations for this seeming anomaly, including the incentives created by the prevailing system of collective bargaining, the reduction in productivity that might accompany greater job security, and the limitation on workers’ prospective downside losses resulting from unemployment insurance, social welfare programs, and the prospect of reemployment. But, whatever the reason, for many workers investor-owned enterprise may not offer strikingly less risk than does worker-owned enterprise.

In short, there is good reason to believe that risk-bearing is not in itself a major obstacle to worker ownership and that it does not play a strong role in explaining the distribution of worker ownership that we observe.

77. K. Berman, supra note 18, at 33–38.
79. Seniority systems of job tenure give the elder half of a firm’s employees an incentive to support a union bargaining stance that exchanges high wages for low job security, and thereby to join with the firm’s investor-owners in putting onto the firm’s younger workers much of the risk of the enterprise. See id. at 393–94.
80. Reduction in productivity could result from the reduced incentive for effort on the part of workers who have substantial job security or from the reduction in efficient reallocation of workers among firms owing to seniority.
C. The Horizon Problem

It is sometimes argued that, quite apart from the problems of raising capital and of risk-bearing just discussed, worker-owned firms are plagued by a “horizon problem” in that they have too little incentive to invest in projects that will pay off only over long periods of time. The source of the problem, it is said, is the workers’ lack of transferable residual claims.\(^{81}\) Since they cannot sell their ownership rights on the capital market at will, they lack the ability that investor-owners have to realize in the present the value of the future returns that investments will bring.

There may well be a horizon problem in firms, such as those in Yugoslavia, in which workers have control but only a limited right to appropriate net earnings and assets—that is, in firms that are worker-managed but not worker-owned. In free-enterprise economies, however, most worker-owned firms with any significant amount of invested capital give their workers residual claims that are transferable. In some firms these claims are transferable at all times and in others they are transferable only upon the worker’s ultimate departure from the firm. For example, shares in the plywood cooperatives can be freely sold to new workers by departing ones, subject only to a right of first refusal by the firm.\(^{82}\) Even such a right to sell shares only upon departure should be sufficient to maintain appropriate incentives for investment. Moreover, even if workers could never withdraw capital from the firm, the workers as a group might be expected to have a long time horizon for investments since the median worker’s expected length of tenure with the firm may well be as long as fifteen or twenty years, or even longer if pension payoff periods are included.\(^{83}\) And a fifteen-year investment horizon is extremely long by contemporary industrial standards.

D. Reversion to Investor Ownership

It has often been remarked that successful worker-owned firms frequently convert (or, as advocates of worker ownership would have it, “degenerate”) to investor ownership.\(^{84}\) For example, there has been gradual attrition from the ranks of the U.S. plywood cooperatives as firms have

\(^{81}\) See Furubotn, The Long-Run Analysis of the Labor-Managed Firm: An Alternative Interpretation, 66 AM. ECON. REV. 104 (1976); Jensen & Meckling, supra note 50.

\(^{82}\) Indeed, holders of the shares need not be currently employed at the firm. K. Berman, supra note 18, at 148, 150. But, since dividends are rarely paid on the shares, they are of little value to anyone who is not an employee. Id. at 150.

\(^{83}\) This assumes that workers generally stay with the same firm for life. But, at least if we exclude a trial period of a few years at the beginning (during which a worker need not be made a voting member of the firm), this may be an accurate assumption in many industries.

\(^{84}\) A typical example from the literature advocating worker ownership is J. Rothschild & J. Whitt, supra note 72, at 179–81. The most general analytic discussions of the issue are Ben-Ner, On the Stability of the Cooperative Type of Organization, 8 J. COMP. ECON. 247 (1984), and Miyazaki, On Success and Dissolution of the Labor-managed Firm in the Capitalist Economy, 92 J. POL. ECON. 909 (1984).
been sold to investors by their members. Similarly, failing investor-owned firms that were bought out by their workers and subsequently succeeded (rather than going bankrupt) have sometimes reverted to investor ownership. 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 worker-owned firms, and that this tendency is an important reason for the minuscule market share that worker-owned firms occupy in the industrial sector. At least two different mechanisms have been offered to explain this supposed tendency.

1. A Tendency Toward Hired Labor

First, it has been argued that when a successful worker-owned firm takes on additional workers, it has a strong incentive to hire them on a salaried basis rather than make them owners. For if the firm's net earnings per worker are higher than the market wage rate—which is presumably what is meant when it is said that the firm is "successful"—it will be more profitable for the existing worker-owners to pay a new worker only the market wage rather than to give her a pro-rata share in the firm's profits. Consequently, the ratio of worker-owners to hired workers 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 a capitalist firm.

The logic behind this argument, however, is based 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 worker-owned firm in question must be due,
not to the fact that it is worker-owned, but rather to some other factor such as long experience in the industry or possession of an important patent. Consequently, the firm would be just as successful, or perhaps even more so, if it were investor-owned. Where, on the other hand, the success of a worker-owned firm is due to the fact that it is worker-owned—say, because workers in the industry in question are more productive, or are willing to work for lower cash compensation, when they are owners than when they are salaried employees—then it should be more profitable for the existing members of the firm to add new workers by giving them a share in ownership than by taking them on only as salaried employees, and there should be no tendency toward investor ownership.

In some industries in which worker ownership is the dominant mode of organization, there has in fact been no conspicuous tendency to substitute hired labor for worker-owners. Law firms, for example, almost universally follow an up-or-out system whereby an employee must leave the firm if she has not been made a partner within a certain number of years, thus assuring 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 worker ownership is the most efficient system of organization for these firms and that deviation from that system would in the long run be disadvantageous. To be sure, in recent years there has been an increasing tendency for law firms to create a class of hired senior attorneys termed "permanent associates" and thus to abandon strict adherence to the up-or-out system. But, as we shall discuss below, this tendency seems best explained by considerations other than the logic of inevitable degeneration just described.

88. If a new worker is brought into an established firm as an owner with a share in future profits equal to that of the already-existing members, and if the new worker is not required to make a capital contribution to the firm upon joining, there will be a redistribution of value from the existing members to the new one (or at least this will be the case if the firm has accumulated value in such forms as capital or goodwill). If these were the only terms on which a new member could be added to the firm, then there would of course be a strong incentive either to add new workers only as salaried employees or not to expand employment at all, even if workers were more productive as owners than as mere employees. The solution is either to give new members a smaller share in earnings than their counterparts who joined the firm earlier or to require that new members make a capital contribution through which they effectively purchase a share in the firm's accumulated value from the already-existing members.

Since the former solution—which may lead to different profit shares for workers who have similar roles in the firm—may accentuate the governance problems discussed below, it is not surprising that established worker-owned firms commonly require capital contributions from new members instead. In some cases these contributions may be a bit disguised. For example, the much larger shares in profits given older partners in law firms, and the granting of a substantial share in a law firm's profits to semi-retired older partners, may be a means by which the younger partners effectively compensate the older partners for the firm's accumulated goodwill.

89. _Infra_ Section VI(B).
2. **Capital Accumulation**

Another liability often imputed to worker-owned firms is that, if they are successful, their value becomes so large over time that younger workers cannot afford to purchase a share in the firm from older workers who are retiring. Consequently, the older workers have a strong incentive to sell their shares instead to outside investors, thus converting the firm to investor ownership.

The problem with arguments of this type is that they rarely make clear precisely why the level of net assets per worker has increased over time. There are, broadly speaking, two possibilities. On the one hand, it could be that the technology employed by the firm has not changed since the workers originally came to own it and that net assets have increased simply because the firm has retained and accumulated some portion of its earnings over the years. In that case, it should be possible for the firm to distribute the accumulated retained earnings to the retiring workers—perhaps by repurchasing from them some or all of their shares in the firm—and thus reduce the net assets per worker to their original level so that new young workers can afford to purchase shares in the firm.\(^{90}\) On the other hand, it could be that net assets per worker have increased because the firm has adopted new technology that requires more firm-specific capital per worker than the technology employed when the workers first acquired ownership, and the firm has used its retained earnings over the years to acquire the required new technology. Consequently, the requisite amount of equity capital per worker may now be much higher than a new worker could or would contribute. It would then follow that because of the change in the capital intensity of the firm, worker ownership is no longer an appropriate form of organization and conversion to investor ownership would be the most efficient course.\(^{91}\)

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

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\(^{90}\) If the retained earnings have been used to pay off loans taken out when the firm was originally formed, it may be necessary for the firm to take out new loans to obtain the funds needed to distribute to the retiring workers—thus in effect levering itself back up to its original level.

\(^{91}\) Note that goodwill is among the common forms of firm-specific capital that a firm might well accumulate over time.
3. Why Are There Conversions to Investor Ownership?

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

In some firms that convert from worker to investor ownership, worker ownership was probably an inefficient way to organize the firm from the start. For example, in some cases worker-owned firms are undoubtedly established out of miscalculation or excessive idealism; conversion to investor ownership is then simply a belated recognition of that fact. In other cases worker ownership, though in itself inefficient for the firm in question, is evidently adopted to facilitate a one-time transaction that could not otherwise be arranged. A common situation of this type is found in failing plants operated by investor-owned firms. Selling the plant to its workers offers a way for the workers, and especially their union, to accept the substantial concessions (such as severe reductions in wages, changes in work rules, and layoffs) necessary for the plant to continue production without loss of face and with the assurance that the fruits of the concessions will not go disproportionately to the firm’s current investor-owners. The concessions having been made, there remains the option of selling the firm back into investor ownership if it succeeds.

Finally, there are situations in which worker ownership was once efficient but has ceased to be so, perhaps because the character of the industry has changed. This is probably the situation in investment banking, for example, in which the capital required per worker and the 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.

E. Summary

The efficiency of worker ownership undoubtedly suffers when substantial amounts of capital, particularly firm-specific capital, are required per worker. Nevertheless, both logic and experience suggest that worker-owned firms can operate successfully with at least moderately high capital intensities. Moreover, there are many industries with low capital intensi-

92. The workers’ union, in particular, may be concerned that signing a collective bargaining agreement with large givebacks may create a precedent that will compromise its bargaining posture at other firms or at other plants of the same firm.
94. The Weirton Steel Company appears to be a prominent example of this phenomenon. See infra note 165.
ties in which worker ownership has failed to take hold. There must therefore be other important costs associated with worker ownership that bear strongly on its viability. The costs of collective decision-making, to which we now turn, appear exceptionally important in this regard.

V. THE COSTS OF COLLECTIVE GOVERNANCE

We noted above that workers are in many respects well situated to monitor a firm’s management and hold it accountable. If the workers are to exercise control effectively, however, they must employ some form of collective choice mechanism—in effect, a political process—to aggregate their preferences and permit them to make decisions as a group. Most typically, a voting mechanism of some sort is employed. Small firms may simply adopt a form of direct democracy in which all the owners vote on important decisions to be taken by the firm. In larger firms, the apparatus for collective governance is likely to take the form of a more elaborate electoral mechanism. The typical model is that which is commonly employed in publicly held investor-owned corporations, in which the worker-owners vote directly only on major “constitutional” changes in the firm while more routine decisions are put in the hands of a representative body, such as a board of directors, whose members are elected periodically by the owners. The representative body, in turn, generally employs a voting process of its own to make decisions. It may also have a more or less elaborate committee structure, and its decisions are likely to be subject to judicial review upon suits brought by individual owners.

The burgeoning public choice literature has begun to document, in the context of governmental institutions, what common sense and casual empiricism suggest: that collective choice mechanisms can engender substantial costs. To date, however, the costs associated with collective choice mechanisms have received little systematic attention in the literature on industrial organization and in analyses of worker ownership in particular. Yet it appears that these costs play a critical role in determining where, and how effectively, worker ownership works.

95. The most significant exception is the analysis by Jensen and Meckling, who have referred to the problem of collective decision-making in labor-managed firms as “the control problem.” Jensen & Meckling, supra note 50, at 488-89, 493-95. Although they do not discuss the issue in detail, they note the possibility for conflicts of interest among the workers in such a firm and suggest that they may be a substantial source of inefficiency:

However the conflicts are resolved, it would be very surprising, indeed, if they brought the firm close to Pareto-optimal performance.

Meanwhile, the process is certain to impose costs. Workers will find it in their interest to organize and engage in various political activities within the firm. When new hires are to be made, those in control will want to see that the new employees conform to their tastes, or at least can be induced to vote for their side. They will similarly want to force nonconformist employees out of the firm.

Id. at 494-95.

