July 15, 2011

WHERE DID MILL GO WRONG?: WHY THE CAPITAL MANAGED FIRM RATHER THAN THE LABOR MANAGED ENTERPRISE IS THE PREDOMINANT ORGANIZATIONAL FORM IN MARKET ECONOMIES

Justin Schwartz

ABSTRACT

WHERE DID MILL GO WRONG?: WHY THE CAPITAL MANAGED FIRM RATHER THAN THE LABOR MANAGED ENTERPRISE IS THE PREDOMINANT ORGANIZATIONAL FORM IN MARKET ECONOMIES

Justin Schwartz, The John Marshall Law School

In this Article, I propose a novel law and economics explanation of a deeply puzzling aspect of business organization in market economies. Why are virtually all firms are organized as capital managed and owned (capitalist) enterprises rather than as labor managed and owned cooperatives? Over 150 years ago, J.S. Mill predicted that efficiency and other advantages would eventually make worker cooperatives predominant over capitalist firms. Mill was right about the advantages but wrong about the results. The standard explanation is that capitalist enterprise is more efficient. Empirical research, however, overwhelmingly contradicts this. But employees almost never even attempt to organize worker cooperatives. I critique the explanations of the three leading analysts of the subject (N. Scott Arnold, Henry Hansmann, and Gregory Dow), all of whom offer are different transactions cost accounts, as logically defective and empirically inadequate. I then propose an explanation that has been oddly neglected in the literature, that the rarity of cooperatives is explained by the collective action problem identified by writers such as Mancur Olson. Labor management is a public good that generates the *n*-person prisoner's dilemma which gives rational actors the incentive to create it in suboptimal (or no) amounts. I support this by reference to the empirical facts about the origin of existing cooperatives and show that this explanation requires no strong version of a questionable rational choice theory. My account points advocates of labor management towards solutions such as institutional changes in incentives, which, however, themselves involve public goods issues.

TABLE OF CONTENTS

WHERE DID MILL GO WRONG?:

WHY THE CAPITAL MANAGED FIRM RATHER THAN THE LABOR MANAGED ENTERPRISE IS THE PREDOMINANT ORGANIZATIONAL FORM IN MARKET ECONOMIES

Justin Schwartz, The John Marshall Law School

ARTICLE

WHERE DID MILL GO WRONG?:

WHY THE CAPITAL MANAGED FIRM RATHER THAN THE LABOR MANAGED ENTERPRISE IS THE PREDOMINANT ORGANIZATIONAL FORM IN MARKET ECONOMIES

Justin Schwartz[†]

INTRODUCTION

As Paul Samuelson pointed out, in perfectly competitive market, it makes no difference whether capital hires labor or labor hires capital.[1] Why, then, is the predominant form of industrial organization in market societies the traditional capital owned and capital managed firm (the capitalist firm)[2] rather than the labor managed enterprise owned and managed by the

[†] Assistant Professor of Law, The John Marshall Law School, Chicago, IL; J.D., Moritz College of Law, The Ohio State University; Ph.D, M.A., The University of Michigan; M.Phil., The University of Cambridge; A.B., Princeton University. Thanks are due to Professor David Schweickart for fruitful discussion and constant inspiration, to Professors N. Scott Arnold for detailed written comments and constructive provocation, to Professors Walter Kendall and William Ford, Elizabeth Anderson, Peter King, Robert and Betsy Bowman, Joel Rogers, Frank Thompson, Tony Smith, Mr. Anthony Cooper, Ms. Nina Strohminger, and to Mr. Chris Yonashonais, my research assistant on a very early iteration of this Article, as well as to participants in various presentations where distant ancestors of this paper were presented.

[1] Paul Samuelson, *Wages and Interest: A Modern Dissection of Marxian Economic Models*, 47 AM. ECON. REV. 884, 894 (1957) ("In a perfectly competitive market, it really doesn't matter who hires whom: so have labor hire 'capital.'") (citing Knut Wicksell, 1 LECTURES IN POLITICAL ECONOMY 109 (E. Classen, trans. 1934)).

[2] It will become important at several points to distinguish between types of capitalist firm, *see infra* notes 126-53, 181-85, and 217-19 and accompanying text including, notably, the classic capitalist firm, often entrepreneurial, with a small ownership group or single owner closely involved in actual management, *see* Armen Alchian & Harold Demsetz, *Production Information Costs and Economic Organization*, 62 AM. ECON REV. 777 (1972), and the open corporation, owned often by many thousands of investors represented by a board of directors and managed by professional management employees. *See* Eugene Fama & Michael Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON. 327 (1983) [hereinafter Fama & Jensen, *Agency Problems*] and *Separation of Ownership from Control*, 26 J. L. & ECON. 301 (1983) [hereinafter Fama & Jensen, *Separation of Ownership*] In addition there is the *traditional* capitalism firm, hierarchically organized and managed (my term), which may be classic or corporate, and the more or less participatory capitalist firm, in which the employees participate to some extent in management decisions. In addition there are more or less employee-owned capitalist firms, such as ESOPs, *see infra* note 56, almost all corporate in form, which may or may not be more or less participatory.

In a companion piece to this Article, *Voice without Say: Why Capital Managed Firms Aren't (More) Participatory* [hereinafter Schwartz, *Voice without Say*], (presently in manuscript on file with the author), I address why capital managed firms, both classic capitalist enterprises and corporations, tend not to institutionalize genuine worker participation. When I write about the "capitalist firm" or the "capital managed firm," I include all forms of workers (the cooperative[3])? This is exactly the opposite of the result predicted by John Stuart Mill, who argued over 150 years ago that such worker run cooperative associations would eventually crowd capitalist firms out of the market because of their superior efficiency and other advantages for workers.[4] What we see is that capitalist firms, both entrepreneurial and corporate, are utterly predominant. Cooperatives barely exist. The idea of a labor managed economy[5] of the sort envisaged by Mill seems fantastically utopian. Is there any compelling reason that modern firms should take the forms that they do and that the economy should be structured along those lines? Actual markets are not perfectly competitive,[6] but that is hardly an explanation without specifying what specifically creates the overwhelming asymmetry in favor of traditional capitalist firms with little or no genuine worker participation. The standard explanation is that

---

capitalist enterprises that are not cooperatives, that is, managed and owned by the workers. All these terms are to some extent matters of degree and debates can arise about particular cases. *See,e,g.,infra* note 181-85 (discussing the attempt of Henry Hansmann, THE OWNERSHIP OF THE ENTERPRISE (1996) [hereinafter Hansmann, ENTERPRISE], to disregard or diminish the labor managed status of the Mondragon cooperatives, perhaps the best known and most successive complex of cooperative production in the world, *see infra* notes 71-82 and accompanying text.

[3] I am concerned here with labor managed and owned enterprises operated and owned by employees and devoted primarily to productive, broadly manufacturing, economic activity rather than with agricultural, consumer, or service cooperatives, which are somewhat more common. *See,* e.g., Hansmann, ENTERPRISE, *supra* note 2, *passim* (surveying the range and distribution of cooperative enterprise). The former are the sort that has been the focus of most discussion of worker control.

[4] John Stuart Mill, PRINCIPLES OF POLITICAL ECONOMY WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 752 (W.J. Ashley ed., Longmans, Green & Co., 9th ed. 1915) (1885) 751 ff [hereinafter Mill, POLITICAL ECONOMY]. Mill's case is summarized *infra* Part I.

[5] *See* Jaroslav Vanek, THE LABOR-MANAGED ECONOMY: ESSAYS BY JAROSLAV VANEK [hereinafter Vanek, THE LABOR-MANAGED ECONOMY]. Vanek, however, considers the optimal form of ownership of an economy dominated by labor managed firms to be social rather than by the workers in the firm, *id.* at 180-81, as Mill envisaged. In this respect Vanek is closer to the model proposed by David Schweickart, AGAINST CAPITALISM (1993) [hereinafter AGAINST] (perhaps the best recent self-identified socialist defense of economic democracy based around labor managed forms), and AFTER CAPITALISM (2002) [hereinafter Schweickart, AFTER] (a sequel).

[6] *See*, *e.g.*, Steve Walt, *The Relation between Competition and Cooperation*, 15 HARV. J.L. & PUB. POL'Y 733, 737 (1992). "Perfect competition refers to the type of market organization in which (1) there are many buyers and sellers of a commodity, each too small to affect the price of the commodity; (2) the commodity is homogeneous; (3) there is perfect mobility of resources; and (4) economic agents have perfect knowledge of market conditions (i.e., prices and costs)," *accord* Dominick Salvatore, MICROECONOMICS: THEORY AND APPLICATIONS 64-65 (5th ed. 2009). Apart from isolated outposts that may approximate these conditions, or some of them, none of these conditions obtain in actual markets, The classic work on the subject is Joan Robinson, ECONOMICS OF IMPERFECT COMPETITION (1933); *see also e.g.*, Friedrich A. Hayek, *The Meaning of Competition*, in INDIVIDUALISM AND THE ECONOMIC ORDER 92 (1948). For the classic mathematical discussion of the perfectly competitive market, *see* Kenneth J. Arrow and Gerard Debreu, *The Existence of an Equilibrium for a Competitive Economy*, 22 ECONOMETRICA, 265 (1954) (discussed *infra* notes 289-91).

Mill was wrong about the efficiency advantages of the labor managed firm over its capitalist competitors.

But Mill was not wrong on that point. The literature shows that participatory organization, even in capitalist firms, has significant productivity advantages over traditional hierarchical capitalist management, and the comparisons favor more fully labor managed and -owned firms no less strongly and perhaps moreso. In this Article, I address the deep puzzle about why these organizational features are uncommon in productive enterprise, and in particular why workers so infrequently even attempt to create their own firms, managed and owned by themselves, that embody these competitive advantages. After critiquing the main standard explanations, I offer a novel explanation that is barely mentioned, much less explored, in the voluminous literature on the subject. The theory is that labor management is a public good the creation of which is impeded by the usual obstacles to collective action.

There are other efficiency-related questions and points of comparison and contrast between the two broad types of enterprise organization, for example, why more far more labor managed firms convert to capital managed firms than vice versa,[7] whether and how the differing organizational incentives might create differential performance or behavior between them,[8] perhaps to the disadvantage of the labor managed firm. However, these matters, while important in thinking about the design of a labor managed firm or labor managed economy or comparisons

---

[7] *See, e.g.* Gregory K. Dow, GOVERNING THE FIRM: WORKER'S CONTROL IN THEORY AND PRACTICE 43 (2003); Hansmann, ENTERPRISE, *supra* note 2, at 46, 80-86; Arnold, *Further Thoughts on the Degeneration of Market Socialism*, 3 ECON. & PHIL. 320 (1980)

[8] Thus Benjamin Ward articulated a famous argument in neoclassical terms that what he calls the "Illyrian" firm [Illyria is the Latin name for the area occupied in part by the former Yugoslavia] will exhibit some perverse incentives, *e.g.*, reducing output in response to an increase in demand *See* Benjamin Ward, THE SOCIALIST ECONOMY: A STUDY OF ORGANIZATIONAL ALTERNATIVES 209 (1967) or maintaining operations even at a loss if the workers will take a pay cut, *id.* at 210, and overinvesting in capital as opposed to labor to avoid dividing profits among more workers, *id.*¸ leading to what might be a suboptimal combination of resources, *id.*, as well as a number of other issues for functioning labor managed firms, some of which are discussed in this Article, where it is argued that they are not responsive to the question I address.

between either existing cooperatives or capitalist firms, do not go to the fundamental issue I discuss here: why so few labor managed firms are formed at all.

In Part I, I set the stage by contrasting Mill's optimistic predictions for the prospects of labor management in a market economy with the skepticism about this form of organization expressed by his contemporary Karl Marx. I confront Mill's hopes with the disappointing empirical facts about the extreme rarity of the labor managed firm that, during the subsequent century and a half, has seemed at least on this point to vindicate Marx and rebuke Mill. In Part II I take up the obvious and standard explanation that labor management and ownership are rare because, *pace* Mill, these organizational forms are economically or otherwise *in*efficient. To keep the discussion manageable, I consider the three candidate explanations that seem to me the strongest or at least the most influential. The ones I consider derive from what is called transactions cost analysis, broadly economic analyses that turn on the idea that the "friction" involved in coordinating interactions within or among institutions, [9] the costs of which play an essential role in explaining outcomes through a quasi-Darwinian process of selection for most efficient, least-cost features, including organizational form (Part II(A)).

I critique three such explanations. Two attempt to account for the greater purported inefficiency of cooperative as opposed to capitalist firm with reference to their respective internal operations (Part II(B)), specifically: (1) the comparative costs of monitoring to avoid shirking and opportunistic employee behavior in firm management and supervision (Arnold[10]), and (2) the higher costs of issues of collective decision making among heterogeneous individuals

[9] *See* Oliver E. Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985) [hereinafter Williamson, INSTITUTIONS] (the most comprehensive modern survey of this approach), and the *Organization of Work,* 1 J. ECON. BEHAVIOR & ORG. 5 (1980) [hereinafter Williamson, *Organization*]. For a summary, *see* Steven N. S Cheung, *Economic Organization and Transaction Costs*. 2 The NEW PALGRAVE: A DICTIONARY OF ECONOMICS 55 (1987).

[10] *See* N. Scott Arnold, *Market Socialism*, 6 Critical Review 517, 534 (1993) [hereinafter Arnold, *Market Socialism*] and THE PHILOSOPHY AND ECONOMICS OF MARKET SOCIALISM: A CRITICAL STUDY 1-49 (1994) [hereinafter Arnold, PHIL. AND ECON.] (an excellent quasi-libertarian critique of Schweickart-style market socialism).

(Hansmann[11]). These explanations involve logical difficulties, and ultimately founder on the evident fact that Mill was right that labor management is more productive than capital; management. The last explanation I take up, (Part II(C)) is that workers so rarely start up cooperatives because of the difficulties of generating enough capital (Dow[12]). This explanation involves inefficiencies regarding the comparative cost of the interactions of the capitalist and cooperative enterprises with the external market environment, specifically the credit market. Dow's version of this explanation avoids the worst pitfalls besetting Arnold's or Hansmann's, but it too is deeply problematic from the point of view of economic logic and empirical fact.

In Part III, I present with my own proposed explanation, that the rarity of the labor managed firm in market economies is primarily due to the sort of collective action problem involved in coordinating the behavior of multiple actors most famously expounded by Mancur Olson in his theory of public goods,[13] namely that collective action to achieve a common interest will produce suboptimal (or no) results if the good is one from which all participate regardless of the contribution of any. In addition, there is the consequent and related problem of lack of models to imitate and inspire due in large part of the very lack of familiarity with labor management precisely because of its rarity.[14] Mill went wrong largely by overlooking the public goods problem as an objection to his prognostication.[15] The top-down, deductive nature of this sort of explanation omits important historical and psycho-sociological explanatory information,

---

[11] *See* Hansmann, ENTERPRISE, *supra* note 2, at 89-98.
[12] *See* Dow, *supra* note 7, at 236-38 *et passim*.
[13] Mancur Olson, Jr., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1968); Russell Hardin, COLLECTIVE ACTION: A BOOK OF RESOURCES FOR THE FUTURE (1982) [hereinafter Hardin, COLLECTIVE ACTION].
[14] See, *e.g.*, Robert F. Bornstein, *Exposure and Affect: Overview and Meta-Analysis of Research*, 1968-1987, 106 PSYCHOL. BULL., 265 (1989) (reviewing studies that document the "mere exposure effect"), and *infra* note 222.
[15] Mill saw the public goods problem clearly in a different context, *viz.*, the need for legal limits on the working day rather than rather than voluntarily adopted ones. Mill, POLITICAL ECONOMY, *supra* note 4, at 239-40, but failed to extend the insight to his prediction about the eventual triumph of the cooperative. *See infra* notes 239-40 and accompanying text.

but if more empirically rich account were fully articulated, I believe it would complement rather than supplant the public goods explanation. In my Conclusion I argue that overcoming the collective action problem for labor management requires, at a minimum appropriate extra-market, *e.g.*, governmental, action to change the incentive structures, but this poses new sets of public goods problems of its own.

II. "THE PROBABLE FUTURITY OF THE WORKING CLASSES": PROGNOSTICATION AND REALITY

D. Mill versus Marx on the Future of Labor Management in Market Economies

The asymmetry between the capital managed and labor managed firm, so overwhelmingly in favor, as an empirical matter, has seemed so much like an inevitable "natural" fact as to rarely rise to consciousness as a question to be addressed. At times of social uncertainty, such as the decline and collapse of Soviet-style Communism, the issue surfaces again.[16] It is useful from the

[16] The issue of an economy organized around labor managed firms enjoyed a fruitful renaissance in this period: important works include, notably, Henry Hansmann, *When Does Worker Ownership Work? ESOPS, Law Firms, Codetermination, and Economic Democracy*, 99 Yale L.J. 1749 (1990))[hereinafter Hansmann, *Worker Ownership*], and its indispensible book length successor, ENTERPRISE, *supra* note 2; Schweickart, AGAINST, *supra* note 5 and AFTER, *supra* note 5; Arnold, *Market Socialism*, *supra* note 10, and PHIL. AND ECON., *supra* note 10; Theodore A. Burczak, SOCIALISM AFTER HAYEK (2006); David Ellerman: THE DEMOCRATIC WORKER-OWNED FIRM: A NEW MODEL FOR EAST AND WEST (1990); Alec Nove, THE ECONOMICS OF FEASIBLE SOCIALISM REVISITED (2d ed. 1991); MARKETS AND DEMOCRACY: PARTICIPATION, ACCOUNTABILITY, AND EFFICIENCY (Samuel Bowles *et. al.* 1993); Dow, *supra* note 7. These studies are merely a few of many that sprang up between the crises that led to the Soviet experiment in Perestroika, and their aftermath, before it became clear that post-Soviet Russia would become a mere autocratic kleptocracy. *See, e.g.*, DAVID HOFFMAN, THE OLIGARCHS: WEALTH AND POWER IN THE NEW RUSSIA; (2002); Peter Reddeway & Dmitri Glinski: THE TRAGEDY OF RUSSIA'S MARKET REFORMS: MARKET BOLSHEVISM AGAINST DEMOCRACY (2001).

