In Defense of Employee Ownership - The Kenneth M. Piper Lecture

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IN DEFENSE OF EMPLOYEE OWNERSHIP

ALAN HYDE*

I. INTRODUCTION: THE RECENT POPULARITY OF MODIFIED EMPLOYEE OWNERSHIP

Our inquiry is into the economic success or failure of the business owned in the majority, and actually controlled, by the people who work there. There are very few such businesses in actual operation, and those few have already been studied microscopically by the political scientists and sociologists, and then over-theorized about by the economists, whose work is cited in the pages that follow. Nevertheless, there are at least four reasons for a fresh look at their success and potential.

First, the vision of an economy of worker-owned businesses is an old and resilient one; it is, in fact, one of the things meant by "communism" in political discourse until an analyst named Marx argued that such an economic vision was "utopian" unless joined with a program for capture of political power. The worldwide disenchantment with all or part of Marx's alternative program—a disenchantment that long predates 1989—has assisted a fresh look at the "utopian" vision he rejected—a

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* Professor, School of Law—Newark Rutgers The State University of New Jersey. This is an expanded version of the Kenneth M. Piper Lecture originally given at IIT Chicago Kent College of Law on March 19, 1991. Thanks to Samuel Bowles, William Bratton, Oliver Hart, Douglas Kruse, Brian Langille, Louis Putterman, William Simon and Clyde Summers for comments on earlier drafts.

1. There are probably only about 2000 American companies of any size that are owned entirely or in the majority by their employees, and this number does not seem to be growing rapidly. The number is larger if one includes as "employee-owned businesses", as some scholars do, professional partnerships such as law firms and accounting firms. Raymond Russell, Sharing Ownership in the Workplace 143-67 (1985); Henry Hansmann, When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy, 99 Yale L.J. 1749 (1990).

2. Michael Sonenscher, Work and Wages: Natural Law, Politics and the Eighteenth-Century French Trades 371-72 (1989); A Dictionary of Marxist Thought 95 (Tom Bottomore ed., 1983) ("There is no systematic treatment of cooperation in the sense of the cooperative movement or particular forms of cooperative production in Marx's and Engel's work, but there are more references to the subject, and more favorable ones, than is sometimes supposed . . . . The comparative idea itself is not condemned, only deformations of it . . . . Cooperation could never defeat monopoly unless it was developed to national dimensions.") citing T. Lowit, Marx et le Mouvement Cooperatif (1962).
vision that always had particular resonance in the resolutely pro-capitalist, anti-socialist segments of the American working class.³

Second, in the past decade, the prospect of mass employee ownership has passed decisively from utopian proposal to big business. Several hurdles have been jumped here. One common argument against the utopian cooperative vision was that such worker owned firms could never attain any size. However, there are now very large and successful companies that are over seventy percent owned by employees, such as Weirton Steel, ranking 288 on the Fortune 500, and Avis Corporation, now privately held but (as everyone knows) America’s Number 2 car rental company. “Employees own a majority of the stock in three of the country’s ten largest integrated steel manufacturers, two of the ten largest private hospital management companies, two of the three largest shipbuilders, two of the ten largest construction companies, and many others.”⁴

Third, the spread in popularity in the United States of Employee Stock Ownership Plans (ESOPs) has suddenly created the possibility of an economy of firms in which the employees are in most cases the dominant shareholders. Already there are more Americans working for firms, more than 4 percent owned by their employees, than there are represented by labor unions. If, as is often asserted, a 15 percent ownership stake permits dominance, “[b]y the year 2000, more than a quarter of the companies traded on the New York Stock Exchange, the American Stock Exchange and Over-the-Counter Market will be more than 15 percent owned by their employees.”⁵

Now a firm with an ESOP, even an ESOP that owns 15 or 25 or 75 percent of stock, is not necessarily a firm that workers control or manage. The ESOP, as envisioned by attorney Louis Kelso and later sanctioned by statute,⁶ was carefully designed to permit companies to donate stock to employees without necessarily parting with any control.⁷ To-

3. DANIEL RODGERS, THE WORK ETHIC IN INDUSTRIAL AMERICA 1850-1920 at 40-45 (1978); Derek C. Jones, U.S. Producer Cooperatives: The Record to Date, 18 INDUS. REL. 342 (1979). An ambitious recent attempt to capture and restate a distinctive vision of “social-republican property,” held by private individuals but requiring active participation in the group of property holders and egalitarian intervention within the group, is William H. Simon, Social-Republican Property, 38 UCLA L. REV. 1335 (1991)[hereinafter Simon]. Simon’s two leading examples are producer cooperatives, such as employee owned businesses, and housing cooperatives.


5. BLASI & KRUSE, supra note 1, at 3, provide a thorough analysis of the phenomenon of public companies with substantial employee ownership through ESOPs and other stock bonus plans.


7. JOSEPH BLASI, EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF? 15-28, 122-57 (1988)(reviewing legislative history). This philosophy animates the ESOP deals actually concluded
day, the typical ESOP is a stock savings plan in which shares are held in trust for employees and voted by a trustee appointed by corporate management.\textsuperscript{8} The company continues to be managed traditionally, and on the whole is less likely than a conventionally investor-owned firm to experiment in worker involvement of various kinds.\textsuperscript{9} Until quite recently, sincere believers in worker management wanted nothing to do with ESOPs, which were seen as inevitably associated with control by conventional managers.\textsuperscript{10} Their preferred institutional model was the cooperative, highly democratic, perhaps organized without any supervisors or leaders, and with jobs rotating.\textsuperscript{11}

by Kelso and his firm. In the words of his associate, Joseph Schuchert: “Our programs are the antithesis of workplace democracy . . . . We’ve been criticized for not giving workers more participation, but we believe workers are natural shareholders, not natural managers.” Employee Stock Plans Turn Into Management Boon, BOSTON GLOBE, January 2, 1985, as quoted in DAVID ELLERMAN, THE DEMOCRATIC WORKER-OWNED FIRM: A NEW MODEL FOR THE EAST AND WEST 105 (1990). In the words of experienced ESOP observer Brian Freeman, “These are just deals, not social programs.” Brian Freeman, Employee Buyouts, 15 INST. ON SEC. REG. (PLI) 33, 48 (1984).

8. These include the "ripoffs" discussed by Blasi in his earlier book, cited supra note 7. Positioning shares in the hands of a trustee loyal to management encouraged the widespread adoption of ESOPs to discourage corporate takeovers, discussed in BLASI & KRUSE, supra note 1, at 139-210. Their recent survey of companies with substantial employee ownership—what they call the “Employee Ownership 1000”—reveals 60 to 75 percent that treat employee ownership simply as a vehicle for employee savings, and an additional 20 to 30 percent of firms they call “feudal” who administer employee stock ownership with no regard whatever for employee interests. Id. at 221-27.

9. Patrick M. Rooney, Worker Participation in Employee-Owned Firms, 22 J. ECON. ISSUES, 451, 453 (1988), surveyed firms with substantial employee stock ownership—47% of stock in the median firm—and found very little involvement of employees through meetings, quality of work life groups, or collective bargaining, let alone participation in investment decisions or the distribution of profits.

10. The supposed contrast between the democracy of the cooperative and the hierarchy of the ESOP dominated much of the popular literature on employee ownership, particularly from a left perspective, up until the middle of the 1980's. See, Jonathan Prude, ESOP's Fable: How Workers Bought a Steel Mill in Weirton, West Virginia, and What Good it Did Them, 14 SOCIALIST REV. 27, 38 (1984), for an interesting journalistic account of the Weirton buyout, spectacularly wrong on its predictions, largely because of hostility to the ESOP form; Henry M. Levin, ESOPs and the Financing of Worker Cooperatives, in WORKER COOPERATIVES IN AMERICA 245 (Robert Jackall & Henry M. Levin eds., 1984); David Ellerman, Notes on the Co-op/ESOP Debate (available from the Industrial Cooperative Association) (1982).

11. The most thorough academic treatments of such workplaces are by sociologists and political scientists interested in testing whether such a degree of democracy was feasible, and generally concluding that it wasn't. JANE T. MANSBRIDGE, BEYOND ADVERSARY DEMOCRACY (1984); JOYCE Rothschild & J. ALLEN WHITT, THE COOPERATIVE WORKPLACE: POTENTIALS AND DILEMMAS OF ORGANIZATIONAL DEMOCRACY AND PARTICIPATION (1986) (both studying cooperative clinics, schools, or other collectives founded in the very early 1970's).

There is some very skeptical theoretical economic analysis of such highly democratic organizations. Michael C. Jensen & William H. Meckling, Rights and Production Functions: An Application to Labor-managed Firms and Codetermination, 52 J. BUS. 469, 475-91 (1979) (analyzing a "pure rental" firm in which no one, not even employees, owns anything); Oliver E. Williamson, The Organization of Work: A Comparative Institutional Assessment, 1 J. ECON. BEH. AU. & ORG. 5 (1980) (analyzing "peer group" firm without any supervision and with job rotation). Even at the time, these were somewhat caricatured versions of employee ownership, as critics pointed out. Louis Putterman, On Some Recent Explanations of Why Capital Hires Labor, 22 ECON. INQUIRY 171 (1984) [hereinafter Why Capital Hires Labor]; Louis Putterman, The Organization of Work: Comment, 2 J.
It is possible, perhaps likely, that most of today's ESOPs will never amount to more than savings plans, in which case the subject of this Article—the genuinely worker-owned and managed firm—will evolve apart from the literature on ESOPs, as of course it did for the century and a half between the origins of utopian socialism and the maturity of Louis Kelso.

There are good reasons however to think that a significant number of the ESOPs of the 1980's will evolve during the 1990's into a new and exciting form of partial worker control. In the next few years the loans that established these leveraged ESOPS will be paid off, more stock will vest in employees, and the sheer quantity of employee-held stock creates interesting possibilities, for example, of alliance with pension funds and other institutional investors. Meanwhile, a corps of lawyers, bankers, and other professionals experimented with combining workplace democracy with ESOP organization, and discovered that the ESOP is not inevitably associated with hierarchical management; indeed, there are ESOPs as "democratic" as the wildest cooperative.

12. This is the theme, meticulously traced out, of Blasi & Kruse, supra note 1.

13. There are still no comprehensive introductions to the new "democratic" ESOPs. One highly democratic ESOP is at Seymour Specialty Wire, see Gary B. Hansen & Frank T. Adams, Saving Jobs and Putting Democracy to Work: Labor-Management Cooperation at Seymour Specialty Wire, Bureau of Labor-Management Relations and Cooperative Programs, U.S. Dep't of Labor, Labor-Management Cooperation Brief No. 11, (1987); or the journalistic account in Jeremy Brecher, Upstairs, Downstairs: Class Conflict in An Employee Owned Factory, 1 Zeta (No. 2), Feb. 1988, at 68-74, reprinted in Building Bridges: The Emerging Grassroots Coalition of Labor and Community 274 (Jeremy Brecher & Tim Costello eds., 1990). Other brief introductions to "democratic" ESOPs include Blasi & Kruse, supra note 1, at 227-30; Steve Newman & Mike Yoffee, Steelworkers and Employee Ownership, 3 J. Employee Ownership L. & Fin. 51 (1991) (companies in which workers represented by the United Steelworkers hold substantial ownership); Catherine J. Ivancic & John Logue, Democratizing the American Economy: Illusions and Realities of Employee Participation and Ownership, in Managing Modern Capitalism: Industrial Renewal and Workplace Democracy in the United States and Western Europe 232-40 (M. Donald Hancock, et al. eds., 1991) (same); Peter Pitegoff, The Democratic ESOP (available from Industrial Cooperative Association) (Jan. 1987); Craig Livingston, Lessons from Three UAW Locals, 6 Lab. Res. Rev. 35 (1985); and the as-yet unpublished paper by my student Alex Kress, Realizing the Potential for Democratically-Controlled Companies (unpublished manuscript, on file with author). A weakness of Blasi's excellent book on Employee Stock Ownership Plans, cited supra note 7, was his failure to include information on "democratic"
that many firms with ESOPs will evolve somewhere in between, with workers exercising the kind of control that shareholders with 15 percent stakes do, though not the kind of control associated with worker cooperatives. This trend makes more pressing a fresh look at the economic desirability of worker management.

Fourth, as I said, the few existing examples of real employee ownership have generated a large academic literature. However, that literature is not marked by consensus. It is a very ideological literature that is marked by a search for the "smoking gun" that will demonstrate decisively that economic ownership is (either, depending on the politics of the researcher), always a good idea for everybody, or could never possibly work for anybody. Since neither of these positions is consistent with the past decade's experimentation with multiple forms of partial employee ownership, it seems time for a fresh look at the literature from a policymaker's point of view, to determine the potential success and failure of genuine employee ownership.

The Article that follows is an attempt to review the literature on the productivity of worker-owned businesses from the perspective of "efficient wage" models of labor contracting; "transaction costs" or "information costs" models of the firm; and theories of internal or "X"-inefficiency. The clearest conclusion is that models of the productivity of worker ownership must be firm-specific; there will never be a "smoking gun" that proves that worker ownership either always works or never works.

More particularly, I shall argue that worker ownership is likely to be highly positive for productivity where local histories of mistrust pre-

ESOPs. The "ripoffs" that Blasi discusses must be understood as typical, but not inevitable, results of ESOP organization.

14. BLASI & KRUSE, supra note 1, at 244-55.

15. Other points of view than the policymaker's are of course possible and perhaps even preferable. My friends and colleagues in the Critical Legal Studies Movement have often alerted us to the deadening effect that legal or economic models of reality may have on our abilities to imagine alternatives. On this view, the task of the scholar of employee ownership would be to demolish the legal and economic assumptions that appear to count against it, such as our very concepts of "property" and "market", and imagine fresh alternatives. This strategy is particularly indicated where, as here, the state of economic knowledge is particularly flimsy, and resort to economics to "prove" the inevitability of the status quo particularly likely to be ideological. Examples of excellent scholarship applying this perspective to problems of labor regulation include Karl E. Klare, Workplace Democracy & Market Reconstruction: An Agenda for Legal Reform, 38 CATH. U. L. REV. 1 (1988); and Joseph W. Singer, The Reliance Interest in Property, 40 STAN. L. REV. 611 (1988).

As will probably be evident in the pages that follow, I have a great deal of sympathy for any reader who, having worked through the academic literature on worker ownership, decides that sanity lies in freeing her mind from it and imagining alternatives. However, in this Article I want to speak directly to the versions of that literature that have shown up in the law reviews, since I believe that a more economically sound model of worker ownership is possible, even within recognized modes of economic analysis.
vent workers and managers from concluding cooperative arrangements that would in fact improve firm productivity, but will not be adopted because of low trust, high probability of opportunism, or high information costs. In this common but not universal scenario, an ownership stake for workers can decrease information costs and increase trust, and be positive for firm productivity. By contrast, a firm without such a history of low trust will almost surely not suffer by increasing employee ownership, but may not experience major productivity gains either. The case for employee ownership in such a firm is political, parasitic on theories of democracy, but is not distinctively economic.

The result, if the Article succeeds, should be an advance in how we think about employee ownership, namely shifting the level of analysis from The Firm to individual firms, and a modest defense of the role of employee ownership, and thus of public policies that advance it.

II. CURRENT ACADEMIC LITERATURE ON EMPLOYEE OWNERSHIP

The format of this Article does not permit a careful and comprehensive treatment of everything that has been written about worker ownership, and I shall be forced to caricature in order to explain how the model of employee ownership proposed here differs from its predecessors. As a general introduction, let me separate the "conceptual" literature, by economists, political theorists, and lawyers influenced by each, from the "empirical" literature by sociologists and political scientists.

A. Conceptual Models of Employee Ownership

The conceptual literature is notable for its simplified, indeed oversimplified, models of employee-owned firms. These never bore much relationship to observable real-world phenomena, and resemble them less over time. In particular, economists do not seem familiar with the idea, now bread-and-butter for attorneys practicing corporate finance, that a firm may be significantly owned by employees in combination with other investors. Yet these simplified models have their point, all the same. They permit the researcher to evade the eponymous question tellingly asked by Professor Hansmann in his recent article in the *Yale Law Journal*: "When Does Worker Ownership Work?" 16

It is not really an exaggeration to say that the existing economic, political science, and legal literature answers that question in one of two ways. The answer is either "always" or "never." Here are slightly cari-

catured—but really, only slightly—explanations of the "always" and "never" simplified models of employee ownership that dominate the conceptual literature by political theorists and some economists.