The costs of collective decision-making might be considered a particular instance of the “influence costs” that have been explored in Milgrom, Employment Contracts, Influence Activities, and Efficient
A. Sources of the Costs

If all workers had the same preferences concerning all matters of firm policy, there would presumably be few costs associated with collective decision-making. On many important issues, however, there are likely to be substantial differences of opinion among a firm’s workers. Sometimes those differences will simply reflect different judgments about the most effective means for achieving a commonly shared goal. But the most serious differences are likely to arise where the individuals involved will be affected differently by whatever decision is taken.

For example, there can obviously be disagreement over the relative wages paid to different workers. Workers may also have different stakes in any pattern of investments chosen by the firm, such as which plants to keep open, which processes to automate, or where to make further improvements in safety. The extent to which workers’ interests diverge in these respects is likely to increase as the division of labor within the firm increases; where all workers do essentially the same job, they will be similarly affected by most decisions and there is likely to be little conflict of interest among them. But there may also be conflicts of interest among workers that have other sources besides differences in job assignments. For instance, the amount of equity capital invested in the firm may differ substantially among workers. This is likely to occur if, as is common, the firm’s pension fund is the principal vehicle through which the workers invest in the firm. Older workers, who have disproportionately large amounts of capital invested, will prefer to have a larger amount of the firm’s earnings attributed to capital (and hence allocated as earnings on amounts invested in the pension fund) and a smaller amount attributed to labor (and hence paid out as wages) than will younger workers.

Such potential sources of conflict might not be very troublesome in practice if there were obvious objective criteria to employ in making the decisions in question—for example, if wages or return on capital could simply be keyed to some unambiguous measure of marginal productivity. But such objective criteria are usually absent or unobservable at reasonable cost. Therefore, in important decisions there is generally considerable latitude for judgment and discretion, and hence room for active disagreement.

Organization Design, 96 J. Pol. Econ. 42 (1988); Milgrom & Roberts, An Economic Approach to Influence Activities in Organizations, 94 Am. J. Soc. S154 (Supp. 1988); Milgrom & Roberts, Bargaining Costs, Influence Costs and the Organization of Economic Activity, in Rational Perspectives on Political Economy (J. Alt & K. Shepsle eds.) (forthcoming). In effect, the argument being made here is that the influence costs that a heterogeneous group of workers impose upon a firm increase significantly when those workers own the firm rather than transact with it simply through market contracting.

96. "Keyed to" rather than "set equal to" since simply paying all factors their marginal product, even if feasible, might not succeed in distributing all of a firm’s net earnings; there could well be surplus left over that the firm would still need to divide up somehow.
The more that participants in a collective choice mechanism disagree, the more costly the mechanism is likely to be. Existing theory in political science and economics does not identify well the sources of the costs involved. Broadly speaking, however, we can say that such costs are of two types. First, there are the costs of inefficient decisions. Second, there are the costs of the decision-making process itself.

Inefficient decisions can arise in several ways. With majority voting, for example, if all participants simply vote their personal preferences, the result may be seriously inefficient if the median voter's preferences (which govern in majority voting) differ substantially from those of the mean, or average, voter (whose preferences should govern if the decision is to be efficient). As a consequence, a majority may, intentionally or unintentionally, inefficiently exploit a minority (that is, adopt measures under which what the majority gains is less than what the minority loses). Or control over the political process can come into the hands of an unrepresentative minority that inefficiently exploits the majority. This is particularly likely to happen when, as is often the case, some individuals are better situated to participate effectively in collective decision-making than others because they have more time, more talent, or more taste for politics. In any case, whether it is the majority that exploits the minority or vice versa, the individuals in the dominant group need not exhibit a high degree of venality for the resulting costs to be substantial. It is sufficient that, as is natural, their own interests simply have more salience for them than do the interests of others.

The costs of the collective choice process, in turn, may also have several sources. Even if workers seek in all cases to exercise their collective control rights as owners without opportunism, and to reach the decisions that will be most efficient for the workers as a whole, they may need to invest considerable time and effort in obtaining knowledge about the firm and about other workers' preferences and in attending the meetings and other activities necessary to reach and implement effective collective decisions. Moreover, we know from public choice theory that the possibility of a voting cycle among alternatives increases as preferences among the electorate become more heterogeneous. Such cycling may be costly if there are transaction costs involved in repeatedly altering firm policies. Finally, if workers seek to behave strategically, then further costs may result from, for example, seeking to hide or discover information or seeking to make or break coalitions. There are, to be sure, measures that can be employed to

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98. In a voting cycle, the electorate's choices become intransitive and hence unstable—for example, voting to adopt policy b over policy a and policy c over policy b, but then voting to adopt policy a in preference to policy c.
limit such costs. For example, delegation of authority to committees can inhibit cycling and can facilitate the vote-trading necessary to mitigate the median voter problem. But then committees themselves can be the source of seriously inefficient decisions.100

B. Comparison with Investor-Owned Firms

The costs of collective decision-making in worker-owned firms would not be an important factor in determining whether enterprise is worker-owned or investor-owned if collective decision-making among the owners of an investor-owned firm were just as costly. But investor-owned firms have an important advantage in this regard. This is obvious where the firm has a single owner. But it is also true where numerous investors share ownership of a firm. Shareholders in a firm generally have a common objective: to maximize the net present value of the firm’s after-tax earnings. To be sure, investors may differ in their tax status, risk preference, or need for liquidity, and such differences can cause them to have different views about firm policy. To a substantial degree, however, investors can avoid conflicts from these sources by sorting themselves among firms.

The important differences among shareholders in a business corporation arise when a subgroup of them also has some other relationship to the firm—such as employee, supplier, customer, bondholder, or majority shareholder101—that the others lack. Much of corporate law is concerned with constraining and resolving these conflicts of interest among shareholders. Yet such conflicts are arguably relatively easy to deal with in comparison to the conflicts of interest among the workers within a firm. For example, the worst forms of opportunism in exploiting inside information can be largely eliminated by adopting relatively simple rules constraining securities trading by insiders. Similarly, serious abuse of minority shareholders by the majority can be checked in large part by promulgating straightforward rules requiring pro rata treatment, by providing appraisal remedies, or by using the market price of the firm’s stock prior to a transaction as a measuring stick for fairness.102

The one place where the law has sought to impose constraints on the treatment of the minority by the majority in collective decisions made by workers is under the “duty of fair representation” that labor law imposes


101. A majority shareholder may have interests that differ from those of the minority because she is in a position to sell control over the firm to somebody else who has one of the other relationships to the firm mentioned here, such as customer.

102. We are concerned here only with the process by which the owners of the firm make decisions among themselves, and not with the agency costs of delegation to management discussed supra Section III(F). As noted there, the latter costs may often be higher for investor-owned firms than for comparable worker-owned firms.
on unions. In contrast to the corporate law rules just mentioned, this body of law has been singularly unsuccessful in generating coherent and effective constraints on opportunistic behavior by union majorities. In general, the duty of fair representation has been effectively employed only to bar overt discrimination based on criteria conventionally considered invidious, such as race or sex.\textsuperscript{103}

VI. Evidence of Governance Costs

A survey of the types of firms in which worker ownership has succeeded suggests strongly that the costs associated with collective decision-making are extremely important in determining where worker ownership is viable and how it is organized. In fact, these costs go far toward explaining the large residual in the existing pattern of worker ownership that remains unexplained by the other costs and benefits of worker ownership surveyed in Sections III and IV above.\textsuperscript{104}

A. Which Firms Succeed?

The most striking evidence of the high costs of collective decision-making can be found in the fact that worker ownership is extremely rare in firms in which there is any substantial degree of heterogeneity in the workforce, or at least among those workers who participate in ownership. Most typically, the workers who share ownership within worker-owned firms all do roughly similar work and are of essentially equivalent status within the firm. Rarely do they have substantially different types or levels of skills, and rarely is there much significant hierarchy among them (that is, rarely does one worker-owner directly supervise another). This is evident in the professional service firms, where worker ownership is best established. The partners in a law firm, for example, are all lawyers of roughly equal skill and productivity who work more or less independently of each other; rarely does one partner have substantial supervisory authority over another. Similarly, the workers in the U.S. plywood cooperatives are only semi-skilled and unspecialized and commonly rotate over time through the various jobs in the mill. Consequently, they have little reason to differ concerning the policies to be adopted by the firm. The manager, who is the only person in the firm with specialized skills and tasks and with substantial supervisory responsibilities, is in nearly all firms not a member of the cooperative but rather hired as a salaried employee.\textsuperscript{105}


\textsuperscript{104} The high costs of collective decision-making in the face of heterogeneous interests have been documented elsewhere as well. For an example, see Libecap & Wiggins, Contractual Responses to the Common Pool: Proportioning of Crude Oil Production, 74 AM. ECON. REV. 87 (1984).

\textsuperscript{105} Greenberg, supra note 18, at 206.
driver-owned transportation cooperatives that are so common throughout the world also fit this mold.

The predominance of this pattern suggests strongly that worker ownership works best when there is minimal opportunity for conflicts of interest among the worker-owners. Evidently the viability of worker ownership is severely compromised when the workers who share ownership play diverse roles within the firm and consequently are likely to be affected differently by important decisions taken by the firm. Conversely, worker ownership evidently is viable when the workers involved all play a similar role within the firm, even if in other respects the net benefits from worker ownership do not appear unusually strong in comparison to situations in which investor ownership is the rule. This suggests that, if costs associated with collective self-governance were not a problem, worker ownership would be far more widespread than it is.

106. The discussion in the text emphasizes the importance of homogeneity in the roles played by the worker-owners within the firm. But similarity in culture and personal values among the worker-owners is evidently also important in making worker self-governance viable. See J. ROTHSCHILD & J. WHITT, supra note 72, at 95–100; see also text accompanying note 145 (noting importance of Basque culture for Mondragon).

107. Internal dissension seems also to have been an important reason why the workers at the Vermont Asbestos Group ultimately sold control of their firm to an outside investor. See supra note 65. “[The experience of bickering and inconclusive meetings convinced many of them that a system with “180 bosses’ cannot work.” M. CARNOY & D. SHEarer, supra note 2, at 157.

The conversion of the investment banking partnership of Lehman Brothers to investor ownership provides another example. See infra text accompanying note 126.

108. One might ask, in particular, what the advantage is to worker ownership in transportation companies. In many of those firms, including most taxi-co operative and presumably many bus and truck transport cooperatives as well, the workers own the vehicles they individually operate. The motivation for this is evidently to provide strong incentives for vehicle maintenance and driver effort. The firm itself, which is largely confined to central sales and dispatching services, therefore requires little capital and has little need for outside investors. At the same time, because of lock-in or because the firm has a regional monopoly on the services it provides, the firm may have some power to behave opportunistically toward its drivers, thus creating an incentive for driver ownership.

Where, on the other hand, the firm itself owns the vehicles and the drivers are salaried, the inherent efficiency advantages to worker ownership are arguably much more modest. United Air Lines, discussed infra note 109, is an example. There seem to be two principal affirmative incentives for adopting pilot ownership at United. The first is to take advantage of the tax benefits from ESOP financing. The second is to provide a flexible structure within which the pilots can make concessions in their terms of employment to help make the airline more competitive.

109. These considerations provide perspective on the recent efforts to convert United Air Lines to employee ownership. In September 1989 an agreement was reached whereby a majority of the company’s voting stock would be acquired by its employees through an ESOP. The company was to be sold, however, not to all of its 60,000 employees but rather only to its 7000 pilots, thus fitting it within the pattern of driver-owned transportation companies just described. The takeover was actively opposed by the airlines’ flight attendants and, especially, by its 23,000 machinists, thus underlining the serious divergence of interests among these different groups of employees. Moreover, the new owners themselves were not an entirely homogeneous class. The pilots were to acquire only 75% of United’s stock. Of the remainder, 15% was to be acquired by British Airways and 10% was to go to a group of about 30 executives within the company’s management. A negotiated allocation of seats on the board of directors sought to deal with the problem of sharing power: the pilots and the management group were to get three seats, while British Airways was to get one seat. In addition, eight seats would be occupied by outside directors who would somehow be selected jointly by management and the pilots. UAL’s Board Approves Wolf Bid After Davis Fails to Increase Offer, Wall St. J., Sept. 15, 1989, at A3, col. 1. Further, the pilots and British Airways had different ideas about the proper course for the company to pursue, and there had long been animosity between the pilots and
B. Structures to Avoid the Costs

Another indication that collective governance can be costly for worker-owned firms lies in the strong tendency of such firms to adopt rules and practices that tend to promote homogeneity of interest among the worker-owners where it might not otherwise exist. For example, the plywood cooperatives nearly all adhere rigidly to a scheme under which all members of the firm receive the same rate of pay regardless of task or seniority. Moreover, the firms explicitly justify this practice as necessary to avoid excessive dissension among the members.110

Even more striking, many of America's largest and most prosperous law firms have long followed a practice of sharing the partnership's earnings equally among all partners of a given age, regardless of individual productivity. This is an astonishing fact. As we have seen, law firms not only can, but do, monitor the productivity of their individual lawyers quite closely. It would therefore seem natural to adjust each partner's return to reflect her productivity, and thus provide a strong financial incentive for efficient performance. Yet the equal-sharing firms abandon all such financial incentives. Obviously there must be some strong countervailing value served by equality in distribution of earnings.