Prior experiments in labor managed firms and economies had attracted a steady but lower-intensity degree of scholarly attention, particularly with the former Yugoslavia, *See, e.g.*, Jaroslav Vanek, THE PARTICIPATORY ECONOMY: AN EVOLUTIONARY HYPOTHESIS AND A STRATEGY FOR DEVELOPMENT (1971); THE LABOR-MANAGED ECONOMY; Branko Horvat, THE POLITICAL ECONOMY OF SOCIALISM: A MARXIST SOCIAL THEORY (1982) (Marx would emphatically rejected a claim that a market society of any sort could be "Marxist," if he had used the term "Marxist."); and the Mondragon collectives in Spain, and *see, e.g.*, Henk Thomas & Chris Logan, MONDRAGON: AN ECONOMIC ANALYSIS (1982); William Foote Whyte & Kathleen King Whyte, MAKING MONDRAGON (1988), and *infra* note 71; as well as the Israeli Kibbutz, *see e.g.*, Melford E. Spiro, KIBBUTZ: VENUE IN UTOPIA (augmented ed. 1970); Daniel Gavron, THE KIBBUTZ: AWAKENING FROM UTOPIA (2000). This only scratches the surface, but the clustering of the dates from the early 1980s to the early 2000s is significant.

In addition, there is a large literature on the labor managed firm in the United States, much of which is surveyed in Hansmann, *Worker Ownership*, supra, and ENTERPRISE, *supra*, and in Schweickart, AGAINST *supra*, and AFTER, *supra*, as well as, *inter alia*, Ellerman, *supra*, and Dow, *supra*. I discuss the main factual conclusions on there is perhaps surprising agreement, unlike the explanations for those facts, *infra* Part I(B)(1) & (2). I also address point of historical perspective to briefly step back to discussions in a previous period of upheaval, and consider the reflections of John Stuart Mill on "The Probable Futurity of the Working Classes,"[17] in light, even more briefly, of Marx's highly critical appraisal of cooperatives. It is neither accurate nor necessary for my purposes to put ideologically loaded labels on an economic model in which the labor managed firm predominates. [18] For my purposes, red flag terms like "socialism," or for that matter "capitalism" are distracting rather than illuminating. I here avoid terminological debates to concentrate instead on explanatory questions. I take no position on questions of public versus private cooperative ownership in this Article. Like Mill, I assume that the firms the organization of which is at issue operate in more or less competitive market economy. A market economy of the sort Mill envisaged in which the labor managed firm is the predominant organizational form I call a labor managed economy.[19]

far more briefly the ESOP – a more or less employee owned but typically not labor managed firm. I do not consider models of a market economy organized around public ownership without labor management, for which, *see, e.g.*, John E. Roemer, A FUTURE FOR SOCIALISM (1994).

[17] Mill, POLITICAL ECONOMY, *supra* note 4, at 752ff (Bk. IV, Chap. VII) (chapter written for the first edition in the revolutionary year 1848).

[18] The idea of the labor managed firm, or even a labor managed (market) economy, is not intrinsically socialist, certainly if socialism is thought to involve the abolition of markets or of private property in productive assets. *See* Marx, *Manifesto, in* Tucker, *supra* note 20, at 469, 484 ("[T]he theory of the Communists may be summed up in a single sentence: Abolition of private property."). Nonetheless, labor self-management has had considerable appeal for socialists as the bloom faded from the Soviet model of central planning, *see, e.g.*, AFTER THE FALL: THE FAILURE OF COMMUNISM 310 (R. Blackburn ed. 1991); *see also* Schweickart, AGAINST, *supra* note 5, and AFTER, *supra* note 5, along with some other works cited in that note, exemplary of a socialist turn towards labor management. For decidedly anti-socialist and highly critical analyses of labor management in a socialist context, *see, e.g.*, János Kornai, THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM 461-512 (1992), or Arnold, Market Socialism, *supra* note 10, PHIL AND ECON., *supra* note 10.

Many socialists would emphatically reject the idea that a market economy, labor managed or otherwise, could be socialist. *See*, for one, Karl Marx, *Critique of the Gotha Programme* [hereinafter Marx, *Gotha*], in Tucker, *supra* at 525, 529 ("Within the cooperative society based on common ownership . . . the producers do not exchange their products . . . ."). Such writers would concur with the characterization of a labor managed firm or even a market economy primary composed of such firms as "capitalism without capitalists," Peter F. Drucker, POST-CAPITALIST SOCIETY 74 (1994), or Keith Bradley & Alan Gelb, WORKER CAPITALISM: THE NEW INDUSTRIAL RELATIONS (1983), as well as Marx himself, *see* 3 CAPITAL: A CRITIQUE OF POLITICAL ECONOMY 571 (trans. David Fernbach, Vintage 1981) (1894) (stating that in a market system workers in labor managed cooperatives "become their own capitalists."); *see also* MARKET SOCIALISM: THE DEBATE AMONG SOCIALISTS (Bertell Ollman ed.1998) (containing essays by self identified socialists on both sides debating whether market socialism is socialism).

[19] *See* Vanek, THE LABOR-MANAGED ECONOMY, *supra* note 5.

Writing in the aftermath of the Revolutions of 1848,[20] John Stuart Mill predicted that over the long run the capital managed firm[21] would be would be superseded by the labor managed firm:

> The form of association, which, if mankind continue to improve, must be expected to predominate, is not that which can exist between a capitalist as chief, and workpeople without a voice in the management, but the association of the laborers themselves on terms of equality, collectively owning the capital with which they carry on their operations, and working under managers elected and removable by themselves.[22]

"[C]onfining ourselves to economical considerations," Mill wrote, "I cannot think that [the working classes] will be permanently contented with the condition of laboring for wages as their ultimate state."[23] Mill anticipated that "the relation of masters and workpeople will gradually be superseded by partnership . . . : in some cases and perhaps finally in all, association of labourers among themselves."[24] Mill, like Marx, thought that democratic worker management would in the long run work better than management by capitalists or their agents. For Mill, among the main advantages of "association" were that it (1) promoted self-realization through meaningful work, converting "each human being's daily occupation into a school of the social sympathies and the

---

[20] Mill expressly tied the possibility of realizing the labor managed firm on a large and growing scale as opposed to merely theorizing about it to the "the French Revolution of 1848." Mill, POLITICAL ECONOMY, *supra* note 4 at 773. This was the same upheaval in which Marx wrote his *Manifesto*. Karl Marx, *Manifesto of the Communist Party* (1848) [hereinafter Marx, *Manifesto*], in THE TUCKER-ENGELS READER 469, 484 (Robert C. Tucker ed., W.W. Norton) [hereinafter Tucker].

[21] Hansmann calls this the "investor-managed firm," Hansmann, ENTERPRISE, *supra* note 2, at 53ff., but this seems to me potentially misleading because, at least in the modern corporation that dominates the economic landscape, the division of ownership and control that has the result that ordinary investors have little or no say in firm management. *See* Adolf A. Berle, Jr. & Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY 6, 346-47 (1932); Edward S. Herman, CORPORATE CONTROL, CORPORATE POWER 6, 7 (discussing Berle & Means, *supra*), 245, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 603 (2006) [hereinafter Bainbridge, *Limited Shareholder Voting*] (underlining the lack of influence of an ordinary shareholder on corporate policy), and *infra* notes 132-33 and accompanying text. Dow's term, "capital managed firm," *see* Dow, supra note 7 at 3-4, 10-12, seems more exact.

[22] Mill, POLITICAL ECONOMY, *supra* note 4, at 772-773. The concept is protean, having no single agreed-upon form, *see* Dow, supra note 7, at 256 ("Is Worker's Control a Unitary Phenomenon?" (arguing that it is not), as will be indicated below in brief discussions of some specific examples, such as the plywood cooperatives or Mondragon, see, e.g., *infra* note 48 and accompanying text. It is sometimes also called "self-management"; "worker management," "participatory management," or "cooperation." Marx and Mill call it "association."

[23] Mill, POLITICAL ECONOMY, *supra* note 4, at 760.

[24] *Id.* at 764.

practical intelligence."[25] It would also (2) be more efficient and productive because it would give workers an interest in "do[ing] the utmost, instead of the least possible, in exchange for their remuneration,"[26] since discipline would be "self-imposed, for the manifest good of the community and not for the convenience of an employer having the opposite interest."[27] And (3) it would "enable [human beings] to work with or for one another in relations not involving dependence,"[28] promoting what we today call democracy, both in the political sphere and the organization of enterprise affairs. "They will require that their conduct and condition shall be essentially self-governed."[29]

Mill, however, unlike Marx, "utterly dissent[ed] from...[socialists'] declamations against competition."[30] Mill's "associations" would produce for profit and trade in markets. Also unlike Marx, Mill thought that a transition to a labor managed economy could occur "without violence

---

[25] *Id.* at 790. This is one of Marx's main themes. Work, he thought "develops the potentialities within nature, and subjects the play of its forces to his own sovereign power." Karl Marx, 1 CAPITAL: A CRITIQUE OF POLITICAL ECONOMY, 283 (4th ed. Ben Fowkes, trans. Vintage Books) (1977) [hereinafter Marx, CAPITAL 1] (*see also* Tucker, *supra* note 20, at 344 (1887), but work under capital, with "the undisputed authority of the capitalist over men, who are merely members of a total mechanism that belongs to him," *id.* at 477; Tucker, *supra* at 395, lead, he said, to "physical and mental degradation, . . . premature death, [and] the torture of overwork," *id*. at 381; Tucker, *supra* at 376). (Neutrality of tone is not in Marx's stylistic repertoire.) In contrast, in the sort of (nonmarket) cooperative production Marx envisages under his conception of communism, is the "freedom [in which] . . . the associated producers [] govern the human metabolism with nature in a rational way, bringing it under their collective control, instead of being dominated by it by it, . . . under conditions most favorable to, and worthy of, their human nature." Marx, CAPITAL 3 *supra* note 18, at 959, or so he surmised.

[26] Mill, POLITICAL ECONOMY, *supra* note 4, at 789.

[27] *Id.* at 778-79. "From the progressive advance of the cooperative movement, a great increase may be looked for even in the aggregate productiveness of industry." *Id.* at 789.

[28] *Id.* at 763.

[29] *Id.* at 758. "Democracy" was a pejorative term in in the mid-19th century, not least for Mill. His concerns about the "tyranny of the majority," Mill, ON LIBERTY 126 (1859) [hereinafter Mill, LIBERTY], *in* UTILITARIANISM AND OTHER WRITINGS (Mary Warnock ed., Meridian 1962), about the "tyranny of the majority," a term derived from Alexis de Tocqueville, 1 DEMOCRACY IN AMERICA 265(trans. Henry Reeve, *et al.*, Knopf 1972)(1835) led him to view the term democracy, with his contemporaries, in a doubtful light even when he supported aspects of what *we* mean by it, including self-governance.

[30] Mill, POLITICAL ECONOMY, *supra* note 4, at 792. "With the exception of competition among labourers, all other competition is for [their] benefit, by cheapening the articles they consume," *id.* at 792; "To be protected against competition is to be protected in idleness, in mental dulness [sic]; to be saved the necessity of being as active and intelligent as other people." *Id.* at 793-94.

or spoliation, or even any sudden disturbance of existing habits and conditions."[31] Associations would multiply and tend to "absorb all work-people."[32] Capitalists would "find it to their advantage" to give up class conflict and "lend their capital to the associations...and at last to exchange [it] for terminable annuities. In . . . some such mode, the existing accumulations of capital might honestly, and by a kind of spontaneous process, become the joint property of all who participate in their productive employment."[33] For Mill, the market itself would quietly and gradually abolish capital management in favor of labor management, an idea that Marx would scorn with all his rhetorical power.[34]

E. The Rarity of Labor Management

3. *Where Mill Was Right*

Mill was broadly correct about the advantages of cooperatives. Richard Freeman and Joel Rogers[35] summarize the results of their study of Employee Involvement (EI)[36] plans in capitalist firms, by saying that EI "programs makes worker's lives better. . . . [S]tudies . . . suggests that, at

---

[31] *Id.* at 791. As is well known, Marx believed that the "ends [of the Communists] can be attained [in general] only by the forcible overthrow of all existing social conditions." Marx, *Manifesto, in* Tucker, *supra* note 20, at 500).

[32] Mill, POLITICAL ECONOMY, *supra* note 4, at 791.

[33] *Id.*

[34] Marx thought that cooperative labor managed production showed that capitalists are "superfluous," Marx, CAPITAL 3, *supra* note 18, at 511, but under capitalism it necessarily reproduced "all the defects of the present system," *id.* at 571, abolishing the opposition between capital and labor "at first only in the form that the workers in the association become their own capitalist." *id*. He did briefly suggest that co-operative credit arrangements owned by workers "present[] . . . the means for the gradual extension of cooperative enterprises on a national scale." *Id.* at 571-72, but he treated cooperatives on par with "[c]apitalist joint-stock companies," *id.* at 572, as "transition forms from the capitalist mode of production to the associated one," *id.*

[35] Richard B. Freeman & Joel Rogers, WHAT DO WORKERS WANT? (1999).

[36] Freeman and Rogers examined capitalist firms with and without EI programs, in which they included quality circles and discussion groups, total quality management, self-directed work teams, safety committees, and other structures, *id.* at 101, which do not give the workers much real say in firm operation and policy. *See* Stephen M. Bainbridge, *Participatory Management within a Theory of the Firm*, 21 J. CORP. L. 657, 688 (1996) [hereinafter Bainbridge, *Participatory Management*] ("One nearly universal characteristic of operational participation is a lack of meaningful employee control over the outcome of decisionmaking process."). Most such programs "focus on issues relating to production," Freeman & Rogers, *supra* at 102. U.S. labor law prohibits capitalist firms from establishing employee groups to assist in determining wages, benefits, or working conditions, *see* Section 8(a)(2) of the National Labor Relations Act, 29 U.S.C. § 158(a)(2), although much illegal discussion of this sort nonetheless occurs in EI programs, *see* Freeman & Rogers, *supra*, at 103, and capitalists do not consult workers on questions of financing, investment, strategic plans, or marketing. Nominally participation is limited to shop floor issues. Even so limited, employees strongly prefer more participation. *Id.* at 138.

a minimum, such programs do not harm productivity on average and, more likely than not, raise it. Most workers want these programs and want them to be more extensive, giving workers greater say."[37] In part because of the rarity of labor managed firm, data are thinner, but available results are similar. Although the results are highly sensitive to social context, workers in cooperatives also benefit from labor management in comparison with capital management.[38] With respect to productivity, cooperatives fare at least as well if not better than their capitalist competitors. U.S. producer cooperatives have higher labor productivity than capitalist firms in many cases.[39] A review of eleven economic studies of the effect of worker decision-making on productivity in labor managed firms found that the relationship was positive in seven cases, negative in two, and zero in two.[40] The plywood cooperatives of the Pacific Northwest showed a 6-15 per cent productivity advantages over conventional mills.[41] The Mondragon cooperatives of Spain "are more efficient than many private enterprises" on several measures of productivity and "have been more profitable than capitalist enterprises."[42] In the mid 1970s, Seymour Melman

---

[37] Freeman & Rogers, *supra*, note 35, at 116. The productivity advantage capitalist firms with EI programs have over ones without is broadly an increase of 2 to 5 percent. *Id.* at 105. In my companion piece to the present Article, Schwartz, *Voice without Say*, *supra* note 2, I address the question, parallel to that raised here, "why doesn't every firm do it?"

[38] Work satisfaction in the U.S. plywood cooperatives was higher than in capitalist plants, Greenberg, WORKPLACE DEMOCRACY: THE POLITICAL EFFECTS OF PARTICIPATION 93 (1986), though 60-66 percent of the plywood cooperators said that if they were to leave, either would not care whether they worked in a cooperative (50.6 percent) or would prefer not to. *Id.* at 90-91. Mondragon cooperators were far more positive, 77 percent of a survey sample agreeing that they made the correct decision when they joined. Thomas & Logan, *supra* note 16, at 190. Reviewing international comparisons with the U.S. plywood cooperatives, Mondragon, the former Yugoslavia, and the kibbutzim. Greenberg, writing in 1982, stated that "without exception, each of these self-managed enterprises of system . . . had made solid advances" in "areas having to do with control over the product and the [profits], formal decision-making processes concerning the enterprise, and work satisfaction." *Id.* at 123-14.

[39] Derek Jones *U.S. Producer Cooperatives: The Record to Date*, 8 INDUS. RELATIONS 342 (1979).

[40] Dow, supra note 7 at 182-83 (citing Chris Doucouliagos, *Worker Participation and Productivity in Labor-Managed Firms and Participatory Capitalist Firms: A Meta-Analysis*, 49 INDUS. & LAB. RELATIONS REV. 301 (1985).

[41] *Id.* (citing Ben Craig & John Pencavel, *The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest,* 82 AM. ECON. REV. 1083 (1992)).