The model that suggests that employee ownership is just about always good for just about everybody does so because it sees employee ownership as the solution to more or less universal problems experienced by employees of modern industrial or service firms: loss of control of work, alienation, an experience of passively following orders.

The "always" model of the employee-owned firm has changed surprisingly little since its origins in the nineteenth century. Both its description and defense are largely in the vocabulary of political theory. A standard trope is the alleged disjuncture between the economic and political realms. Democracy is justified for reasons standard in political theory since Aristotle: many heads are better than one, perhaps, or the one wearing the shoe knows where it pinches, or as a solution to the problem of obedience to law, that bases it on the consent of the governed. The argument for democracy at work is then parasitic on the general political defense of democracy. The employee-owned firm is painted very vaguely, but prominent in the palette are tones of participation and responsiveness. The books end with a call for employee ownership, without too much in the way of specifics. 17


The most economically sophisticated version of the "always" argument came to my attention after this speech was given. In an unpublished paper, Samuel Bowles and Herbert Gintis defend employee ownership as likely to be positive for the efficiency of all firms, drawing heavily on both the "efficiency wage" models of the labor market and "information costs" models of the firm. When published, theirs should be the standard defense of worker ownership in any anthology of economic writing on the subject. Their analysis parallels my own in many respects, and its economic sophistication much greater than my impressionistic account; I shall be drawing on it below. Nevertheless, it is still an "always" model; it has no scope for arguing that employee ownership might be a good idea for some firms but not others. This is accomplished, as is customary in economic analysis, through a set of simplifying assumptions, forthrightly identified by the authors but which nevertheless disable them from developing a firm-specific theory. Among these are that workers within the firm provide identical services and have no conflicts of interest, and that supervision of workers, here, as often in this literature, called "monitoring", involves no human labor and thus no agency problems in motivating or supervising the monitor. Samuel Bowles and Herbert Gintis, TheDemocratic Firm: An Agency-Theoretic Evaluation, in THE MICROFOUNDATIONS OF POLITICAL ECONOMY: PARTICIPATION, ACCOUNTABILITY, AND EFFICIENCY (S. Bowles, H. Gintis, & B. Gustafsson eds., forthcoming) [hereinafter Bowles & Gintis]. (Page citations are to a manuscript version on file with the Chicago-Kent Law Review). Since the potentially interesting variations among firms are smoothed out, it becomes literally impossible within their model to argue that employee ownership might work some places but not others.

Bowles and Gintis argue that democratic firms can always attain efficient allocations of wage rates and worker effort that are unavailable to capitalist firms. While I will argue below that this is often the case, it is not clear to me why it should always be the case; why democratic firms must
A similarly rosy "always" model of employee ownership, rosy in the sense that it suggests that every or nearly every imaginable enterprise would benefit from employee ownership, is presented by Jaroslav Vanek, particularly when he is popularizing his own work. For example, Vanek presents an extremely appealing picture of an economy dominated by employee-owned firms: firms would be small, as there would be no incentive to expand beyond the point at which economies of scale are no longer realized; there would thus be more competition; less wasteful expenditure on promotion and advertising; full employment; and less environmental pollution, as plants are owned by those who work in and live near them.\(^{18}\)

Across the Library, perhaps, in the economics section, lies a competing body of theoretical literature that suggests that employee ownership cannot possibly ever work for anybody.\(^{19}\) In this version, employee always reach this point and why capitalist firms never can. Bowles and Gintis rely on a different, and less clearly stated, set of simplifying assumptions here. In assuming the existence of more efficient wages, they draw a line in which worker output increases for each increase in wages. Surely this line must trail off after some level of worker effort. The capitalist is assumed to be indifferent to any point on this line, but is assumed not to be able to reach a hypothetical point, off the line, "at which efficiency has unambiguously increased: production is the same, while monitoring inputs have been reduced . . . and could be reallocated to productive purposes. In addition, worker welfare has risen because effort is unchanged, monitoring and hence dismissal probability is reduced, and wages are higher." \textit{Id.} at 25. I will argue below that such a lovely move is sometimes possible, making a case for employee ownership, and present a theory explaining why some, perhaps most, capitalist firms will not reach this point without employee ownership. But I do not understand, and will not argue here, why no capitalist firm could ever reach this lovely point.

Perhaps as a result of these simplifying assumptions, the authors, though they believe they have shown that the democratic firm is "unambiguously more efficient," \textit{id.} at 34, than the capitalist firm, still rely in places of their argument on the kinds of "political theory" arguments identified in text. "Our first claim is that in a capitalist economy the employment relationship gives the employer power over the worker, that on democratic grounds this power should be democratically accountable, and that a workplace democracy is a means towards securing this democratic accountability." \textit{Id.} at 13; \textit{see also} \textit{id.} at 13-21 (developing this argument). Now as it happens I agree with this. However, one who doesn't would thus probably have to conclude that Bowles and Gintis have failed to demonstrate that employee ownership is always preferable to capitalist ownership.

My thanks to Duncan Kennedy for making this stimulating paper available to me.

18. 
JAROSLAV VANEK, \textsc{THE PARTICIPATORY ECONOMY: AN EVOLUTIONARY HYPOTHESIS AND A STRATEGY FOR DEVELOPMENT} 21-38 (1971). Vanek's more technical work displays awareness of inefficiencies of pure employee ownership, including tendencies toward underemployment, JAROSLOV VANEK, \textsc{GENERAL THEORY OF LABOR-MANAGED MARKET ECONOMIES} 193-96 (1970) \[hereinafter \textsc{GENERAL THEORY}\], and underfinancing, Jaroslav Vanek, \textit{The Basic Theory of Financing of Participatory Firms, in THE LABOR-MANAGED ECONOMY} 186 (1977), that are much less prominent in the popularized treatment.

19. In addition to the Williamson and Jensen & Meckling articles cited supra note 11, see Eirik G. Furubotn, \textit{The Long-Run Analysis of the Labor-Managed Firm: An Alternative Interpretation}, \textsc{66 A.M. ECON. REV.} 104 (1976); Eugene F. Fama & Michael C. Jensen, \textit{Separation of Ownership and Control}, \textsc{26 J. L. & ECON.} 301 (1983); Eugene F. Fama & Michael C. Jensen, \textit{Agency Problems and Residual Claims}, \textsc{26 J. L. & ECON.}, 327 (1983). Like the Williamson and Jensen & Meckling articles, this literature models a factitious employee firm that bears very little resemblance to any observable firm.

While this literature is fairly well-known in law schools, due, no doubt, to the influence of the
owners would (like other neoclassical economic actors) maximize their current income, so that every dollar that comes in would be paid out in wages;\(^\text{20}\) the firm would never plan or invest;\(^\text{21}\) it would never expand, since each new employee would just divide this static income stream into a smaller rivulet;\(^\text{22}\) the firm could generate no internal funds for investment, while no sane outside investor would ever finance such a firm;\(^\text{23}\) which would go to a speedy grave unless imposed on the unwilling through force of law.

*Journal of Law and Economics* and to Professor Williamson's law school teaching, there is a substantial critique of it within the economics journals which to my knowledge has never been cited in any law review. In the notes that follow I shall cite both the critiques of employee ownership and the critiques of the critiques.


21. In part this is just the corollary of the assumption that the employee-owned firm would maximize members' incomes by paying out every dollar of revenue as wages. The literature sometimes suggests additional reasons that employee-owned firms would prefer consumption to investment, and this has become known as the "horizon problem": Furubotn, *supra* note 19. The empirical literature on employee owned firms fails however to illustrate any "horizon problem"; if anything, worker owners have rather longer horizons than today's investors! Hansmann, *supra* note 1, at 1774; David P. Ellerman, Horizon Problems and Property Rights in Labor-Managed Firms, 10 J. COMP. ECON. 62 (1986).

22. A surprising and counterintuitive result of the early models of employee ownership was that such firms would never expand beyond the original group of employees. Ward, *supra* note 20; Jaroslav Vanek, General Theory, *supra* note 18. This too lacks empirical support and turns out not to be theoretically sound either. Bonin & Putterman, *supra* note 19; Katrina V. Berman & Matthew D. Berman, An Empirical Test of the Theory of the Labor-Managed Firm, 13 J. COMP. ECON. 281 (1989); Kathryn Nantz & Roger Sparks, The Labor-Managed Firm under Imperfect Monitoring: Employment and Work Effect Responses, 14 J. COMP. ECON. 33 (1990); J. Michael Montias, On the Labor-Managed Firm in a Competitive Environment, 10 J. COMP. ECON. 2, 7 (1986) ("safety of employment may provide the strongest incentive for individuals to join LMF's"); Branko Horvat, The Theory of the Worker-Managed Firm Revisited, 10 J. COMP. ECON. 9, 12 (1986) (same "absurd results" of falling supply in the face of rising prices would obtain if profit-maximizing firms are treated as maximizing profit per unit of capital); A.A. Brewer & M.J. Browning, On the Employment Decision of a Labour-managed Firm, 49 ECONOMICA 141 (1982); Alfred Steinherr & J.-F. Thisse, Are Labor-Managers Really Perverse, 2 ECON. LETTER 137 (1979). Hajime Miyazaki & Hugh M. Neary, The Illyrian Firm Revisited, 14 BELL. J. ECON. 259 (1983), assume by contrast that workers in a worker-managed firm would not maximize current payout but would rather contract among themselves to increase the value of their membership, in particular, their "income-employment security." Under this not implausible assumption, the firm ends up creating an internally-financed scheme of income insurance. With incomes insured, employee-owners accept work sharing and bear all other risks of firm nonperformance.

23. See Jensen & Meckling, *supra* note 11, at 473. This is true definitionally (but only definitionally) if the employee-owned firm is defined in advance as a firm with nothing to sell or pledge to investors. In the real world, employees can sell shares in any form they like. Benedetto Gui, Basque Versus Illyrian Labor-Managed Firms: the Problem of Property Rights, 8 J. COMP. ECON. 168 (1984).

In recent years in the United States some employee-owned firms have reduced the level of employee ownership through public offerings, such as at Weirton Steel, or through simple sale to private investors. See infra note 46 and accompanying text.
B. Empirical Literature on Employee Ownership

The most important point to emerge from study of the empirical literature on employee ownership is that neither conceptual model—neither "always" nor "never"—could possibly be correct. Let me sum up six of the most significant findings, and the challenges they present to the competing conceptual models. These are the central facts about employee ownership, which a more convincing model will eventually have to explain.

First, there are in fact a great many successful, long-lived, employee-owned and managed firms in the United States and elsewhere. These firms have survived without government subsidy, often in hostile environments. This fact alone should give pause to one drawn to the "never" school.

Second, such genuine employee-owned businesses succeed in almost any imaginable industry, with all types of employees. Among those studied in the greatest depth include: plywood manufacturing cooperatives; refuse collection; the Weirton Steel Corporation, for a time the best-performing company in the American steel industry; professional partnerships, such as law and accounting firms; taxi cab collectives; con-


25. Nearly all the literature referred to in this section deals with genuine employee-owned and controlled firms. As we have seen, supra notes 7-10, there is little reason to anticipate that a standard American ESOP to date will have behaved differently from a standard firm, since it is a standard firm, plus a savings plan. The few articles in this section that deal with ESOPs are clearly identified.


27. Stewart E. Perry, San Francisco Scavengers: Dirty Work and the Pride of Ownership (1978); Russell, supra note 1, at 71-104.


struction companies;\textsuperscript{31} artisanal manufacturing;\textsuperscript{32} supermarkets;\textsuperscript{33} the complex of industrial enterprises at Mondragon, Spain.\textsuperscript{34}

In short, successful employee ownership and management is found in the production of goods and services; among educated and less-educated employees; performing tasks both simple and complex; in enterprises as large as several hundred workers and in some cases larger.\textsuperscript{35}

30. \textsc{Gunn}, supra note 26, at 152-72; \textsc{Russell}, supra note 1, at 105-41.
31. While few sizable American construction companies are owned collectively, perhaps ten percent of Italian building and construction is carried on through employee collectives, including the fifth largest construction company in Italy. \textsc{Mark Holmström}, \textit{Industrial Democracy in Italy: Worker Co-ops and the Self-management Debate} 22 (1989).
32. \textsc{Holmström}, supra note 31, passim.
34. \textsc{William Whyte} \& \textsc{Kathleen K. Whyte}, \textit{Making Mondragon: The Growth and Dynamics of the Worker Cooperative Complex} (1988); \textsc{Keith Bradley} \& \textsc{Alan Gelb}, \textit{Worker Capitalism: The New Industrial Relations} (1983); \textsc{Henk Thomas} \& \textsc{Chris Loggan}, \textit{Mondragon: An Economic Analysis} (1982).
35. I am therefore at a loss to explain Hansmann’s statement, following a similar summary, that: “The types of industries in which worker-owned firms are found, and the structures those firms assume, are remarkably similar everywhere.” Hansmann, supra note 1, at 1759 (footnote omitted).

Hansmann’s is practically the only attempt in the literature to develop a theory that explains the actual observed success of employee ownership, and as such is an enormous step forward, although for reasons to be developed I am not convinced by the theory that Hansmann eventually works out. For Hansmann, the chief cost that employee ownership imposes on a firm is the cost of inefficient internal governance. As a result, employee ownership is likely to succeed only “when there is minimal opportunity for conflicts of interest among the worker-owners.” \textit{Id.} at 1784. Essentially, for employee ownership to succeed, there must be only one level of worker, relatively homogeneous, capable of being compensated at equal rates or (like taxi drivers or lawyers) with time inputs that are easily and uncontroversially metered.

I share with Hansmann a desire to develop a theory that actually explains the observable patterns of employee ownership. Moreover, I agree with him to the extent that conflicts of interest, internal to the firm, will play a large explanatory role in the theory I develop here.

While this whole article is in a sense a response to Hansmann, it may be helpful to state briefly why I was not convinced by his theory. (1) Hansmann simply does not deal with employee-owned factories, involving several different job descriptions and hierarchies, except for an analysis, with which I largely agree, as to why Mondragon is not really employee-controlled, \textit{id.} at 1790-94. Perhaps Weirton Steel has not been employee-owned and successful long enough to permit generalization, or even inclusion on the list of successful employee ownership. \textit{See supra} note 28. However, Hansmann should have done much more with Italy, the Western country with the largest proportion of cooperatively-owned firms, where long-standing cooperatives run profitable factories employing several hundred workers. \textit{See Holmström, supra note 31}; \textsc{Derek C. Jones} \& \textsc{Jan Svejnar}, \textit{Participation, Profit Sharing, Worker Ownership and Efficiency in Italian Producer Cooperatives}, 52 Economica 449 (1985). Hansmann is dismissive of both the size of the co-ops, Hansmann, \textit{supra} note 1, at 1759, though most Italian factories are small, and, for reasons I cannot determine, their internal democracy, \textit{id.} at 1795. He also treats them as subsidized, \textit{id.} at 1794, which is somewhat exaggerated. \textit{See Rob Paton, Reluctant Entrepreneurs: The Extent, Achievements and Significance of Worker Takeovers in Europe} 80-84 (1989); \textsc{Michael A. Conte}, \textit{Entry of Worker Cooperatives in Capitalist Economies}, 10 J. Comp. Econ. 41, 44-5 (1986)

(2) Hansmann errs in asserting that employee ownership only survives where employees are prepared to be treated equally. His own example shows successful employee ownership in firms of decidedly unequal compensation. Hansmann’s chief (virtually only) example, to which he devotes five pages (1785-90), is the alleged practice among large law firms of “sharing the partnership's
Few of these firms are subsidized. In short, the "never" models have a tough time explaining the successes of employee ownership.