Gilson and Mookin111 seek to explain this practice as a mechanism for risk-sharing. Yet, while this may be among the functions the practice serves, it seems extremely implausible that risk-sharing is the principal motivation for it. At the time they enter into the equal sharing scheme, the lawyers involved have already achieved great prosperity and security. They have proven their professional competence and have become partners, with effective lifetime tenure, in an established law firm. Commonly their expected earnings are many hundreds of thousands of dollars per year. Could such individuals nevertheless be so risk averse that they are

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110. K. Berman, supra note 18, at 151-56; Greenberg, supra note 18, at 178.
prepared to relieve their partners of all financial incentives for productivity simply to assure that their own income will always be the same as that of the other partners their age.\textsuperscript{112}

This is improbable. Rather, it seems likely that these equal-sharing schemes are adopted in important part to reduce the costs of collective decision-making. An equal-sharing rule provides a simple focal point\textsuperscript{113} for deciding how to divide the pie. Law firms that do not adopt equal-sharing rules commonly employ formulas under which a partner's share is determined according to specified indicia of productivity, such as hours billed or number and value of new clients brought to the firm. Such formulas—as opposed to less formal approaches under which a manager or committee is simply given discretion to set relative shares as seems appropriate without being bound to a rigid formula—are evidently an alternative effort to establish more or less objective, and hence uncontroversial, criteria for dividing the pie where equal sharing is too difficult to justify.\textsuperscript{114} Even so, there is considerable dissension within firms about the structure of these formulas, and the resulting disagreements are an important source of instability and dissolution among law partnerships.

Indeed, in general, worker ownership seems to thrive only where, if equal sharing is not practicable, individual worker productivities are sufficiently easy to measure so that some relatively objective, and hence uncontroversial, method of pay that is based on that measure can be employed. Thus we find worker cooperatives among taxi drivers and refuse collection crews, where members of the cooperative bill clients individually and can simply be compensated with a fraction of those billings, while worker cooperatives are correspondingly rare among those firms—which constitute the overwhelming bulk of all large firms today—in which production requires the joint effort of large numbers of workers with different skills performing different tasks, so that the productivity of individual workers is quite difficult to assess with any precision.

Worker-owned firms also commonly strive hard to assure that not only

\textsuperscript{112} This inference is reinforced by the tendency of lawyers to gather in firms in which they share the same specialty and have similar clients—as in firms of patent lawyers, labor lawyers, and so on. If lawyers were highly risk averse, one would expect to see a much stronger tendency toward firms that are highly diversified in terms of both specialties and clients.

\textsuperscript{113} That is, a decision criterion that is so conspicuous or conventional that, though arbitrary, it serves as a natural point of agreement. See T. Schelling, The Strategy of Conflict 57-59 (1980).

\textsuperscript{114} Gilson and Mnookin observe that all productivity formulas are necessarily imperfect and thus create incentives for suboptimization by the lawyers at the expense of the firm as a whole. Gilson & Mnookin, supra note 111, at 352. And this, they suggest, adds to the attractiveness of equal sharing rules. This is surely true so far as it goes, but it gives emphasis to the question—not explicitly addressed by Gilson and Mnookin—of why it is that firms do not adopt the third alternative mentioned here of permitting earnings to be adjusted to each partner's productivity, but in a discretionary fashion that does not involve a precise formula that can be gamed. A plausible answer to this question is that the exercise of such substantial power by an individual or small group tends to give rise to time-consuming and divisive political activity within the firm. An example is provided by the investment banking partnership of Lehman Brothers, discussed infra text accompanying note 126.
pay, but also amount and even type of work, is equalized among the members of the firm. The worker-owners in the plywood factories, as already noted, commonly rotate through the different jobs over time, so that there is little long-run specialization of work among them. Law firms strongly resist admitting to the partnership any lawyer who is not of roughly the same competence and productivity as the other partners; less qualified lawyers, if valuable to the firm, are kept on as permanent salaried associates rather than as partners who simply receive a smaller share of earnings.\footnote{116}

Similarly, law firms strongly resist letting some partners work fewer hours than average in exchange for a smaller share. The recent rapid increase in the number of women lawyers, for example, has created considerable pressure for part-time work arrangements to permit time for child-rearing. Many law firms now willingly accept such arrangements for young salaried associates, but refuse to permit women to be partners on a part-time basis.\footnote{117} This refusal is sometimes explained on the ground that clients demand that attorneys be available full time or that attorneys must practice full time to keep up their skills.\footnote{117} But these explanations seem forced. Rather, it appears likely that such inequalities among members of the firm are also resisted at least in part because they tend to destabilize the cooperative governance structure.\footnote{118} A simple rule under which everyone does essentially the same amount and kind of work, and receives the same pay, is by far the easiest to agree upon and to enforce,\footnote{119} and these advantages are evidently often sufficient to outweigh the costs

\footnote{115} Members of university faculties, which are worker-governed enterprises of a sort, are familiar with similar phenomena. There is, for example, a strong tendency to equalize teaching loads within a given faculty, as to both number and nature of courses, regardless of the relative productivities of different individuals as teachers and scholars. Individuals, such as clinical faculty at professional schools, who must for curricular reasons be assigned a different mix of teaching responsibilities, may be given tenure but are generally denied voting rights. See Hazard, Curriculum Structure and Faculty Structure, 35 J. LEGAL EDUC. 326, 331-32 (1985).

\footnote{116} This is true, moreover, of some of the firms that hold themselves out as being among the most progressive in their flexibility in permitting associates to work part-time. See, e.g., Testimony of Antonia Grumbach of New York’s Patterson, Belknap, Webb & Tyler before the A.B.A. Commission on Women in the Profession (Feb. 6-7, 1988).

\footnote{117} Sorensen, Life Beyond the Law Office, 70 A.B.A. J. 68 (July 1984).

\footnote{118} In this vein, it is interesting to note that Aoki has suggested that a “preference for a relatively homogeneous labor force” on the part of management may be among the most important reasons why leading Japanese firms such as Toyota have chosen a low level of vertical integration with their suppliers. Aoki, Aspects of the Japanese Firm, in The Economic Analysis of the Japanese Firm 28 (M. Aoki ed. 1984).

\footnote{119} How does a firm determine, for example, how much and what kind of work is required to earn 60% of the amount a full-time partner would receive? Simply billing 60% as many hours to clients as the average full-time partner might be thought insufficient. For example, the firm may incur fixed costs, such as health insurance or office space and equipment, that do not vary with a partner’s billable hours. Or for most partners, the first 60% of the hours worked in a given week may be the easy ones to give up, while it is the other 40%, which often require working evenings and weekends and adjusting one’s personal life, that are most begrudged and thus should be compensated at the highest marginal rate. So, to receive a 60% draw, one should perhaps be required to bill 75%—or 65%—or 85%—of the hours that a full-time partner bills. Objective criteria for making such a decision are likely to be lacking, and any choice therefore could well be contentious.
such a simple rule engenders in the form of inflexibility, poor incentives, and lack of diversification among the workforce. (This is not to deny that when it comes to denying partnerships to women under conditions acceptable to them, simple sexism may also play a role.)

To be sure, it is possible that such egalitarian practices are unusually common in worker-owned firms at least in part for other reasons. In particular, it may be that causation runs the other way from that suggested here: Worker-owned firms may be unusually inclined to adopt egalitarian practices simply by virtue of the fact that they are worker-owned, and not because such practices are necessary to reduce governance costs. For example, there is evidence that a worker at a given firm tends to judge the adequacy of his salary in considerable part in relation to the amount paid other workers at the same firm. Consequently, he will accept a lower wage so long as he is among the best paid, and will require a larger wage if he is among the lowest paid. The result is that the wage structure within a given firm is less dispersed than differences in productivity among workers would predict; the workers at the top of the wage scale compensate the workers at the bottom, as it were, for the privilege of being on top. It is possible that when workers at a firm share ownership of the firm rather than being simply salaried employees, this effect is intensified—that is, the workers are then even more inclined to consider themselves as a collective reference group for purposes of judging their individual welfare. If so, this would lead worker-owned firms to have less differentiated wage structures than similar investor-owned firms. Such a phenomenon would not, however, explain why it is that worker ownership tends to arise only where the workers involved are highly homogeneous to begin with.

In recent years, the size of corporate law firms has increased dramatically. Firms are now highly departmentalized, and the size of teams that work on major projects has also become large. Consequently, there is now substantial horizontal and vertical division of labor within firms. Under such circumstances, norms requiring equal contributions from all senior attorneys become harder to maintain, and equal sharing of earnings becomes harder to justify. These developments presumably help explain the increasing tendency among law firms to hire “permanent associates” who remain with the firm indefinitely as salaried employees rather than as

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121. The same tendency to judge one’s wages in relation to one’s co-workers can also lead to an inefficient rat race as each worker seeks to advance relative to the others, with the result that they all work harder while their relative status in the firm remains unchanged. See R. FRANK, CHOOSING THE RIGHT POND: HUMAN BEHAVIOR AND THE QUEST FOR STATUS 132-53 (1985). Where all workers are paid the same, however, there is no incentive for such a rat race. Consequently, if sharing ownership significantly increases the tendency to judge one’s welfare in relation to that of one’s fellow workers, then rules of equal pay should be more common among worker-owned firms than among investor-owned firms.
partners. By this device, ownership of the firm can be confined to a relatively homogeneous class of attorneys without cramping the firm’s growth or diversification. For similar reasons it seems predictable that law firms might seek to accommodate as permanent associates rather than as partners the increasing numbers of senior women attorneys who wish to work only part time, although laws and norms concerning sex discrimination may inhibit firms from pursuing this approach.

The ultimate means for a service firm to avoid the governance costs associated with worker ownership, however, is to convert to investor ownership. And this is, in fact, the path being followed in many of the service professions. Advertising firms began converting from the partnership form to investor ownership in the early 1960s, and most of the larger firms are now investor-owned.122 Similarly, investment banking began abandoning the partnership form in the 1970s, and most of the larger firms there, too, are now investor-owned.122 Medical practice has been following the same route; today there are large numbers of investor-owned health maintenance organizations.124

Evidently one reason such firms convert to investor ownership is to attract larger amounts of capital than can conveniently be supplied by the professionals who work for them.125 But there is evidence, too, that the conversions serve to alleviate governance problems. Firms in these industries have been growing larger and more complex, offering a broader range of services, and exhibiting more internal specialization and departmentalization. Presumably consensus among the professionals within these firms concerning policies to be followed and division of the firm’s earnings has consequently become increasingly difficult to secure. Striking evidence of this appears in the well documented sale of Lehman Brothers, one of the nation’s oldest investment banking partnerships, to American Express in 1984. Although a need for capital seems to have played a role there, the


123. For example, even by 1979 only 12 of the 40 largest investment banking firms (in terms of capital) were organized as partnerships. (Figures compiled from Securities Industry Association, Securities Industry Yearbook (1980).)

124. Although early HMOs were predominantly nonprofit, the recent trend has been strongly toward the for-profit form. As of March 1988, 47.6% of HMOs were for-profit rather than nonprofit, and 82.6% of plans less than two years old were for-profit. Interstudy, The Interstudy Edge: Quarterly Report of HMO Growth and Enrollment as of March 31, 1988 1 (1988). There appear to be no accurate data on the percentage of for-profit HMOs that are investor-owned rather than doctor-owned. Investor-owned HMOs are, however, common. For example, Prudential Insurance Company operates a chain of more than 100 HMOs nationwide, many of which are directly owned by Prudential. Telephone interview with Kathy Nelson, Prudential Insurance Plan Reviewer (March 22, 1989). Moreover, it appears that the need to obtain capital for expansion is one reason that increasing numbers of HMOs are adopting the for-profit form. Richards, Exit the White Coat, Enter the Pinstriped Suit, 292 Brit. Med. J. 539, 540 (1986).