[42] Thomas & Logan, *supra* note 16, at 109. It is telling that cooperative employment in manufacturing made up only about 3 percent of the Basque population so employed, but cooperative investment was about 77 percent of all Basque industrial investment. *See* Whyte & Whyte, *supra* note 16, at 219 (1981 figures). The plywood cooperatives showed a 6-15 per cent productivity advantages over conventional mills. *Id.* (citing Ben Craig & John Pencavel,

found that the highly democratic Israeli kibbutzim "showed higher productivity of labor (26 percent), higher productivity of capital (67 percent and 33 percent), larger net profit per production worker (115 percent) and lower administrative costs.[43] In the mid-1980s, most kibbutzim experienced serious economic problems, [44] apparently due to soaring debt at a time of severe inflation, together with unwise stock market speculation.[45]

Another dimension of comparison is the "death" rates of labor managed firms versus capital managed firms. A 1988 study of the "death" rates from all sources, including dissolution and conversion to capitalist firms, showed that the relative rates in France were 6.9 percent for labor managed firms and 10 percent for capital managed manufacturing firms; in the U.K., 6.3 percent for labor managed firms to 10.5 percent for all industries, 9 percent in Italy, where, the cooperative sector is one of the most robust in the world.[46] Dow concludes that labor managed

---

The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest, 82 AM. ECON. REV. 1083 (1992)).

[43] Seymour Melman, *Industrial Efficiency Under Managerial versus Cooperative Decisionmaking: A Comparative Study of Manufacturing Enterprises in Israel*, in 2 SELF-GOVERNING SOCIALISM 203, 208-211 (Branko Horvat, *et al.*, eds. 1975).

[44] *See* Gavron, *supra* note 16, at 139 (noting that only 45 or so of the 270 kibbutzim remained in a prosperous or reasonably good financial situation). Gavron's conclusions are ambiguous if not actually mutually inconsistent. He states that the facts that "some fifty relatively successful kibbutzim prove than the system *can* work," *id.* at 152, but also that the seven-decade survival of the kibbutz was "in some ways an optical illusion . . . . the economic failure of many kibbutzim was hidden from view," *id.* at 157, because "in previous economic crises somebody was always available to pick up the tab," *id.* at 154, including the other kibbutzim and the Israeli government. Economists call this "moral hazard," "the greater tendency of people who are protected from the consequences of risky behavior to engage in such behavior." Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 201-04 (2008).

After the near-collapse of the capitalist financial system of 2008, the difference with respect to efficiency, between the need for a guarantor of last resort for the kibbutzim and many of the largest U.S. corporations is far from evident. *See, e.g.* Andrew Ross Sorkin, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS – AND THEMSELVES (2009) (discussing, *inter alia*, the Troubled Assets Relief Program (TARP), the Emergency Economic Stabilization Act § 101, 12 U.S.C § 5211, which pumped over $1 trillion into the coffers of America's largest corporations; Richard A. Posner, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009) (similar, from a more analytical perspective).

[45] *See* Gavron, *supra* note 16, at 144-145 (inflation and debt), 157 (stock speculation). Gavron attributes the crisis, ultimately, to a decay in the kibbutzim's original utopian motivations as market pressures and consumerism triumphed over the egalitarian values that had sustained the kibbutzim for most of the 20th century. *Id.* at 283. Degeneration for various reasons is a problem for labor managed firms. *See supra* note 7, *infra* note 190. But this is not the issue that occupies us here.

[46] *See* Avner Ben-Ner, *On the Stability of the Cooperative Form of Ownership*, 8, J. COMP. ECON. 241 (1988) (cited in Dow, *supra* note 7, at 226). Dow remarks that the death rate for labor managed firms in the Netherlands and

firms are "not rare because they fail disproportionately often. Once created they appear robust. Rather, they are rare because they are created much less often than [capital managed firms]."[47]

Furthermore, labor managed firms do actually tend to embody many of the democratic and labor friendly features that Mill and other advocates of this form of organization hoped for: employment security, egalitarian pay scales, genuine participation with managerial authority in all aspects of firm policy, transparency as to finances, and democratic control of the enterprise, among other attractions.[48] In sum, Mill was right about the efficiency advantages and other appeals of labor management. But this only heightens the puzzle.

4. *Where Mill was Mistaken*

Mill was mistaken, and Marx correct, at least about the tendency for labor managed firms to displace capital managed firms in the ordinary operation of the market. Producer cooperatives remain a decidedly minor form of productive organization. Part of the issue is definitional: what is a labor managed firm, and is it the same thing as a cooperative? We may understand labor

---

Sweden is over four times that in France of the U.K., but attributes this to the fact that cooperative sector in those countries being smaller and newer. *Id.*

[47] Dow, *supra* note 7, at 227.

[48] For example, in the Plywood cooperatives, apart from the higher-paid general manager, the worker-owners "normally receiv[ed] equal pay," Dow, *supra* note 7, at 53 (citing Ben Craig & John Pencavel, *The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest,* 82 AM. ECON. REV. 1083 (1992)). Cooperative membership guaranteed the workers a job at whatever the coop was paying. *Id.* at 54. Although in theory members could be fired, and in most plants one or two actually had been, "the ability of the organization to discharge an owner is severely restricted." *Id.* at 55. The directors were currently employed owner-workers, *id.* at 54, and members had, and routinely exercised, a right to examine any firm data or documents they wished. *Id.* at 54. "In general the coops exhibit[ed] a robust form of organization democracy where representative institutions are reinforced by rather wide-spread participation on part of individual workers." *Id*. (citing Greenberg, *supra* note 38). In the less directly democratic Mondragon co-operatives, where workers elect a Governing Council annually, *id.* at 59, which was responsible for appointing or hiring managers, *id.* at 59, there is a limited ratio, typically one to three between the lowest and highest wages, *id.* at 60 (after 1985, widened to one to six, *id.* at 63). There had been no layoffs in any coop prior to 1983, *id.* at 62, and after that, only 30 of (then) 18,000 members had to take advantage of Mondragon's internal unemployment insurance. *Id.* Organizational changes giving more authority to management and increased use of hired labor have created debates about to what extent Mondragon remained democratic, *id.*, *see also* Sharryn Kasmir, THE MYTH OF MONDRAGON: COOPERATIVES, POLITICS, AND WORKING-CLASS LIFE IN A BASQUE TOWN (1996); George Cheney, VALUES AT WORK: EMPLOYEE PARTICIPATION MEETS MARKET PRESSURE AT MONDRAGON (updated ed.1999), Mondragon has "retained internal democratic structures at the level of the coop." Dow, *supra* note 7, at 64. *See also infra* notes 134, 136.

(self) management[49] for our purposes on analogy to capital management: in the capital managed firm, ultimate control rests with the investors or their representatives, while in the labor managed firm, ultimate control rests with the workers or their representatives.[50] For reasons I discuss elsewhere,[51] all or virtually all existing labor-managed firms in capitalist societies are worker cooperatives, that is, worker owned enterprises,[52] but not vice versa.[53] Terms like "labor owned" and "labor managed" are often used interchangeably in the literature, which, like Hansmann,

[49] It is common in the literature to refer to an enterprise in which management decisions are made by workers themselves or their elected representatives or hired managerial employees a worker *self*-managed firm, perhaps for emphasis and perhaps because "labor management" could be ambiguous between the management of labor *by* capital, or in any event not by workers, and management of labor by themselves. For the sake of greater brevity and parallelism with "capital management" (itself, incidentally potentially similarly ambiguous), I mean by labor management throughout this Article the management of the enterprise primarily by, or under the control of, the workers who work there.

[50] *See* Dow, *supra* note 7, at 5. Dow refines this rough distinction by saying that "[a] capital managed firm (KMF) is defined as an enterprise in which ultimate control is allocated by virtue of an in proportion to capital supply, while a labor managed firm (LMF) assigns control by virtue of, and in proportion to labor supply." *Id.* Schweickart defines worker-self management by saying: "Each productive enterprise is managed democratically by its workers." Schweickart, AGAINST, *supra* note 5, at 68. He continues:

> Each productive enterprise [a term he does not define] is managed by those who work there. Workers are responsible for the operation of the facility: organization of the workplace, factory discipline, techniques of production, what and how much to produce, how the net proceeds are to be distributed. Decisions are made democratically: one person, one vote. Of course in a firm of some significant size, some delegation of authority will doubtless be necessary.

Id. Gunn offers a three-part definition of what he calls "worker's self-management": (1) shared goals, including but not exhausted by "maximizing income per worker," Christopher Gunn, WORKER SELF-MANAGEMENT IN THE UNITED STATES 17 (1984), (2) "absence of *direct* external control, either by capital owners by an autocratic government hierarchy" (emphasis in original), *id.*, and (3) "process based on democratic principles – rules and procedures that allow all participants an equal voice in the management of the organization." *Id.* Hansmann, whose *official* main focus is on comparing ownership rather than management structures, does not appear to attempt to define any practice of labor management. *See generally* Hansmann, ENTERPRISE, *supra* note 2. For reasons of simplicity and because I do not wish to build in as a matter of definition, any particular form of control such as one-worker/one-vote, I adopt Dow's more austere conception.

[51] *See* Schwartz, *Voice without Say*, *supra* note 2 (offering an explanation of why genuine participation and more or less full labor ownership are causally linked).

[52] Schweickart's self-managed firms *would* not be cooperatives, so defined. "Although the workers manage the workplace, they do not own the means of production. These are the collective property of society." Schweickart, AGAINST, *supra* note 5, at 69; accord Michael W. Howard, SELF-MANAGEMENT AND THE CRISIS OF SOCIALISM: THE ROSE IN THE FIST OF THE PRESENT 14-15 (2000) (defending Schweickart's view).

[53] In their American Bar Association study of the law of cooperatives, Charles Autry and Roland Hall fail to include labor management as a feature of the cooperative. They define a cooperative as one owned and democratically controlled by "the people who use its services or buy its products," of the law of cooperatives, Charles T. Autry and Roland F. Hall, THE LAW OF COOPERATIVES (2009). It is possible that "use of services" includes employment, but Autry and Hall do not elaborate.

focuses at least formally more on ownership than control,[54] leading to some confusion about the topic of discussion and the causal structure of the phenomenon to be explained. Labor ownership, to a greater or lesser degree, need not involve labor management. At least in the United States, where (partial) labor ownership typically takes the form of the Employee Stock Ownership Plan (ESOP),[55] it typically does not involve labor management, and may not even involve a significant degree of labor participation. Accordingly, I devote attention to forms of labor ownership, such as ESOPs, where "control over the firm generally remains in other hands,"[56] only insofar as these provide evidence about labor management. I set aside the German policy of legally enforced "codetermination" (*Mittbistimmung*), which involves worker representation on the boards of large firms,[57] but which seems to have little if any measurable

[54] *See* Hansmann, ENTERPRISE, *supra* note 2, at 11 (stating that a firm's "'owners . . . are those persons who share two formal rights: the right to control the form and the right to appropriate the firm's profits, or residual earnings" and noting that "formal control . . . does not necessarily mean effective control"), *see also id.* at 13 (defining, in a hypothetical example of a milk coop, "*ownership* rights [as being] held by virtue of, and proportional to, one's sale of milk to the firm) (emphasis added). When Hansmann, among other writers, treats concrete examples, however, such as the plywood cooperatives in the U.S. Pacific Northwest or Mondragon in Spain, his focus tends to be more on control, specifically on the sort of managerial decisions that Schweickart mentions, Schweickart, AGAINST, *supra* note 50. Those are typically included as among the bundle of rights that comprise ownership, but ownership [Hansmann's right to appropriation of residual earnings] need not include managerial rights. *See also* Dow, *supra* note 7, at 2-3, 113 (illustrating with useful tables how ownership and control are independent dimensions of firm organization).

[55] ESOPs, enabled by legislation introduced, beginning in 1973, by Senator Russell Long, son of Huey Long ("the Kingfish"), a former Louisiana governor and a populist United States Senator), are deferred compensation or qualified retirement plan under ERISA and the tax code. There today are roughly 11,000 such plans covering roughly ten million employees. *See* Andrew Stumpff: *Fifty Years of Utopia: A Look Back at Louis Kelso's* The Capitalist Manifesto *and the Weird History of the ESOP*, 62 TAX LAW. 419, 431 & n.75 (2009). Kelso, an economist turned banker, was the intellectual entrepreneur who sold Senator Long, Chairman of the Senate Finance Committee, and a populist himself, on the idea. *Id.* at 421. *See* Louis O. Kelso and Mortimer J. Adler, THE CAPITALIST MANIFESTO (1958); Joseph R. Blasi & Douglas L. Kruse, THE NEW OWNERS: THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS (1991).

[56] Hansmann, ENTERPRISE, *supra* note 2, at 69. In 1986, a federal government survey of 3,000 ESOPs found formal employee involvement in decisionmaking in no more than 15 percent, "informal" participation in 76, but largely restricted to safety, working conditions, and other immediate worker concerns (overall 42-30 percent) rather than organizational goals or means to meet them (overall 13-11 percent); moreover, while overall 95 percent of the surveyed firms allowed workers to make suggests and 33 percent allowed some degree of shared decision-making with management, only in 10 percent of the surveyed ESOPS did employees make decisions on their own. Joseph R. Blasi: EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF? 202-204 (1986) (citing U.S. GAO, EMPLOYEE STOCK OWNERSHIP PLANS: BENEFITS AND COSTS OF ESOP TAX INCENTIVES FOR BROADENING STOCK OWNERSHIP 41-43 (1986)).

[57] *See, e.g.,* Dow *supra* note 7, at 83-91,

effect on firm operation or performance.[58] Although I have adopted the austere definition of a producer cooperative for analytical purposes, labor management and ownership in producer cooperatives are generally associated with egalitarian and democratic organizational features that distinguish them from capitalist enterprises and which constitute their main interest to Mill and most modern students.[59]

The terminological imprecision also creates difficulty in arriving at even rough measures of the rarity of the labor owned *or* managed firm in modern market economies. The broad outlines, however, are clear even if numbers vary: essentially, labor managed firms is a "peripheral form of organization that prospers only in narrow niches."[60] According to the Census Bureau, in 2002 there were 23,343,821 firms in the United States, of which 5,687,759 hired employees.[61] A 2005 survey by the University of Wisconsin Center for Cooperatives (UWCC) found 21,367 cooperatives in six sectors, none industrial or manufacturing; and a 2004 UWCC study counted 400 worker cooperatives, excluding ESOPs.[62] Hansmann's 1991 figures for farm

---

[58] *See* Hansmann, ENTERPRISE, supra note 2, at 111-12 ("Codetermination has not had a substantial impact on firm decision making at the board level, which continues to be dominated any shareholder interests . . . . Worker representatives. . . . arguably play a largely informatuional role . . . . [and do not appear to] exercise meaningful control.").

[59] *See supra* note 48 and accompanying text, and *infra* note 136.

[60] Dow, *supra* note 7, at 47. Speaking merely of employee ownership, such "firms are rare in the industrial sector of the American economy." Hansmann, ENTERPRISE, *supra* note 2, at 66.

[61] U.S. Census Bureau, *Statistics about Business Size* (including Small Business) from the U.S. Census Bureau, http:/www.census.gov/epcd/www/smallbus.html, accessed 3/11/2011.

[62] The National Cooperative Month Planning Committee of the University of Wisconsin's Center for Cooperatives (UWCC) counted 21,367 cooperatives, COOPERATIVE BUSINESS IN THE UNITED STATES: A 2005 SNAPSHOT 4 (2005), *at* http://www.uwcc.wisc.edu/info/stats/uscoopbus05.pdf, accessed July 14, 2011 (copy on file with author). The sectors were: agricultural, financial (credit union and farm credit), electric utilities, and grocery. *Id.* p. 1. The Committee noted that "other sectors" including "worker coops" were not easily covered in the survey. *Id.* at 3. The agricultural and electrical power coops surveyed were the closest things to productive firms, and involved revenues and assets in the billions. *Id.* at 4. Autry and Hall gleaned from U.S. government sources a figure of 47,000 cooperatives, *see supra* note 53, at 4. Their definition of cooperatives, which excludes labor managed firms, must be taken into account in assessing the usefulness of this figure for our purposes. According to a 2004 study by UWCC the University of Wisconsin's Center for Cooperatives stated, "[t]here are approximately 400 *worker* co-ops [distinguished from ESOPs] in the U.S. In general, they are 100% worker-owned and ascribe to the cooperative principle of "one member, one vote". They vary widely in their management and pay structures, from remarkably "flat" to more conventionally hierarchical. The country's largest worker owned co-op is Cooperative Home Care, a home health care agency in the Bronx . . . . [w]ith 780 employees. . . . Most worker co-ops are much smaller, ranging from 20-200 employee-owners." Greg Lawless & Anne Reynolds, *Worker Cooperatives: Case Studies, Key*

marketing and producing cooperatives are broadly consistent with these results.[63] Based on these figures, worker cooperatives, that is, worker owned and managed firms, excluding ESOPs and professional service partnerships, constituted 0.007 percent of U.S. producer firms with employees. Such firms can have more economic weight than their size would indicate. The plywood cooperatives of the Pacific Northwest were the most successful labor owned and managed industrial enterprises in the U.S. in the 20th Century.[64] At their height in the early 1960s, roughly 27 plywood manufacturers, each employing several hundred workers, were cooperatives. They accounted for 25 percent of the industry's output during World War II,

---

Criteria, and Best Practices, UWCC Staff Paper No. 3, 1 (July 14 2004) (emphasis added) (copy on file with author).

[63] *See* Hansmann, ENTERPRISE, *supra* note 2, at 120. He also discusses retail, wholesale and supply firms, utilities, clubs, housing, nonprofits, banks, and insurance. In addition, more questionably, Hansmann treats law firms and other sorts of professional partnerships as labor owned and-managed enterprises, *Id.* at 67 ("Partnerships and professional corporations common in the service professions . . . are among the world's purest examples of employee ownership . . . [and these professions] are virtually the only industries dominated by employee owned firms."); *see also* Dow, *supra* note 7, at 49-50 (stating without discussion that professional partnerships are "arguably the largest category of worker-controlled enterprise in modern economies"; Dow does not give this form of cooperative management and ownership significant discussion in his account, concentrating instead of classically understood producer cooperatives.).