Third, however, we do not observe entire industries that are dominated by employee-owned firms, except where alternative arrangements are legally prohibited, such as law firms. This is a significant and embarr-
rassing fact for the "always" school, which tends to explain the low spread of employee ownership in terms of the weight of tradition, cognitive awareness of options, cultural factors that limit employee ownership to extreme risk-takers, high start-up costs in training a democratic workforce, free-rider and coordination problems, and similar factors.\textsuperscript{36}

Without denying these, it is harder to explain why, even after successful employee ownership, there are so few industries in which it is the dominant form. In countries and industries that have seen successful employee ownership, there would then be cognitive awareness of options, a break with tradition and other cultural factors, lower training costs. Yet even here one sees plenty of investor-owned plywood companies, steel mills, Italian artisanal factories, and (in medicine and accounting) professional partnerships.\textsuperscript{37}

Fourth, substantial anecdotal evidence links the adoption of employee ownership to substantial productivity gains \textit{in individual firms}.\textsuperscript{38}

Fifth, however, large-scale comparisons of employee-owned firms with controlled groups of conventional firms reveal a more mixed, but basically positive, picture on productivity.\textsuperscript{39} There do not appear to be

\begin{itemize}
  \item \textsuperscript{36} See, e.g., Bowles & Gintis, supra note 17, at 35-42; Louis Putterman, \textit{Some Behavioral Perspectives on the Dominance of Hierarchical over Democratic Forms of Enterprise}, 3 \textit{J. Econ. Behav. & Organization} 139 (1982).
  \item \textsuperscript{37} Bowles & Gintis, supra note 17, at 34, who believe that democratic firms are "unambiguously more efficient," explain the prevalence of capitalist organization most importantly due to wealth inequality, the inability of workers to found businesses or borrow to do the same. While the first is true for the United States, the second is overstated. Bank loans to ESOPs are subsidized through the tax laws, specifically, I.R.C. § 133 (West Supp. 1991), which since 1984 permits lenders to exclude from income half of the income received on loans to ESOPs. This section was initially highly successful, and major banks lent billions of dollars to ESOPs, setting up ESOP departments and acquiring significant experience in and commitment to ESOPs, partly because in such loans a commercial bank takes on some of the functions of an investment bank. Alan Hyde & Craig Harnett Livingston, \textit{Employee Takeovers}, 41 \textit{Rutgers L. Rev.} 1131, 1141 n.30, 1142 n.34 (1989). Statutory amendments in 1989 restrict the exclusion to loans to ESOPs that own a majority stake in the company. It appears that bank loans to ESOPs fell off quite sharply after the restriction. Blasi & Kruse, supra note 1, at 75. If Bowles & Gintis are correct, the banks' behavior is most surprising: having learned that ESOP loans are good, safe loans, why shouldn't they keep lending to "unambiguously more efficient" firms?
  \item \textsuperscript{38} See studies cited in Blasi, supra note 7, at 221, 269. Such stories are journalistic staples; the most recent example I have seen is Raju Narisetti, \textit{Worker Input Helps an ESOP—and a Company—Work}; \textit{Wall St. J.}, July 12, 1991, at B2. Note that managers typically attribute productivity increases to ESOPs \textit{at their firm}, even where studies do not bear this out. See, Most Managers Believe ESOPs Boost Productivity, 43 \textit{Employee Benefit Plan Rev.}, Dec. 1988, at 84; Blasi, supra note 7, at 232-36.
  \item \textsuperscript{39} Excellent, skeptical reviews of the literature are Blasi, supra note 7, at 221-38 and 267-73, and J. Bonin et al., supra note 24, at 26-40.
\end{itemize}
any studies that find employee-owned firms clearly and significantly less productive than conventional firms, so the “never” school takes cold comfort from the empirical literature, and thus “never” discusses it. The sharpest productivity differences between employee-owned and conventional firms occur in some of the long-lived firms listed above, firms with real employee control—not, typically, through an ESOP—over a long period of time. Even this literature lacks the “smoking gun” that would be necessary to support the thesis of the “always” school, that all or just about all firms would benefit from employee ownership. Moreover, if employee ownership is limited to shares in an ESOP, and there is

40. “There is no evidence that employee ownership hurts companies. Any claim that modern economic organization requires centralized ownership by individual capitalists or clear domination by managers insulated from absentee owners is simply unfounded.” Blasi, supra note 7, at 231 (footnote omitted).

One recent study, published after Blasi's 1988 literature review, attempts to untangle the effects of employee ownership from employee participation and finds, uniquely to my knowledge, that substantial employee ownership (median 48 percent), unaccompanied by any device for participation, such as union representation, is positive for productivity only at low levels but then diminishes productivity for each added percentage of employee ownership. This is the only empirical study I have ever seen purportedly demonstrating negative productivity effects to employee ownership. On the other hand, the study confirms the now-conventional response that employee ownership together with employee participation is positive for productivity, although it is possible that the productivity effects come entirely from the participation and that ownership plays an insignificant role. Michael Conte and Jan Svejnar, The Effects of Worker Participation in Management, Profits, and Ownership of Assets on Enterprise Performance, in NEW DEVELOPMENTS IN THE LABOR MARKET: TOWARD A NEW INSTITUTIONAL PARADIGM 59 (Katherine Abraham & Robert McKersie eds., 1990).

If these results were to be confirmed in other studies, this would represent a significant negation of the theory I present here. Throughout this Article, I assume the more conventional result, discussed by Blasi and others, in which ownership without participation is neutral (not negative) for productivity, and ownership plus participation yields more productivity gain than participation alone. See generally Alan S. Blinder, Introduction, in PAYING FOR PRODUCTIVITY: A LOOK AT THE EVIDENCE 13 (Alan S. Blinder ed., 1990) [hereinafter PAYING FOR PRODUCTIVITY].

At the moment, I am not too troubled by the Conte and Svejnar paper. The sample was very small. Only forty firms were represented in the survey. The key category, of firms with employee ownership and no participation scheme, contained only five firms. Conte & Svejnar, supra at 72. There were no firms in the study that had participation plans and no employee ownership, so the respective effects of each were determined by regression. Id. at 69. All data were gathered in the recession year 1980-81, and, as the authors discuss, it is likely that endogenous variables explain the poor performance of the five firms with substantial ownership and no participation. “It may be, for example, that the presence of ESOPs with a high percentage of the firm’s total assets is a consequence rather than a cause of inferior productive performance.” Id. at 75. This must be at least partly correct; firms do not randomly adopt either participative or ownership schemes but do so in response to some endogenous factor. I await Conte and Svejnar's future research, in which they attempt to "tackle the endogeneity issue," id. at 75, with interest.


42. Partly because of the endogeneity issue discussed supra note 40, it is not clear that firms that have never felt the need to experiment with employee ownership and participation would benefit that much from adopting it.
little direct employee participation, it is difficult to demonstrate much, or any, productivity gain for whole groups of firms as compared with other whole groups of firms.43

Sixth, employee-owned firms often go through a distinctive life cycle described by several economists.44 Employee-owned firms often begin during economic recessions, when employees buy out failed or failing conventional firms. (Note how damaging is this simple fact to the “never” school; there are many examples of successful employee-owned firms where the identical firm, when conventionally owned, was failing or actually failed).45 Such recession births succeed because workers will make concessions to themselves—lower wages, reduced staffing levels, other productivity gains—that they would not make to a management that might use them opportunistically. When the general economic climate improves, the employees sell the firm to private investors. (Obviously damaging to the “always” school. Yet employee-owned firms do indeed frequently sell out to private investors.)46

Now unfortunately this is an economist’s model and corresponds imperfectly to the empirical reports; as such it belongs in this section only tenuously. Moreover, the economists build into their models certain dubious or counterfactual assumptions.47 Nevertheless, I include this

43. See BLASI, supra note 7, at 221-38, and 267-73; Conte & Svejnar, supra note 40, at 76.


45. There were a number of such highly publicized cases in the early 1980’s. Corey Rosen & Alan Cohen, Employees to the Rescue: The Record of Worker Buyouts, 6 J. L. & CO. 213 (1986); Deborah Groban Olson, Union Experiences with Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases and Cooperatives, 1982 Wis. L. REV. 729, 753-80. Perhaps the five companies identified by Conte & Svejnar, supra note 40, with high employee ownership, low participation, and low productivity, fell into this group.

46. Schroeder & Hoett, supra note 28; Finance Briefs, N.Y. TIMES, May 5, 1989, at D12 (both on Weirton Steel); RUSSELL, supra note 1, at 97-104 (scavenger companies); Jones, supra note 3 at 342, 349-50, 354-55 (1979); James P. Miller, Some Workers Set Up LBO’s of Their Own and Benefit Greatly, WALL ST. J., Dec. 12, 1988, at A1 (on sale of employee owned businesses to public ownership).

47. Ben-Ner assumes, 8 J. COMP. ECON. at 258, that worker-owners have nothing they can sell as individuals should the firm become successful. This fortifies the conclusion that in such a case they would sell the whole firm. However, it does not accurately describe firms that are worker-owned through an ESOP, which can select any mix of employee or investor ownership, as occurred in May 1989 when the Weirton Steel Corporation made a public offering. BLASI & KRUSE, supra note 1, at 57-62, review public offerings of stock in companies substantially owned by ESOPs. The worker may have to put the stock to the ESOP rather than selling it on the market.

Miyazaki assumes, supra note 44, at 930, that the firm after worker ownership will experience no productivity growth. This is certainly possible, and suggests that such worker owners should probably sell to investors, who might manage the company better. It also suggests that Miyazaki’s model has no application to the worker-owned firm that is becoming more productive and, for that reason, won’t sell out to investors who won’t manage it any better than the employees.
model here as a "fact" to be explained because it does correspond to a common, observable pattern in employee-owned businesses, though not an inevitable one.

It seems to me that the empirical literature on employee ownership is difficult if not impossible to interpret within the frameworks of the existing conceptual literature. The answer to the riddle of employee ownership simply cannot be, in our economy, either "never" or "always." This points out the need for newer models of the employee owned firm, that will better explain its pattern of successes. The answer to Professor Hansmann's question, "When Does Worker Ownership Work?", will have to start with the word "sometimes." In part III of this Article, I will sketch out the outlines of such a new model, confident that it will be far from the last word on the subject, but hopeful that it may inspire others to even more convincing accounts of employee ownership.

II. RECENT ECONOMIC ANALYSIS OF EMPLOYMENT CONTRACTS IN THE MODERN FIRM

Employee ownership is probably at its most appealing in those individual firms, where in addition to ordinary conflicts of interest between managers and employees, a history of management opportunism has led to low trust of management among employees. A likely employee response in such cases is to withhold information that management would like to have, so as to forestall further management opportunism. Management is now faced with some combination of uncertainty or very high information costs. In these circumstances, it is likely that management and employees will conclude employment contracts that are suboptimum both for individuals and the firms. Introducing employee ownership in such firms, where accompanied by institutions for genuine employee control, offers the prospect of reduced conflict of interest and supervision cost, increased information, fewer Prisoner's Dilemmas, and thus more efficient long term labor contracting for individuals and the firm.

In such firms, however identified, employee ownership should indeed be positively associated with productivity increases. In firms not initially suffering from such internal inefficiency, the introduction of employee ownership may realize some savings in supervision costs and information costs but is unlikely to result in dramatic productivity increases.

Ultimately, one's position on whether, as a matter of public policy, widespread employee ownership should be encouraged, should depend
on one's estimate of the amount of internal inefficiency in contemporary firms.

That, in a nutshell, is my proposed new "information costs" model of employee ownership. I put it forward confident at this point that the reader of this Article will make nothing of it, unless he or she is familiar, as many legal readers now are, with three distinct and rarely related bodies of economic literature on employment contracts in modern firms: "efficiency wage" models of the labor market; the "property rights" analysis of information costs in modern firms; and theories of internal or "X"-inefficiency. None of this literature is specifically focussed on employee-owned firms; none of the theorists is an identified advocate of employee ownership, and at least some strongly oppose it. Nevertheless, I believe that the insights that these schools contribute to our understanding of labor contracts go a long way toward solving the problem of employee ownership.

48. This might be an appropriate spot for a disclaimer that rarely appears in law review articles; perhaps it should appear more often. I am not an economist and have no training in economics or mathematics beyond undergraduate level courses. In citing articles below, I have not necessarily worked through all the equations and am not vouching for their accuracy. My goal throughout is to synthesize an economic model that makes sense of the empirical literature on employee ownership, supra notes 25-47, which is not usually the goal of economists. I cite economics articles for two purposes. First, as stimuli to our own thoughts, provided by scholars who have thought about these problems from different frames of reference than those in which I was trained. When I do that, I'm not really interested in then checking out all the author's equations; rather, I stop and ask myself whether his view is consistent with what I know about the world.

Second, I want to convey to legal readers some sense of the range of variation in economic approaches to these subjects. At the moment in American law schools an unhealthy situation obtains in which scholars on the political right frequently cite economics articles, while scholars on the left rarely do. This often gives a misleading picture of the state of economic knowledge on particular issues. Young legal scholars these days often attempt to refute what they term the "standard economic analysis" of a particular subject, when they are instead refuting a neoclassical analysis that is found principally in articles by lawyers and would barely be taken seriously by professional economists.

For example, virtually every article on employee ownership ever published in an American law review cites the classic article by Jensen & Meckling, supra note 11, which "proves" that labor-managed businesses would be so inefficient that no investor would ever lend money to them. I believe this Article is the first ever to cite the substantial critique of Jensen & Meckling within economics journals, supra notes 19-25. In citing this critique, I am performing both functions mentioned above. I am not vouching for the critique's superiority as economic analysis, nor am I competent to award such an accolade. I am performing the service of citing economics articles not otherwise cited in law reviews, which complicate a picture often presented as unduly simple. And I am advancing a model which seems to me closer to observable behavior, since, at least given certain subsidies, banks fall all over each other trying to lend money to Employee Stock Ownership Plans. See, e.g., David Neustadt, Lenders Court Employee Stock Plans: Tax Breaks, Loan Packaging Help Make Them Popular, AM. BANKER, Sept. 2, 1987, at 22; Daniel Bell & Mark Keating, The Lending Environment for ESOP Companies: The Ohio Bank Study (Northeast Ohio Employee Ownership Center, Department of Political Science, Kent State University, 1987). (I am of course aware that these loans are subsidized and thus do not refute Jensen & Meckling. They do suggest, along with all the other evidence marshalled throughout this Article, that Jensen & Meckling's model, like all "never" models, must simply be too bleak.)
All three bodies of literature have arisen to explain why one or another observed feature of firm or labor market behavior deviates from a neoclassical model of firm behavior. In a neoclassical model, all firms hire inputs, and produce outputs, efficiently, so that competitive markets for all inputs and outputs will clear. As applied to labor contracts, firms will hire workers so long as wages do not exceed the value of marginal product added; workers not hired will decrease their demands; and eventually labor markets, like all others, will clear, irrespective of any idiosyncrasies of any firm’s particular production function. As we shall see, in diverse ways, labor markets deviate from this model.49

Part II of this Article aims to provide concise summaries of this literature. Part III attempts to synthesize them into a theory of employee ownership.

A. “Efficiency wage” models of the labor market: why firms employ long-term labor contracts

“Efficiency wage” models of the labor market arose to explain “the key problem in macroeconomics . . . the explanation of unemployment, which is seemingly involuntary and varies with aggregate demand. Most

49. “The history of labor economics reflects a shifting pattern of relations between labor students and economic theorists that is only partially the result of the not-infrequent expressions of dissatisfaction with traditional labor market analysis by labor economists.” PAUL McNULTY, THE ORIGINS AND DEVELOPMENT OF LABOR ECONOMICS: A CHAPTER IN THE HISTORY OF SOCIAL THOUGHT 5 (1980). One can write the history of labor economics—McNulty has—as an account of the battle between classical or neoclassical and other models. Neoclassical models are supplemented in the ways discussed infra in text, and further supplemented with such factors emphasizing the institutional or political character of labor markets that prevent actors from behaving as neoclassical maximizers, see, e.g., JOHN T. DUNLOP, WAGE DETERMINATION UNDER TRADE UNIONS (1944); or the “ideal” or “moral” factors that influence perceptions of what employees “should” be paid, e.g., ROBERT SOLOW, THE LABOR MARKET AS A SOCIAL INSTITUTION 5-21 (1990).

Meanwhile, extreme deviants have even questioned whether workers are actually paid the value of their marginal products. PETER D. MCCLELLAND, THE AMERICAN SEARCH FOR ECONOMIC JUSTICE 371-80 (1990); Robert H. Frank, Are Workers Paid Their Marginal Products?, 74 AM. ECON. REV. 549 (1984); James L. Medoff & Katherine G. Abraham, Experience, Performance, and Earnings, 95 Q. J. ECON. 703 (1980).