125. See supra Section IV(A).
sale was precipitated by a breakdown in internal governance that had its roots in conflicts between the old-line bankers and the newly powerful traders within the firm.\textsuperscript{126}

Further evidence comes from the recent emergence of a number of "boutique" investment banking firms organized as partnerships.\textsuperscript{127} These firms have only a small number of partners and concentrate on only a portion of the investment banking business, such as mergers and acquisitions. Yet they frequently have large amounts of capital per partner,\textsuperscript{128} suggesting that the need for capital is not a decisive factor in the growth of investor ownership and that governance problems also play an important role.

C. Representative Versus Participatory Democracy: The Case of Mondragon

The firms in which worker ownership is commonly found are, like law firms, typically small enough to permit the employment of highly participatory forms of direct democracy. As we noted earlier, however, if worker ownership is to be established in a firm with a large workforce, then worker control must presumably be exercised through a representative rather than a highly participatory form of democracy.\textsuperscript{129} The most obvious model is one, analogous to that employed in widely held investor-owned corporations and in other types of large cooperatives,\textsuperscript{130} under which the workers elect representatives to a board of directors which in turn is responsible for appointing and overseeing the firm's managers. One might speculate that, where the workforce is heterogeneous, indirect representation of this sort could have an advantage over more direct forms of democracy in securing professional management and avoiding high process costs or inefficiently biased decisions. On the other hand, such a system of indirect representation might insulate management so well as to effectively disempower workers—that is, increase the agency costs of delegation to management—and thus sacrifice some of the potential advantages of worker control.

A system of representative rather than direct democracy is in fact the approach taken in the affiliated group of worker cooperatives at Mondragon, Spain. Because of the substantial degree of success these firms have achieved (by a variety of measures their average productivity has

\textsuperscript{126} See K. Auletta, \textit{Greed and Glory on Wall Street} (1986).
\textsuperscript{128} \textit{Id.} at 162.
\textsuperscript{130} Experience with other types of cooperatives is discussed \textit{infra} Section VI(E).
regularly exceeded that of Spanish industry in general\textsuperscript{131}, and because of the extraordinary amount of attention they have received among advocates of worker ownership, they call for close consideration.

The industries in which the Mondragon firms are engaged are moderately capital-intensive. Nevertheless, the firms evidently have not, over the long run, had difficulty obtaining the necessary capital.\textsuperscript{132} Thus the experience at Mondragon provides further evidence that capital accumulation and risk-bearing are not in themselves insuperable obstacles to worker ownership in a broad range of industries.

It is arguable, however, that the success of the Mondragon system is dependent upon a variety of constraints that the system imposes on the scope of worker control. In an individual firm within the Mondragon group, direct worker participation in governance is largely confined to annual meetings at which the workers elect representatives, in at-large elections, to a nine-member supervisory board of directors for staggered terms of four years. The board, in turn, is responsible for appointing the firm’s managers, who serve for a minimum of four years and cannot be removed during that term except for cause.\textsuperscript{133} Not surprisingly, the firms have a strongly managerial character. It appears that leadership comes largely from the top, and for the most part the electoral mechanisms are employed simply to ratify proposals made by management.\textsuperscript{134} In fact, in apparent recognition that the electoral mechanisms provide at best a highly attenuated means for workers to influence management, each firm has a “social council” that is elected by the workers separately from the election of the firm’s board of directors and that serves as the principal avenue by which the interests of the workers in a firm are made known to management. In contrast to the members of the board of directors, who are elected at large, the members of the social council are elected by local constituencies within the firm. The social council, however, merely acts in an advisory capacity to management and has no formal authority. Such a social council could as well exist in an investor-owned firm, and in fact its role parallels that of works councils or unions in investor-owned firms.\textsuperscript{135}

Perhaps more important than these procedural limitations on worker governance are the substantive limitations that the Mondragon system im-

\textsuperscript{131}  H. Thomas & C. Logan, \textit{supra} note 46, at 96–130.
\textsuperscript{132}  Id. at 125–26.
\textsuperscript{134}  This is reflected, for example, in the experience surrounding the 1974 strike at Ulgor, the largest of the Mondragon cooperatives. The changes in firm policies that precipitated the strike, the (quite severe) response of the firm to the strikers, and the reforms in the social council undertaken after the strike all seem to have been undertaken by the firm’s management acting largely on its own and not under the direct influence of the firm’s rank and file. See W. Whyte & K. Whyte, \textit{supra} note 37, at 91–107; \textit{see also id.} at 113–27 (describing introduction of more participative forms of shop-floor work organization as being introduced by management).
\textsuperscript{135}  W. Whyte & K. Whyte, \textit{supra} note 37, at 40.
poses on the decisions that the workers can make. The workers in an individual firm are narrowly constrained in the extent to which, and the ways in which, they can appropriate the firm's net earnings. They are not free to set their wages at any level they wish; rather, each firm must adopt a system of wages that deviates only within narrow bounds from a scale established by the Mondragon system's central bank. 136 Ten percent of the net earnings remaining after payment of these wages must be devoted to educational, cultural, or charitable purposes; 137 the rest must be retained and invested in capital accounts. At least twenty percent of net earnings must be put in a collective account that cannot be appropriated by the firm's workers, even upon retirement from the firm, and this percentage increases according to a formula as the firm becomes more profitable. The remaining profits—no more than seventy percent of total profits—are invested in accounts for the individual workers. The amounts in these accounts cannot be withdrawn before retirement but earn interest (which is paid to the workers annually in cash) at six percent. These financial arrangements are imposed on the individual cooperatives by a "contract of association" that they enter into, at the time of their formation, with the Mondragon system's central bank; they are apparently not subject to alteration by a cooperative's workers or management. 138

The managerial character of the Mondragon firms, as well as the attenuation of the workers' property rights in the individual cooperatives, is accentuated by other features of the system. Individual cooperatives that are engaged in a given type of production—consumer goods manufacturing, for example, or furniture making, or agricultural production—are federated into a larger organization whose leadership is effectively appointed by the managers of the constituent cooperatives. These higher level organizations often have considerable authority over their member firms. In particular, there is substantial pooling of profits among the firms within a given group, so that profitable firms underwrite the losses of unprofitable ones. Similarly, individual workers can be reassigned from one firm to another within the group.

In addition, each individual cooperative must affiliate itself with the

136. Id. at 71. In light of the observations above about the tendency of worker-owned firms to adopt equal-sharing rules, it is interesting to note that although the Mondragon cooperatives have not adopted equal wages as the norm, they have until recently deliberately kept the spread between the highest and lowest wages in the firm compressed to a three-to-one ratio. Workers toward the bottom of the wage scale receive wages roughly equal to those prevailing in the local economy; it is therefore on skilled employees, and particularly managers, that the compressed wage binds. To retain managers, the wage spread has recently been increased to 4.5 to 1, with consequences that are not yet clear. Id. at 43. These constraints on the wage spread apply only to workers who are members of the cooperative, however. Firms are free to employ up to 10% of their workers simply as hired employees who are not members, and this authority is used to hire skilled employees who must be paid a wage higher than that which can be paid members. Id. at 203.

137. This is in fact a requirement that Spanish law imposes on all cooperatives; it did not originate within Mondragon. Id. at 42.

138. Id. at 69-71; H. Thomas & C. Logan, supra note 46, at 149-58.
system's central bank, which also exercises substantial influence over the individual firms. The bank's wage-setting authority has already been mentioned. Each firm must also obtain whatever additional capital it needs from the bank and must invest any capital surplus with the bank.\textsuperscript{139} Moreover, the bank retains and exercises the authority to replace by itself an individual cooperative's management, or to take over the firm's operations directly, in case of poor performance.\textsuperscript{140} The bank, whose own board of directors is dominated by the managers of the constituent cooperatives, is itself evidently a highly managerial institution; as of 1987, the two individuals who had long served as chairman of the bank's board of directors and as its chief executive officer were both among the five persons who had founded the Mondragon group more than thirty years before, and the chairman of the bank's board was also chairman of the board of the largest individual firm in the Mondragon system and of the federated group to which that firm belongs.\textsuperscript{141}

In short, workers' rights to control and to participation in earnings are substantially attenuated, and the individual firms cannot really be said to be fully owned by their workers. Rather, the Mondragon system has something of the character of a large nonprofit holding company that delegates to the employees of each subsidiary the right to elect the subsidiary's management. More particularly, Mondragon bears some resemblance to a private university, such as Harvard, whose constituent schools and departments have substantial budgetary autonomy and are largely self-governing but are subject to the right of the central administration to intervene when it feels necessary.

The institutions established within Mondragon therefore suggest some distrust of power exerted by workers through mechanisms of collective decision-making. Moreover, in the Mondragon system a conscious decision has been made to keep each individual cooperative relatively small, preferably with fewer than 500 workers. That decision was made following an eight-day strike in 1974 at the oldest and largest of the cooperatives, which then had 3500 workers (and which has since been partially broken up). In larger cooperatives, it was evidently concluded, workers and managers become too remote from each other, and important advantages of the cooperative form are lost.\textsuperscript{142}

Thus, Mondragon does not provide clear evidence that full ownership of a large firm with a heterogeneous labor force can be successfully placed in the hands of its workers. Indeed, the Mondragon experience is consis-

\textsuperscript{139} W. Whyte & K. Whyte, supra note 37, at 69.
\textsuperscript{140} Id. at 75. During 1983, for example, the bank intervened in the affairs of the constituent cooperatives on 34 occasions. In the process, it replaced two chief executive officers, the chairpersons of three boards of directors, and six department managers. Id. at 172.
\textsuperscript{141} Id. at 68–69.
\textsuperscript{142} R. Oakeshott, supra note 28, at 205; H. Thomas & C. Logan, supra note 46, at 35, 92.
tent with the general pattern that we have already observed: Successful cases of full worker ownership (as opposed to the attenuated form of worker ownership found at Mondragon) remain largely confined to small firms in which a highly participatory form of democracy is feasible, and in which the members are highly homogeneous.\textsuperscript{143} More particularly, although there is clearly a strong element of real worker democracy at Mondragon, the experience there does not provide clear evidence that, with a representative form of democracy, the costs of collective decision-making can be made acceptable for worker-owned firms with a heterogeneous work force.

On the other hand, Mondragon provides evidence that an attenuated form of worker ownership, in which the firm is operated \textit{on behalf of} its workers though not fully owned by them, can sometimes be successful in industrial enterprise. The precise strength of this evidence remains unclear. It has not yet been demonstrated how easily the Mondragon experience can be replicated, and there are reasons to be cautious in concluding that replication will often be feasible.\textsuperscript{144} Among these reasons are the ethnic homogeneity, insularity, and low mobility of the Basque population from which the Mondragon system draws its workforce.\textsuperscript{145} To date, in any event, Mondragon remains unique: It has not spawned successful imitators on a similar scale either in Spain or elsewhere.

D. \textit{Other European Experience}

Mondragon aside, the characteristics of worker cooperatives throughout Europe follow a consistent pattern that tends to confirm the conclusions suggested above concerning the efficiency of worker ownership.