While smaller law and other professional service firms organized as partnerships may approximate producer labor management and ownership, there is significant variation. The larger firms are, unlike standard labor managed enterprises, extremely "hierarchical," Marc Galanter & Thomas M. Palay, *Why the Big Get Bigger: The Promotion-to-Partner Tournament and the Growth of Large Law Firms*, 76 VA. L. REV. 747 (1990), reprinted in LAWYERS: A CRITICAL READER 57 (Richard L. Abel, ed. 1997). The average ratio of associate employees and non-equity partners to equity partners among the *AmLaw* 200 highest grossing law firms of 2.40:1, *see* Benjamin L. Landis, *Financial Health Indicators Diverge Wildly Among AMLAW 200 Firms*, 23 NO. 6 OFCOUN. 10, 10 (2004). Even an overall average counting smaller law firms indicates that hired employees are common in smaller firms. The average ratio of associates to partners in law firms nationwide was .67 in 2005 (i.e., 67 associates for every 100 partners, *Firm Finances*, 06-10 PARTREP. 4 (2006). Accounting firms were far more skewed. "The Big Six are generally characterized by taller hierarchies and considerably higher associate-to-partner ratios. . . . For example, in 1989 Arthur Andersen & Co., one of the [then] Big Six, had 40,136 professional personnel, of whom 2,405 (6.0%) were partners." Galanter & Palay, *The Many Futures of the Big Law Firm*, 45 S.C. L. REV. 905, 913 (1994).)

Moreover, larger professional partnerships rarely embody the democratic structures characteristic of producer cooperatives. "[U]ndemocratic corporate law firms," Laura Nader, *Controlling Processes in the Practices of Law, Hierarchy and Pacification in Movement to Reform Dispute Ideology*, 19 OHIO STATE J. DISP. RES. 1, 23 (1993) is virtually a redundant expression. Some courts are coming to recognize that under an economic reality test, mere ownership does not make many equity law firm partners anything but de facto employees in the traditional sense, *see, e.g., EEOC. v. Sidney Austin Brown and Wood*, 315 F.3d 696, 706 (7th Cir. 2002); David B. Wilkins, *Partner, Shmartner! EEOC v. Sidney Austin Brown and Wood*, 120 HARV. L. REV. 1264 (2007). For these reasons, among others, I set aside data regarding professional partnerships as not genuinely pertinent to the concern at hand: genuine labor management and ownership.

[64] *See* Greenberg, *supra* note 38; *see also* Gunn, *supra* note 50, at 99-131 (chap. 4) (citing studies) and Dow, *supra* note 7, at 50-57.

diminishing to about 10 percent by the 1960s and 1970s.[65] Just three remained labor managed cooperatives at the turn of the 21st century. [66] "Peripheral," is, if anything, a gross overstatement.

The situation is marginally less dismal for the labor managed firm in Western Europe,[67] notably in Italy, which had around 11,000 labor managed firms employing 428,000 workers in 1981, and France, which had 1,300 firms with roughly 34,000 workers in 1986.[68] Since the beginning of the last century Israel has had the kibbutz, comprising a combination of cooperative housing arrangements with productive enterprises. There were 267 kibbutzim in 2000, with from

---

65 *See* Gunn, *supra* note 50, at 100-102."'The plywood cooperatives are not a movement but a phenomenon. Excluding the four earliest mills, this phenomenon took place between 1945-1955." Dow, supra note 7 at 53 (citing Carl Bellas, INDUSTRIAL DEMOCRACY AND THE WORKER-OWNED FIRM: A STUDY OF TWENTY-ONE PLYWOOD COMPANIES IN THE PACIFIC NORTHWEST 31 (1972)).

66 Dow, *supra* note 7, at 50 (citing John Pencavel, WORKER PARTICIPATION: LESSONS FROM THE WORKERS CO-OPS OF THE PACIFIC NORTHWEST (2001)).

67 Outside the industrialized West, the labor managed (but not labor owned) firm became the predominant organizational form in the former Yugoslavia for roughly forty years, between 1950 and the self-destruction of Yugoslavia in 1989. *See* Joel B. Dirlam & James L. Plummer, AN INTRODUCTION TO THE YUGOSLAV ECONOMY (1973); Branko Horvat, THE YUGOSLAV ECONOMIC SYSTEM: THE FIRST LABOR-MANAGED ECONOMY IN THE MAKING (1976); Milovan Djilas, THE UNPERFECT SOCIETY: BEYOND THE NEW CLASS (1969); Harold Lydall: YUGOSLAV SOCIALISM: THEORY AND PRACTICE 191 (1984) ("Yugoslavia did remarkably well for thirty years [until the mid 1980s.]" (Lydall is a harsh critic of the Yugoslav model.)

Thinkers will debate the reasons for its crisis and its relation to the bloody collapse of the Yugoslav state for a long time to come. *See, e.g*. Louis Sell, SLODOBAN MILOSOVIC AND THE DESTRUCTION OF YUGOSLAVIA (2002) (attributing the collapse of Yugoslavia to nationalism and partisan politics); Lenard J. Cohen, BROKEN BONDS: THE DISINTEGRATION OF YUGOSLAVIA (1993) (explaining the collapse as a matter of political failure to accommodate competing regional needs); Catherine Samary, YUGOSLAVIA DISMEMBERED (Peter Drucker, trans.) (1995) (contending that the catastrophe was due to regional resentment along nationalist lines due to neoliberalism and foreign intervention that encouraged ethnic cleansing); Susan L. Woodward: SOCIALIST UNEMPLOYMENT: THE OF YUGOSLAVIA, 1945-1990 (1995) (arguing that international debt and failures of self-management created an intolerable level of unemployment that had centrifugal effects when it fell unequally on different republics within the Yugoslav federal system).

The Yugoslav experience is rich in lessons for the understanding of the labor managed firm and economy. However, Yugoslav labor management was imposed top down by the *ukase* of the Yugoslav Communist Party, *see* Djilas, The UNPERFECT SOCIETY, *supra* at 220-23); Schweickart, AGAINST, *supra* note 5, at 61, and so its *genesis* is not pertinent to the question I address here, which is rather why, in a market system, labor managed firms do not marginalize capital managed ones by the operation of market forces, as Mill predicted, rather than vice versa. For this and for reasons of manageability, I here largely set aside the Yugoslav evidence.

68 Dow, *supra* note 7, at 47. Earle gives a higher figure for Italy in 1986. *See* John Earle, THE ITALIAN COOPERATIVE MOVEMENT (1986); Hansmann cites 1981 figures for France of "several hundred" worker cooperatives employing about 40,000 persons, of whom 61 percent were members, Hansmann, ENTERPRISE, *supra* note 2, at 67, and in Italy of "several thousand" worker coops employing about 215,000 workers (citing Mark Holmstrom, INDUSTRIAL DEMOCRACY IN ITALY: WORKERS CO-OPS AND THE SELF-MANAGEMENT DEBATE 6, 21 (1989), and R. Oakeshotte, THE CASE FOR WORKER'S CO-OPS 123, 146 (1978)).

100 to 1,000 members each.[69] A recent study describes the kibbutz movement, itself a rather special product of unique circumstances, as "in a state of turmoil,"[70]

Hands-down, the most successful, long-lasting experience with this form of organization is the Mondragon group in Basque country in northern Spain.[71] Starting as a trade school in the early 1940s, Mondragon opened its first producer coop with five workers in 1954.[72] As of the turn of the 21st century, Mondragon had about 150 member cooperatives,[73] including dozens of manufacturing firms, among them Spain's leading tool and die maker and the leading refrigerator manufacturer;[74] as well as enterprises producing electronics, and some involved in education, research and development, and retail sales.[75] It had about 42,000 employees,[76] up from 15,000 in 1979,[77] organized in cooperatives averaging about 225 workers each,[78] and capped at 350-500.[79] Mondragon had $7 billion in annual sales and was the tenth largest private firm in Spain.[80] The failure rate of Mondragon member co-ops is less than three percent.[81] Although Mondragon has representation or acquired firms in about twenty other countries, including China, India, and

---

[69] Gavron, *supra* note 16, at 1 (2000). The number has remained stable since 1954, *see* Spiro, *supra* note 16, at 5.
[70] Gavron, *supra* note 16, at 1. His conclusion is that with the decay of the idealistic and collectivist values that imbued the early kibbutzniks, *id.* at 158, 187, 282, "[t]he kibbutizim will conue to exist as settlements, . . . [but] they will not be kibbutzim," *id.*
[71] Mondragon is the subject of a vast literature. Central studies include Thomas & Logan, *supra* note 16, Whyte & Whyte, *supra* note 16; Roy Morrison, WE BUILD THE ROAD AS WE TRAVEL: MONDRAGON, A COOPERATIVE SOCIAL SYSTEM (1991); Kasmir, *supra* note 48; Cheney, supra note 48.
[72] *See* Whyte & Whyte, *supra* note 16, at 27-31. The first cooperative, Ulgor, made domestic appliances, was established by conversion of a capital managed firm in 1954 by five graduates of the school and the entrepreneurial founder, a priest, Don Jose Maria Arizmendiarrieta. *See infra* notes 273-81 and accompanying text for more discussion.
[73] Dow, *supra* note 7, at 64
[74] *Id.*
[75] *Id.* at 61.
[76] *Id.* at 64.
[77] *Id.*
[78] *Id.*
[79] *Id.* at 62. This followed the cooperatives' only strike, at one unit, Ulgor, that had grown past 3,000 workers. *Id.* at 61-62.
[80] *Id.* at 64.
[81] *Id.* at 61.

several North African and Latin American countries,[82] in part by converting capital managed firms to cooperatives,[83] this highly successful organizational model has not been much imitated elsewhere and shows no signs of either attracting large numbers of workers away from wage labor in capital managed firms, contrary to Mill's prediction,[84] or forcing capitalists to "place the operations of industry on such a footing,"[85] Given that cooperatives are legal[86] and workers (or indeed capitalists) might do as Mill suggested, why have they not? Thus Jon Elster's pointed question: "If cooperative ownership is so desirable, why are there so few cooperatives?"[87] More crisply, where did Mill go wrong?

II. THREE TRANSACTIONS COST EXPLANATIONS

A. The Evolutionary Hypothesis, the Coasean Background, and Transactions Cost Analysis

In a suggestive article in 1950, the economist Armen Alchian argued, [88] on the model of natural selection in biological evolution, that markets select for firms that embody features, such as organizational forms which, for whatever reason they are adopted, are in some sense more efficient in comparison to the competition.[89] "The realization of profits is the criterion according to which successful and surviving firms are selected,"[90] so that "if all firms are slightly different . . ., those who have their fixed internal conditions closer to . . . the optimum position [in a given

[82] *Id.*
[83] *Id.* at 64
[84] *See* Mill, POLITICAL ECONOMY, *supra* note 4, at 760-61.
[85] *Id.* at 761-62. Mill gives two grounds for this prediction: social and moral pressure in the face of class conflict, *id* and economic advantage, as labor managed firm would, Mill supposed, "tend more and more to absorb all work-people," *id.* at 791, leaving capitalists at a disadvantage in competition for labor.
[86] *See* Hansmann, Enterprise, *supr*a note 2, at 85-87.
[87] Jon Elster, *From Here To There, or, If Cooperative Ownership Is So Desirable, Why Are There So Few Cooperatives*? *in* SOCIALISM (Ellen Frankel Paul, *et al.* eds. 91 (1989) Unfortunately, Elster offers no answer. "The argument of this paper is apparently inconclusive: We just don't know whether the observed lack of cooperatives is due to their inherent inferiority or to interactions with the non co-operative environment." *Id.* at 110.
[88] Armen E. Alchian, *Uncertainty, Evolution, and Economic Theory*, in Economic Forces at Work, 58 J. POL. ECON. 211 (1950) [hereinafter Alchian, *Uncertainty*], reprinted *in* ECONOMIC FORCES AT WORK 1 (1970).
[89] *Id.* at 20. The appeal to the notion of "efficiency" raises all the questions about what is meant by that slippery term, *see* Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, *in* MARKETS, MORALS, AND THE LAW 93, 97-98 (1988) (defining and explaining these terms); I discuss the meanings of "efficiency further in Schwartz, *Voice without Say*, *supra* note 2.
[90] Alchian, *Uncertainty*, *supra* note 88 at 19.

set of conditions] will have a greater probability of survival. They will grow relative to other firms and become the prevailing type . . . ."[91] In general, in a competitive environment "the force of competitive survival . . . [will] eliminate higher cost firms. . . . "[92] Applying this idea to the question at hand, as Alchian did only in passing, the philosopher N. Scott Arnold stated that "[t]he organizational forms of business firms can be given an evolutionary explanation by reference to the market test of relative efficiency. If an organizational form . . . is common and . . . persist[s], then there is probably some efficiency advantage."[93] Alchian also emphasized that convergence due to competitive pressures is fueled by imitation,[94] and that comparative efficiency of different "patterns of behavior and organization are predictable *if* they are tried."[95] I shall return to these related important qualifications.

Granting Alchian's Darwinian hypothesis, if labor management really offers efficiency advantages over traditional capitalist firms, should not cooperative forms of enterprise organization proliferate, ultimately marginalizing capital management in the way that, in fact, capitalist enterprise has marginalized cooperative organization? In the labor owned cooperative

---

[91] *Id.* at 25. It will be noticed that I, like almost everyone else who writes on the subject, use productivity, output per factor input, as a proxy for profitability. Direct profitability comparisons between capitalist firms and cooperatives are extremely scanty. David Schweickart suggested to me in conversation (May 22, 2011) that one reason this is that profit, thus profitability, means different things for these different forms of organization. Profit is usually understood as as net return on investment. Net return is what is left after paying the cost of the factors of production, including, traditionally, labor, raw materials, machinery, rent or mortgage on real estate, interest on loans, taxes and the like. The point Schweickart made was that for capitalist enterprises, labor is a cost: wages to workers mean less for the investors and owners, but for cooperatives, *labor is not a cost*. The workers *are* the owners, so net return on their investment *is* their profit. This makes direct comparison difficult. It is possible to construct metrics that control for the difference, but the informativeness of the results would be debatable. For this reason, productivity is probably a better measure when comparing capitalist firms to cooperatives. One uses the data one has, and for the most part the comparisons of all sorts of firms in the literature refer to productivity.

[92] *Id.* at 27.

[93] Arnold, PHIL AND ECON., *supra* note 10, at 105*; Market Socialism*, *supra* note 10, at 534 (citing Alchian, *Uncertainty*, *supra* note 88); and PHIL. AND ECON. *supra* note 10, at 102-105. Arnold, strictly speaking addresses market socialism, not merely or only labor management, but his point applies to the more limited target as well.

[94] Alchian, *Uncertainty*, *supra* note 88 at 28-30.

[95] *Id.* at 32 (emphasis in original).

there is, or need be, no group of owners or investors apart from the workers themselves[96] who control production. On the contrary, it would seem that worker-owners who claimed the entire residual enterprise income as their own and also determined management practices would have a strong incentive, other things being equal, to choose the most productive organizational forms. The empirical evidence is that participatory forms with employee ownership are more productive.[97] This poses the question, where did Mill go wrong? If the micro-efficiencies on the firm level are real, why have not cooperatives proliferated and beaten capitalist firms in the market? Capitalists may have little or no interest in offering worker participatory options,[98] but workers need not rely on capitalists. They can form cooperatives and make these options themselves. As we have seen, overwhelmingly, they do not.

The theory underlying the sort of objections considered here proceeds from the insight, assumed away in neoclassical economic models,[99] is that economic interactions – transactions – are themselves costly. This is one of those points so obvious that it is in fact profound and which has wide-ranging implications for economic analysis. In 1937 Ronald Coase[100] argued famously that the reason the economy is organized into firms at all instead of individuals contracting bilaterally with each other or all economic activity coming under the roof of a single firm, as in a

---

[96] Cooperatives require capital, and perhaps may need more than workers can generate from their own resources or even from the income stream of an established enterprise. Dow, *supra* note 7, and others, argue that it is the lack of investor confidence in repayment by cooperatives that largely explains why this organizational form is rare. *See id.* at 188-89, 236-38. I address this explanation in Part II(C).

[97] Participation enhances productivity most when combined with profit sharing, job security, narrow wage differentials, and enhanced worker. David Levine & Laura Tyson, *Participation, Productivity, and the Firm's Environment*, PAYING FOR PRODUCTIVITY: A LOOK AT THE EVIDENCE 203 (Alan Blinder ed. 1990) [hereinafter PAYING FOR PRODUCTIVITY](cited in Schweickart, AGAINST *supra* note 5, at 100); Martin L. Weitzmann & Douglas L. Kruse, *Profit Sharing and Productivity, in* PAYING FOR PRODUCTIVITY *supra at* 95 (cited in Bainbridge, *Participatory Management*, *supra* note 36, at 703 n.280

[98] Why capitalists and capitalist management do not rely more on worker participation than they do, given the efficiency advantages of such participation is a further puzzle, in many ways no less perplexing that the one I consider here. My answer is set forth in Schwartz, *Voice without Say*, *supra* note 2.

[99] *See* note 6.

[100] Ronald Coase, *The Nature of the Firm, in* THE FIRM, THE MARKET, AND THE LAW 33, 40 (1988) (reprinted from 4 ECONOMICA, *N.S.* 386 (1937.

planned economy, is because that the boundary between the firm and the market was drawn roughly at the point that it became in some sense more efficient for economic actors to organize their economic "bureaucratically," in a firm-like manner, than contractually, by agreeing separately on each thing to be done. As Coase himself put it fifty years later:

> Whether a transaction would be organized within the firm . . . [or integrated] or whether it would be carried out on the market by independent contractors depended on a comparison of the costs of carrying out these market transactions with the costs of carrying out these transactions within an organization, the firm. [101]

Coase is generally regarded as discussing the explanation for the existence and boundaries of traditional hierarchically organized capital owned and managed enterprise as an alternative to a firmless economy consisting of contracting individuals or a centrally planned economy consisting, in effect of one large nonmarket firm. However, nothing in Coase's insight by itself requires traditional, hierarchical organization within the firm. The internal organization of the firms resulting from transactional efficiencies might be labor managed and democratic[102] even if a Coasean explanation of existence of the firms is correct.