Of course, the mere fact that a model has been discredited in its discipline of origin does not keep it from finding a home in the law reviews, the Museum of Discredited Models. For purely neoclassical analyses of labor markets, see Richard L. Doernberg & Jonathan R. Macey, ESOPs and Economic Distortion, 23 HARV. J. ON LEGIS. 103, 141 (1986) (“Why would the employees have lost their jobs upon a sale? Would they be replaced by more efficient workers?”); Richard Epstein, In Defense of the Contract at Will, 51 U. CHI. L. REV. 947 (1984), and Richard Epstein, Agency Costs, Employment Contracts, and Labor Unions, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 140 (John W. Pratt and Richard J. Zeckhauser eds., 1985)(“When one employee is wrongfully discharged, another will typically be hired in his place, so that the personal hardship of one is offset by the benefits that are conferred upon another.”). This is true, of course. It is equally true, within a neoclassical framework, that there is no such thing as unemployment; that labor markets clear; and that the wrongfully discharged worker will therefore immediately obtain another position that pays precisely what his old job did. Of course, one must remember here that “true” is being used here, as economists do, to mean “assumed.”
markets seem to clear, but not the labor market. Why?"  

The "efficient wage" hypothesis is that firms may and do find it efficient for their own purposes to pay wages only above the rate that unemployed workers would accept. Thus, new workers will not be hired, labor markets will not clear, and there will be unemployment.

Why on earth would firms insist on overpaying workers in this way? Theorists of efficient wages have by now generated quite a long list of ways in which labor productivity to the firm may increase with the wage paid, not all of which are germane to our purposes today. In most versions of "efficient wage" models, the workers, who are being paid more than the wage the firm could get away with paying new hires, are comparatively senior employees, who receive their "efficient" wage as part of a long-term package designed to tie them to the firm. In some accounts, these workers were paid less than their productivity when they were newly-hired; like law firm associates, they subsidized senior employees. The implicit bargain is that their wages will increase as they stay at the firm, irrespective of whether their productivity increases, and even if it decreases.
Why does the firm want to tie workers over the long term in this way? Some firms don't, of course; firms located in what "dual labor market" theorists call the "secondary" sector. The literature suggests many reasons that long-term contracts with increasing wages, not tied to marginal productivity, might be an efficient arrangement for the firm, particularly (though not necessarily) the "primary sector" firm. An employee who is being paid right at the value of his marginal product has few reasons not to goof off (or "shirk", as these writers have it); he may not be detected, and if he is, and is fired, the loss to him is not so great and another, equally-poorly paid job may be available. Paying employees a premium will increase the costs to them of shirking, or of voluntary quitting, or striking. The firm will also benefit if the premium wages are perceived as fair by workers and pay off in higher morale and higher voluntary effort.

Why do workers agree to such long-term employment contracts? Economists have not studied this question as carefully as the question of firm efficiency. One can certainly see why employees might prefer an arrangement that provides them greater security against wage reductions in their later years, although one cost that these employees will pay for the arrangement, where legal, is the institution of mandatory retirement. Still, these long term contracts pose some obvious dangers to employees. The firm receives some of its biggest benefits "up front" and may well have incentives to behave opportunistically late in the game, by


57. One recent survey revealed strong preferences for receiving increasing wages over time, even after respondents were exposed to economic arguments suggesting that they should rationally prefer greater payments up front that then decline over time. Respondents' verbal explanations revealed that they derive positive utility just from feeling that their wages are going up; respondents also mentioned concern about inflation, desire to maintain or improve living standards, and the like. George Loewenstein & Nachum Sicherman, Do Workers Prefer Increasing Wage Profiles?, 9 J. Lab. Econ. 67 (1991).

58. Lazear, supra note 53, at 1264. That is, the firm might retain some senior employees if it could reduce their wages, but won't if it must pay them at rates well above the marginal product they contribute.
attempting to fire employees, or deprive them of their earned benefits.  

B. The Firm as a “Nexus of Contracts”: opportunism and strategic behavior among parties to relational contracts

Concern over just such opportunism is an important feature of a second body of literature on modern employment contracts, the literature conceptualizing the firm as a nexus of relational contracts. To be sure, these authors worry obsessively about “shirking” or opportunism by employees, and seem blithely unconcerned about possible opportunism by managers. We, however, may overcome this omission and learn much about the contours of modern employment contracts in doing so.

Many readers of law reviews are now familiar with the analysis of firms as the locus of long-term relational contracts among investors, managers, and other employees. On this view, the firm is a “legal fiction”; ontologically prior are these contracts among factors of production.

This conception of the firm originated in order to correct a factitious distinction between “firms” and “markets.” Ronald Coase had raised

59. Weiler, supra note 53, at 66-67. Lazear, supra note 53, at 1271 asserts that the firm has no incentive to cheat on the contract since such cheating will affect its reputation among the next generation of workers, who will simply demand more. See also Edward P. Lazear and Robert L. Moore, Incentives, Productivity, and Labor Contracts, 99 Q. J. ECON. 275 (1984). This seems wildly optimistic, not merely because of the anecdotal refutation offered by the many “unjust discharge” cases brought by employees on the losing end of such employer opportunism. There is little reason to think that the danger to their reputation could really discourage employers from such opportunism. Shapiro & Stiglitz, supra note 55, at 442; cf. Benjamin Klein & Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. POL. ECON. 615 (1981); Weiler, supra note 53, at 73-78; David Charny, Nonlegal Sanctions in Commercial Relationships, 104 HARV. L. REV. 373, 417-20 (1990).

60. It is interesting, to this noneconomist observer, how seldom these two bodies of literature: “efficiency wage” models of the labor market, and the new economic theory of the firm, link up, despite some obvious points of intersection: both use the metaphor of “contract” to describe long-term relations and both offer significant correction to simple neoclassical models. For example, Lloyd R. Cohen, The Firm: A Revised Definition, 46 So. Econ. J. 580 (1979), a meditation on the Coase and Alchian & Demsetz controversy, defines the firm as an economic entity whose internal purchases of factor inputs, such as labor, are at rates other than the value of their marginal product. Yet Cohen does not cite any of the “efficiency wage” literature, that makes the same point. Nor does that literature cite Cohen.


the question of when production takes place through contracts that link market participants, and when within the boundaries of a firm. He identified the firm with authority relations, and concluded that relations within a firm will be efficient when concentrating bureaucratic authority is more efficient than the "transaction costs" associated with markets.\textsuperscript{64}

Armen Alchian and Harold Demsetz later argued that Coase's contrast between the firm's authority relations, and the market's free contracting, was overdrawn. Certainly, within the firm, the boss may order an employee to do something, and if the employee doesn't, she will be fired. On the other hand, that is just the way market actors can enforce their will, if at all: threatening to terminate, then terminating, the relationship. The firm may be regarded as a series of coordinations of various inputs; it is not so different from a market. The ordinary aspects of firm organization that we observe—shareholders ("residual claimants"), professional managers, supervisors—do not demonstrate any superiority for hierarchy as such, but rather efficient reduction of information costs, here the costs of "metering input productivity and metering rewards."\textsuperscript{65}

Now most people sympathetic to working people, whether liberals or leftists, will be tempted to dismiss this account as a mystification, for reasons of which I am well aware but which I shall relegate to a footnote.\textsuperscript{66} Let us instead treat this account as the beginnings of a more

\textsuperscript{64} Ronald H. Coase, \textit{The Nature of the Firm}, 4 ECONOMICA 386, 386 n.5 (1937). Coase's appreciation that markets are not always automatically the most efficient ways to accomplish things has not always been remembered in Chicago.


\textsuperscript{66} Hierarchies don't arise just because they are efficient and may perpetuate themselves long after they have ceased to be efficient at all, because people in power enjoy having power and do not give it up willingly. One thing that people with power and money are particularly good at doing is getting intellectuals to make up funny stories explaining why it is just and proper for people with money and power to retain those attributes; such stories must always be regarded with suspicion. Alchian and Demsetz don't just model the firm in a particular way because it is "true"; recall that economists use "true" to mean "assumed". All generalizations are to some extent normative (including my own); Alchian and Demsetz's generalizations are not merely implicitly legitimatory, they are expressly so. A model of the firm as "just" a nexus of "voluntary" contracts, like those between a grocer and his customer, eliminate any claim that firms have "power" over others. Conservative political commentators now frequently invoke this picture as a definitive defense of the legitimacy of the corporation. \textit{See, e.g.} Robert R. Hessen, \textit{In Defense of the Corporation} (1979). No doubt this frankly legitimatory goal has turned many political liberals and leftists away from encountering with the "property rights" or "transaction costs" school. I think this has been a mistake, and that there is room for very valuable dialog between this school and others. Victor Goldberg made the same point in a very interesting discussion of similarities and differences between "radical" and "transaction costs" accounts of employment contracts. Victor P. Goldberg, \textit{Bridges Over Contested Terrain: Exploring the Radical Account of the Employment Relationship}, 1 J. ECON. BEHAV. & ORGANIZATION 249 (1980). \textit{See also} Katherine Van Wezel Stone, \textit{Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities}, 55 U. CHI. L. REV. 73, 151-72 (1988). For example, as we have seen, most contemporary labor economists similarly model employment relations in
complete explanation for the prevalence of private ownership and hierarchical organization, and see how to make it more convincing.

For my purposes, the most valuable insight of the "nexus of contracts" school is their continuing insight that contracts in modern firms, though (on their view) on balance an efficient way of coordinating inputs compared to other institutional forms, do not really settle anything. The contracts are entered into under informational uncertainty, possibly with asymmetries of information, and there is an ever-present danger that one side will "shirk" its obligations. Contractual parties must therefore monitor each other's performances, while the monitoring itself imposes "agency costs." In some cases, of course, a solution is to renegotiate particular contracts after unanticipated surpluses or losses have appeared, the firm being, after all, just a nexus of such contracts. However, as Oliver Williamson has shown, for parties in long term relationships, the transaction costs of such renegotiations will be staggering, and out of desperation they may select one dominant party to impose a solution which, as Williamson does not point out, simply raises the agency costs of monitoring the authoritarian manager.

Let me put this sensitivity to agency costs together with the litera-

In this Article, I focus on the contrast between hierarchical and democratic organization within firms. I am not pursuing Coase's question of firm organization versus market organization. Those interested in Coase's question must conclude that Alchian and Demsetz do not really answer it. "[I]t is unclear why the problems of joint production and monitoring cannot also be solved through the market [i.e., via a contract]. In fact one does not need to look far to see examples of market solutions to these problems, such as auditing between independent contractors." Hart, supra note 62, at 1762.

67. The one exception that the transaction cost theorists make to this generalization is not adequately defended by them and does not sit well with their theory. Ownership of shares of a company becomes, in their view, a contract made by a "residual claimant" who thus has incentives to monitor the performance of all other actors. What has never been successfully explained is why the "residual claimant" doesn't act under the same uncertainties, with the same incentives to opportunism or shirking, that other actors do. Dow, supra note 61. In truth, there is a fundamental and unresolved conflict between the views that "firms must be [both] ownable and saleable if they are to be operated efficiently" and the view of the firm as merely the site of numerous individual contracts. Louis Putterman, The Firm as Association versus the Firm as Commodity: Efficiency, Rights, and Ownership, 4 Econ. & Phil. 243 (1988).

68. "Agency costs" are the sum of (1) monitoring expenditures by the principal; (2) bonding expenditures by the agent; and (3) all residual losses. Jensen & Meckling, supra note 63, at 308.

69. Once parties are locked into each other, for example a highly-trained senior employee and a firm, external markets will not provide a proper evaluation of each party's opportunity costs. The only feasible kind of "ex ante" contract setting out each side's obligations will have to be so flexible as to leave much room for later negotiation. Yet there are costs associated with such later negotiation: the simple costs of negotiation; the sheer waste of distributional negotiations as each side tries to capture ex-post surpluses not clearly allocated by their underlying agreement, or to redistribute ex-post losses; inefficient initial allocation of investments, as each party tries to avoid being held up later on, at the ex-post stage. Oliver E. Williamson, The Economic Institutions of Capitalism 163-205 (1985).
ture on efficient wage contracts, to show some of the much-commented, intensely real-world problems that are likely to result in modern, primary sector firms. These fall into two main groups: problems of managerial opportunism, and poor incentives for employee performance.

First, under long-term employment contracts, as we have seen, employees bear substantial risks of managerial opportunism. Later in their careers, employees are, according to the contract, to be paid more than the value of their contemporaneous marginal product. Management will have incentives to shirk on these payments. For example, management may exploit the employees’ location-specific investments; that is, it may extort modifications in the long-term contract by threatening disinvestment or relocation, or may actually disinvest or relocate. Management may (and does) overstate the assets in the pension fund, then remove them for its own purposes, or terminate the pension plan. Management, as in the recent strike at the New York Daily News, may have incentives to force workers into striking, so that management may avoid having to pay those pensions that the workers themselves have paid for. Finally, employees bear the risk of takeovers, in which the acquirer may (and, all during the 1980’s, did) renge on the firm’s earlier implied promise of longevity.

Second, under the standard efficient wage contract, employees, who are paid gradually increasing wages irrespective of their contribution to productivity, may lack adequate incentives to work fully. “Work fully” here includes at least two aspects of employee performance. The first, 70. The extensive law review literature addressing this issue demonstrates how such managerial opportunism is immune from legal challenge. JAMES B. ATLESON, VALUES AND ASSUMPTIONS IN AMERICAN LABOR LAW 111-35 (1983); Robert A. Gorman, The Negligible Impact of the National Labor Relations Act on Managerial Decisions to Close or Relocate, 58 TUL. L. REV. 1354 (1984); Staughton Lynd, Investment Decisions and the Quid Pro Quo Myth, 29 CASE W. RES. L. REV. 396 (1979); Stone, supra note 66, at 151-72.

71. According to Howard Weitzmann, executive director of the Association for Private Pension and Welfare Plans, about 15,856 defined-benefit pension plans were terminated in 1989, 37 percent more than had been terminated the previous year. Beware: Pensions Are an Endangered Species, L.A. TIMES, July 30, 1990, quoted in BLASI & KRUSE, supra note 1, at 107.

72. Goldberg, supra note 66, at 267 n.38, predicted this. The Supreme Court encouraged it with its holding in NLRB v. Burns Int’l Sec. Services, Inc., 406 U.S. 272, 281-91 (1972), unanimous on this point, that a successor owner of a business, even one who retains the predecessor’s workforce, takes free and clear of any existing collective bargaining agreements, rejecting the contrary doctrine of the National Labor Relations Board. A later holding made clear the implication that the acquirer is also normally free to discharge any or all of the unionized workforce without arbitrating the discharges. Howard Johnson Co., v. Detroit Local Joint Executive Bd., 417 U.S. 249 (1974). This was undoubtedly one of many factors behind the wave of corporate takeovers in the 1980’s and specifically why acquirers could make money by liquidating other companies, or run them more “efficiently” than their earlier owners. See Andrei Shleifer & Lawrence H. Summers, Breach of Trust in Hostile Takeovers, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 41 (Alan Auerbach ed., 1988) (associating hostile takeovers with situations in which shareholders will benefit ex post from renunciation of compensation arrangements that were ex ante efficient).
extensively modelled by both “efficient wage” and “transaction cost” theorists, involves choosing to work hard rather than to shirk. This is a rather offensive and insulting way of putting the point, and runs the risk of making the theory seem unreal, since the many observers of the chronic lagging productivity growth of the American economy rarely observe much sheer goofing off or consider it an important aspect of low productivity.\footnote{In my experience as an observer of the world of employment, academics are rarely in a position to lecture working people about “shirking.”}

In my opinion, “shirking,” as used by the economists, should be more accurately and less offensively understood as referring to a second phenomenon, in my view unquestionably more important economically. This involves active contribution to improving firm productivity—as the consultants say, “working smarter, not just working harder”—through active suggestions, participation in work reorganization, productivity monitoring, and the like. For example, employees face choices whether or not to invest their own time in education and training. The firm’s pay structure will provide incentives for such investment if it rewards employees, or reimburses them, or permits them to share in resulting productivity gain. In a standard wage structure, however, education really is its own reward.