Among European countries, as we have noted, Italy and France apparently have the highest concentrations of successful worker cooperatives.\textsuperscript{146} Italy subsidizes worker cooperatives in general through tax exemptions and special credits,\textsuperscript{147} which presumably helps account for Italy’s unusually large population of worker cooperatives. Moreover, both France and Italy grant construction cooperatives special advantages in bidding for government business, which may be important in explaining the high concentration of cooperatives in that industry.\textsuperscript{148} In any event, the construction companies and artisanal firms that constitute the bulk of the worker

\textsuperscript{143} Even in the few worker-owned firms that are moderately large, such as the major accounting firms with thousands of partners, there is generally a high degree of homogeneity among the worker-owners. Moreover, among these firms, as at Mondragon, there is a high degree of federation, with local branch offices being run relatively autonomously.
\textsuperscript{144} One important test, perhaps, will be whether leadership of the Mondragon system can be passed on successfully from its founders to the next generation.
\textsuperscript{145} See W. Whyte & K. Whyte, \textit{supra} note 37, at 9–12, 255–56.
\textsuperscript{146} R. Oakeshott, \textit{supra} note 28, at 146.
\textsuperscript{147} \textit{Id.} at 146, 154, 160, 162.
\textsuperscript{148} \textit{Id.} at 124, 126, 150.
cooperatives in these countries roughly conform to the type of firm in which worker ownership has proven viable elsewhere: They involve low amounts of capital per worker and tend to have relatively little hierarchy, consisting in large part of a single horizontal stratum of similarly skilled workers.449

The Italian worker cooperatives are all affiliated with one of three associations, each of which is connected with one of the nation’s political parties. In particular, well over half of the cooperatives, including most of the largest and most successful firms, are members of an association (the “Lega”) affiliated with the Italian Communist Party. Although the facts are unclear, there is reason to believe that these cooperatives are neither very independent nor very democratic and that control comes largely from the top down through the Lega.450 Thus the Lega-affiliated cooperatives, like the firms often found in other countries that are only beneficially owned by their workers, may indicate only that certain types of firms can be operated successfully on behalf of their workers, but not necessarily by the workers or their elected representatives. Furthermore, in both France and Italy the statutes governing worker cooperatives impose on them a quasi-nonprofit structure, requiring that a substantial fraction of net earnings be retained in accounts not distributable to the worker-members and prohibiting the distribution of net assets to members upon dissolution.451

England has far fewer worker cooperatives than France or Italy, but the pattern is similar. Omitting partnerships of service professionals, such as solicitors, those cooperatives that have been successful over the long run can be divided into two groups. The first group has its origins in the labor and cooperative movements of the late nineteenth century. The numbers of these firms have been declining throughout this century; by one count there were only sixteen remaining in 1973. The firms in this group are typically small artisanal cooperatives; more than half are in printing or bootmaking.452 The second group consists of more recently-founded firms associated with the Industrial Common Ownership Movement (ICOM). There were eleven of these firms as of 1977. They include some moderate-sized industrial enterprises with a fair record of success. The ICOM firms, however, are not fully worker-owned. The workers have no claim on the firms’ net assets, their rights to participate in current net earnings are constrained, and ultimate authority over important aspects of the firms’ affairs are in the hands of trustees who are not elected by the workers.453 In short, these firms are, like many other so-called worker coopera-

449. Although the available sources do not address the issue clearly, it seems plausible that the construction cooperatives, which are typically small, often contain only workers from a single trade, such as electricians or bricklayers, thus further assuring homogeneity of interest among the members.
451. Id. at 141, 154; Zevi, supra note 32, at 242.
452. R. Oakeshott, supra note 28, at 52–73.
453. Id. at 74–107.
tives, in important part simply managed on behalf of their workers and not actually controlled by them.

In summary, the experience in these countries seems to provide little affirmative evidence that large firms with heterogeneous workforces can operate successfully under full worker ownership, if by full worker ownership we mean that the workers have complete claim to the firm’s residual earnings and that ultimate authority over the firm’s affairs is in the hands of the workers or their elected representatives.

E. Other Types of Cooperatives

The conclusion that worker ownership works, but only when the worker-owners have highly homogeneous interests, is reinforced by the experience with other types of cooperatives. Both producer and consumer cooperatives of a variety of types are extremely common in the American economy. For example, although consumer cooperatives are rare in retail enterprise, there are large numbers of wholesale and supply firms that are organized as consumer cooperatives and that have as their customers retail stores, manufacturing firms, or farms. Similarly, agricultural products are commonly marketed, and sometimes processed, by farmer-owned producer cooperatives. Many of these producer and consumer cooperatives are very large firms with hundreds or thousands of members. And democratic governance commonly works quite well in even the largest of these firms: The members of the board of directors are elected democratically by the members and are clearly responsible (and responsive) to them, rather than being effectively appointed by the firm’s management as in many investor-owned firms. In virtually all situations in which they have prospered, however, these cooperatives are characterized by extreme homogeneity among their members. The members of the wholesale and supply cooperatives are typically similar-sized firms that purchase similar types and quantities of goods from the cooperative. And the members of the agricultural marketing and processing cooperatives are typically farms that sell to or through the cooperative a single, highly homogeneous agricultural commodity.\textsuperscript{154}

VII. Experience with Partial Employee Participation

The importance of governance costs relative to the other costs and benefits of worker ownership is further underscored by the accumulated experience with various forms of partial worker participation in earnings and control, forms that fall short of full worker ownership.\textsuperscript{155}

\textsuperscript{154} Hansmann, supra note 14, at 288.

\textsuperscript{155} Recent years have brought rapidly increasing numbers of management buyouts of firms whose stock had previously been publicly traded. In these transactions, the firm is converted to private ownership through the repurchase of all of its stock by a group including the firm’s senior manage-
A. Employee Stock Ownership Plans

The widespread adoption of ESOPs is not an unbiased indicator of their efficiency. Although the ESOP concept has been actively promoted since the 1950s, it did not become popular until ESOPs were granted substantial federal tax subsidies beginning in 1974—tax subsidies that have since been broadened and deepened—and until it was discovered that creation of an ESOP could be a useful defensive tactic for management in an attempted corporate takeover. It is entirely possible that, without these special advantages, ESOPs would remain rare.

Whatever the motivation for adopting ESOPs, however, one of the most striking facts about them is that they generally provide for participation only in earnings and not in control. Only rarely are they structured to give the workers a significant voice in the governance of the firm.

To begin with, a substantial fraction of the stock held by ESOPs is non-voting stock. Further, the power to vote the voting stock held by an ESOP is commonly not exercised by the workers who are the beneficiaries of the plan. In the latter regard, the tax law plays a significant role. For a privately-held corporation to obtain the tax benefits provided for ESOPs, the power to vote stock held by the corporation’s ESOP need not be passed through to the workers, but rather can be voted by the plan’s trustee. The trustee, in turn, can be appointed by the firm’s management without consultation with the workers who are the plan’s beneficiaries. In
publicly-held corporations, in contrast, voting power must be passed through to the workers on all ESOP stock actually allocated to the workers—which is to say, not purchased through borrowing, as in the popular "leveraged" ESOP.\footnote{161}

These tax law provisions are evidently important in understanding the pattern of ESOPs that has evolved. If we exclude so-called tax credit ESOPs—that is, ESOPs created under a special (and now repealed) provision effectively providing for a one hundred percent tax subsidy to the plan—roughly ninety percent of all ESOPs are in privately-held firms. Moreover, there are very few publicly-traded firms in which an ESOP has more than twenty percent of the firm's stock, and perhaps none in which the plan has a majority of the stock.\footnote{162} Thus firms in which a majority of the stock is held by an ESOP are, it appears, almost exclusively privately held. And, although the law permits (but does not require) that votes on ESOP stock be passed through to employees in privately held firms, this is done in only a distinct minority of such firms.\footnote{163} Thus, ESOPs generally do not permit much worker participation in control of the firm in either publicly or privately held firms. In fact, an extensive 1986 survey found that only 4 percent of sampled firms with ESOPs had any nonmanagerial employee representatives on their boards of directors and found no firms with ESOPs in which employee representatives constituted a majority of the board of directors.\footnote{164}

What is particularly interesting here is that voting rights have not been passed through to workers even in some firms—such as the much-publicized Weirton Steel Company—in which the ESOP owns one hundred percent of the firm's stock. Rather, voting rights are held by the ESOP's trustee, who in turn is appointed by a self-perpetuating board.\footnote{165}

\footnote{161. I.R.C. § 4975(e)(7) (1989).}
\footnote{162. J. Blasi, supra note 26, at 90–93, 103. A 1987 survey reported one publicly traded company in which an ESOP held more than 50% of the company's stock. Employee Benefit Research Institute, Issue Brief 11 (No. 74, Jan. 1988). Note, moreover, that ESOPs in publicly-held companies are commonly so-called leveraged ESOPs in which a substantial fraction of the stock held by the plan has been purchased with funds borrowed by the plan. In such ESOPs, the tax law permits the trustee rather than the workers to vote that portion of the stock that has been financed with debt, thus diluting the workers' voice.}
\footnote{163. U.S. GEN. ACCOUNTING OFFICE, supra note 24, at 39, reports that only 25% of nonleveraged ESOPs (the type most commonly found in privately held firms) pass through full voting rights to plan participants.}
\footnote{164. Id. at 40. These figures may understate the degree of effective worker representation achieved through ESOPs. It has been suggested to me in correspondence that, among firms with ESOPs, "there are several hundred in which the employees elect the board of directors," but in which the employee representatives are evidently primarily drawn from management. Letter from Corey Rosen (Apr. 11, 1990) (on file with author).}
\footnote{165. In 1982, the Weirton Steel Company was purchased on behalf of its workers through an ESOP, which acquired 100% of the company's stock. The workers were not, however, given the right to vote the stock. Rather, all voting rights involving the board of directors were given to the ESOP trustee, who was in turn to vote as directed by a special committee of the board. The workers were given only the minimum voting rights required by law, namely the right to vote on all matters requiring a more-than-majority vote, such as amendments to the corporate charter or liquidation of the corporation. J. Blasi, supra note 26, at 211–16.}
In effect, these firms are operated as nonprofit institutions in which directors with control but no claim on residual earnings are charged with managing the firm as fiduciaries for the benefit of the workers.\textsuperscript{168}

It follows that ESOPs are quite paradoxical when viewed in terms of conventional perspectives on worker ownership. The common view seems to be that worker participation in corporate governance is highly desirable but that the risk and the high cost of capital that workers face if they participate in ownership of a firm that is at all capital-intensive are serious liabilities. By these criteria, one would expect worker ownership to be structured to maximize workers' participation in control but to minimize their contribution of capital. ESOPs, however, have just the opposite character. Since they provide for participation in residual earnings through purchase of stock (rather than, for example, through a simple profit-sharing plan), they amplify workers' problems of illiquidity and risk-bearing. Yet at the same time they typically give workers no voice at all in the management of the enterprise.\textsuperscript{167}

If the advantages of worker participation in control exceeded its costs, then one would surely expect to see much more worker control in firms with ESOPs, and particularly in the 1000 or more firms in which the ESOP owns a majority of the firm's stock. These firms, or their workers, are already incurring most of the principal costs of worker ownership—particularly the high costs of bearing undiversified risk that worker ownership imposes on workers. The fact that workers typically do not participate in governance of these firms suggests strongly that those responsible for structuring them believe that any reduction in agency costs that might result from making management directly accountable to the firm's workers, even though the workers are already the firm's beneficial owners, would be outweighed by the costs—perhaps in the form of inefficient decisions or high process costs—that would be engendered by the political process required for such accountability.\textsuperscript{168}

To be sure, the creation of ESOPs in which votes are not passed through to workers can probably be explained at least in part as an effort

\textsuperscript{166} For further discussion of firms like these that are only beneficially owned by their workers, see infra Section X(A).

\textsuperscript{167} Typically adoption of an ESOP not only fails to bring an increase in workers' formal participation in control but also fails to bring an increase in informal participation by workers in firm decision-making. See Employee Benefit Research Institute, supra note 6.

\textsuperscript{168} In firms in which the ESOP does not own 100\% of the firm's stock, passing control to the workers might also increase the costs associated with that portion of the firm's capital that is provided by non-worker shareholders (for example, by creating the risk that the workers will opportunistically exploit them). This is not a problem in firms in which the ESOP already owns 100\% of the firm's equity.
on the part of corporate managers to preserve or increase their autonomy. Such ESOPs protect managers both from hostile takeovers and from direct accountability to the workers. But managerial opportunism alone seems insufficient to explain the virtually complete absence of worker control even in firms in which an ESOP holds a majority of the firm’s equity. If creation of an ESOP with pass-through of votes to the workers would be more efficient than either no ESOP or an ESOP without pass-through of votes, then one would expect to see hostile takeovers undertaken with the aim of creating such a structure—or at least to see such ESOPs put in place upon the successful completion of hostile takeovers undertaken for other reasons. In fact, one would expect to see employees themselves, perhaps through their unions, participating in such hostile takeovers (as the pilots’ union has been, for example, at United Air Lines).

Widespread experimentation with ESOPs is still too new to permit unequivocal lessons about worker ownership to be drawn from them. But so far the experience with ESOPs provides little affirmative evidence that direct worker participation in the control of enterprise through ownership can be made both effective and efficient with a heterogeneous workforce, while it provides considerable circumstantial evidence suggesting that such participation may be quite costly.

B. Beneficial Ownership

As we have just noted, firms in which an ESOP owns all of the company’s equity are typically not controlled by their workers but by trustees who manage the firms as fiduciaries for the workers. Thus, these firms are not fully worker-owned but rather, in a sense, are nonprofit firms that are operated on behalf of their workers.169 Similarly, the most successful large-scale experiments with worker-owned industrial enterprise in Britain, the ICOM cooperatives, have also been structured with only beneficial worker ownership.170 And, as we have seen, the same is also true to some extent of Mondragon and of the French and Italian worker cooperatives. In short, examples of successful worker ownership in industrial enterprise commonly do not involve true worker cooperatives but rather firms that are only beneficially owned by their workers.