Arnold and Hansmann offer arguments with very different, indeed, inconsistent, transactions cost premises to explain the prevalence of traditional organization and ownership patterns. To some extent the explanations, particularly Hansmann's are plausible and enlightening, and Arnold's, though defective, locates real issues that any enterprise, including a cooperative, must solve. However, they do not solve the problem raised in this Article. In addition to specific problems with each version, both suffer from three grave defects: (1) they are inconsistent with the empirical evidence that supports the efficiency advantages of labor management, (2) they do not explain why the problems that they say beset cooperatives have not also and to a similar degree inhibited the development of corporations, and (3) their purported

---

[101] Ronald Coase, *The Nature of the Firm: Origin*, 4 J.L. ECON. & ORG. 3, 17 (1988).
[102] As noted, there is a rough correlation, *see supra* note 48.

mechanisms kick in too late, explaining (if they do) why any cooperatives that are formed have certain features rather than why cooperatives are not formed to begin with.

B. Transactions Costs Internal to the Enterprise

3. *Arnold: The Fear of the Monitor is the Beginning of Efficiency*[103]

Arnold begins with Alchain's "Darwinian" presumption of efficiency[104] that favors, he thinks, traditional organizational forms, or they would not flourish.[105] For this to be more than handwaving, however, the explanation must identify specific comparative efficiencies on which traditional organization is superior. Arnold suggests, first, that the traditional capitalist firm is more efficient than the cooperative enterprise because it better solves a crucial public goods problem.[106] The problem concerns how to tie (monetary) reward to productivity where team production makes individual output hard to meter.[107] Arnold claims that productive activity faces a *n*-person prisoner's dilemma: If shirkers – or as Arnold prefers to call them, opportunists – get the same rewards as workers, it will be rational for all not to work (as hard), and productivity

[103] *See* 9 *Proverbs* 10 ("The fear of the Lord is the beginning of wisdom") (King James).
[104] Arnold, PHIL. AND ECON., *supra* note 10, at 105; *Market Socialism*, *supra* note 10, at 533 (citing Alchian, *Uncertainty*, *supra* note 88).
[105] Arnold, PHIL. AND ECON., *supra* note 10, at 106; *Market Socialism*, *supra* note 10, at 535. Arnold cites Alchian & Demsetz, *supra* note 2, who specifically defend the efficiency superiorities of the single-owner classical capitalist firm rather than the open corporation, *see* also Fama & Jensen, *Agency Problem*s and *Separation of Ownership*, *supra* note 2. The distinction will be important shortly, *see infra*, notes 126-53, 182-85, 217-19, and accompanying text.
[106] Public goods are defined as goods that satisfy the common interests of members of a group and that members of the group share whether or not they contribute to the creation of those goods; that is, no group member can be excluded from a public good. *See* Olson, *supra* note 13, at 14-15, *see also infra* Part III(A) (explanation of nature of a public goods problem).
[107] Arnold, PHIL. AND ECON., *supra* note 10, at 106; *Market Socialism*, *supra* note 10, at 535-36 (citing Alchian & Demsetz, *supra* note 2, at 778-79).

will suffer.[108] To minimize this, recourse to a monitor with managerial powers is necessary.[109] It is the monitor's job to "put the fear of God in the workers."[110]

Cooperatives use monitors as well.[111] Arnold recognizes that as far as the Alchian-Demsetz account explains anything, it does not explain why the "bosses" (Arnold's term) make crucial strategic investment decisions and supply the firm's capital, that is, why most firms are not cooperatives with some sort of managerial structure. He contends that this is because production is most efficient if managers are *capitalists* or at least non-worker investors, i.e., residual claimants and primary capital providers.[112] The idea is that capitalists must bear the "total wealth consequences" of their decisions, which gives them an incentive to be smart and careful that they would not have if they were using someone else's money and if their reward depended on the further judgment of another monitor.[113] The market is the capitalists' monitor.[114]

As Arnold acknowledges, cooperators – worker owners of labor managed firms – are also residual claimants and must bear the wealth consequences of their decisions.[115] But, first, he says, these consequences are more dispersed, especially in larger firms.[116] Cooperators are fractional rather than full residual claimants,[117] so the public goods problem, the incentive to

---

[108] Arnold, PHIL. AND ECON., *supra* note 10, at 107; *Market Socialism*, *supra* note 10 at 535-36. Arnold defines opportunism as "self-interest seeking with guile." *Market Socialism*, *supra* note 10 at 535-36 (citing Williamson, INSTITUTIONS, *supra* note 9, at 30), a broader notion than shirking. For more on the prisoner's dilemma, *see infra* notes 247-51 and accompanying text.
[109] Arnold, *Market Socialism*, *supra* note 10, at 536.
[110] *Id.* at 539. In his book-length analysis, Arnold takes a classical rather than a Biblical turn and invokes Juvenal's slogan, "*Quis custodiet ipsos custotodes?"* – Who watches the watchers? Arnold, PHIL. AND ECON., *supra* note 10, at 108.
[111] *See, e.g.,* the discussions of the different managerial structures of the plywood cooperatives and Mondragon in Dow, supra note 7 at 53.
[112] Arnold, PHIL. AND ECON., *supra* note 10 at 109; *Market Socialism*, *supra* note 10 at 537 (citing Yoram Barzel, *The Entrepreneur's Reward for Self-Policing*, 25 ECON. INQUIRY 103 (1987).
[113] Arnold, *Market Socialism*, *supra* note 10, at 537
[114] *Id.* Marx insists on a similar point in many places. *See, e.g.,* Marx, CAPITAL1, *supra* note 25 at 381 ("Under free competition, the immanent laws of capitalist production confront the individual capitalist as a coercive force alien to him."), Tucker *supra* note 20, at 376.
[115] Arnold, *Market Socialism*, *supra* note 10, at 538.
[116] *Id.*
[117] *Id.*

shirk or act opportunistically, remains.[118] Second, democratic accountability will tend to produce popular rather than effective managers, so shirking and opportunism will be more prevalent.[119]

This set of superficially plausible arguments faces at least three crucial difficulties.[120] First, cooperative management seems no less effective at monitoring, and may be more so, than capitalist organization. As we have seen, labor management is no less productive than capital management and may be moreso.[121] Second, the problems that Arnold attributes to the cooperative form vis a vis the classical capitalist firm appear no less pronounced there than in the open corporation, which has flourished in modern market economies, albeit without displacing the classical capitalist firm. Third, Arnold's explanation comes in at the wrong stage, explaining (if they do) why cooperatives fail in market competition with traditional capitalist firms rather than why so few of them are formed at all.

The first point concerns the facts about the relatively monitoring efficiencies of traditional capitalist enterprises versus cooperatives.[122] Here, for reasons that Mill identified long ago, cooperators have a strong incentives to monitor each other.[123] Moreover, the evidence is that they do so effectively. Case study evidence indicates that shirking is not an "important problem" in labor managed firms: "Almost all reports emphasize the prevalence of mutual monitoring and

---

[118] *Id.*

[119] *Id.* at 538-39.

[120] Arnold admits these are "hypothetical rational choice explanations," Arnold, PHIL. AND ECON., *supra* note 10, at 109, and not genetic or historical explanations. *Id*. at 110. However, my own collective action-public goods explanation, inspired by Olson, *supra* note 13, is an explanation of the same sort, so until I deliver on the empirical evidence that I believe supports and complements the public goods explanation I am in no position to criticize Arnold on this point.

[121] *See supra* Part I(A)(1).

[122] As noted elsewhere, when it comes to the bottom line, the evidence is that cooperatives and participatory organizational forms are actually superior to capitalist firms with respect to efficiency. *See supra* notes 35-47 and accompanying text, and Schwartz, *Voice without Say*, *supra* note 2.

[123] *See* Mill, POLITICAL ECONOMY, *supra* note 4, at 77 (it would give workers an interest in "do[ing] the utmost, instead of the least possible, in exchange for their remuneration," *id.* at 789, since discipline would be "self-imposed, for the manifest good of the community and not for the convenience of an employer having the opposite interest," *id.* at 778-79.)

relatively low levels of formal supervision."[124] As Hansmann says, "Employee ownership also gives each employee an incentive to monitor his fellow employees and apply pressure on them not to shirk, an incentive largely lacking in an investor-owned firm." [125] In sum, Arnold's shirking/opportunism explanation is an *a priori* prediction of a non-problem. It essentially does not occur in labor managed firms, and whatever monitoring issues there may be do not diminish the productivity and other advantages of labor management.

The second point is that Arnold's shirking/opportunism explanation proves too much. Similar transaction costs concerns that Arnold raises for cooperatives also apply to the open corporation, which has come to dominate economic production in market societies, even if the classical capitalist firm has not been wholly displaced by the open corporation. Until the last decades of the 19th century the entrepreneurial or classic capitalist firm accounted for almost all nonagricultural production,[126] but by 1985, the top two hundred corporations owned over 60 percent of all U.S. manufacturing assets. [127] In 1984, the top 500 corporation's sales and profits

[124] Dow, *supra* note 7, at 183 (citing studies).

[125] *See, e.g.* Hansmann, ENTERPRISE, *supra* note 2, at 70. *See also* Bradley & Gelb, *supra* note 18 (discussing management and mutual monitoring in Mondragon). Arnold himself acknowledges that management monitoring in Mondragon is "highly effective," Arnold, *Market Socialism, supra* note 10, at 540. If absenteeism is a measure of shirking, in the Mondragon cooperatives it runs half the rate of capitalist firms. *See* Logan & Thomas, *supra* note 16 at 49-52. Greenberg, analyzing the "two way, open, and relatively freewheeling" communication between managers and workers in the plywood cooperatives, Greenberg, *supra* note 38, at 48, asks "how is this complex production process" with more 150 people on a shift coordinated without close supervision?, *id.*, states that the answer that "cropped up in every one of our interviews" was that "[t]he shareholders individual manage themselves and each other. . . . If . . . some members are nor contributing . . . groups of worker-shareholders will tend to act as collective supervisors on the job." *Id.* at 49. Daniel Gavron, the leading student of the crises in the kibbutz, does not mention monitoring as a problem. In fact, he says the kibbutziks, far from showing "avoidance of effort and lack of initiative" Gavron, *supra* note 16, at 155, created a "productive society" in the kibbutz, *id.*

[126] Richard Edwards, CONTESTED TERRAIN: THE TRANSFORMATION OF THE WORKPLACE IN THE TWENTIETH CENTURY 24 (1979).

[127] In "1954-1979, the share of GNP represented by the Fortune 500, the 500 largest companies in the United States, grew from 37% to 58%." William J. Murphy, *Proposal for a Centralized and Integrated Registry for Security Interests in Intellectual Property,* 41 IDEA 297, 301 (2002). Some writers estimate the percentage of the U.S. GNP coming from the Fortune 500 to be as "low" as about "40% of GNP coming from Fortune 500 companies" today, Roger L. Torneden, *Will Devaluation of the Dollar Pull the U.S. Out of Depression Once Again?* 15 NEXUS: CHAP. J. L. & POL'Y 67, 71 (2009-2010), but 40 percent is still substantial. *See also* Richard Edwards, *et al.* THE CAPITALIST SYSTEM: A RADICAL ANALYSIS OF AMERICAN SOCIETY 74-75 (3d ed. 1986) [hereinafter Edwards, CAPITALIST SYSTEM] (almost half the GNP). At least "1/3 of Fortune 500 companies are family businesses." Michael V. Bourland, *Implementation and Documentation of the Succession Plan*, SM003 ALI-ABA 689 (2006).

accounted for about half the GNP.[128] At the turn of the 21st century, while corporations comprised only 20 percent of U.S. businesses, they accounted for 85 percent of U.S. business revenues; globally, the largest 1,000 corporations produced about four-fifths of the world's output.[129] There is some overlap between open corporations and classical capitalist ones: almost 40 percent of public traded Fortune 500 companies are in some sense "family" corporations[130] and thus could be regarded as at least quasi-classical. Moreover the smaller, more classical capitalist corporation is a lively and substantial economic presence.[131]

The traditional investor-owned open corporation run by managerial employees and overseen by a board is nonetheless a towering presence in the economy and hardly likely to wither away. The open corporation shares with the labor managed firm the key features that, according to Arnold, should put both at a competitive disadvantage with respect to classical capitalist firms. In fact the situation with the classic open corporation should be, in theory, far worse. The shareholders owners – the investors – in the open corporation have little if any say in enterprise management. "[S]hareholder voting has very little to do with corporate decisionmaking. . . . The vast majority of corporate decisions . . . are made by the board of directors acting alone, or by persons [managers] to whom the board has properly delegated authority."[132] Moreover, the managers themselves are at best only fractional residual claimants –

---

[128] Edwards, CAPITALIST SYSTEM, *supra* note 127, at 74-75.

[129] Samuel Bowles, *et al.*, UNDERSTANDING CAPITALISM: COMPETITION, COMMAND, AND CHANGE (3d ed. 2005) [hereinafter Bowles, UNDERSTANDING CAPITALISM].

[130] Many publically traded firms are also "family" firms by some definitions. *See* Belén Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 390 (2006) (family firm defined as one in which the founder, or a member of his family, is an officer, a director, or the 5 percent equity owner; on this definition, 37 percent of all Fortune 500 firms are family firms. *See id*. at 394

[131] "Small business corporations defined as firms with under 500 employees contributed forty-eight percent of nonfarm United States employment and thirty-eight percent of the G.N.P." Richard Salterman, *Perceptions Bearing on the Public Policy Dynamics of Corporation Law* 20 HAMLINE L. REV. 261, 264-65 (1996). *See also* Murphy, *supra* note 127, at 301 (discussing the growth since 1979 of the new entrepreneurial economy as an increasing source of jobs and private wealth vis a vis the classic open corporation).

[132] Bainbridge, *Limited Shareholder Voting*, *supra* note 21, at 603. This is a legal requirement as well as a sociological fact. Delaware law stipulates corporation's business and affairs are "managed by or under the direction

are, in fact, employees.[133] The monitoring of managers in the open corporation devolves ultimately on the board of directors. Despite the principal-agent problems, transaction costs, moral hazard, and related difficulties generated by this structure and two centuries of history and the growth of multinational corporations show that this organizational structure can compete highly effectively with the classical capitalist firm in many contexts.

In fact, the labor managed firm, by contrast, is structured for the purposes of comparison more like the classical capitalist firm than its far more successful rivals, including the open corporation. Like the owner of classical capitalist firm, the worker owners in the fully labor managed and owned enterprise, exercise a greater degree of direct control over enterprise policy.[134] As the evidence shows, further, cooperative members generally exercise effective mutual monitoring and monitoring of management.[135] The institutions in the cooperative that

of a board of directors." 8 Del. Code. Ann. § 141. Shareholders have virtually no right to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions. Bainbridge, *supra*, *id.* Delaware law is important because practical defines U.S. corporate law. "More than 850,000 entities, including over half of all U.S. publicly traded companies and over 60 percent of the Fortune 500 companies, are organized under Delaware law." Lawrence A. Hamermesh, *The Challenge to Delaware's Preeminence in Corporate Law: Federal Interference May Not Pose the Greatest Danger to the State's Future Success*, 27-FALL DEL. LAW. 8, 8 (2009).

[133] *See* Herman, *supra* note 21, at 244 (noting the decline in direct control since 1900 and the increase in direct control by managers who own relatively little stock and yet possess considerable decision-making authority.") To acknowledge this is not necessarily to endorse support the "managerialist" thesis of Berle & Means, *supra* note 21, according to which the "managerial revolution" has stripped private property of significance and left corporations in the hands of neutral technocrats who do not much care about profitability. Cf. Herman, *supra*, at 257-264 (remarking on the lack of theoretical and empirical support for managerial discretion to depart from the profit motive) and Maurice Zeitlin, THE LARGE CORPORATION AND CONTEMPORARY CLASSES 37, 156-160 (1989).

A better account is Alfred Chandler's classical analysis of the "ascendency of the manager" as a trained cadre of specialist employees who decided "prices, output, deliveries, wages, and employment," relegating the representatives of the entrepreneurial family founders, who generally lacked the requisite knowledge and experience, to an "essentially negative role." Alfred D. Chandler, Jr., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 490-91 (1977). Chandler further notes that in the large open corporation, "members of the entrepreneurial family rarely became active in top management unless they were themselves trained as professional managers." *Id.* at 491. Chandler's thesis, which largely concerns the fate of successful publicly traded firms, is consistent with family ownership and with first generation entrepreneurial capitalism. Chandler entertains no illusions about the disappearance of private property, the profit motive or the competitive pressures that select for profit-maximizing behavior in competitive capitalism.

[134] *See* Dow *supra* note 7, at 52-64, discussing how, *e.g.*, the workers in the plywood cooperatives and Mondragon exercised real (if in the case of Mondragon decreasing) control over enterprise decisions.