Whatever one understands to be meant by “shirking,” everyone can see that a scheme in which wages are hardly tied at all to individual or small group productivity does not create incentives for avoiding it. Firms could theoretically solve this problem by flexibility in wages, directly tying wages to performance, but for all the reasons explored by both schools of economists this is rarely efficient. The inefficiencies have mostly to do with conflicts of interest between managers and employees. For example, piece rate systems of compensation seem to theoretical economists to be efficient incentive schemes, since they tie remuneration to productivity. But, as is well known, they rarely work out that way in practice. Employees develop ways of beating the system. They mislead the expert setting the rates, hide new work methods, and sanction socially those who work beyond socially approved rates. Moreover, such systems are complicated and require a great deal of expensive management time.\footnote{See generally, Edward Lawler, Pay and Organizational Effectiveness (1971); William F. White, et al., Money and Motivation: An Analysis of Incentives in Industry (1955); Daniel J. B. Mitchell, et al., Alternative Pay Systems, Firm Performance, and Productivity, in Paying for Productivity, supra note 40, at 36-42.}

In the models of both the “efficiency wage” and “transaction cost”
school, firms have basically only one way to prevent shirking: by creating bosses, who monitor employee performance and discharge nonperforming employees.\textsuperscript{75} This scheme creates costs of its own. First, the direct cost of paying the bosses.\textsuperscript{76} Second, it is well known that hierarchical organization often demotivates employees.\textsuperscript{77} Finally, it creates new costs, the costs of preventing shirking by the bosses.

I find this a depressingly realistic picture of employment relations in many American firms. Employees bear substantial risks of job loss, pension loss, and other management opportunism; the incentives for top performance by employees are inadequate and inefficient; there is too much emphasis on the negative incentives of monitoring and job loss; and overall there is too much aggregate involuntary unemployment.

\textbf{C. Information costs and externalities: why inefficient employment contracts arise and persist}

Transaction cost theorists do not deny the existence of these costs; they seem to take a perverse pleasure in modelling the inside of a firm as a Hobbesian war of all against all, where anyone who promises to do anything for anyone immediately tries to figure out how to get out of it. They do tend to assert, however, that whatever the costs of this scheme,

\textsuperscript{75} In the original statement by Alchian & Demsetz, \textit{supra} note 65, at 781-87, the monitor of employee performance is a private owner (or "residual claimant"), whose residual claim to firm earnings gives him incentives to monitor others' performance. Alchian and Demsetz forthrightly "assume" that monitoring by a single individual is more efficient than monitoring by a team, \textit{id.} at 786. They do not consider another alternative, monitoring by an individual, who holds the monitoring position for periods in a rotation, then relinquishes it to others; this might be equally efficient. \textit{See} James A. Mirrlees, The Optimal Structure of Incentives and Authority Within an Organization, 7 \textit{BELL J. ECON.} 105 (1976); \textit{see also} Louis Putterman, \textit{On Some Recent Explanations of Why Capital Hires Labor, 22 ECON. INQUIRY} 171, 173 (1984).

Later treatments locate the monitoring function in supervisors hired by the residual claimants, \textit{e.g.} Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975); Guillermo A. Calvo & Stanislaw Wellisz, \textit{supra} note 55; Joseph E. Stiglitz, Incentives, Risk and Information: Notes Towards a Theory of Hierarchy, 6 \textit{BELL J. ECON.} 552 (1975). This is certainly a more realistic picture of the firm, but creates the unsolved riddle of how firms prevent shirking by the supervisors, who are of course just employees of a sort. "Other questions are: what makes the monitor honest?; if monitoring is observable, why can't it be hired on a fee-for-service basis, and if it isn't, how does it induce effort? When is mutual monitoring, motivated by profit sharing, superior to hierarchical monitoring with possible worker resistance?" Louis Putterman, \textit{After the Employment Relation: Problems on the Road to Enterprise Democracy, in MICROFOUNDATIONS, supra} note 17, at n.2.


it must be efficient, or something different would be observed.  

As a would-be reformer of this scheme, I deny the last assertion, which has been called "Economic Darwinism." The arrangements described might persist despite being suboptimum both for individuals and firms. There are at least five broad classes of reasons why this is so.

The first three basically accept the "Economic Darwinism" framework, but show how parties can adopt arrangements which either appear to reduce costs for them, or actually reduce costs for them, yet are suboptimum because of costs imposed on others, or costs that the parties pay but do not recognize.

The first stems from the very kind of transaction and information costs to which these theorists have drawn our attention. Briefly, the division of the workforce into managers and employees, each with opportunities to cheat, leads to all contracts being made in very low levels of information. Parties have incentives to withhold information and no incentives to pay the price necessary to obtain the other's information. In other words, parties may think that longterm fixed employment contracts with high levels of supervision are efficient, and they may actually be efficient, within a framework that treats as fixed the high information costs stemming from the division of the workforce into supervisors and employees. This constraint however is far from fixed, and, if lifted, may result in efficiency gains.

Second, the externalities of this scheme mean in effect that the public subsidizes it, so its greatest cost—continued aggregate unemployment—is not experienced as a cost by the parties. Third, even if each side shared more information, pervasive low trust will lead to Prisoner's Dilemmas in which cooperative, maximizing solutions will be rejected.

Of course, there are other classes of reasons that suboptimum bargains may arise and persist that traditionally have been of less interest to

78. See, e.g., the contributions to the Symposium, supra note 62, by such "contractarians" as Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416, 1444 (1989), or Fred S. McChesney, Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg, 89 COLUM. L. REV. 1530, 1539-45 (1989). Recall that economists use efficient in a precise way: no one can be made better off unless someone else is made worse off. There is no such thing as an arrangement being more efficient than another.  

79. Why Capital Hires Labor, supra note 11, at 185-86.  

80. This is the central point of Bowles & Gintis, supra note 17, at 21-35. See also Oliver D. Hart, Optimal Labour Contracts under Asymmetric Information: An Introduction, 50 REV. ECON. STUD. 3 (1983); Martin L. Weitzman & Douglas L. Kruse, Profit Sharing and Productivity, in PAYING FOR PRODUCTIVITY, supra note 74, at 95, 104: "The defense of profit sharing and worker participation largely involves challenging the basic assumptions of the property rights school. In less extreme settings than perfectly costless monitoring and supervision finding the optimal degree of profit sharing becomes an extraordinarily complicated problem in the theory of the second or third best." (footnote omitted).
economists but which we cannot exclude. Suboptimum arrangements (such as investor ownership) may serve the political interests of those who have acquired political power and suppressed alternatives. Or such suboptimum arrangements may have become conventional, creating very high entry costs to anyone seeking to challenge the convention.

1. The high information costs of hierarchy

In the models of the “transaction cost” school, hierarchy arises “naturally” in order to provide information that the firm, or its owners, can use to monitor employee performance and sack the nonperformers. These models omit the costs of hierarchy in preventing firm managers from having access to information.

Employees, in my experience, typically regard none of the above package as optimal from their perspective. They would prefer not to bear such heavy risks of layoff, corporate takeover, or managerial opportunism with their pensions or other savings. They do not regard the level of supervision to which they are subjected as optimum either. As they do not plan to shirk, certainly not in the sense of goofing off, they would much prefer a scheme in which they promise not to shirk and to work up to certain levels, and to assume the risk of some work sharing if necessary, in exchange for management’s promise not to layoff and to reduce

81. Mark J. Roe, A Political Theory of American Corporate Finance, 91 COLUM. L. REV. 10 (1991) (political factors explain American pattern of widespread investor share ownership, as opposed to concentrated institutional ownership); see also Charles Sabel & Jonathan Zeitlin, Historical Alternatives to Mass Production: Politics, Markets and Technology in Nineteenth-Century Industrialization, PAST & PRESENT, Aug. 1985, at 133, for a historical study of the driving out of efficient alternatives.

82. This concept is particularly important in the work of the economist Harvey Leibenstein, discussed infra 102-13 and accompanying text. “Even the survival of an economic enterprise does not depend on efficiency in an absolute sense. At most, all that matters is the relative efficiency of firms vis-a-vis each other. Furthermore, there are a variety of sheltering mechanisms, and various ways in which an organization can operate under sheltered circumstances. Some organizations can themselves contribute to increasing the degree of shelter from competitive forces. Hence, stability, survival, and inefficiency can all persist for long periods of time.” HARVEY LEIBENSTEIN, INSIDE THE FIRM: THE INEFFICIENCIES OF HIERARCHY 4 (1987)[hereinafter INSIDE THE FIRM]. See also David I. Levine & Laura D'Andrea Tyson, Participation, Productivity, and the Firm's Environment, in PAYING FOR PRODUCTIVITY, supra note 40, at 183, 204-35 (discussing systematic bias of the market system against efficient participatory workplaces); Jon Elster, From Here to There; or, If Cooperative Ownership is So Desirable, Why Are There So Few Cooperatives?, 6 SOC. PHIL. & POL'Y 93 (1989) (explaining paucity of cooperatives through importance of convention, adverse selection, free rider problems and the like).

83. There have been numerous recent experiments with varieties of team production or other ways of reducing the density of supervision. In every account I’ve seen, employees are quite happy to be less supervised. See, e.g., HECKSCHER, supra note 35, at 138-46; SHOSHANA ZUBOFF, IN THE AGE OF THE SMART MACHINE: THE FUTURE OF WORK AND POWER 245-310 (1988); GREENBERG, supra note 26, at 40-50, 78-81.
levels and intensity of monitoring. If management is indifferent to this choice, why won’t it let the employees have their way?

I think that Alchian and Demsetz, Jensen and Meckling, Williamson and others are basically right to see this problem as partly one of information costs.\textsuperscript{84} Employees are simply not in a position to make a credible promise to supply enough effort to compensate management for assuming greater risk.\textsuperscript{85} Management, under conflict of interest,\textsuperscript{86} will assume that insuring employees against risks of layoff and job loss will create the “moral hazard” familiar from insurance, where insuring against an event creates incentives for its occurrence.\textsuperscript{87} “Hence, the outcome of this bargaining situation (or contract) is what economists call ‘second best.’ The deviation from a first-best solution (optimum) and the resulting misallocation of risk is the true cost of the information imperfections that characterize the typical employment situation.”\textsuperscript{88}

As set out here, the problem in designing optimum employment contracts is partly the problem well-studied by economists of the proper tradeoff between incentives and risk. It seems generally accepted that efficient solutions to this tradeoff cannot be found under conditions of asymmetric information.\textsuperscript{89} Yet that is precisely the process of employment contracting under conflicts of interest. Efficient tradeoffs would require that management know employees’ preference for risk, maximal feasible work effort, and all employees’ other ideas for improving productivity. Employees will, however, never volunteer this information to a management that will surely use it opportunistically. Management has no other way of acquiring the information at reasonable cost, so manage-

\textsuperscript{84} “Partly” because I would broaden their approach to include the kinds of internal or “X” inefficiency resulting from low trust that is associated with the work of Harvey Leibenstein, discussed infra Part IID. For comparisons with the “information costs” school, see Harvey Leibenstein and Klaus Weiermair, X-\textit{Efficiency}, \textit{Managerial Discretion, and the Nature of Employment Relations: A Game-Theoretical Approach, in Management Under Differing Labour Market and Employment Systems} 79 (G. Dlugos, et al. eds., 1988) [also in Leibenstein’s Collected Essays].

\textsuperscript{85} Perhaps management would be indifferent if employees could post a bond against their future shirking. Lorne Carmichael, \textit{Can Unemployment Be Involuntary?: Comment, 75 AM. ECON. REV.} 1213 (1985) suggests that such a bonding scheme should reach employment equilibrium without unemployment. However, real world employees obviously do not have the resources to post such a bond. Moreover, existing compensation schemes tying workers to firms are not good substitutes for such a hypothetical bond. George A. Akerlof & Lawrence Katz, \textit{Workers’ Trust Funds and the Logic of Wage Profiles}, 104 Q. J. ECON. 525 (1989).

\textsuperscript{86} Bowles & Gintis, \textit{supra} note 17, at 7, call this “contested exchange.”

\textsuperscript{87} The friends of the born nurse
Are always getting worse.


\textsuperscript{88} Nalbantian, \textit{supra} note 77, at 11-12.

ment supervises and monitors instead of seeking cooperation, and the resulting mix of risk bearing and incentives is optimum for no one.

2. Externalities and subsidies

Probably the biggest single cost of the current regime of efficient wage contracts is the cost of continuing involuntary unemployment.\textsuperscript{90} Because firms are divided into supervisors and employees, they will adopt rigid pay scales and high supervision rather than flexible wages, work sharing, incentive pay, and low supervision. Because wages are not flexible, we have mandatory retirement;\textsuperscript{91} excessive risk of discharge and layoff;\textsuperscript{92} and unwillingness to hire potential workers who would be happy to be paid the value of their marginal product or even less.

Firms do not experience this cost as a cost at all. Employees experience the constant anxiety of job loss. The bulk of the cost, however, is born by the chronically unemployed, and to a lesser extent by the society that pays, through transfer payments, and through such destructive behaviors associated with chronic unemployment as mental illness, violence towards self and others, crime, alcoholism, and disease.\textsuperscript{93}

I wish to stress this point, since, when we turn our attention back to employee ownership, we will see that much is made of the subsidization of employee ownership through ESOP legislation and tax treatment of cooperatives.\textsuperscript{94} I do not deny such subsidization,\textsuperscript{95} but also wish to point out the extremely heavy social subsidization given the current regime of employment contracts, in which, as so often occurs, costs are socialized while profits are private.\textsuperscript{96}

\textsuperscript{91} Lazear, supra note 53.
\textsuperscript{92} Supra Part II B.
\textsuperscript{93} MEYER HARVEY BRENNER, MENTAL ILLNESS AND THE ECONOMY (1973); NORMAN T. FEATHER, THE PSYCHOLOGICAL IMPACT OF UNEMPLOYMENT (1990). High wages, in a very real sense, are subsidized by the families of the chronically unemployed.
\textsuperscript{95} I don’t want to overstate it either. A major theme of BLASI & KRUSE, supra note 1, at 88-138, is that employees typically pay for all or most of their ESOP, through restructuring of wages and benefits, such as wage concessions, elimination of defined-benefit pensions, profit sharing, or health benefits. But see Susan Chaplinsky & Greg Niehaus, The Tax and Distributional Effects of Leveraged ESOPs, 19 FIN. MGMT. 29, 37 (1990), finding that 48.2% of ESOPs increase employee compensation; 39.8% leave employee compensation unchanged; 6.0% decrease overall employee compensation.
\textsuperscript{96} In his oral comments to these remarks when given as the Piper Lecture, Professor Macey observed that such “subsidies” as transfer payments, unemployment benefits, and the social costs of
The work of the "efficiency wage" and "transaction costs" theorists helps us see the subtle as well as the obvious ways that the public, and the unemployed, subsidize "efficient wage" contracts. The obvious subsidy, central to all varieties of "efficient wage" theory, is that wages exceed marginal productivity, so labor markets do not clear, unemployment is created as an externality, and the public and the unemployed pay for the unemployment.97

The subtle subsidy is that, by paying for the externalities created by "efficient wage" contracts, the public inhibits the private adoption of solutions to unemployment. There is no shortage of proposals to mitigate unemployment, or (more narrowly) layoffs during recessions, through work sharing, in which firms would respond to downturns through shared salary and wage cuts, not layoffs.98 Of course, unions are already free to negotiate such plans, and employers free to adopt them voluntarily; why are they so unusual? Efficiency wage theory provides one answer: labor productivity will drop if wages drop, as good workers leave, or for other reasons.99 In Professor Weitzman's proposal, workers would be compensated for the income lost under work-sharing by profit-sharing, permitting the workers to recapture some of the productivity gained.100 The "transaction costs" school explains why workers will never agree to this: workers, particularly workers without unions, are in no position to monitor company reporting and administration of profits.

unemployment, are neutral as between employee-owned and capitalist-owned firms and therefore cannot be said to subsidize the latter. This is formally true but, if the models of the "efficient wage" theorists are correct, untrue in practice. Most economic models of employee ownership, as well as empirical studies, supra note 22, find that such firms in practice would take great pains to avoid involuntary unemployment, and would thus rarely occasion the payment of the various social subsidies for unemployment. It is just as if the state built a highway system and then asserted that it was neutral, subsidizing neither trucking nor railroads.