A plausible inference to be drawn from this pattern, it has been suggested here, is that worker control would be inefficiently costly with a workforce as heterogeneous as those to be found in most industrial firms. One might concede this point, however, and nevertheless argue that even

169. The essential characteristic of a nonprofit firm is that it has no owners in the sense defined here—that is, no class of individuals who participate in both control and residual earnings. More particularly, the individuals who exercise control over a nonprofit firm are barred from distributing to themselves its net earnings. See Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835, 838-40 (1980).
170. See supra text accompanying note 153.
firms that are only beneficially owned by their workers are often preferable to investor-owned firms. Indeed, many advocates of worker ownership explicitly call for giving workers only the type of attenuated property rights that are found at Mondragon and elsewhere.\textsuperscript{171}

Some of the most important benefits of worker ownership discussed in Section III could presumably still be realized with only beneficial ownership instead of full worker ownership. The problems of monitoring workers, worker lock-in, strategic bargaining behavior, and poor communication of worker preferences arise principally because of the conflict of interest between workers and owners that characterizes an investor-owned firm. Even beneficial worker ownership promises to eliminate that conflict of interest in substantial part.

On the other hand, serious countervailing inefficiencies may result if industrial firms are structured, in effect, as nonprofits in which workers have beneficial ownership but lack essential elements of full ownership, including ultimate authority to replace top management or to compel distributions of earnings or assets. To begin with, such a structure largely insulates the firm’s management from any direct incentives to perform efficiently. Further, such firms are subject to special problems in adjusting their capital stock. When nonprofit firms need a rapid infusion of capital, they often have difficulty raising it since they cannot sell equity shares.\textsuperscript{172} Conversely, when market conditions permit, nonprofit firms tend, by retaining earnings, to accumulate capital well beyond the amount needed for an efficient scale of operation.\textsuperscript{173} This occurs, it appears, because accumulation serves the interests of the firm’s management, who gain from it an expanded empire and greater security. And the firm’s beneficial owners, lacking voting control, are powerless to prevent such excessive accumulation even though it leaves them worse off than they would be if the earnings involved were distributed to them rather than reinvested.

For these reasons, only if two conditions are satisfied does it make sense

\textsuperscript{171} E.g., R. Dahl, supra note 2, at 140–52; Ellerman, Workers’ Cooperatives: The Question of Legal Structure, in Worker Cooperatives in America, supra note 2, at 270–73; Vanek, Introduction, in Self-Management: Economic Liberation of Man, supra note 2, at 24.

\textsuperscript{172} See Hansmann, The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms, 40 Nat’l Tax J. 71, 77–78 (1987) (reporting empirical finding that market share of nonprofit firms grows much more slowly than that of for-profit firms when demand increases rapidly in a given industry; suggesting nonprofits are constrained in their access to capital).


Note that a nonprofit firm that, as is common, itself “owns” at least some fraction of the capital it employs (whether it obtained that capital through gifts or retained earnings) can continue to reinvest the return on that capital and thus grow even if the rate of return it is earning on that capital is below the prevailing market rate of return on capital. As a consequence, a nonprofit firm can be less efficient than its competitors and still gain market share over them, even in the absence of tax exemptions or other subsidies.
to organize an industrial firm as a nonprofit, managed on behalf of but not by its workers: (1) for reasons such as those surveyed in Section III, there would be severe inefficiencies in contracting for labor if the firm were investor-owned; (2) for reasons such as those surveyed in Section V, collective governance by the workers would be extremely costly. In such circumstances, the inefficiencies of the nonprofit form might be less than either the costs of labor contracting that would accompany investor ownership or the costs of collective decision-making that would accompany true worker ownership.

The fact that worker-owned firms in the industrial sector are typically only beneficially owned by their workers suggests that condition (2) holds. The fact that even beneficial worker ownership rarely appears in complex industrial firms where it is not heavily subsidized suggests that condition (1) does not hold. Taken together, these conclusions imply, in turn, two things. First, if workers are to be given some form of ownership interest in an industrial firm, it is most efficient to structure the firm as a nonprofit managed on behalf of, but not by, its workers. Second, the costs associated with contracting for labor on the market—that is, the inefficiencies of investor ownership—are nevertheless insufficient to justify the costs of adopting the nonprofit form to avoid them. In short, industrial firms that are only beneficially owned by their workers may be more efficient than fully worker-owned firms, but are evidently less efficient than investor-owned firms.

174. Four of the ten ICOM cooperatives in England were essentially donated to their workers by their former owners. R. OAKESHOTT, supra note 28, at 74.

175. There are other situations in which it appears to be efficient to give beneficial ownership of a firm to a class of individuals who transact with the firm. As the discussion in the text suggests, these situations typically have two characteristics in common. First, ordinary contractual devices are insufficient in themselves to protect the individuals in question from highly costly opportunistic behavior on the part of the firm. Consequently, granting ownership to someone other than those individuals will make transactions between those individuals and the firm costly or infeasible. Second, the class of individuals in question cannot effectively exercise control over the firm. Consequently, it is not possible to protect them simply by giving them full ownership. Rather, the firm can at best be managed on their behalf by trustees.

These are the circumstances under which firms formally organized as nonprofits typically arise. Organizations that are donatively financed, such as the American Cancer Society and the Red Cross, are the most obvious examples. The directors of these organizations are fiduciaries who manage the organizations on behalf of their donors, who are too numerous, dispersed, and transitory to exercise effective voting control. See Hansmann, supra note 169, at 843-866. That article argues that nonprofits typically arise to protect consumers of the firm’s services. But nonprofits can also serve to protect individuals who sell services to the firm. Just as there are both producer and consumer cooperatives, there can be both producer and consumer nonprofits. Fully worker-owned firms are producer cooperatives; firms that are only beneficially owned by their workers are producer nonprofits.

Some firms, though not formally organized as nonprofits, are nominally owned by a class of individuals who are incapable of exercising effective control, with the result that effective control is entirely in the hands of a self-appointing management. Mutual life insurance companies are a clear example. Such an ownership structure may often be efficient for reasons similar to those that justify the nonprofit form. See Hansmann, supra note 14, at 28-84.
C. Codetermination

It has been argued that, since inefficiency is likely to result if either investors or workers alone have control over decision-making concerning variables that cannot be explicitly governed by contract between them, greater efficiency is likely to be achieved if some mechanism for shared decision-making between workers and investors can be arranged.\textsuperscript{176} The most direct approach to such shared decision-making between workers and investors is to establish joint control formally by having workers and investors participate equally in electing representatives to the firm's board of directors. This is essentially the approach that has been mandated by law in Germany for all large firms under the label of "codetermination."\textsuperscript{177} From all that has been said above, however, one would expect that true sharing of formal control, through the firm's internal political process, between two such heterogeneous groups as workers and investors would be highly inefficient. And indeed this seems consistent with the German experience. Codetermination does not generally seem to have resulted in effective worker participation in control of the corporation at the board level; rather, control essentially remains in the hands of investors. Instead, the real value of codetermination lies, it appears, in the access it gives workers to accurate and credible information about the firm that would otherwise be confined to management.\textsuperscript{178} This information can then be used by the workers when bargaining with management in contexts other than decision-making at the board level—as when the firm's management bargains with individual workers, with the works councils, and with the unions—where shared information presumably reduces the incentive for, and hence the costs of, strategic bargaining behavior. In short, the primary effect of codetermination has arguably been just to provide workers with some informational seats on the board of directors.\textsuperscript{179}

\textsuperscript{176} The most sophisticated exposition of this view is offered in M. Aoki, The Cooperative Game Theory of the Firm (1984), and in Aoki, A Model of the Firm as a Stockholder-Employee Cooperative Game, 70 AM. ECON. REV. 600 (1980).

\textsuperscript{177} See generally Federal Minister of Labour and Social Affairs, Co-determination in the Federal Republic of Germany (1980).

\textsuperscript{178} Aoki has himself noted this. M. Aoki, supra note 176, at 167.

\textsuperscript{179} A very different approach to worker participation in the control of enterprise was offered by the Swedish Meidner Plan, initially proposed in the early 1970's, under which a controlling interest in large firms would eventually come to be held in a mutual fund controlled by the Swedish national labor federation. The Plan provided that workers in individual firms would be given the right to vote the shares initially accumulated by the fund up to a total of 20% of the firm's total stock; shares accumulated by the fund beyond that would be voted by a labor board covering the entire industrial sector in which the firm operated. R. Meidner, Employee Investment Funds (1978).

By thus providing for only a limited degree of worker control at the level of the firm, the Plan might have avoided some of the internal political costs associated with simple worker ownership while still promising to reduce the incentive for a firm's management to behave opportunistically with respect to its workers. On the other hand, control of firms by labor-dominated boards at a sectoral level may have engendered some inefficiencies of its own, such as monopolization. In any event, all efforts to use such a device to affect corporate control seem to have been abandoned in 1982 when, instead of the original Meidner Plan, a much more modest scheme was enacted that created five regional wage
D. Unionization

In those firms in which workers bargain collectively through labor unions, workers already employ a political process for the purpose of aggregating their individual interests. The difference between such an arrangement and the type of collective representation involved in worker ownership, of course, is that the union's political process is used not to select the firm's management but rather to select representatives to bargain with a management chosen by the firm's shareholders.

It might at first seem that unions have most of the costs and few of the benefits of worker ownership. On the one hand, because unions do not involve full worker ownership, they do not entirely remove the possibility that the management of the firm will behave opportunistically toward the workers (or vice-versa). Yet, on the other hand, they potentially have all the costs of collective decision-making among workers.

There is probably some truth to this view, and this may help explain the declining importance in the United States today of the adversarial model of collective bargaining that was adopted in American law in the 1930s. Whatever the overall efficiency of that model of worker representation, however, there are many ways in which it has been adjusted in apparent recognition of the problems of collective representation on which we have been focusing. To begin with, workers with managerial or supervisory responsibilities are generally not unionized; rather, it is usually only the workers who comprise the lowest, most horizontal stratum among the firm's employees who belong to a union. Moreover, where the jobs held by the unionized workers are particularly diverse, the workers are frequently split up into separate bargaining units. As a consequence, there is commonly a fair degree of homogeneity of interest among the workers represented by any given union.

Further, unions typically bargain with management over only a relatively narrow range of issues immediately touching on the employees' interests, such as wages, hours, and job classifications. Other issues, such as

earners' funds, none of which is permitted to own more than 8% of the stock of any single firm. Flanagan, Efficiency and Equality in Swedish Labor Markets, in THE SWEDISH ECONOMY 125, 170 (B. Bosworth & A. Rivlin eds. 1987).


181. Where more senior employees form unions, they tend to be highly homogeneous, as in the case of teachers or pilots.

182. Under section 8(a)(5) of the National Labor Relations Act, only "wages, hours, and other terms and conditions of employment" are mandatory subjects of bargaining between the employer and the union. 29 U.S.C. §158(a)(5). This provision does not prevent negotiation between the union and the employer concerning other issues, such as investment decisions, but instead simply makes bargaining over such issues optional (or "permissive") rather than mandatory. For a discussion of the current interpretation of the scope of the duty to bargain under section 8(a)(5), see Stone, Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities, 55 U. CHI. L. REV. 73, 86-96 (1988).
as the firm’s investment policies or even its policy on layoffs, are seldom bargained over even though in theory it might be more efficient if workers were to be more actively involved in deciding such issues.\textsuperscript{183} Indeed, unions themselves seem to avoid broader involvement of this sort, intentionally keeping the scope of bargaining narrowly confined.\textsuperscript{184} There may be a variety of reasons for this. But, whether it is cause or consequence, by adopting this strategy a union avoids some possibilities for costly internal conflict; expanding the scope of bargaining might bring substantial costs, in terms of both process and outcomes, that would outweigh any concomitant benefits. By confining themselves to such matters as wages, hours, and job classifications, unions can largely avoid the necessity of making invidious distinctions among their members. They can leave that task to management and adopt the simpler and less controversial strategy of pressing for greater equality with respect to the subjects they bargain over.

Finally, it is often observed that unions are seldom democratic.\textsuperscript{185} This is commonly deplored in both the social science and policy literature, much as the general absence of genuine shareholder democracy in publicly-held business corporations was deplored twenty years ago. But it may be that greater democracy would bring much higher governance costs without a corresponding improvement in the accuracy with which the union members’ preferences are represented. Michels’ iron law of oligarchy\textsuperscript{186} may in fact be an economic law, at least where unions are concerned.

Similar considerations may help explain why it is that bargaining between a union and a firm is often conducted in large part by representatives from the union’s national office and not just by local union officials: This helps defuse even further the problem of local internal politics.

In short, experience with collective bargaining does not provide strong evidence that democratic processes can be effectively employed to represent the interests of a heterogeneous class of workers in general corporate decision-making.