[135] *See supra* notes 123-24 and accompanying text.

corresponds to the corporate board have a more varied structure and go by a variety of names.[136] To have a uniform term, we may say the direction and management of a labor managed firm is vested in a "works council."[137]

One might expect the labor managed firm to perform better than the open corporation because members of the works council are typically far more substantial residual claimants[138] than the typical corporate board member, if perhaps not as well as the classical capitalist firm, where the capitalist has full residual claimant status.[139] Corporate boards tend to lack the owner's residual interest. [140] In general, if Arnold's argument for the greater efficiency of the classical capitalist firm applies, it should apply with more force against open corporations than

---

[136] In a pattern perhaps modeled on the structure of the open corporation, the plywood cooperatives called their governing body, unimaginatively, the "board of directors," Greenberg, *supra* note 38, at 32-33, which, operated under the control of an annual general membership meeting of all shareholders, i.e., cooperative workers, but the board operated under somewhat tighter formal control than that of an open corporation. *Id.* at 33. Mondragon, which operates an association of cooperatives that comprise, in a sense, a single enterprise, has developed, since the reforms of the 1980s, a complex governing structure that are "challeng[ing] to present . . . graphically, since they do nor form a typical pyramid or flowchart, but are more like a dynamic web of shifting notes . . . in which] the levels [are] always interacting. Morrison, *supra* note 71, at 17-18. Under Spanish law ordinary corporate law does not apply to cooperatives, *id.* at 17; and with some variations vests ultimate power, like the plywood coops, in an annual general assembly of all owner-workers, which selects a governing council and a social council hire senior management, implement policy set by the general assembly, and decide shop floor issues, while the managers and coop officers have an advisory management council corresponding roughly to the management of a capitalist firm. *Id.* at 19. Other variations may exist.

[137] *See* WORKS COUNCILS: CONSULTATION, REPRESENTATION, AND COOPERATION IN INDUSTRIAL RELATIONS (Joel Rogers & Wolfgang Streck ed. 1995).

[138] Arnold, acknowledges that management monitoring in Mondragon is "highly effective," Arnold, *Market Socialism*, *supra* note 10, at 540 and that Mondragon workers monitor each other horizontally, *id.*

[139] Arnold, *Market Socialism*, *supra* note 10, at 539.

[140] *See* Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: the Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 140 (1997) (stating that over two thirds of boards of large American industrial corporations are composed of outside directors); Elizabeth Cosenza, *The Holy Grail of Corporate Governance: Independence or Democracy?*, 2007 B.Y.U. L. REV. 1, 25 (2007) (noting that "many independent directors own small amounts of their company's shares and receive compensation instead through large cash payments"; their "stakes . . . in the enterprises they oversee therefore do not reflect 'the performance-based concerns of ownership, but rather the interests of . . . highly salaried company employee[s].'") . *See also* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW 921, 922 (1999) (stating that the median firm in 1991 had an eleven member board, and three insider directors, dropping to two in 1997. Insider directors are of course high-level employees. *See* Cosenza, *supra* at 23. In 2009, half of S&P 500 companies had only one inside director, the CEO. Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 136 (2010). Fairfax notes that this shift to outside directors represents a change from the 1930s to the 1950s, when inside directors held some 50 percent of board seats. *Id.* at 135. Non-CEO inside directors, of course, face a classic conflict of interest "because they are unlikely to contradict the CEO who is their work boss." Thuy-Nga T. Vo, TO BE OR NOT TO BE BOTH CEO AND BOARD CHAIR, 76 BROOK. L. REV. 65, 129 n.116 (2010).

cooperatives. If it fails against corporations, it should fail against cooperatives. On Arnold's terms one would expect an economy in which labor managed firms competed with classical capitalist ones while the open corporation was a fairly marginal form – perhaps as marginal as the producer cooperative is today.

Arnold concedes that corporations face the problems adumbrated here regarding monitoring and opportunism.[141] In his piece *Market Socialism,* Arnold puts the point quite forcefully, but then retreats to a comparison of opportunities for "exploitation" (roughly the effect of opportunism on the other workers and society) in a market socialist system that "are not found in the open corporation under capitalism."[142] Market socialism, to be fair, is Arnold's official topic, and the labor managed firm and economy that is my own topic, which would result if most enterprises were labor owned and managed, is not a socialist system.

In his expanded book-length treatment,[143] Arnold attempts to come to terms with the implications of his admission that the open corporation which plays so large a role in a modern capitalist economy is apparently at a disadvantage with respect to the cooperative on the monitoring point at which he says the cooperative is at a disadvantage with the classical capitalist firm.[144] Arnold gives an extended discussion in broadly Coasean terms of various real and supposed transactions cost efficiencies of the open corporation, *e.g.*, that through vertical integration, bringing decision making and asset ownership under a single roof rather than coordinating acquisition and use of specialized assets through short term contracts, fewer resources need be expended to protect against potential opportunism by input providers and

---

[141] Arnold, *Market Socialism,* supra note 10, at 546 ("It seems that shareholders in the open corporation face the same problem[s].")
[142] *Id.* at 547.
[143] Arnold, PHIL. AND ECON., *supra* note 10.
[144] *Id.* at 136-153.

customers,[145] and the supposed joining of ultimate decision-making authority to residual claimant status of shareholders.[146] Some of efficiencies are illusory – shareholders, we have seen – have little or no power in large open corporations[147] – Arnold has no persuasive response to the shirking/opportunism problem that he acknowledges pervades the open corporation because of the separation of ownership and control.[148] Arnold's response is to invoke the power of the board of directors in monitoring the management.[149] But as noted, control by corporate boards that typically lack significant shareholder's residual interest,[150] involve significant principle agent and moral hazard costs, especially in the absence of effective shareholder power, as Arnold acknowledges.[151] His ultimate reply is that the market will handle it with the aid of securities analysts, a misplaced faith.[152] Even more to the point here, it does not go to the comparison with cooperatives, where the equity owners do exercise the much more of the sort of direct control that classical capitalists do. A noncomparative answer is no real explanation at all.[153]

---

[145] *Id.* at 138.
[146] *Id.* at 142.
[147] *See supra* note 132-33 and accompanying text.
[148] Arnold, PHIL. AND ECON., *supra* note 10, at 147.
[149] *Id.* at 148-49.
[150] *See supra* note 132, 140 and accompanying text.
[151] Arnold, PHIL. AND ECON., *supra* note 10, at 149 ("the principal-agent relationship between the boards and the equity owners is itself in need of monitoring.")
[152] *Id.* at 150. This claim shows a certain naiveté about the way the securities analysis business operates. These are the people who, after all, told us that Enron set "'the industry standard for excellence,'" . *See* Bethany McLean & Peter Elkind, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 229 (updated edn. 2004) (quoting Edward Tirello (Deutsche Bank securities analyst), among others). "The modern analyst . . . was more a marketer than a researcher and was almost entirely consumed by short term considerations." *Id.* at 231. And the analysts were very much for sale. "There was simply too much investment-banking business at state *not* to have a screaming buy on [bad] stock [like Enron]." *Id.* at 233. "Since research units were now directly generating revenue, rather than providing 'objective' analysis, . . . , analysts pushed stocks despite knowledge of balance sheet fraud and bubble marketing." Karen Ho, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET 78 (2009). Lest it be thought that Sarbanes-Oxley Act, 15 U.S.C. §§ 7201-66, has restored integrity to the business, we need only contemplate the meltdown of 2008, in the aftermath of which we are still currently living.
[153] Ironically, it is a considerable virtue of Arnold's approach to comparing and critiquing social arrangements to insist, in general, on such comparisons. *See, e.g.*, *id.* at 28 (". . . a critic must show that some type of [proposed social arrangement or organizational structure] avoids whatever vices have been attributed to [an alternative arrangement or structure]") (here, capitalism and socialism, but the point applies equally to capital managed and labor managed enterprises); N. Scott Arnold, MARX'S RADICAL CRITIQUE OF CAPITALIST SOCIETY: A RECONSTRUCTION AND CRITICAL EVALUATION 3-27 (1990) (explicating in detail the requirement for alternatives that can be compared.)

The third and logically most fatal problem with Arnold's explanation is that it enters too late. The mechanisms Arnold identifies would explain why labor managed firms failed at a higher rate than capital managed firm of any type, if they correctly identified real relative inefficiencies and if in fact labor managed firms failed at a higher rate than capital managed ones.[154] In both cases the purported fact Arnold's mechanism is intended to explain (inefficiencies dues to monitoring costs) does not hold against either the classical capital firm or the open corporation, as we have seen. But even if it did, the problem Arnold identifies would only emerge once a labor managed firm had been created and was in competition with capital managed rivals that could, if Arnold were correct, boast superior efficiencies. The specific transactions costs Arnold identifies would not, even if valid, explain why labor managed firms are so rarely created relative to their capitalist rivals. Recall Alchian's caveat that the comparative efficiency of different "patterns of behavior and organization are predictable *if* they are tried."[155] And this is the central puzzle. "The main problem[] for [labor managed firms] is that they are rarely created. . . . "[156] This pattern of behavior and organization is not tried.

In view of the theoretical and empirical arguments for the efficiency advantages of labor management vis a vis traditional capitalist organization, any explanation of why this form of organization is rare must start here. Alchian's second caveat, that nothing succeeds like success, because successful models will be imitated,[157] simply poses the same problem over again. Where are there not countless thriving labor managed firms to inspire the sincerest form of flattery?

[154] Neither the empirical evidence or (at least with respect to the open corporation) the theoretical transactions cost analyses support Arnold's claims about the relative inefficiency or implicit prediction of a higher failure rate of the labor managed firm compared to the classical capitalist firm or open corporation. *See supra* notes 46, 47 and accompanying text.
[155] Alchian, *Uncertainty, supra* note 88, at 32 (emphasis in original).
[156] Dow, *supra* note 7, at 125. With respect to Arnold's own official target, market socialism, whether market socialism would be macro-economically more or less efficient cannot bear on why it does not develop "in the womb" of capitalism, since the macro-(in)efficiencies would only emerge when that system was in place.
[157] Alchian, *Uncertainty, supra* note 88, at 28-30.

Whatever the merits or weaknesses of Arnold's specific transactions cost case against market socialism in particular, insofar as they are proffered to explain why labor managed firms are so rare, they cannot explain why such firms are not formed at any significant rate to succeed or fail in whatever ratios to their capital managed competitors in the first place. Hence I turn to the very different transactions cost analysis of Henry Hansmann, which starts by conceding practically all the advantages that Arnold would deny to the labor managed firm.

4. *Hansmann: The Costs of Collective Decision-Making*

Hansmann's exceptionally lucid although somewhat idiosyncratic survey of common but inadequate explanations for the rarity of the labor managed firm is only one of the many merits of his indispensible study.[158] One could hardly ask for a better statement of the problem I address in this Article than Hansmann's summary:

> [E]mployee ownership holds the promise of significant efficiency advantages, avoidance of opportunism . . . ., less strategic behavior in bargaining, better communication of employee preferences, and reduction of worker alienation. These advantages presumably explain the success of employee ownership in those industries where it is commonly found. But the magnitude of the potential efficiency gains from these sources correlates poorly with the actual pattern of employee ownership. In general, these potential gains seem, greatest in large-scale hierarchical firms, which are typically investor owned . . . [159]

Hansmann's proposed explanation is that "the costs associated with collective decision making" explain much of the existing pattern of employee ownership and determining where it is viable.[160] Hansmann's point is that while the employees are generally better situated to oversee management effectively, "they are far more likely than investors to differ among themselves

---

[158] Hansmann, ENTERPRISE, *supra* note 2, at 66-88. A particularly valuable aspect of his study, not relevant to my discussion here but worth remarking upon, is his extended exploration of the patterns of different types of *existing* cooperative ownership, *see id.* chaps. 7-14.

[159] *Id.* at 74-75. Hansmann uses the terms "employee (or investor) owned," *see supra* note 21,where I have used Dow's terms "labor (or capital) managed," for reasons explained there. In this section, however, I largely use Hansmann's terminology. The ellipses omit Hansmann's statement that employee ownership is most common in professional service firms, *id.* at 67. I have explained my skepticism about Hansmann's treatment of such enterprises, such as law firms, as involving genuine employee ownership, or at least employee ownership of the sort that interested Mill and interests most students of the topic. *See supra* note 63.

[160] *Id.* at 91.

concerning the firm's policies."[161] Hansmann's study of the patterns of employee versus investor ownership (to use his terms) leads him to conclude employee owned firms are scarce where "there are substantial differences among employees who participate in ownership. Most typically, employee-owners all do extremely similar work and are of essentially equivalent status within the firm."[162] Employee ownership, Hansmann says, "works best when there is little opportunity for conflict of interest among the employee-owners . . . . and is viable when the employees all play a similar role within the firm."[163] The most serious problem Hansmann sees for employee ownership is when the employee-owners "play diverse roles within the firm and consequently will be differently affected by important decisions taken by the firm."[164] He offers here the illustrative examples of the law firm partnership (which, as noted, he takes to be a relevant sort of employee ownership), the plywood cooperative, and the "driver-owned transportation cooperatives so common throughout the world."[165]

Hansmann denies Arnold's claims that employee ownership is inherently less efficient than investor ownership *tout court*. But his account is undermined, first, by a weaker version of that claim, that employee owned firms that are less homogenous in interest incur sufficiently crippling transaction cost inefficiencies that investor owned firms avoid to explain their virtual absence from the economic landscape. Second, Hansmann's account too fails to explain why open corporations do not face the problems he attributes to employee owned firms, or not with such crippling severity. Third, insofar as Hansmann's theory is an account of why so few employee owned or labor managed firms are started, it also comes in too late to explain a non-phenomenon. Transactional conflicts in decision making might explain a higher rate of failure

[161] *Id.* at 90.
[162] *Id.* at 91
[163] *Id.* at 92.
[164] *Id.* at 92.
[165] *Id.* at 91-91.

among such firms than among investor owned firms, if there was a higher failure rate, but the explanation would presupposes a plethora of employee owned firms failing at a higher rate to start with. It is the absence of which is precisely the issue at question.

I do not dispute that reducing the incentives for and actuality of conflict among persons engaged in productive activity, and therefore the transactions cost of attaining agreement on what to do and how to do it, is likely, on the whole to enhance efficiency.[166] With regard to assessing relative efficiency advantages of different due to transactions costs of this sort, the key question is whether dissension in employee owned enterprises on decisions important to the firm create greater and less manageable conflicts than the kinds of decision making that prevail in investor owned enterprises. It is true that employee owned firms tend to have lower or (in some cases) virtually no pay differentials, and in some cases, a relatively undifferentiated set of tasks.[167] In some cases, like plywood cooperatives, avoidance of conflict is an expressly stated rationale for this practice.[168] Nor can it be doubted that disputes about compensation (differential and otherwise[169]) can be a serious source of contention.[170] More generally, collective decision

[166] I express this in a qualified way because homogeneity of interest and lack of conflict is not necessarily an unmitigated efficiency advantage, I do not wish to minimize the inefficiencies due to nonconflictual agreement on bad ideas based in "groupthink." See Irving L. Janis, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 9 (2d ed. 1983) (defining groupthink as "the mode of thinking that persons engage in when concurrence-seeking becomes so dominant in a cohesive ingroup that it tends to override realistic appraisal of alternative courses of action"); *see* Robert S. Baron, *So Right It's Wrong: Groupthink and the Ubiquitous Nature of Polarized Group Decision Making*, in 37 ADVANCES IN EXPERIMENTAL SOC. PSYCH. 219 (Mark P. Zanna ed., 2005); Marleen O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1309 (2003). As Mill emphasized, free discussion, lively criticism, and a diversity of perspectives are not only valuable in themselves, but the surest means to forming reliable and true beliefs. Mill, ON LIBERTY, *supra* note 29 at 126, 146 *et passim*.
[167] See, *e.g.*, Hansmann, ENTERPRISE, *supra* note 2, at 92; Dow *supra* note 7, at 53.
[168] Hansmann, ENTERPRISE, *supra* note 2, at 92 & n.6; Greenberg, *supra* note 38, at 178.
[169] The employee owners of cooperative enterprise must make potentially divisive decisions about compensation even with a flat pay scale, for example, whether to maintain compensation at current levels in economic difficulty at the cost of having to reduce employment by buying out members, or in better times whether to increase their own compensation at the risk of foregoing investment and savings. Similar questions must be faced by the management, and ratified by the owners or their representatives on the board, of traditional or even participatory capitalist firms.
[170] Raymond Russell, SHARING OWNERSHIP IN THE WORKPLACE 181 (1985) (arguing that in three different types of employee owned firms, whether compensation is equal or not, "the politics of sharing income appears to be the most volatile issue . . . ," requiring consensus that "the existing compensation system is fair.") (quoted in Hansmann, ENTERPRISE, *supra* note 2, at 92 n.5.

making is indeed costly. But conflict over decision making due to heterogeneity, is meant to explain the rarity of cooperative start-ups rather than, in part, their distribution in different economic sectors and activities, Hansmann fails to show it.

Hansmann is careful to consider whether it might be that "causation runs the other way . . . .: [that] employee owned firms may be unusually inclined to adopt egalitarian practices simply because they are employee owned and not because such practices are necessary to reduce governance costs."[171] He responds that this would not explain why "employee ownership tends to arise only where the employees involved are highly homogeneous to begin with."[172] Unfortunately Hansmann fails to adequately address what constitutes homogeneity of interest. It is, he says, "a social construct"[173] limited by culture and institutions,[174] such that "what passes for homogeneity of interest in one setting may not in another."[175] In the present context, the only sort of homogeneity that Hansmann mentions is the instance, like the plywood cooperative, where "all workers have essentially the same role in the firm."[176] But nothing he suggests indicates any support for this being the causal condition of the plywood cooperatives' flat pay structure – even though those cooperatives expressly invoke avoidance of compensation conflicts

---

[171] Hansmann, ENTERPRISE, *supra* note 2, at 95. Hansmann even offers evidence for this hypothesis, noting that workers at such firms will tend to accept lower pay if it is more equal and demand higher pay if it is less so and they are among the lowest paid. *Id.*

[172] *Id.*

[173] *Id.* at 98. Thus it was once legally acceptable in the U.S. to pay people of different colors different wages. *Id.*

[174] *Id.* The problem is not especially tractable. *See* Martha Minow, *Not Only for Myself: Identity, Politics, and the Law*, 75 OR. L. REV. 647, 657-58 (1996) "The persistent failure of group-based categories to yield consistent applications hints at the defects in their boundaries, their origins, their applications, and their ultimate meaningfulness. The coherence [of group identities] is further challenged, though not automatically undermined, by historically shifting boundaries." There is a reason that Marx's discussion, in CAPITAL 3, *supra* note 18, of "What makes a class?" breaks off without an answer after 38 lines. *See id.* at 1024-26.