97. In this example, we see clearly the economists' use of "efficient": typical employment contracts are "efficient" if neither workers nor the firm could be made better off except at the expense of the other, even if this "efficiency" imposes direct costs on the unemployed and on society. So often, "efficiency" is just a euphemism for the old British army expression "I'm all right, Jack." (The expression is implicitly completed by a common two-word imperative expression, left unspoken).


100. WEITZMAN, supra note 98, at 82-95.
Absent such monitoring, the company would be "tempted to cheat."  

D. Internal or "X"-Inefficiency: How low trust leads to the persistence of inefficient labor contracts

The combined models of the "efficient wage" and "transaction costs" school present what I find a compelling picture. At least in some firms (and so far we need form no estimation of their quantity), patterns of labor contracting may exist in which employees, rightly fearing management holdups and opportunism, withhold efforts or information that might improve firm productivity. The resulting employment contracts are suboptimum for firms (in terms of reduced productivity and losses from excessive supervision and labor unrest) and employees (in terms of inefficient allocations of the risk of job loss and incentives for better performance). Understanding the dynamics of this process in individual firms is enhanced by studying yet a third body of economic literature, the somewhat controversial literature on "internal" or "X"-inefficiency.

The concept of internal or "X"-inefficiency was developed to explain the fact that sometimes individual firms experience very large gains in productivity. This fact is commonplace to management consultants, who make their living through bringing about such gains, and to the economists who study enterprise in developing countries and who first develope.


While this Article favors experimentation with employee ownership as a device for lowering information costs, this particular information cost, the workers' cost of acquiring accurate information about company finance, could be lowered considerably with modest reforms to the law under Section 8(a)(5) of the National Labor Relations (Wagner) Act, 29 U.S.C. § 158(a)(5). That section creates an employer's obligation to bargain in good faith, which includes an obligation to share information with the union that is extraordinarily modest in comparison with most European practice. Compare Leslie K. Shedlin, Regulation of Disclosure of Economic and Financial Data and The Impact on The American System of Labor-Management Relations, 41 OHIO ST. L. J. 441 (1980) with Washington Materials, Inc. v. NLRB, 803 F.2d 1333 (4th Cir. 1986) (no duty to disclose financial statements despite company claim that it was losing bids); ACL Corp. d/b/a Atlanta Hilton and Tower, 271 N.L.R.B. 1600 (1984) (no duty to disclose financial records).

Low trust and high information costs are not the only reason unions so rarely negotiate work-sharing and flexible pay arrangements. State programs of unemployment insurance typically compensate only victims of total unemployment, not those partially unemployed due to work sharing. Under principles of moral hazard, such insurance programs help bring about total unemployment. See generally Short-Time Work Compensation: A Formula for Work Sharing (Ramelle MaCoY & Martin Morand eds., 1984).

102. The controversy lies in these economists' relaxation of the postulate that economic actors maximize satisfaction; this redefinition of rationality is controversial among economists. See Leibenstein & Weiermair, supra note 84.

The basic works on internal inefficiency are the following works by Harvey Leibenstein: Collected Essays of Harvey Leibenstein (1989); Inside the Firm, supra note 82; Beyond Economic Man (1976). See also Roger R. Frantz, X-Efficiency: Theory, Evidence, and Applications (1987).
oped the theory. They report productivity gains of fifty percent or more after “simple reorganizations of the production process, e.g., plant-layout reorganization, materials handling, waste controls, work methods, and payments by result.”\textsuperscript{103} Such gains are, however, deeply puzzling to neoclassical economists who assume that all firms use inputs efficiently and experience what neoclassical economists call “inefficiency” (and Leibenstein calls “allocative inefficiency”) only because of regulation, monopolies, cartels and the like. Internal or “X”-inefficiency is simply the name for all inefficiencies that distinguish two plants that purchase identical inputs, at identical prices, with identical knowledge of the state of the art, and nevertheless produce different output.\textsuperscript{104}

Of course, even employee-owned firms will have internal inefficiencies. However, I want to focus on the particular form of internal inefficiency that Professor Leibenstein has emphasized in his recent work: the inefficiency that results from low trust between contracting parties, and the group processes that subsequently institutionalize the suboptimum arrangement, which may persist despite being suboptimum for all affected individuals and the firm.

1. The inefficiency of hierarchy: low trust and suboptimum deals

We have seen how the “transaction costs” school explains some suboptimum employment contracts as resulting from asymmetries of information that cannot efficiently be remedied. Leibenstein has illustrated another variety of suboptimum contract that may result, despite perfect information, simply from low trust between parties.

His initial illustration involves the bargaining in the second act of the opera \textit{Tosca}.\textsuperscript{105}

\begin{itemize}
\item \textsuperscript{103} Harvey Leibenstein, \textit{Allocative Efficiency vs. “X-Efficiency,”} 56 AM. ECON. REV. 392, 399 (1966)[hereinafter \textit{Allocative Efficiency}].
\item \textsuperscript{104} Harvey Leibenstein, \textit{Aspects of the X-efficiency Theory of the Firm}, 6 BELL J. ECON. 580 (1975). It includes “(1) intra-plant motivational efficiency, (2) external motivational efficiency, and (3) nonmarket input efficiency.” Leibenstein, \textit{Allocative Efficiency}, supra note 103, at 406-07.
\item Leibenstein believes that internal inefficiency does not merely supplement allocative efficiency but dwarfs it; internal inefficiency is much more important economically despite the emphasis of professional economists on allocative inefficiency. To the extent that the economic literature on worker ownership, supra notes 19-23, focuses solely on such issues of allocative inefficiency as allocation of employment and investment, it reinforces Leibenstein’s point. “Whereas theorists studying the [Labor-Managed Firm] concern themselves mainly with allocative issues . . ., empirical researchers view questions of internal organization (e.g., x-efficiency) and variations in the productivity of a given group of resources as being at least as important from a policy standpoint.” Bonin et al., supra note 24, at 26.
\item \textsuperscript{105} Libretto by Luigi Illica and Giuseppe Giacosa after the play by Victorien Sardou, music by Giacomo Puccini. Anatol Rapoport originally adapted this incident in \textit{The Use and Misuse of Game Theory}, Sci. AM., Dec. 1962, at 108, 113.
\end{itemize}
The main protagonists are Tosca, a beautiful singer, and Scarpia, chief of police in Rome during the Napoleonic occupation. At the point relevant to our purposes, Scarpia has captured Tosca's lover, who has been sentenced to be shot. Scarpia makes Tosca an offer she cannot refuse. If she will sleep with him, he will substitute fake bullets for the real one. She accepts. On the way to the rendezvous, Tosca discovers a dagger which she can use to kill Scarpia, if she so chooses.

Let us now stop the story in its tracks, so to speak, to consider the options. Scarpia can (1) stick to the agreement and order blank bullets used, or (2) he can leave the real bullets in and get rid of his rival for Tosca's affections. Tosca now has two options: she can honor the agreement and sleep with Scarpia, or she can use the dagger on Scarpia, and maintain her honor. Table 5.1 shows the payoffs in terms of utilities.

### Table 5.1

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In cell I Tosca sleeps with Scarpia and Scarpia uses the blanks. This has a relatively low but positive payoff for both. While Tosca saves her lover, she yields to the hated Scarpia. Similarly Scarpia enjoys Tosca, but he does not get rid of his rival. Cell II is the best for Scarpia since he enjoys Tosca and gets rid of his rival. This had a high payoff for Scarpia (+500 utils), and the lowest possible payoff for Tosca since she loses her loved one and yields to Scarpia. Cell III is the reverse of cell II. Here Tosca is best off since she gets rid of the hated Scarpia and saves her lover. Cell IV is clearly inferior to cell I for both. For Scarpia it is worse since he gets killed. For Tosca it is worse since her lover is killed.

How will they choose? If each tries to choose independently we can see that the Prisoner's Dilemma outcome (cell IV) occurs. Consider Scarpia's logic: if Tosca will succumb he might as well get rid of his rival and not substitute the blank bullets. If he thinks Tosca will
refuse or might kill him then he certainly has no reason to substitute the blanks. Hence he opts for the real bullets. Tosca's logic is similar. If Scarpia sticks to his bargain and has given the order to substitute the blanks then there is no point in yielding to him. She might as well use the dagger. If Scarpia has not given the order, then of course, she will kill him for revenge, rather than submit. Obviously, this type of thinking on both their parts results in the Prisoner's Dilemma outcome. Since the opera is a tragedy, it follows the logic of the situation. In the end, all the main characters go to their doom. The final scene has Tosca throwing herself off the rampart of the Castel Sant'Angelo after killing Scarpia, and upon learning of the death of her loved one.

For economics, the Tosca example of the Prisoner's Dilemma is more fundamental than the original Prisoner's Dilemma story. In the original, the fact that the two prisoners did not communicate was of the essence. In Tosca distrust is of the essence. In Tosca, the contending parties could, and did, communicate. In fact, they had worked out a satisfactory contract. What they did not have was mutual trust, and the mutual incentives to keep the contract. Present self-interest based on distrust made both parties worse off than would have been the case under the contract. Thus, the Tosca story is a member of a class of Prisoner's Dilemmas, which is essentially a mutual distrust dilemma.106

The remainder of Leibenstein's book is concerned with analogous bargaining between employees and managers. Employees may decide not to perform to the maximum, not trusting management to reward them for additional effort.107 Management may not reward employees or improve the quality of work life, reckoning that such gifts to employees will not be reciprocated.108 A cooperative solution that maximizes payoffs to all affected individuals will be rejected.

Now it is not news that low trust often describes relations between employers and employees. Alan Fox showed some time ago how much of the institutional apparatus of employment relations is explained by

106. INSIDE THE FIRM, supra note 82, at 44-46.
107. Here, as throughout this Article, I would urge that this be understood not primarily as a reference to "working harder", loading more sacks onto a truck, in the famous example of Alchian & Demsetz, supra note 65. The more interesting Prisoner's Dilemma involves whether employees will "work smarter"; suggest improvements; monitor productivity losses through poor decisions by supervisors or fellow employees; think about what they are doing. See supra note 74.

Of course, in particular settings the incentive problem is indeed to produce incentives for "working harder." In law firms, the problem is not really to induce associates to "work smarter." Law firm associates are screened carefully for personalities and academic records of working very smart indeed. Gilson & Mnookin, supra note 29, at 376-78. What large private law firms routinely induce, that government agencies and public interest offices do much less successfully, is indeed "working harder," in terms of exceptionally large quantities of sheer hours worked. Worker ownership is a substantial component of this incentive to "work harder": the winners will make partner.

108. Of course, where management believes, as a result of what it knows about workplace norms and conventions, that such gifts will be reciprocated, it will make them. Leibenstein is carrying forward, and describing the outer limits to, the process described in George A. Akerlof, Labor Contracts as a Partial Gift Exchange, 97 Q. J. ECON. 543 (1982).
this fact. Leibenstein's work goes further in two respects. First, it shows how such low trust is strictly economically inefficient; it imposes high information and supervision costs and leads to inefficient bargains. Second, it is the firm-specific theory we have been looking for; it suggests that the inefficiencies due to low trust will vary from firm to firm.

It is probably unnecessary to point out all the ways we have already seen that managerial opportunism contributes to low trust. We have already seen that management may exploit location-specific investments by threatening, or undertaking, capital mobility or disinvestment; by laying off; by lack of accountability to employees; by monkeying with pensions. Low trust may also reflect miscellaneous idiosyncratic reasons, such as a history of incompetence.

2. Conventions: the perpetuation of suboptimum bargains

"Transaction costs" economists do not reject the idea that low trust may lead to Prisoner's Dilemmas and suboptimum bargains, but their models tend to assume that someone—the firm's residual claimant, for example—will have incentives to push the suboptimum bargain to an efficient outcome, so that the suboptimum bargain will not persist. The great contribution of Leibenstein's work on conventions is to show that this is not the case.

Briefly, as Alchian and Demsetz say, firms exist to coordinate productive inputs. Just about any "coordination point" is better than no coordination. The suboptimum bargain resulting from the Prisoner's Dilemma will persist over time as the coordination point. In order to change the convention, a given individual will have to challenge peer groups and convince large numbers of people to change their behavior. It is rare for any individual to be in a position to do this.

110. While the variation may be one of degree, the amounts may be substantial. I would not be inclined to argue with someone who claims, like Bowles & Gintis, supra note 17, that all capitalist firms experience such inefficiencies of contested exchange, low cooperation, low trust, high information costs. Nevertheless, the amount of such inefficiency will vary from firm to firm, and I would not rule out the possibility that there may be capitalist firms with comparatively rather low internal inefficiency resulting from low trust. For example, Professor Leibenstein believes that many Japanese firms have substantially surmounted this problem, INSIDE THE FIRM, supra note 82.
111. For a darkly hilarious ethnography, see TOM JURAVICH, CHAOS ON THE SHOP FLOOR: A WORKER'S VIEW OF QUALITY, PRODUCTIVITY, AND MANAGEMENT (1985). Anyone entranced by the starry-eyed vision of small-batch custom manufacturing in MICHAEL J. PIORE & CHARLES F. SABEL, THE SECOND INDUSTRIAL DIVIDE: POSSIBILITIES FOR PROSPERITY (1984), should immediately read this book as an antidote.
112. Alchian & Demsetz, supra note 65, at 778.
113. INSIDE THE FIRM, supra note 82, at 60-97. For example, an individual who favors reducing hierarchy as a public good will probably not challenge that hierarchy for reasons familiar from the
The convention story is familiar to anyone familiar with any institution, certainly including employee relations. There is scant if any evidence that firms administer their employee relations policies to achieve anything like the economist's "efficiency." For example, firms adopt the same benefits programs that everyone in their region and industry does, even if they would benefit from something different. Firms don't administer their ESOPs for maximum financial advantage. Leibenstein's work on conventions explains these behavioral findings much better than a neoclassical theory that assumes that all firms produce efficiently, or theories that assume that a private owner as residual claimant can efficiently, without high information or transaction costs, break a convention and push a firm to efficiency.

III. A Firm-Specific Model of Successful Employee Ownership

We are now in a position to describe (or model, if you like) a particular type of firm in which employee ownership might succeed. Employee ownership can be an attractive solution to a firm experiencing:

1. high conflicts of interest between managers and employees.
2. low trust between managers and employees, as a result of ideological, cultural, or firm-specific factors.
3. suboptimum employment contracting as a "solution" to these problems; that is, employment "conventions" that institutionalize:
   a. low incentives for employee productivity, or
   b. high unnecessary supervision costs; or
   c. inefficient allocation of risks.

In Leibenstein's language, the firm in question will be experiencing high levels of internal or "X"-inefficiency due to some combination of information asymmetries or low trust between employees and managers.

115. Chaplinsky & Niehaus, supra note 95, at 36.
116. Recall that we defined our task, supra note 48, as a "sometimes" theory of successful employee ownership that fit with the observable pattern of successful employee ownership.
or, if already successfully employee-owned, such as a law firm, would experience such high internal inefficiency if it converted from employee to investor ownership.

The essence of the concept of internal inefficiency is that it explains observed variations within an industry, variations among firms purchasing similar inputs in similar markets to produce similar outputs. Consequently, it is not easy to generalize about the shared characteristics of "firms with high internal inefficiency due to low trust." However, three common patterns of "low trust between employees and managers" go a long way toward explaining nearly all observable successful employee ownership, and explain that pattern much better than Professor Hansmann's rather reductionist, and readily falsifiable, theory, that limits successful employee ownership to easily metered service employees.117 These are patterns, not causes-and-effects; they help identify the sorts of situations for which employee ownership is promising.