VIII. OTHER PROBLEMS WITH WORKER GOVERNANCE

One might concede that the high costs of worker governance have been a critical constraint on worker ownership but nevertheless believe that these costs have some other source than heterogeneity of interest among the workers or that, whatever the source of the costs, they can be made

\begin{enumerate}
\item \textsuperscript{183} See Aoki, supra note 176, at 151–71.
\item \textsuperscript{184} There is some evidence, however, that unions are beginning to aspire to a broader role in corporate decision-making. See Stone, supra note 182.
\item \textsuperscript{185} E.g., S. Lipset, M. Trow & J. Coleman, Union Democracy: The Internal Politics of the International Typographical Union 3–13 (1956).
\item \textsuperscript{186} R. Michels, Political Parties (1962).
\end{enumerate}
manageable through experience and organizational innovation. Two such arguments deserve special attention.

A. Workers May Lack Managerial Skills

It is sometimes argued that worker ownership is common among service professionals but rare among industrial workers simply because the latter lack the skills necessary for governance of a firm. For example, blue-collar workers may have insufficient knowledge of management or finance to select or police the firm’s managers effectively. Or such workers may be inclined to be short-sighted in planning; the high salience of wages and working conditions may make the workers focus on those concerns to the detriment of new investment.

Quite possibly there is some truth to this. The prevailing patterns of ownership suggest, however, that the skill level of workers is much less important than their homogeneity of interest in making worker ownership feasible. Worker ownership is evidently viable among blue-collar employees where there is little diversity of interest, as with the drivers in the transportation cooperatives or the semi-skilled workers in the plywood manufacturing cooperatives. Conversely, worker ownership is rare among white-collar workers who are not highly homogeneous, such as those employed in retailing, hotel and restaurant services, health care other than physician services, or computer programming.

An individual worker need not herself have the expertise to make managerial decisions in order for her to exercise her voice effectively as an owner. She need only be able to vote intelligently in electing the firm’s directors. Consider, for example, a firm like General Motors. It is quite believable that even an assembly line worker at GM is in a position to act more thoughtfully in electing directors than are most of that firm’s public shareholders, since she is likely to be more willing and able to obtain relevant information about the candidates and to act on it. Furthermore, many of GM’s workers are not assembly line workers, but rather financial planners, design engineers, foremen, and marketing executives. These latter types of workers presumably have a great deal of information relevant to an assessment of the firm’s management, and are also likely to have special influence with less informed blue collar workers in deciding whom to elect as directors. Thus, it is quite plausible that, if the workers owned GM, they would elect a more effective board of directors and hold them more accountable than do the firm’s current public shareholders—or at least that this would be the case if, contrary to fact, there were no important conflicts of interest among the firm’s workers.
B. **Workers Lack Experience with Governance**

It has also been argued that a major obstacle to widespread worker ownership is simply the absence of the customs, mores, and standard procedures necessary to make worker governance effective.\(^{187}\) According to this theory, workers must first become accustomed to the notion of managing the firm where they work and develop the experience and methods needed for the task. This is presumably a cumulative process; workers in one firm can benefit from the example of another. Consequently, once the proper institutions and procedures are well established and there is substantial accumulated experience in working with them, worker ownership will compete effectively with investor ownership in a broad range of settings, including those in which there is substantial heterogeneity of interest among the workers.

We cannot dismiss this argument out of hand. Organizational innovation and diffusion have often proceeded slowly in other settings.\(^{188}\) But, in the case at hand, there is strong reason to be skeptical.

Institutions for collective governance play a central role in American culture and are familiar to most citizens in a broad range of settings, from presidential elections to the Girl Scouts and the local Moose Lodge. Workers, in particular, have long been familiar with collective governance in unions—an important experience discussed above. In such a cultural environment, it is hard to argue that lack of experience with collective self-governance in general is a major obstacle to the viability of worker ownership. At most one can argue that the obstacle is lack of knowledge about, or experience with, the specific types of governance mechanisms that are needed to permit employees to act collectively in managing industrial enterprise.

The experience with ESOPs and at Mondragon suggests that the most suitable forms for worker self-governance in large-scale enterprise may involve a complex combination of representative and fiduciary mechanisms. Further experimentation and experience in developing these organizational forms may therefore help to reduce their costs. Perhaps there are sufficient gains yet to be had in this respect to yield important improvements in the viability of worker ownership. But this seems unlikely. Even in the United States there has already been considerable experience with forms for worker self-governance in service enterprise and in small-scale industry. Further, there has accumulated over many decades substantial experience with consumer cooperatives and with other types of

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188. For example, it appears that it took nearly 40 years for the multidivisional form of managerial organization to replace the older and evidently less efficient line-and-staff form throughout American industry. A. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (1977).
producer cooperatives (such as farmer-owned processing and marketing cooperatives), some of which rank among the nation’s largest industrial firms. These firms provide useful models for the governance of worker cooperatives as well. Moreover, their success suggests strongly that where there are substantial gains to be had from collective ownership, its development will not long be inhibited simply by lack of experience with institutions for collective governance in the particular setting involved.\footnote{189} 

The experience with housing cooperatives and condominiums is instructive in this regard.\footnote{190} Prior to 1961 the condominium form was essentially unknown in the United States, and its close cousin, the housing cooperative, was largely confined to the rich. Since then, however, changes in property law have made the condominium form feasible, and developments in taxation have made it financially attractive for a broad range of individuals. As a consequence, the condominium form has now spread rapidly and widely through the housing market even though it requires, at its core, a mechanism for collective self-governance by the owner-occupants. There is reason to believe that collective governance in housing condominiums is costly and that, in part for that reason, without substantial tax subsidies the condominium form would be far less common than it is.\footnote{191} Moreover, it appears that the mechanisms for collective governance in condominiums are continuing to evolve—for example, by delegating increasing authority to hired management—in ways that reduce these costs. Nevertheless, the basic governance mechanisms necessary to make condominiums viable in competition with investor-owned (that is, rental) buildings developed quite rapidly. If so many individuals can so quickly become accustomed to collectively governing the apartment building where they live, why can they not also quickly become accustomed to collectively governing the firm where they work? Evidently more is required to make worker ownership viable than simply additional time to get accustomed to it.

IX. Legal and Cultural Obstacles to Worker Ownership

It is often suggested that legal and cultural obstacles are principally responsible for the paucity of worker-owned enterprise in market economies. Upon examination, however, it appears that these obstacles, if significant at all, are far less important than the costs of worker ownership surveyed above.

\footnote{189} For further discussion of the nature, size, and governance of consumer and producer cooperatives in general, see Hansmann, \textit{supra} note 14.

\footnote{190} For a more detailed discussion, see Hansmann, \textit{Condominium and Cooperative Housing: Transactional Efficiency, Tax Subsidies, and Tenure Choice}, 19 \textit{J. Legal Stud.} (forthcoming 1990).

\footnote{191} \textit{Id.}
A. Legal Constraints

In the United States, at least, it is hard to argue that the law has been a serious obstacle to the success of worker ownership. There appear to be no explicit legal prohibitions on worker ownership of enterprise. On the contrary, there is at least one business—law—in which investor-owned firms have been explicitly proscribed by law throughout the United States.192

In general, organizational law—that is, corporation law and partnership law—is sufficiently flexible to permit the formation of nearly any type of worker cooperative. In theory, the cooperative corporation statutes should provide the simplest and most direct approach, and in some states those statutes are in fact suitable for this purpose.193 In many jurisdictions, however, the business corporation statutes are more workable, owing largely to the rudimentary and sometimes narrowly constricted character of the cooperative statutes.194 With the business corporation statutes, some manipulation is required to assure that earnings and votes are distributed to workers in the fashion appropriate for a worker cooperative. It has been argued, therefore, that worker-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 for the latter.195

The presence of such a standard form may have some significant effects. It not only reduces the transaction costs of forming a firm (for example, by making the form comprehensible to a broader range of attorneys) but also gives the form a degree of visibility, recognizability, and legitimacy it might otherwise lack.196 A bank lending officer, for example, might well feel more secure in making a loan to a worker cooperative formed according to the pattern set forth by a special worker cooperative statute than in making a loan to a worker cooperative formed through complex manipu-

192. See infra Section X(D).
193. For example, the Wisconsin cooperative corporation statute, in providing that net earnings are to be paid to the corporation’s “patrons,” seems to impose no limitations that would prevent the organization’s workers from being classified as its “patrons.” Wis. Stat. Ann. § 185.45 (West 1957).

[Formerly] the worker cooperative corporate form lacked the legitimacy accorded by express statutory authority.

The new [Massachusetts] worker cooperative statute was intended to give such enterprises legitimacy and familiarity in the eyes of lenders, suppliers, customers, government officials, managers, and workers.
lination of a business corporation statute. It seems unlikely, however, that the inconvenience of the lack of a standard statutory form has in itself been an important obstacle to the development of worker-owned enterprise. To begin with, the business corporation statutes generally serve as a standard form only for publicly held corporations; closely held business corporations, which are extremely common, often require some special drafting. Also, there have long been conspicuous examples of worker-owned corporations, such as the plywood cooperatives, that have been successful without the benefit of standard statutory forms and that are available to serve as models for other worker-owned firms.

Furthermore, tax law is probably much more important than organizational law in determining which organizational forms prosper. And tax law has long favored, rather than discouraged, worker ownership. At least since 1931, net earnings distributed to members of a workers’ cooperative have escaped (at least to a substantial degree) the corporate income tax that is levied on net earnings distributed to investors.197 In addition, since 1964, net earnings that are retained rather than distributed by a worker cooperative have been similarly free from the corporate tax.198 Finally, since the early 1970’s a varying, but in most years very substantial, package of tax benefits has existed for employee stock ownership plans.199

B. 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 worker ownership on ideological grounds and have used their authority to hamper its development and deprive it of cultural legitimacy.200

Undoubtedly some Americans see worker ownership as socialistic and therefore evil. But it seems hard to argue that there is strong ideological resistance to worker ownership in general. As noted in the Introduction, worker ownership in fact has shown broad ideological appeal to the right

197. Olympia Veneer Co. v. Commissioner, 22 B.T.A. 892 (1931) (worker cooperative can deduct patronage dividend as wages even if, with dividend, effective hourly wage received by members substantially exceeds that prevailing in industry, since members of cooperatives are more productive than hired employees). Since 1964, worker cooperatives have been held to qualify for the treatment accorded other types of cooperatives under Subchapter T of the Internal Revenue Code. Linton Plywood Assoc. v. United States, 410 F. Supp. 1100, 1107 (D. Or. 1976); Linton Plywood Assoc. v. United States, 236 F. Supp. 227, 228 (D. Or. 1964); Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 322 (1965). This provides an even more generous result than the wage deduction granted in Olympia Veneer, supra, for it permits the exclusion from gross income, for purposes of the corporate income tax, of all net earnings that derive from work performed by members (as opposed to hired workers) in a worker cooperative and that are allocated as patronage dividends.

198. Linton Plywood, 236 F. Supp. at 228.

199. See supra text accompanying note 157.

200. E.g., M. Carnoy & D. Shearer, supra note 2, at 144, 188.
as well as the left in the United States, and the advocates of ESOPs have played strongly on this fact.

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

X. SOME IMPLICATIONS FOR POLICY

The analysis presented so far has been largely positive; we have been concerned principally with understanding why worker ownership has developed according to the pattern we observe and what this tells us about the inherent strengths and weaknesses of this form of organization. We can, however, derive from this analysis some implications for future policy.

A. Employee Stock Ownership Plans

The numerous studies of ESOPs that have been undertaken to date, while not conclusive, have failed to present clear evidence of improvements in either worker productivity or firm profitability once tax subsidies are taken into account. And because ESOPs typically do not provide for substantial worker participation in governance, and hence do not (except where the ESOP owns all of the firm's equity) eliminate the conflict of interest between labor and management, they arguably lack most of the other benefits, in addition to improved incentives for productivity, that might accompany full worker ownership. At the same time, ESOPs yield the poor allocation of risk that is among the most serious disadvantages of worker ownership. Consequently, ESOPs are arguably less desirable, in general, than an alternative package consisting of a well-diversified pension fund and a profit-sharing compensation plan—a combination that offers most of the advantages of ESOPs while lacking the serious disadvantage of requiring that the workers contribute equity capital.