[175] *Id.*

[176] *Id.* It must be acknowledged that a common Basque culture and heritage has almost certainly played some part in Mondragon's success. *See, e.g.,* Kasmir, *supra* note 48 *passim* (discussing commonalities and conflicts in Basque working class culture and history and their role in Mondragon's development). *See also* my discussion of the role of the community in the initial financing of Mondragon, *infra* Part III(B). But as Kasmir underlines, people with a common cultural heritage are not always in harmony. *See* Kasmir, *supra*, at 90-120 (discussing political conflicts between nationalism and socialist politics in the town of Mondragon in the context of the 1974 strike at the founding cooperative, Ulgor, "remember[ed] as one of the most divisive events in recent [local] history," *id.* at 92).

as a reason for such a structure. Thus far, then, there is no reason to believe that Hansmann has correctly identified or even adequately defined the dependent and independent variables.

The major counterexample to the claim that homogeneity, however that is understood, is a causal condition of successful employee ownership is Mondragon, the most successful employee owned cooperative in the world market. This enterprise, as noted, embraces a wide variety of activities, different kinds of manufacture, service, and other productive activity, in which the employee owners perform diverse kinds of tasks and occupy different roles, and has a narrow but not flat pay scale.[177] Hansmann responds quite implausibly by attempting to remove Mondragon, in part, from the roster of employee owned enterprises. Mondragon, he notes, uses representative democracy and restrains the extent and ways in which employees can appropriate firm earnings.[178] While Hansmann does not deny that Mondragon workers do "participate meaningfully in control,"[179] he argues that these restrictions and other governance structures and enterprise policies mean that in Mondragon, "worker's rights to control and . . . earnings are attenuated, and the individual firms cannot really be said to be fully owned by their workers."[180]

This answer is unpersuasive. It amounts to saying that only direct democracy without governance or investment policies would count as "real" or "full" worker ownership and control,[181] but this is argument by fiat, a mere attempt at persuasive definition. Hansmann does not even attempt to offer a theoretical justification for this claim. The logic of Hansmann's argument would imply that, for example, in open corporations, the minimal control, extensive governance mechanism, firm policies regarding investment and charitable contributions, and

---

[177] *See supra* notes 72-83 (variety of Mondragon's activities), 48 (relatively flat pay scale).
[178] *Id.* at 100 (asserting that electoral mechanisms are a "blunt" means of control of management and noting that Mondragon rules limit worker's choice of wage scales and require that 20 percent of earnings be retained for investment and 10 percent devoted to educational, cultural, or charitable purposes).
[179] *Id.* at 102.
[180] *Id.*
[181] Further, Hansmann does not consider the possibility that the rules that he claims make Mondragon less than fuller worker owned can be altered, amended, or replaced by the Mondragon workers.

restrictions on what investors can do with their shares, such the rules governing different classes of stock, means that these are not "fully owned" by their investors,[182] or, for that matter, that legal limitations on property use mean that the classic capitalist does not "fully" own his productive assets. There is a sense in which all ownership and control is a matter of degree. [183] But Hansmann wishes to have it both ways, arguing that the governing mechanisms of the open corporation and the body or corporate law are "means for conflicting and resolving the worst of these conflicts in corporate decision making,"[184] while contending that Mondragon's rules means that it is not a genuine case of employee ownership, but at best an "attenuated" one. In that case we would be comparing attenuated investor ownership with attenuated employee ownership, and to show that the transaction costs in decision making are less with the open corporation than with Mondragon would require some evidence or argument.[185] Hansmann offers none, and in face of the vitality and success of Mondragon in comparison with its traditional capitalist rivals, any such argument would face some uphill sledding.

---

[182] *See* Hansmann's discussion of corporate governance rules as a means of mitigating the costs of collective decision making. Hansmann, ENTERPRISE, *supra* note 2, at 62-64.

[183] Taken to its natural conclusion, Hansmann's reasoning implies a theory of democracy under which only unmediated direct democracy is real or full democracy; representative constitutional democracy would not quite make the grade; likewise only ownership without limits is real ownership. It is no surprise that Hansmann does not articulate this essentially anarcho-syndicalist theory out loud. *See, e.g.*, DEMOCRACY (Philip Green, ed. 1993), where, despite a wide range of different democratic theories discussed, from radical to elitist, this theory does not even receive an entry; and the corresponding theory of ownership would imply that any restriction on my use of my property, legal or contractual, means that I do not fully own it, is one that is not even maintained by contemporary radical libertarians. The leading libertarian thinker of the late 20th century, Robert Nozick, rejects anarchy and defending a minimal state that *ipso facto* involves rules limiting use of property. *See* Robert Nozick, ANARCHY, STATE, AND UTOPIA 88-148 (1974). Indeed, it is hard to understand how possession could count as ownership without legal rules of property, contract, and tort that define and therefore restrict the use of what is possessed. *See* Richard A. Epstein, SIMPLE RULES FOR A COMPLEX WORLD (1995) (another libertarian perspective, more expressly addressing property law); Cass R. Sunstein, THE PARTIAL CONSTITUTION 51-59 (1996) (left-liberal argument tracing the recognition that property rights are legal creations).

[184] Hansmann, ENTERPRISE, *supra* note 2, at 90.

[185] *Id.* at 102. When considering whether and what rules might be used to reduce opportunism among employees, Hansmann, after discussing corporate law, turns to the legal "duty of fair representation" under the NLRA, which he asserts has been "singularly ineffective" in preventing exploitation of minorities by majorities "in contrast to the analogous doctrines in corporate law." *Id.* He offers no evidence in support of he claims about either side of this contrast, and he does not here consider Mondragon's governance rules as a way of, *inter alia*, reducing the costs of conflict and decision making in a large and diverse enterprise owned and managed by the employees.

Finally, if Hansmann intends to explain why so few cooperatives are started by appeal to this sort of transaction cost, he, like Arnold, has started too late. The costs of conflicts among diverse groups of employees regarding decisions about compensation and other matters can only arise where the employees have the power to make decisions. But as Alchian noted,[186] the innovation or policy must be tried in the first place to be tested in the crucible of the market, and the mystery remains why the labor managed firm is not more widely tried. The question remains open. Where did Mill go wrong?

C. Transactions Costs External to the Enterprise: Dow's Capital Formation Problem

Arnold and Hansmann explain the rarity of cooperatives because of transactions costs that arise inside the enterprise that account for why cooperatives are purportedly less efficient than capitalist firms. We have noted three things about such explanations. First, whatever the specific mechanism they locate to account for comparative inefficiency, the middle term in the explanation, that cooperatives are less efficient, conflicts with the empirical evidence. Second, both sorts of explanation run ashore, logically, in accounting for the open corporation, which, on their terms, should be less efficient, thus, in Alchian's terms, less prevalent, than cooperatives. Third, both explanations arrive after the train has left because they presuppose problems with functioning cooperatives when the issue we face is why so few of them are formed to begin with.

It is a merit of Dow's account that it largely avoids all these problems. Dow's full account[187] is complex, multi-factored, and embedded in a deep theory about the inalienability of labor versus the alienability of capital.[188] I address a somewhat limited version that sidetracks the deep theory and picks up on the strand that goes directly to the question posed in this Article, which Dow himself concedes to be the (or a) crucial issue. "The main problem[] for [labor

[186] *See* Alchian, *supra* note 88, at 32.
[187] Dow, *supra* note 7, at 234-59.
[188] *Id.* at 234-36.

managed firms] is that they are rarely created. . . . "[189] Dow's explanation turns on his claim about "the inabilities of workers to offer credible guarantees of repayment to [outside] investors" in labor managed firms.[190] Labor managed firms, especially if they are capital intensive, lack assets, and involve economies of scale or scope,[191] face financing problems not faced by capital managed competitors.[192] Dow does not attempt to explain any purported comparative productive inefficiencies of labor management; on the contrary, he denies at length and with evidence that they exist.[193] Second, for the most part the explanation does not involve any puzzling asymmetries between classical capitalist firms and open corporations. Finally, Dow locates the proposed explanation at the right point: "access to financing is crucial to firm formation."[194] Unlike Arnold's monitoring efficiencies or Hansmann's heterogeneity transactions costs, which only kick in, if they do, once the labor managed firm is up and running, this, in accord with the King of Hearts' rule, begins at the beginning,[195] with the comparative problems for forming such an enterprise as opposed to a capitalist firm.

---

[189] *Id.* at 125.
[190] *Id.* at 237. The other two "threads" in Dow's "causal tapestry," *id* at 234 are, respectively, "the internal composition of control groups, especially size and degree of heterogeneity," *id.* at 238, essentially Hansmann territory; and "the commodification biases that undermine [labor managed firms]," *id.* at 238, in which the inalienability of labor may lead to underinvestment, degeneration by shift to wage labor, and investor takeovers or transformations into capital managed firms," *id*. at 239. Whatever the merits of or problems with Dow's spinning out these two threads, they go to the well-functioning of an existing labor managed firm and its comparative efficiencies vis a vis capital managed rivals, not to my subject, because they presuppose the labor managed firm has already been formed, whereas my question is why so few of them are.
[191] *Id.* at 237
[192] Dow does not treat this problem as a transactions cost, restricting that term to his discussion of Hansmann, *see* Dow, *supra* note 7, at 121-26, but capital formation difficulties are classic transactions cost if the term is extended to reach issues beyond firm boundaries – as, on a broadly Coasean approach, they should be. It was in determining why there were firm-market boundaries at all that Coase came to consider the issue of transactions cost. *See supra* notes 99-100 and accompanying text.
[193] Dow, *supra* note 7, at 240 (Labor managed firms "have no evident problem with labor productivity. . . . [T]he direct comparisons with capital managed firms are favorable to labor managed firms.").
[194] *Id.* at 236.
[195] "'Begin at the beginning,' the King said, very gravely, 'and go on till you come to the end: then stop.'"Lewis Carroll, ALICE'S ADVENTURES IN WONDERLAND, *in* THE ANNOTATED ALICE 158 (1865) (Martin Gardner ed. 1960).

As Dow puts his central idea, the problem is that "in capitalist firms, wealthy investors simply [sic] pool their assets to acquire firm assets,"[196] while labor managed firms, especially if they are capital intensive, "must find a . . . way of financing . . . assets, but they often founder on shoals of limited wealth and liquidity constraints."[197] I shall return in a moment to the curious and problematic fact that labor managed firms are generally self-financed.[198] Here I address Dow's arguments that "commitment" asymmetries explain why outside financing should be more available for capital managed than labor managed firms, and find them wanting.

As Dow implies, (capital intensive) capitalist firms can be initially financed in other than the entrepreneur's -- here the workers' -- own assets: they can, for example, borrow capital from banks, issue shares, or sell bonds to raise money from the public. Why cannot, and perhaps more importantly, do not, labor managed firms have recourse to the same sources of capital assets? That is why Dow frames the problem as one of offering "credible guarantees to investors," whom, he thinks, have more worry about being repaid with labor managed than a capital managed firm. It is not obvious, however, why this should be so. If investors are economically rational,[199] one would expect them to be concerned with the safety and profitability of their assets. Why would investors, whether loan officers at banks or private purchasers of stocks and

---

[196] *Id.* at 236.
[197] *Id.*
[198] Dow, *supra* note 7, at 191. Dow's notes that in ESOPs workers have rarely if ever exercised effective control over capital financing and investment, even where they put up the money. *Id*. at 191. *See also* Hansmann, ENTERPRISE¸ *supra* note 2, at 75-76 ("The proliferation of ESOPs in the manufacturing sector indicates that a firm's employees can often provide substantial equity capital without crippling costs.").
[199] The underlying theory of economic rationality is called rational choice theory. It has been variously characterized, but on one useful summary, it includes the following claims: (1) rational behavior involves maximizing a set of preferences , (2) rational agents are egoistic, self-interested, or mutually disinterested in the welfare of others; (3) the preferences of rational agents satisfy certain sorts of consistency; (4) rational choice is choice under uncertainty, where agents maximize the expected value of their own payoffs; and it is sometimes added (5) that rational choice involves the behavior of individuals rather than groups. *See, e.g.,* Donald P. Green & Ian Shapiro, PATHOLOGIES OF RATIONAL CHOICE THEORY: A CRITIQUE OF APPLICATIONS IN POLITICAL SCIENCE 14-17 (1994) (characterizing the elements); RATIONAL CHOICE (Jon Elster ed. 1986). Obviously this is a highly idealized theory, like the (related) theory of the perfectly competitive market discussed *supra* note 6. I return to this point in Part III(C).

bonds wish to invest in *less* productive, thus, by proxy, probably less profitable firms? Even if investors and lenders are not economically rational,[200] on Alchian's quasi-Darwinian model, the market should over the long run favor behavior that, however caused or motivated, tracks rational, profit-maximizing behavior. Investors and lenders who so act for whatever reason should prosper more than their rivals whose behavior as well as their motivation is irrational.[201] Imitation should amplify investment and loans to more successful labor managed firms.[202]

Dow's presentation of his capital formation explanation is uncharacteristically thin and admittedly speculative. Comparative empirical data is lacking.[203] Dow says, first, that once the investors have committed . . . funds or physical assets to the labor managed firm, . . . [its members] *may* take advantage of this situation by "paying themselves high wages, depreciating equipment rather than supplying effort, or pursuing risky projects in which the investors would be left holding the bag."[204] The empirical evidence contradicts the concern that worker owners tend to overpay themselves rather than making necessary investments.[205] And Dow gives no

---

[200] There is a great deal of evidence people are not, in fact, economically rational. See, *e.g.*, JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Amos Tversky & Daniel Kahneman, *et al.*, eds. 1982); John H. Holland, *et al.*, INDUCTION: PROCESSES OF INFERENCE, LEARNING, AND DISCOVERY (1989); BEHAVIORAL LAW AND ECONOMICS (Cass Sunstein ed. 2000); HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT (Thomas Gilovic *et al*. eds. 2002). I return to this in discussing my own explanation of the rarity of labor management, *see infra* Part III(C).

[201] Alchian, *Uncertainty, supra* note 88 at 19-20

[202] As Alchian noted, imitation drives much economic behavior. *Id.* at 28-39. *See also infra* note 22 (discussing evidence for the "mere exposure" or "familiarity" effect, on which the familiar is more attractive because of its familiarity – another empirically grounded behavioral irrationality.

[203] Dow, supra note 7 at 192 ("There are no data comparing the cost of external capital for [capital managed versus labor managed firms], so it is impossible to determine directly whether [labor managed firms] are disadvantaged in the credit market relative to similar [capital managed firms].") This is a very damaging admission for Dow's account.

[204] *Id.* at 237 (emphasis added).

[205] Thus Mondragon's response to economic difficulty in the 1980s was for the workers to cut wages, *see* Morrison, *supra* note 71, at 187-88; Whyte & Whyte *supra* note 16, at 182-83 (addressing the situation at a particular coop). Morrison underlines that, in response to proposed economic sacrifices, cooperators were "reluctan[t] . . . to sacrifice current income for possible long term benefit." *Id.* at 196. This is not surprising but neither is it evidence of a tendency to loot the firm at the expense of necessary investments. Ward argued that economic theory predicts, if anything, overinvestment in capital, *see* Ward, *supra* note 8, at 309. The evidence on this is mixed. *See* Thomas & Logan, *supra* note 16, at 136 (supporting in the case of Mondragon), Dow, *supra* note 7, at 190 (citing studies that labor managed firms have lower capital-labor ratios than their capital managed competitors and suggesting that Mondragon's cooperative bank explains that anomalous case).

reason to think that if there is a problem for cooperatives, it is worse than the tendency of capitalist managers to feather their own nests at the expense of shareholders and investment.[206]

Dow, speaking of raising capital by sales of nonvoting shares, states without evidence that labor managed firms might take worse advantage of outside investors than capitalist firms: "[T]here is no reason why dividends would ever be paid, apart from the firm's concern with its reputation or its need for further capital later."[207] But these are weighty incentives to keep the investors happy. Moreover, it is unclear from Dow's presentation or anything in economic theory or behavioral psychology why the same considerations do not apply with equal force to capitalist firms. Dow dismisses the force of a lender's threat to refuse to extend further credit to a deadbeat,[208] but offers no plausible argument that labor managed firms are likely, much less more likely, to stick it to creditors than capitalist firms. Why they should engage in such self-destructive and counterproductive conduct as a matter of course Dow nowhere explains. Dow raises the speculative worries that, with regard to bank loans, the borrower may pursue "risky projects with a high upside potential,"[209] without giving any evidence that this occurs, while ignoring the capitalist financier's own astounding high appetite for risk, which lenders and investors tolerate and encourage.[210]

---

[206] *See* the (in)famously eloquent condemnation of capitalist management parasitism by the fictional Gordon Gekko (modeled on corporate raider Michael Milliken) in Oliver Stone's WALL STREET, where Gekko denounces " these bureaucrats, with their steak lunches, their hunting and fishing trips, their corporate jets, and their golden parachutes." As Arnold puts it, they "siphon pure profits from the residual claimant and quasi-rents from the . . . hapless capital provider into [their] own pocket[s] . . . . *e.g.*, in the form of inflated salaries, perks, and other forms of on-the-job consumption. Arnold, PHIL. AND ECON., *supra* note 10, at 141.