A. "Low trust" as the common thread in employee ownership

First, employees may not trust managers because they are professional employees who have been socialized into deep distrust of managerial types. What, after all, is a "professional" but one who, on the basis of specialized learning, can successfully command respect and autonomy from most managerial or nonprofessional authority?118 When we deal with employee-owned law firms, we deal with an institution close to the experience of many readers of these pages, so I ask you whether you think law firms would be more efficient if organized as corporations, with shareholders, Boards of Directors, career managers. All my experience

117. Hansmann, supra note 1, at 1783-84.
118. The large literature on the supposed conflict between "professional autonomy" and "bureaucratic management" includes: Eliot Freidson, Professional Powers: A Study of the Institutionalization of Formal Knowledge 158-84 (1986); Alvin W. Gouldner, The Future of the Intellectuals and the Rise of the New Class (1979); Magali Sarfatti Larson, The Rise of Professionalism: A Sociological Analysis 178-244 (1977) (noting the growth of an ideology of autonomy of professionalism as professional work conditions become threatened by bureaucratic or managerial authority); Richard Abel, American Lawyers 199-200 (1989) (The historic independence of lawyers from bureaucratic management may be declining as law firms are increasingly managed by full-time professional managers.). See also David M. Rabban, Distinguishing Excluded Managers from Covered Professionals Under the NLRA, 89 Colum. L. Rev. 1775, 1832-52 (1989). I agree with Robert L. Nelson, Partners With Power: The Social Transformation of the Large Law Firm 233 (1988) that "professional autonomy" has often been used in contradictory ways. I use it here to note, as Nelson does, that firm lawyers are not really subject to "deskilling" or "proletarianization," that they "exercise considerable discretion and control over the work process," id. at 188; and in particular are supervised only by other professionals, not professional managers. In particular I am not suggesting that there is any substantial autonomy from clients, id. at 223, nor am I rejecting Nelson's observation, which seems right to me, that in large law firms both the values of "partnership" and the values of "management" serve as vehicles for the projection of power by dominant partners. Id. at 78-79, 121-22.
tells me that they would lose efficiency; that lawyers would never put in
the hours, the effort, the initiative for managerial types that they will for
a firm owned by themselves or where a future ownership stake is part of
the motivational package. Just ask who works harder and smarter, the
lawyers who own their own firms or the lawyers working under bureau-
cratic management.  

Second, employee ownership may succeed, at least comparatively,
where employees for whatever political or cultural reason simply will
never accept or trust managerial authority.

Third, nonprofessional, nonpolitical employees may distrust man-
agement for deep if idiosyncratic reasons: they believe that this manage-
ment has through this opportunism messed up this company, and they
will not trust that management any more. For example, the firm may, as
a result of conventional capitalist management, be bankrupt or on the
verge of bankruptcy.

This third pattern is of the greatest economic interest but is the least
intuitively obvious. After all, if cranky professionals or far-out
countercultural types won't work for anyone but themselves, then some-
body should design situations in which they will work, but without any
sense that any wider economic questions hang in the balance. What is
the connection between internal inefficiency in the typical industrial firm,
and work organization or employee ownership?

B. Employee ownership and information costs

Let me answer this question in two steps. First, common to a great
deal of observable real world employee relations is a managerial effort to
induce employees to share information with management. Second, it is
easily demonstrable that, at least in some situations, an ownership stake
will induce such information-sharing that other, competing forms of in-
ducing employees will not.

1. What employees know:

To my mind, Karl Marx never wrote anything more beautiful than
the famous discussion of the architect and the bee. At the risk of alienat-
ing readers who may conclude that an article quoting Marx cannot possi-
ably be for them, let me quote the passage.

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A spider conducts operations which resemble those of the weaver, and a bee would put many a human architect to shame by the construction of its honeycomb cells. But what distinguishes the worst architect from the best of bees is that the architect builds the cell in his mind before he constructs it in wax. At the end of every labour process, a result emerges which had already been conceived by the worker at the beginning, hence already existed ideally.¹²²

For over a century, theorists of work and management, whether of the right or left, have often embarked from just this starting point: the idea that employees hold a great deal of knowledge that their employers do not have and would like to get. This was of course true of nineteenth century craft workers, who, through their control of the production process, had more effective control of the pace and quantity of production. This lead to the first great managerial campaign to acquire employee knowledge, the “scientific management” program of Frederick Winslow Taylor, in which employees were minutely observed, and their jobs then broken down into comparatively unskilled, repetitive jobs, the holders of no single one of which would be in a position to hold up or restrict production.¹²³

Remarkably, however, even after Taylorist “deskilling,” ordinary industrial workers today still control information that management lacks. The uneducated machine operator is likely to be the only one in the place who knows exactly how to operate that particular machine, how to keep it maintained and functional, long after management has refused to put any more money into it and the manufacturer has ceased to make replacement parts.¹²⁴

From this perspective, the common thread among quality circles, quality of work life programs, and team production, all popular management reforms, is that all seek to create environments in which employees will share information with management that they will never share under conventional labor relations. At their most benign, the groups may engender suggestions about safer or more productive work processes, although even this kind of information sharing goes too far for some employee advocates, particularly if the productivity suggestions result in job

¹²². 1 Karl Marx, Capital 284 (Fowkes trans. 1976).
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loss. At their most sinister, they may engender information about employee union sentiments and become the vehicles for psychological manipulation of employees, destroying employee solidarity to facilitate management control. Their ultimate potential either for capitalist efficiency, or employee participation, remains unclear.

2. Efficiency advantages of employee ownership:

If the chief efficiency advantage of employee ownership then is overcoming low trust and lowering information costs, it cannot be shown, necessarily to yield efficiency gains over a capitalist-owned firm which extensively employs team production or quality circles. For example, Professor Leibenstein's preferred institutional arrangement for overcoming internal inefficiency appears to be, not employee ownership, but rather variants on Japanese employee relations.

However hard to demonstrate, there may in theory be several ways in which structuring an ownership stake for employees in a participatory workplace will induce higher trust and lower information costs than simple resort to quality circles or team production without an ownership stake.


128. This is the crux of my disagreement with Bowles & Gintis, supra note 17. Of course, this pertains only to the efficiency case for employee ownership, leaving intact the political theory case. Moreover, the difference may be purely theoretical if capitalist firms do not in practice otherwise realize the efficiency gains that they would under worker ownership.

129. INSIDE THE FIRM, supra note 82, includes an extensive discussion of Japanese management practices. By contrast, I do not believe that Leibenstein has ever discussed employee ownership.

130. This is consistent with the empirical literature associating productivity gains with the combination of employee ownership and participation that could not be achieved by either individually. See Rosen, supra note 4, at 30, and sources cited therein. Jon Hyman has suggested one important theoretical reason why this might be so. As Robert Axelrod and others have shown, whether "low trust" will move to "cooperation," avoiding Prisoners' Dilemmas, depends strongly on whether games are repeated or not. ROBERT AXELROD, THE EVOLUTION OF COOPERATION 15-69 (1984). Whatever the theoretical potential of quality of work life groups for achieving such cooperation, in practice in the United States they rarely survive long enough to have any such effect; most peter out within five years. EDWARD COHEN-ROSENTHAL & CYNTHIA BURTON, MUTUAL GAINS: A GUIDE TO UNION-MANAGEMENT COOPERATION 122 (1987); C. HECKSCHER, supra note 35, at 133.
a. Workers may disclose even more information for productivity, work smarter, since the result will not necessarily be layoff, and anyway they can determine the result.

Critics of quality of work life programs have discussed extensively the fact that management normally retains complete discretion over whether or not to implement the suggestions of the participants. This might seem to place an upper limit on the kind of productivity suggestions that astute employees will adduce. With an ownership stake, employees will reveal no less information, and may disclose more. At the same time management loses incentives to misrepresent firm profitability to workers if those workers are also shareowners.

b. Workers will reveal preferences on risk-bearing.

A basic idea of the "efficiency wage" school, also familiar in practice, is that in some workplaces, workers would be willing to adopt a more flexible wage system in which at least some wages would be tied directly to individual or group productivity. Such a scheme should in theory be more efficient, since it provides better incentives to employees to work hard and smart, and permits firms to adjust to economic downturns with wage adjustments rather than layoffs. However, in low trust workplaces, workers will not trust management to administer such schemes, and therefore withhold information on their willingness to assume more risk. They continue to withhold such information in QWL groups where they fear management opportunism. They will share such information with themselves. Or in other words, an employee-owned company is a company in which the Board of Directors always has, essentially without cost, information on employee preferences.


132. Simon, supra note 3, at 1344, points out that "... impediments to easy exit from the community create inducements for internally participatory efforts to improve the community" (citing ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES (1970)).


134. Hansmann, supra note 1, at 1765-68.

135. Some readers have objected that most shareholders are in no position to monitor management and there is no reason to expect employee shareholders to do a better job. Obviously the empirical picture is far from clear, but there are numerous structural reasons that employee shareholders might effectively monitor management: they are physically at the point of production; they may have union or other organization to overcome collective action problems; their information costs are lower; they are disposed to voice over exit.
c. Workers will be willing to bear the risk of tying between performance and wages since they don't have to trust management.

This has been a feature of every one of the well-publicized, perhaps over-publicized, worker buyouts of failing firms in order to preserve jobs. It always turns out that workers will make concessions to themselves, mostly tying compensation to firm performance, that they would not and did not make to management.

d. One of the best-documented, clearest advantages of employee-owned firms is substantial savings in the number of supervisors.

This is highly significant, as many new computerized work processes have created the technological possibility of eliminating useless supervisors and replacing them with teams of workers, all working on the same data base and monitoring each other. It appears that employee-owned firms will be at a substantial advantage over conventionally-owned firms in realizing these savings.

e. Workers with an ownership stake should be likelier to invest in firm-specific education or other investments of their time, energy, or savings that are specific to the firm.

f. There is a possibility that an ownership stake may motivate workers through diffuse psychological mechanisms.

We are not on firm ground here; the literature does not clearly demonstrate any such relationship in observable employee-owned firms. This fact is puzzling, however, and may simply reflect gaps in

136. Over-publicized because these were never either typical or the most promising occasions for employee ownership.

137. BLASI & KRUSE, supra note 1, at 88-138.
138. GREENBERG, supra note 26 at 43-44.

139. For a fascinating study of conventionally-owned paper mills that experimented with just such team production, see ZUBOFF, supra note 83. Despite substantial savings, increased productivity, and increased worker job satisfaction, the experiment was terminated by managers fearful for their positions. See also LARRY HIRSCHHORN, BEYOND MECHANIZATION: WORK AND TECHNOLOGY IN A POST-INDUSTRIAL AGE (1984).

140. The assumption, that "ownership of" or "property rights" in an asset will create incentives for further marginally productive investment, is central to the literature typified by Oliver Hart & John Moore, Property Rights and the Nature of the Firm, 98 J. Pol. Econ. 1119 (1990).

141. I share Hansmann's skepticism, see Hansmann, supra note 1, at 1769-70. The unpromising psychological literature includes: J. Lawrence French & Joseph Rosenstein, Employee Ownership, Work Attitudes, and Power Relationships, 27 Acad. Mgmt. J. 861 (1984) (finding no relationship between share ownership and job satisfaction, at least in company where management owned most of stock and no visible efforts made at participatory culture); Tove Helland Hammer et al., Absenteeism When Workers Have a Voice: The Case of Employee Ownership, 66 J. Applied Psychol. 561 (1981) (no change in absenteeism rates after conversion to employee ownership); Richard T. Long, The Relative Effects of Share Ownership vs. Control on Job Attitudes in an Employee-Owned Com-
techniques of motivation. It would seem that over time, employee-owned firms should be able to design cultures of motivation that are more effective than in conventional firms and would also pay off in terms of job satisfaction.

These, then, are the potential efficiency and productivity advantages of the employee-owned firm. Are there any ways in which employee ownership would be negative for productivity? I would say no, for a simple reason: employee-owned firms are always free to be as hierarchical as they like. Workers can of course select any structure of management hierarchy they like, since it is responsive to them. Employee ownership need not resemble food co-ops. If they need managers, they can and do hire them.

This glib conclusion could be challenged if anyone could identify some structural feature of worker-run businesses that would make them unwilling to hire managers, even where those managers would contribute marginal product above the cost of hiring them. This problem just flips around all our earlier models of the firm. The neoclassicist would have to concede that the employee-owned firm will hire the manager at once. The transaction costs school would point out the cost of monitoring the manager, but, once these costs are added in, the manager will still be hired if it is efficient to do so. Only the internal inefficiency school might be concerned that conventions of team production would impede adoption of the more efficient managerial hire. I suppose that they might; however since this problem cannot be documented for real world employee-owned firms it appears that such conventions are weak, if they exist at all. Indeed, employees in our culture are so conditioned to accept managers that it would seem that the conventions would run the other way.

In conclusion, then, the efficiency or productivity case for employee ownership seems to me both empirically and conceptually very strong,

pany, 31 Hum. Rel. 753 (1978) (comparison of employees who owned stock with similar employees who did not revealed no differences in motivation and weak differences in integration and satisfaction; however, comparison not clear since many nonshareholders intended to buy into ownership in the near future). On the other hand, both Greenberg, supra note 26, at 65-114, and Hochner et al., supra note 33, at 181-82, report increased job satisfaction after conversion to employee ownership, although in the Hochner study, non-owners who participated in Quality of Work Life programs were more satisfied than owners.

142. Recall that the literature, with perhaps one exception, fails to identify any such cases; see supra note 40.

143. Putterman, supra note 11, at 274.

144. "Labor-managed cannot mean that labor owns the firm in the traditional sense, that is, it cannot mean that tradable residual claims on the firm are held by employees. If that is all it means we are back to the traditional profit maximizing firm." Jensen & Meckling, supra note 11, at 475.
although likely to be a different case for each firm, and stronger in some firms than others.

C. The Problem of Risk Allocation

There is one very strong argument against an ownership stake for many workers, and that is the problem of allocation of risk. As we have seen, most working people in the primary sector of the contemporary American economy already are tied to their employer by implicit long-term employment contracts that leave them with a great deal of firm-specific and location-specific investment. What investments do working people have? They do not own stocks or bonds and do not have much savings. They may own a home, but in smaller communities the value of that home will not be independent of the economic strength of the leading employers. To an extent unique in the industrialized world, their access to health care and retirement security will also be a function of their employer's health.

These background facts are not inevitable, and may even be internationally deviant, but they are facts about the American economy today, and it cannot be said that there is any strong political likelihood at present of change to a more Western European-style welfare state. Under the circumstances, it is rational for most employees, who already bear quite substantial risks of their firm's poor performance, to take on no risks other than those imposed by the background system.

This fact explains for me both the historic low incidence of worker ownership in most industries, and the tendency of worker owned firms to revert to private ownership. In order to understand this, we must look quite closely at the actual risks born by employees under various common arrangements.

From the time collective bargaining over pensions became common at the end of the Second World War until the recession of the early 1980's, primary sector employees attempted to reduce any risk they bore of their employer's poor performance, through negotiated packages of benefits. These either were actually negotiated by labor unions, or awarded by employers mimicking the union sector, often trying to keep unions out. Some of these benefits, such as supplemental unemployment benefits, were funded by the employer and thus not really free of risks of employer nonperformance. The jewels of the crown, however, were the defined benefit pension, and the health insurance plan. Employers and employees paid for these plans, of course, but the money paid would then be invested by insurance companies and plan trustees in a portfolio of
investments, so that benefits could thereafter be paid to employees irrespective of their employer's fortunes.

I cannot cite attitude surveys of American workers or their leaders from the 1950's through 70's, but the many conversations I have had with labor people over the years about employee ownership, and my own sense of rationality, convinces me that this kind of risk aversion explains much of labor's lack of interest in worker ownership during those years. The experiences of the Great Depression shaped these attitudes. Employee stock ownership was all the rage in the 1920's, and by 1930 about 2.5 percent of the workforce had bought shares valued at over $1 billion, roughly the equivalent of the value of ESOP holdings in the early 1980's—shares mostly worthless after the 1929 crash.\textsuperscript{145} Moreover, I think that working people and their organizations were right to pursue security from risk during the postwar period, and if such a deal were actually available, would be right to pursue it again.

With the advantage of 1991's hindsight, it is now clear that the pension and health arrangements of the 1950's through 70's did not provide the security for which working people hoped. If the "efficiency wage" people are right, the difficulty of downward wage adjustment may have led to a readiness to lay off workers and a wariness about hiring new ones.\textsuperscript{146} Pension funds became easy prey for both corporate and union leader greed; federal regulation came too little, too late, guarantees neither the continued existence nor financial health of pension plans, makes no real effort to enable working people to monitor their pensions and does not even purport to permit them to control them.\textsuperscript{147} None of


\textsuperscript{146} See \textit{supra} notes 53-59 and accompanying text.