This suggests strongly that ESOPs have been adopted principally to gain tax subsidies. And the tax subsidies are very difficult to justify as a matter of policy. This would be true even if ESOPs brought important

201. For a review of the literature, see J. BLASI, supra note 26, at ch. 8 and Appendix D.
202. As discussed supra text accompanying note 158, in recent years another motivation for adopting ESOPs has been to help defend managers from corporate takeovers. Whether this motivation alone would be sufficient to cause many firms to establish ESOPs is impossible to say. In any event, from a policy point of view, this seems no more principled a reason for ESOPs than the tax subsidies.
improvements in efficiency, since firms would then have an incentive to adopt ESOPs even without encouragement from the tax code.\textsuperscript{203} Given the doubtful efficiency of ESOPs,\textsuperscript{204} there is no apparent justification for the tax subsidies at all. Moreover, these subsidies are quite costly, and increasingly so.\textsuperscript{205} For the latter reason at least, if not on efficiency grounds, the ESOP tax subsidies are likely soon to be curtailed. In fact, the Chairman of the House Ways and Means Committee has already introduced legislation to repeal the principal tax subsidy to ESOPs.\textsuperscript{206} And when the tax subsidies disappear, it seems likely that ESOPs will lose their popularity.\textsuperscript{207}

One could, of course, argue that we have yet to experiment meaningfully with an important variation on the ESOP that might make it efficiency-enhancing: passing votes through to workers in those ESOPs that hold sufficient stock to give the workers a meaningful share in control. But that seems unlikely to offer an improvement. Where the ESOP holds less than one hundred percent of the firm’s stock, the workers would have to share voting control with non-worker investors of capital, and the resulting conflicts of interest between the two groups would give strong incentives for inefficient decision-making. And even where the ESOP holds all of the firm’s voting stock, so that the workers alone would control the firm, the prognosis seems poor from all that has been said here about the apparent costs of worker governance.

\textsuperscript{203} To be sure, one could argue that tax incentives accelerate the experimentation and accumulation of experience necessary to cause worker ownership to become viable and accepted, and that this experimentation and experience are worth subsidizing because their fruits have the character of public goods, available for all firms and their workers to learn and profit from. Yet, as discussed supra Section IX(A), it seems unlikely that lack of institutional innovation and experience have been important obstacles to the spread of worker ownership.

\textsuperscript{204} Alternatively, one might seek to justify tax subsidies to ESOPs on distributional grounds, arguing that they help to redistribute wealth to the working class. But there seems no reason to believe that workers, rather than the investors who own the firms in question before the ESOPs are adopted, will capture most of the benefit of the subsidy.

\textsuperscript{205} Indeed, perhaps the only clear inference about the efficiency of ESOPs that can be drawn from their current popularity is that the magnitude of any inefficiencies associated with them probably do not, in general, exceed the size of the tax subsidies granted them.

\textsuperscript{206} The GAO estimates that “the cost of ESOP tax incentives averaged between $1.7 billion and $1.9 billion per year during the period 1977–1983, for a total of $12.1 billion to $13.3 billion over that period.” U.S. GEN. ACCOUNTING OFFICE, supra note 24, at 5. The 50% interest exclusion for ESOP debt has been estimated, by itself, as likely to reduce tax revenues by eight billion dollars over the five years beginning in 1989. Rostenkowski Acts to Repeal ESOP Provision, Wall St. J., June 8, 1989, at C1, col. 6 [hereinafter Rostenkowski].

\textsuperscript{207} Namely, I.R.C. § 133, which grants a 50% interest exclusion on ESOP debt. See Rostenkowski, supra note 205.

\textsuperscript{207} This not to deny that ESOPs may have some advantages over other types of profit-sharing plans. One of these may be informational: Although more finely tuned incentive pay schemes with better risk-sharing properties can undoubtedly be devised, granting workers ownership of stock is an easily understood means of conveying to workers that they have an interest in the long-run profitability of the firm. Ownership of stock may also have a symbolic entitlement or endowment effect, giving workers a stronger proprietary attitude toward the firm than they would have with an incentive pay scheme, such as a phantom stock plan, that gives the workers a similar pattern of returns but without the trappings of ownership. Cf. Krehm, Thaler & Kaheman, An Experimental Test of the Endowment Effect and the Coase Theorem 1987 (unpublished paper on file with author).
B. Codetermination and the Fifth Directive

Since 1972 the European Economic Community has been considering a proposed Fifth Directive on company law that would extend German-style codetermination to all large firms in Europe, with the modification that employees would have the right to elect only one-third, rather than one-half, of the board of directors.\footnote{208} Despite eighteen years of debate, the Fifth Directive has yet to be enacted. From the analysis offered here, continued inaction is arguably the best course.

Codetermination, as observed above, evidently has not led to a true sharing of control between labor and capital in Germany. Rather, its primary effect appears to have been simply to provide workers with more credible information about firm policy. It may therefore offer no important advantages over a system, such as that which has been in effect in Sweden since 1976, in which employees are just given an entitlement to have up to three representatives on the board of directors.\footnote{209}

The same is presumably true of the EEC's proposed Fifth Directive. In granting workers the right to elect only one-third rather than one-half of the board, that proposal abandons any notion of sharing control equally between labor and capital. Yet it still grants workers substantially more representation than seems necessary for informational purposes, and thus seems to be aiming at a degree of direct labor participation in control of the firm at the board level. To the extent that it succeeds in this regard it threatens to lead to the problems of costly decision-making described above, both in the selection of the worker representatives and, perhaps more importantly, within the board itself. If, as seems to be the case, collective self-governance is excessively costly even for workers alone when the labor force is heterogeneous, then there is little reason to believe that electoral mechanisms, and particularly voting within the board of directors, will work efficiently when those mechanisms must not only resolve conflicts among different groups of workers but also deal with the more serious conflicts of interest between labor and capital.\footnote{210} It seems better policy to leave working control of the board in the hands of either capital or labor alone and then have the board, or the managers it appoints, deal with the unrepresented factor simply by contractual means.\footnote{211}

\footnote{208. For history and documentation, see essays in Workers' Participation in the European Community: The Fifth Directive, in 13 BULL. COMP. LAB. REL. (R. Blanpain, J. Janssen van Raay & A. Mouy eds. 1984).
\footnote{210. In this respect Germany, with its conservative, cooperative, and well-disciplined labor movement, may provide a misleadingly low estimate of the extent to which codetermination would increase the costs of corporate decision-making within European firms in general.
211. Williamson, supra note 75, at 1207–9, also argues that labor representation on a corporation's board of directors in a voting capacity (as in codetermination), rather than merely for informational purposes, is inappropriate. His reasoning, however, is somewhat different from that offered here. Workers' firm-specific investments, he claims, can be adequately protected through contractual
In many firms, to be sure, one-third of the board seats would probably be insufficient to have any important influence on corporate decision-making; control would effectively remain exclusively in the hands of capital. And in those firms, such a large labor contingent on the board would be unnecessary at best, and at worst would mislead workers into thinking that they participate meaningfully in direct control over firm policy.

C. The New Employee Cooperative Corporation Statutes

Several states have recently enacted special statutes providing for the incorporation of worker cooperatives.212 These statutes do not extend the available range of organizations beyond those that can be formed under the business corporation statutes or under well-drafted general cooperative corporation statutes.213 Rather, they at best provide a simpler statutory standard form for worker cooperatives and, in the process, give that form a legislative imprimatur of sorts. As argued above, however, it seems unlikely that the awkwardness of using existing corporation law to craft worker cooperatives has played an important role in inhibiting their proliferation.214 Consequently, although these statutes cause no particular harm,215 there is little reason to believe that their enactment will have much effect in spreading worker ownership.

D. Prohibition of Investor-Owned Law Firms

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 organi-

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213. The worker cooperative statutes differ from other corporation statutes in making special provision for systems of "internal capital accounts" to provide for distributions to members, and in designating a class of organizations denominated "internal capital account cooperatives." The capital accounts involved, however, seem equally available under business corporation statutes and general cooperative corporation statutes. Thus agricultural cooperatives, which are formed under cooperative or business corporation statutes, often employ complex methods of capital accounting among their members. See Hansmann, supra note 14.

214. See supra Section IX(A).

215. The statutes are, however, needlessly specialized, vague, and awkwardly drafted (being piggybacked, as they are, onto the general corporation statutes). A more useful reform would be to redraft the general state cooperative corporation statutes where necessary to make them more functional and more general and, in the process, to make it clear that all forms of consumer and producer cooperatives, including worker cooperatives, can be formed under them. For some suggestions along these lines, see Hansmann, Reforming Nonprofit Corporation Law, 129 U. PA. L. REV. 497 (1981).
zation that sells legal services to the public if that organization is not wholly owned by lawyers who practice in it, as in the case of the conventional law partnership or professional service corporation.\textsuperscript{216} Since this provision of the Model Rules, or a close counterpart, has the force of law in virtually every state,\textsuperscript{217} worker-owned firms are presently the only available form for organizing the practice of law. When the Model Rules were adopted in 1983, the original draft called for eliminating this restriction. Ultimately, however, the ABA rejected the reform.\textsuperscript{218}

It seems likely that law firms will continue to grow larger and more internally specialized and complex—a path they have followed consistently for many decades and which they have pursued at an accelerated pace in the past twenty years.\textsuperscript{219} This is likely to increase the capital needs of these firms and to put increasing strain on their governance mechanisms, as it has in the other service professions. And this, in turn, is likely to lead to increasing pressure for law firms to follow the other service professions in shifting toward investor ownership.\textsuperscript{220}

Should the Model Rules' prohibition of investor ownership be retained in the face of this pressure, leaving it to market forces alone to determine whether lawyer ownership will continue to be the exclusive form for organizing law firms? Similar restrictions on investor ownership of medical practices were eliminated by preemptive federal legislation more than fifteen years ago\textsuperscript{221} with results that appear generally salutary. Since the public policy justification for such restrictions seems even less compelling in law than it was in medicine,\textsuperscript{222} it is arguably time that they be abandoned by lawyers as well.


\textsuperscript{217} The Rules, like the Code that preceded them, are typically adopted by the states through judicial rather than legislative action. See C. Wolfram, Modern Legal Ethics 56–57, 62–63 (1986). Most states have adopted some form of the Model Rules, and of these nearly all have followed Rule 5.4 without significant variation. ABA/BNA Lawyer's Manual on Professional Conduct paras. 01:3, 91:401 (1990).

\textsuperscript{218} G. Hazard & W. Hodes, The Law of Lawyering 469 (1989).


\textsuperscript{222} See Hansmann, supra note 215, at 538–45; G. Hazard & W. Hodes, supra note 218, at 469–78. To be sure, health maintenance organizations serve an insurance function and thus are likely to have larger needs for capital than do typical law firms. Consequently, the costs of prohibiting investor ownership are arguably much smaller in law than in medicine.
XI. CONCLUSION

The classical model of the business firm, under which formal control is confined to suppliers of capital while management in turn deals with workers through market contracting, leaves room for considerable inefficiency in the form of agency costs between owners and managers and opportunistic behavior between the firm and its workers. In theory, worker ownership promises substantial efficiency improvements in these respects. And in practice it appears that worker ownership often is more efficient than investor ownership when the workers involved are highly homogeneous. The evidence suggests, however, that direct worker control of the firm brings substantial costs with a heterogeneous workforce—costs that are generally large enough to outweigh the benefits that worker ownership otherwise offers. For similar reasons, true sharing of control between labor and capital is not promising as a route to efficiency.

Consequently, it is difficult to justify public subsidies for worker ownership (such as tax preferences for ESOPs) or policies that mandate a large role for workers in control at the board level (such as German-style codetermination). Other forms of worker participation appear to offer better prospects for improving on the efficiency of the classical model. For example, simple profit-sharing plans may be a better approach to increasing incentives for productivity, while works councils, quality circles, labor-management committees, and informational seats for labor on the board of directors are probably more suitable means of improving the flow of information between management and workers.

It is paradoxical that the aspect of worker ownership often extolled as its principal virtue—participation in governance of the firm through democratic institutions—appears in fact to be its greatest liability. In business firms as in other settings, political mechanisms operate crudely. In comparison to market contracting, they evidently aggregate and represent the interests of a heterogeneous group relatively inefficiently in all but the most severe situations of market failure. Even then, fiduciary mechanisms may generally be a more effective substitute for the market than are political institutions: Firms managed for their workers, it appears, often perform better than firms managed by their workers.

To be sure, all such conclusions must be tentative. We know too little about organization theory in general, or about intra-firm political mechanisms in particular, to draw definitive conclusions about the relative efficiency of alternative assignments of earnings and control. Organizational innovations may yet make worker ownership viable in circumstances where it has previously failed to make headway. At present, however, it seems most reasonable to predict that successful instances of worker ownership will remain largely confined to firms with highly homogeneous classes of worker-owners.