When Jensen & Meckling, \textit{supra} note 11, at 473 observe: "Given a choice, potential investors will not voluntarily put their wealth in the hands of codetermined firms; and this includes labor itself, even though many unions in the United States could easily do just that by buying entire companies with their [sic] pension funds," they are so at odds with reality as to make it difficult to attend seriously to the rest of their argument.
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these legal background considerations is inevitable; they simply reflect the political weakness of working people and their organizations.

Professor Hansmann reflects these developments in observing that the risk of layoffs makes working for an investor-owned firm rather risky too. (He does not mention the risks of disinvestment, capital mobility, or sheer discriminatory discharge). He concludes that: "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." I cannot accept this conclusion, for which no authority is cited. I guess Hansmann and I have been talking to different people. No goal has shaped union bargaining behavior more over the last fifty years than the protection of employees from risk and insecurity. The fact that the arrangements they negotiated turned out not to be such effective protection does not demonstrate that they were motivated by anything other than a desire to eliminate risk, or that the rejected paths, including tying employee security to firm performance, were not rejected precisely because of their riskiness.

I mentioned before that the 1980's saw worker buyouts in which it emerged that workers were willing to assume more risk. These are very important, but must be seen in context. After the scales have fallen from their eyes, after the company is on the ropes, the pension plan revealed to be underfunded, concessions inevitable, sale to a raider probable—then workers may be willing to accept a different sort of risk, particularly if they acquire some control in the process. Still, imagine that a good fairy could present working people or their leaders with a choice: a risk-free environment in which a welfare state or employers provided iron-clad promises of health, unemployment, disability, and retirement security; or, on the other hand, an economy in which all enterprise was owned and controlled by employees, but there were few public benefits providing a floor, and few opportunities for diversifying investments. Of course the votes would divide, but who is confident that the second alternative would be decisively preferred?

I believe that risk aversion is the single greatest problem with em-

148. On the extent and importance of the last, see Weiler, supra note 53, at 63-78.
149. Hansmann, supra note 1, at 1773.
150. Supra note 45.
151. This is nearly always the scenario in that small minority of employee ownership deals with heavy union involvement, such as the deals discussed in Steve Newman & Mike Yoffee, Steelworkers and Employee Ownership, 3 J. Employee Ownership L. & Fin. 51, 59-60 (1991). Blasi & Kruse, supra note 1, and Rosen, supra note 4, are right to observe that this is an overcommented, tiny minority of employee ownership deals. However, they are the only deals with much union involvement; in other deals, one can be certain that employee ownership serves primarily management interests and will not be structured to serve maximally employee interests.
ployee ownership and the single greatest obstacle to its wider spread. This conclusion is fortified by examining the pattern so commonly observed in which businesses become employee owned in recessions, make dramatic recoveries, and sell to private investors. Why do they sell out? Hansmann, as usual discussing few actual examples, answers: "The most likely explanation is that worker ownership is not an efficient mode of organization for the firms involved." This conclusion is preposterous, given that in nearly all such cases studied a firm driven to the brink of bankruptcy by management opportunism and investor ownership has experienced incredible revival under employee ownership to the point where outside buyers are attracted who never were under investor ownership.

The reason they sell out is no secret. It is mentioned publicly in nearly every case of sale to private ownership, including Weirton Steel, the one actual case that Hansmann mentions: risk diversification for employees. This includes at least two components, depending on whether the employees are currently employed, or facing retirement.

First, the company may need more capital, to modernize or expand, and employees simply do not want so much concentrated risk; they seek a partnership with an outside investor in furtherance of their original goals, and for the same reason anyone else would.

A second component is the problem of repurchase liability. By law, ESOPs must stand ready to repurchase the shares of employees, partly so that employee ownership is diluted only by group, not individual decision, and partly to permit employees to diversify their own investments. If the company has really turned around under employee ownership, such repurchase liability can be very expensive, in some cases

152. See the accounts of Weirton Steel, supra note 28. On the theory, see Ben-Ner, supra note 44; Miyazaki, supra note 44.

153. Hansmann, supra note 1, at 1778.

154. One of the reasons Weirton undertook a partial public offering was that the employees vested in the ESOP did not want to risk undertaking a $500 million expansion of capacity all by themselves. Myron S. Scholes & Mark A. Wolfson, Employee Stock Ownership Plans and Corporate Restructuring: Myths and Realities, 19 FIN. MGMT. 12, 19 (1990) (citing Michael Schroeder, Has Weirton's ESOP Worked Too Well?, supra note 28, at 66). Similarly, the Copper Range Company went from 100 percent to 20 percent employee owned in order to raise funds for modernization. Workers each received around $50,000 for their shares, and the purchaser, a German company, retained the same Board of Directors, with heavy employee representation. Newman & Yoffee, supra note 151, at 59-60.

155. Employees who have participated in an ESOP for ten years or who have reached the age of 55, whichever comes later, have the right to sell their stock back and diversify their stock holdings. 26 U.S.C. § 401(a)(28). Employees who have received nonpublicly traded shares have the right to put these to the company. 26 U.S.C. § 409(h)(1)(B). See generally ROBERT W. SMILEY, JR. & RONALD J. GILBERT, EMPLOYEE STOCK OWNERSHIP PLANS 17 (1989).
requiring nearly all the company’s cash. Yet requiring such repurchases is necessary lest employees be left with an intolerable assumption of risk, in which they would approach the retirement years invested in a solitary investment.

Risk diversification is thus in both theory and practice the most serious problem with employee ownership as now practiced in the United States. It explains why rational employees will normally want only a partial ownership stake in their employer: in order to protect their retirement and health security. Risk diversification also explains why it is so hard to observe majority employee ownership selected by employees without preexisting professional or political disposition towards employee ownership. Essentially, only employees faced with risks of job and benefit loss, that in the particular case outweigh the risk of having retirement and health benefit funds so heavily invested in a single employer, will voluntarily select majority employee ownership. (It further explains once again why theories of employee ownership must be firm-specific). Finally, it explains why we observe both a strong theoretical and empirical case for the efficiency of majority employee ownership, and yet so few firms attempting to achieve those efficiency gains. Once again, economists would describe this as a tradeoff between incentives for performance and allocation of risk.

In my opinion, advocates of employee ownership have given insufficient attention to solving the problem of risk diversification. Partial solutions to this problem exist. There are a number of ways that ESOP investment may be made less risky for employees. Others are not le-

156. One early example of such a case has frequently been discussed at ESOP meetings, though so far as I know not written about anywhere. A small chain of Midwestern discount retail stores, listed on the New York Stock Exchange, became in 1981 100 percent owned by an ESOP. Management was committed to a participatory culture and involved employees heavily in training in running profitable stores. The chain did spectacularly well. Theft dropped to one-tenth of the industry average; employees made no concessions of any kind. Moreover, stock prices rose generally after 1981. The private valuation of the stock rose from $19 million at the time it went private to $165 million. Share repurchases from retiring or departing employees were taking all the company’s cash. In the spring of 1985, the ESOP sold its stock for $170 million to a venture capitalist who retained no employee ownership. The average employee of the discount stores received $300,000! The stock has continued to rise in value, and while new ESOPs have been studied, they are now too expensive. Charles Smith, Economic Democracy and Employee Stock Ownership Plans, Presentation at the Walt Whitman Center for the Culture and Politics of Democracy, Rutgers University (April 25-27, 1991).

157. Scholes & Wolfson, supra note 154, at 19, discuss several currently-practiced techniques for reducing employee risk. The most common appears to be to have employees hold convertible voting preferred stock, generally less risky than common. Another less common technique is to have the ESOP invest in assets other than company stock. By law, the ESOP must invest “primarily” in employer stock, and while the Department of Labor and Internal Revenue Service have never defined this phrase, most professionals assume that the ESOP need only invest half its assets in the
gally permissible, but could become so with regulatory change. As employee ownership spreads, other devices for reducing employee risk would become feasible. Ultimately, however, there is a plain conflict between having the bulk of employee savings and benefits trust funds invested in their own employer, and security for those employees.

My personal preference would be to decouple employee ownership from retirement and health security entirely. It is purely historical accident, and a distinctively American accident, that they have anything to do with each other at all. I would prefer to see employee ownership in large enterprises understood in the terms of this Article, that is, as that ownership stake large enough to permit employee control (in connection with other investors), communication and implementation of employee preferences regarding risks and incentives so as to optimize firm performance, and protection against unnecessary job loss or relocation. To me this makes most sense if layered on top of retirement and health security provided through public benefits plans. Since there is no practical way of realizing this particular plan in America in the near future, employee ownership will remain self-limiting, to employees willing to accept either a very small stake, or a much larger stake accompanied by fairly great risk.

sponsoring employer’s stock. In practice, however, four-fifths of ESOPs invest over 75 percent of their assets in stock of the sponsoring employer.

Finally, the ESOP could be combined with another defined contribution benefit plan invested entirely in bonds. All these techniques inevitably make the ESOP safer for employees, yet less potent as a control device, since employees will end up owning less common stock. There is simply no way of having both sides of this dilemma.

158. Before 1987, it was possible to combine an ESOP with a defined benefit plan that provided a floor, guaranteeing, say, 50 percent of terminal salary, but distributed only if the ESOP failed to meet the goal. Scholes & Wolfson, supra note 154, at 19.

159. For example, one could imagine pensions and health benefits plans in which trust assets were administered by a bank or insurance company, owned partly by its own employees and partly by the employees of other employers whom it served. That bank would invest funds in a portfolio of employee-owned and community-owned businesses. Although the bank’s owning shares in these businesses would obviously dilute the control exercised by their own employees, one suspects that for ideological reasons such a bank would normally support the strategies of the local employee-owners, as well as providing a way for them to bear less risk. Something like this scheme exists among the complex of employee-owned businesses in Mondragon, Spain; see Thomas & Logan, supra note 34, at 155-58. See also Simon, supra note 3, at 1378-80.

160. Today we are predisposed, by the models of the legislative process of the public choice school, to understand any legislation benefiting (say) employees as an example of their rent-seeking. In fact, the favorable tax treatment of deferred compensation, which is deductible to the employer as a business expense when contributed, though not taxable income to the employee until distributed later, had a different origin. In 1939, the Vandenberg-Herring Subcommittee, Senate Subcommittee of the Committee on Finance, issued its Survey of Experiences in Profit Sharing and Possibilities of Incentive Taxation, 84 Cong. Rec. 7401, declaring profit sharing to be “essential to the ultimate maintenance of the capitalist system.” Id. at 7402. Elite concession during perceived crisis, not rent-seeking, explains the bulk of pro-employee legislation. I try to generalize this into a theory in Alan Hyde, A Theory of Labor Legislation, 38 Buff. L. Rev. 383 (1990).
IV. POLICY IMPLICATIONS

The public policy case for modest subsidization of employee ownership stakes thus depends on two propositions, both deriving from earlier defenses of employee ownership, but neither one previously articulated in this form.

First, employee ownership is a potentially attractive device for improving productivity in those firms routinely overinvesting in supervision due to some combination of low trust and conventions of excessive supervision. This seems to me the convincing variation on the constant theme of advocates of employee ownership, that employee ownership improves firm productivity, a claim that, when reduced to that kind of stark form (starker than sophisticated advocates of employee ownership would put it), must be treated skeptically.  

On the other hand, one cannot simply ignore the steady stream of anecdotal reports of businesses completely turned around under employee ownership. It is time to begin tentative generalization about these businesses, mindful that the nation's experience with employee ownership is expanding quickly and that our generalizations will become richer and better over the next decade. Given today's empirical record, the best I can do for my own purposes is that employee ownership seems associated with a particular set of productivity gains: overcoming low trust; reducing supervision levels; permitting employee incentive systems linked efficiently to firm performance; and increasing communication of employee productivity suggestions and preferences regarding risk and incentives.

No doubt over the next decade we will form a clearer picture of the firms for which employee ownership will be positive for productivity. The time is past, however, for "always" or "never" theories, and one would hope that scholars of employee ownership might join hands in constructing firm-specific theories that are consistent with observable reality.

Now this first defense of employee ownership depends entirely on its productivity impact within individual firms and is bound to raise the economist's question: since such firms should be expected to operate efficiently on their own, why subsidize employee ownership? This Article has answered that question. Public policy funds numerous activities in the hopes of increasing the productivity of private firms: job training, a functioning financial market, various tax subsidies and disincentives.

161. See, e.g., BLASI, supra note 7; Hansmann, supra note 1, at 1763 n.54.
The power of conventions, cultural familiarity with inefficient levels of supervision, and the desire of those exercising power to hold on to it all lead to a kind of market failure in which individuals who might desire and benefit from employee ownership as a public good cannot procure it through private initiative. Modest inducements to experiment with employee ownership shares—the tax treatment of ESOPs and cooperatives—have been quite effective in overcoming convention, management opportunism, and related market failure.

The case for continuing or expanding this level of public support is not independent of the level of serious "X"-inefficiency in American firms, that is, what proportion of lagging American productivity is explained by these factors that firms left alone will never do anything about. I know of no way of forming a reliable estimate of this figure, but can only signal my intuitive sense that Leibenstein has this one just about right.

My second defense of employee ownership is a macroeconomic defense that has not previously been made. I think that partial employee ownership is the road to a "share economy" that might reduce continued high unemployment. If the "efficiency wage" scholars are correct, high unemployment results in significant part from wages that do not adjust downward in recessions and yet are not incentives for optimum performance either. Let us be very clear about whose wages those are. After the "givebacks" and concession bargaining of the 1980s, it cannot seriously be maintained that the union wages of working people resist downward adjustment. It is even more the salaries of managers and supervisors, often socially unnecessary to begin with, that routinely soar above market-clearing levels.

Considerable empirical evidence supports the idea that employee ownership is associated with sharply reduced levels of supervision, concessions by employees, and greater assumption of risk by employees.

162. Elster, supra note 82, at 108-10; Simon, supra note 3, at 1401-03.
163. Allocative Efficiency, supra note 103, at 397. Leibenstein's estimates, from studying tariffs and monopolies, that the welfare costs of "allocative" inefficiency (monopolies, cartels, regulation) are "trivial"—perhaps one tenth of one percent—while inefficiency internal to firms, and resulting from low trust, convention, poor motivation, and the like, is responsible for far greater welfare losses. On the other hand, corporate law types are painfully familiar with the general tale of efficiency gains unlocked due to reductions in agency costs—the tale that figured in all the defenses of 1980's corporate takeovers, though which turns out to be difficult to establish one way or the other (Bill Bratton made this point to me).
164. Here again the law may have played a facilitative role, due to doctrines of the National Labor Relations Board that require employers to negotiate about corporate transformations such as subcontracting, relocation, and partial closure only when these "turn on labor costs", that is, where the bargaining will turn to labor concessions and givebacks. Dubuque Packing Co., 303 N.L.R.B. No. 66, 1991-1992 NLRB Dec. (CCH) ¶ 16,687 (June 14, 1991).
Widespread adoption of employee ownership stakes could well facilitate more flexible wage structures, less reliance on the negative incentives of monitoring and supervision, more positive incentives tied to firm performance, and thus more entry level jobs at market wages. Employees would be irrational to trust management to administer a "share economy"; but they can and will do so themselves. This macroeconomic case for encouraging employee ownership shares has little or nothing to do with individual firm productivity improvements, though as I have said those will come too.

CONCLUSION

While the current literature on employee-owned and managed firms would certainly not support on economic grounds a law imposing such structures on all firms, it provides good reason to think that America gets its money's worth with modest subsidies to acquire practical knowledge and expertise in employee ownership. This subsidization would be even more valuable if it could be targeted, as it is not now, on those firms for which employee ownership offers greatest promise, and on those participatory varieties of employee ownership that reduce low trust and involve workers in combatting internal inefficiency.

A generation from now, if current trends continue, we will be able to look back with pride at our policies that enabled working people to own their own jobs.

165. Miyazaki & Neary, supra, note 22, show how a labor-managed firm can create efficient, internally-financed income insurance. With incomes insured, employee-owners will accept work-sharing and be willing to bear other risks of firm performance.