[207] Dow, *supra* note, 7 at 248.

[208] *Id.* at 247.

[209] *Id.* at 246. "Investors may worry that workers will use their decision-making powers in an opportunistic fashion." *Id.* at 188. As Gekko reminds us, *supra* note 206, this does not seem to deter investors from investment in capitalist firms where the investors *know* that management will act opportunistically. *See also infra* note 210.

[210] As anthropologist Karen Ho states in her study of the ethos of Wall Street, "The very structure of Wall Street . . . encourages the milking of the present and a strategy of [bad investments] more for the purpose of generating profit than protecting against risk," Ho, *supra* note 152, at 322 (discussing how "many Wall Streeters came believe that they had in fact mastered risk" by "commoditizing it").

Dow invokes moral hazard considerations, stating that workers might leave a failing labor managed firm,[211] thus creating reluctance for outside investors or creditors to put up capital. but he does not explain how this problem is any worse than the risk such capital providers face with capitalist firms that can declare bankruptcy in the face of collapse, leaving unsecured creditors or equity investors with little or nothing. Dow dismisses the fact that, with a labor managed firm as with a capital managed one, insofar as a lender has a security interest in the assets bought by the investments from the loans, whether a mortgage on real estate or a claim to capital goods as collateral,[212] the lender is in precisely the same position in both cases, and the equity investor is no worse or better off facing failure or default of either sort of enterprise.

It *is* a striking fact, however, that outside financing for labor managed forms is almost as rare as such firms themselves.[213] Mondragon, unusually, has established its own cooperative

---

Dow's book was published in 2003, after the bursting of the dot.com bubble might have undermined the idea, suggested to me by Joel Rogers, that labor managed firms are perceived as too risky by bankers and other lenders the conservatism of which is hard to overstate whose "conservatism is hard to overestimate" (personal communication, May 1, 2011, on file with author). At this writing we still live in the shadow of the irrationally risky investments that led to the current crisis. In Richard Posner's elegant account of the depression (he is not one to mince words) of 2008, with respect to the housing bubble that was the proximate cause of the current in, with the relation or elimination of bank regulation, "banks became willing to make 'subprime' mortgage loans – a euphemism for mortgage loans at high risk defaulting. (Some of the loans were what was called NINJA loans – no income, no jobs, no assets . . . . [and no credit check].) Posner, *supra* note 44, at 23.

Moreover, "the attractiveness of risky . . . investing is enhanced by the asymmetrical response of investors to . . . an investment strategy. A strategy that produces good results attracts new investments. . . [but a fund . . . that does poorly . . ., will lose investors . . . at a slower rate than it gains them when it does well." *Id.* at 26. To say that the banks acted recklessly is a ludicrous understatement, *see* Posner, *supra; see also* Sorkin, *supra* note 44, describing how the great banking houses of America went down like ninepins when the bubble burst, Bear Stearns, Lehman Brothers, American International Group, Fannie Mae and Freddie Mac, and other beneficiaries (or as with Lehman, non-beneficiaries of TARP, *see* Sorkin, *supra* at 355-63 and *supra* note 44).

Nor is scandalously risky behavior limited to mortgage lending. Consider Enron, slightly less than a decade earlier, the poster child firm for most of the 1990s, which was a mirror maze that ran for a decade, essentially, on the irrational, Peter Pan-like conviction of the banks and the investors that a firm that generated no cash, borrowed little money, and issued little stock, could somehow fly. *See* McLean & Elkind, *supra* note 152, at 323 (updated edn. 2004) (quoting one analyst as saying to *Fortune* magazine in 2000 "How exactly does Enron make its money? . . . If you figure it out, let me know."). Lest these instances be thought of as anomalous, *see* the classic history of crises, Charles P. Kindleberger, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (rev. ed. 1989).

[211] *Id.* at 186. Dow does not, here, phrase this in terms of an initial financing problem, as I have here reframed it.

[212] Dow, supra note 7 at 246-47.

[213] *Id.* at 190 (noting that "traditional worker's cooperatives have been financed entirely by member's personal savings and retained earnings.")

bank, the Caja Laboral Popular,[214] but this is virtually unique. The kibbutzim were partly financed by land grants from the Israeli government or proto-state Zionist organizations,[215] and, as I have discussed, received government assistance when they faced economic crisis in the 1980s.[216] But these are unusual cases. There is a puzzle about why labor managed firms tend to rely on self-financing, but Dow's arguments do not identify an empirically grounded significant difference from capital managed ones in their behavior or the risks they pose to the creditors or lenders that would seem to explain why labor managed firms are overwhelming self-financed.

One potential difference, in Horvat's vivid expression, is that cooperatives find it hard to obtain bank and trade credits because capitalist enterprises and lenders "spontaneously reject the alien tissue."[217] Dow puts bones under this flesh by suggesting that with respect to debt financing, "bankers have found it awkward to deal with the democratic governance system used by the coops, and the coops have likewise been reluctant to accept contractual restrictions imposed by bankers."[218] The same point could apply equally to equity investors. Dow suggests that lenders, and, presumably, outside investors may "prefer to deal with undemocratic firms having a single peak owner because it is easier to influence the policies of such firms."[219] But this simply recreates the sort of puzzle with Arnold and Hansmann about asymmetries between labor managed and classical capital firms that fail to account for why *corporations*, which lack a

---

[214] *See* Whyte & Whyte, *supra* note 16, at 68-87; Thomas & Logan, *supra* note 16, at 75-95; Morrison, *supra* note 71, at 86-102. Whether and to what extent the Caja can be regarded as "outside" financing, given that it is a member cooperative on Mondragon, is a fine point. However, as noted *infra* Part III(B), the start-up funds for Mondragon's founding cooperative were provided externally.

[215] *See* Spiro, *supra* note 16 at 71 (discussing how one kibbutz received its land from the Jewish National Fund); Gavron, *supra* note 16, at 19-20 (describing how some pre-State kibbutzim borrowed capital from the Zionist Settlement Office)

[216] *See supra* note 44 and accompanying text (discussion the Israeli government bailout of the kibbutzim.

[217] Branko Horvat, THE POLITICAL ECONOMY OF SOCIALISM 456 (1982).

[218] Dow, supra note 7 at 190 (noting that "non-voting equity is almost never used by [labor managed firms]").

[219] *Id.* at 186-87. In a classical capitalist firm, this might be a limited partner, who receives profits but takes no part in management of the enterprise.

"single peak owner" are not likewise disadvantaged.[220] Why, on this reasoning, should creditors and investors be willing to give money to corporations but not cooperatives?

One explanation of why bankers and investors might prefer to deal with less productive but more familiar capitalist enterprises that avoids this problem, but does not appear to have been explored in the literature, suggested by Alchian's point that nothing succeeds like success.[221] The very rarity of labor managed firms might create doubts by lenders and creditors simply because they are unfamiliar: it is less that their behavior is predictably more problematic to capital suppliers, but such enterprises may be unattractive to them *because* they are less predictable on the basis of experience, or simply, unfamiliar. Social psychological research indicates that the "mere exposure effect," the tendency to prefer the familiar,[222] has a measurable effect on investment decisions.[223] Dow hints at something like this when he states that "it can be costly to create a reputation for cooperative behavior, but a reputation of this sort could be a vital prerequisite for attracting inputs without surrendering control rights."[224] How much this creates irrational bank or investor aversion to labor managed firms is unknown, but if Alchian is right, the successes of those who overcome the familiarity bias might be expected to have more success in the capital market. On the other side, a very different sort of explanation is that labor

[220] *See supra* notes 126-53, 182-84, and accompanying text.
[221] "[P]atterns of behavior and organization are predictable *if* they are tried." Alchian, *Uncertainty*, *supra* note 88, at 32.
[222] Also called the "familiarity principle." *See, e.g.*, Angela Y. Lee, *The Mere Exposure Effect: An Uncertainty Reduction Explanation Revisited*, 27 PERSONALITY & SOC. PSYCHOL. BULL. 1255, 1255 (2001); Chip Heath & Amos Tversky, *Preference and Belief: Ambiguity and Competence in Choice under Uncertainty*," 4 J. RISK AND UNCERTAINTY 5 (1991); Robert F. Bornstein, *Exposure and Affect: Overview and Meta-Analysis of Research*, 1968-1987, 106 PSYCHOL. BULL., 265 (1989) (reviewing studies that document the "mere exposure effect"). This effect helps account for the importance of name recognition in advertising, *see* Jochim Hansen & Michaela Wänke, *Liking What's Familiar: The Importance of Unconscious Familiarity in the Mere-Exposure Effect*, 27 SOC. COGNITION 161 (2009) (demonstrating that mere exposure to brand names increases liking for the names independently of conscious recognition of the exposure); political campaigns, *see* Paul E. Schaffner, *et al.*, *Candidate Name Exposure and Voting: Two Field Studies*, 2 BASIC AND APPLIED SOC. PSYCHOL. 195 (1981), and even academic evaluation, *see* A. Serenko & N. Bontis, *What's Familiar Is Excellent: The Impact of Exposure Effect on Perceived Journal Quality*, 5 J. INFORMETRICS, 5, 219 (2011).
[223] *See* Gur Huberman, *Familiarity Breeds Investment*, 14 REV. FIN. STUD. 659 (2001).
[224] Dow, *supra* note 7, at 189.

managed firms might resist outside financing because "workers are vulnerable to opportunistic abuse by investors [or lenders]"[225] who might insist on control rights as a condition for extending credit, perhaps because of the mere exposure effect , and then use that control to exploit the workers or deprive them of the advantages that make a democratic managed firm, attractive to begin with.[226]

Whatever the cause of the general tendency of labor managed firms to be self-financing, the ability of workers to raise large sums on their own – enough, *e.g.*,, to take over United Airlines – raises serious questions about the aspect of Dow's explanation of the infrequency of such firms that relies on the supposed greater costs of obtaining capital to account for why such firms are rarely even started.[227] Dow admits that the existence of ESOPs suggests that even where workers bear the brunt of the burden of initial financing, "workers may be better able to supply capital than has sometimes been assumed."[228] He notes that employees in some capital managed firms, such as sports teams and film companies) have enough wealth to buy them,[229] but do not. On a less well-remunerated level of employment, Dow further points out that workers in existing coops have paid steep entry fees, e.g., to join the plywood cooperatives or Mondragon.[230] Union pension funds "can also have assets exceeding the net worth of the firms

---

[225] *Id*. at 188.
[226] *Id.* at 189. Dow cites a study arguing that to avoid certain sorts of employee opportunism, "lenders take over management of the production process." *Id.* at 1986 (citing Mukesh Esewan & Ashok Kotwal, *Why Are Capitalists the Bosses?*, 99 ECON. J. 162 (1989)).
[227] It may, however, help explain in part the observed distribution of employee ownership. *See* Hansmann, ENTERPRISE, *supra* note 2, at 76-77.
[228] Dow, *supra* note 7, at 191. Dow notes that in ESOPs workers have rarely if ever exercised effective control over capital financing and investment, even where they put up the money. *Id*. at 191.
[229] *Id.* at 192.
[230] *Id.* at 192-23. He states that "the workers who paid these prices were not in any sense a representative sample of the labor force as a whole." *See infra* note 263 on the costs of buying in to the plywood cooperatives or Mondragon. Dow, *supra* at 193. However one wonders why workers with exceptional reserves of wealth would seek essentially unskilled traditional manual labor in a plywood factory.

that employ the union's members."[231] As Hansmann says, dismissing Dow's general sort of capital formation account, "The proliferation of ESOPs in the manufacturing sector indicates that a firm's employees can often provide substantial equity capital without crippling costs."[232]

Dow's explanation of the rarity of startups of labor managed firms due to capital constraints, then, is less than fully persuasive. There *are* differences in the way existing labor managed and capitalist firms are financed that call for further investigation: I suggest two avenues of research to explain why labor managed firms tend to be self-financed: (1) that the mere exposure effect, with its demonstrated consequences for investment decisions may contribute to the observed divergences in financing methods, and (2) that worker's reluctance to surrender control over the firm's management to outside investors as a condition of obtaining financing.[233] However, Hansmann's conclusion that capital constraints are not the key barrier, nor perhaps even a really significant one, appears to be correct.

III. WHERE MILL WENT WRONG: A PUBLIC GOODS/COLLECTIVE ACTION ACCOUNT

D. Public Goods and Connective Action – The Theoretical Framework

So where did Mill go wrong? The reasoning behind Mill's prediction that the labor managed and owned firm should come to predominate in the market over traditional capitalist rivals is not merely plausible but also well supported by empirical evidence. Such firms have a significant productivity advantage,[234] which rebuts the purported explanation of why they have not done proliferated premised on their alleged inefficiency. Furthermore they embody

---

[231] Dow, *supra* note 7, at 191. Union pension assets become less significant as union membership falls. The percentage of private sector workers in unions [union density] fell to 6.9 percent in 2010, down from 7.2 percent, the lowest rate for private sector workers in more than a century" Stephen Greenhouse, *Union Membership in U.S. Fell to a 70-Year Low Last Year*, THE NEW YORK TIMES (Jan.21, 2011). However this does not explain why unions did not user their economic power to buy out their member's employers in the mid-20th century, when they represented as third of the nation's private sector workers. Bowles, UNDERSTANDING CAPITALISM, *supra* note 129 at 166-66 (Figure 7.1) (citing U.S. Bureau of Labor Statistics (BLS), *Historical Data Series*, available at http://data.bls.gov)
[232] Hansmann, ENTERPRISE¸ *supra* note 2, at 75-76.
[233] *Id.*
[234] *See supra* notes 35-43 and accompanying text.

democratic features that workers who have experienced participation say they value.[235] Raising capital does not explain why they are so rare, although the questions of why they are not funded by outside investors calls for investigation. And whatever costs their operation, as opposed to their creation, may pose, they appear to have a profitability and survival rate equal to traditional capitalist competitors.[236] Given the efficiency advantages and worker preferences, on Alchian's logic, workers should have formed many successful labor managed enterprises owned by themselves and triumphed in the market, at least over the corporation if perhaps not over the classical capitalist firm as well. And yet they have not. Why not?

The explanation I propose is both novel and striking obvious, but has received only the most passing attention by scholars. It turns on the sort of collective action or public goods problem identified by Mancur Olson as an obstacle to the formation and operation of groups that have a common interest, here both economic and other.[237] In addition I hypothesize that the mere exposure effect may magnify this obstacle. The explanation can be stated in two sentences:

(1) A labor managed firm is a public good that faces the obstacles set forth by Olson, according to which collective action to provide public goods tends to generate incentives to free ride and produce suboptimal outcomes.[238]

---

[235] *See supra* notes 48 and accompanying text.
[236] *See supra* notes 46-47 and accompanying text.
[237] *See* Olson, *supra* note 13.
[238] Why this has not been proposed and investigated at something like the length and with the intensity of explanations like those we have considered and rejected is I find puzzling given the extensive attention to public goods problems in the social scientific, legal, and philosophical literature. To give an indication of scholarly neglect of this sort of explanation, consider the three authors whose works I have taken at my targets and who cover, among them, practically all the important literature on the topic in English. The terms "collective action," "free rider," "public good(s)" or "prisoner's dilemma," of which the public goods problem is a generalization, (*see infra* notes 248-53 and accompanying text) do appear in the index of Arnold, PHIL. AND ECON., *supra* note 10, at 293-301 Arnold's "opportunism" is a version of a free rider problem, but one very different from that considered here. Olson's name and work is not cited in his bibliography. *See id.*at 283-91. Hansmann considers public goods in the very narrow context of a role for nonprofit firms, *see* Hansmann, ENTERPRISE, *supra* note 2, at 230-31; the terms "collective action," "free rider," "prisoner's dilemma," and Olson's name are not in his index, *see id.* at 365-72 (he has no separate bibliography). Dow mentions, in a single paragraph, "major collective action problems [that] arise in the context of an employee buyout, Dow, *supra* note 7, at 220; he considers Hansmann's heterogeneity version of a collective *choice* explanation, ENTERPRISE, *supra* at 200-206, but this is a very different explanation from mine. "Collective *action*," apart from the brief mention cited *supra* makes no appearance in his extremely comprehensive survey of the rarity of worker's control, and Olson also fails to appear in his bibliography. *See id.* at 291-311. The

(2) Being unfamiliar, it is therefore less attractive to workers and perhaps investors and lenders.

Ironically, Mill himself recognized the problem in a different context with his usual insight and stated in typically crystalline prose, discussing why government action was required to limit the working day. Such a reform "will not be adopted unless the body of operatives bind themselves to one another to abide by it."[239] But "however beneficial the observance of the regulation might be to the class collectively, the immediate interest of every individual would lie in violating it."[240] Olson could not have said it better. Mill did not see that it applied no less to "operatives" creating their own "associations" than to shortening the working day. Such an account should also be embedded in a historical context with detailed psychological and economic analysis that must await future work.

The theoretical framework of the collective action or public goods problem is familiar and may be stated briefly. A public good is defined as a good that satisfies the common interest of the members of a group and from which no member can be excluded.[241] Olson showed that it is (economically) rational,[242] other things being equal, for each not to contribute to the creation

---

closest approach to this sort of explanation that I have discovered is Schweickart's very short, unelaborated statement, *see* Schweickart, AGAINST, *supra* note 5 at 239, discussed *infra* notes 265-73 and accompanying text.

[239] Mill, POLITICAL ECONOMY, *supra* note 4, at 963.

[240] *Id.* at 964.

[241] Olson, *supra* note 13, at 14-15

[242] *See supra* note 199 (discussion of elements economic rationality). Olson further underlines that "[e]conomic incentives are not . . . the only incentives; people are sometimes also motivated by a desire to win prestige, respect, friendship, and other social and psychological objectives ." *Id.* at 60. There may be "social incentives" to contribute even where economic ones are lacking." *Id.* These Olson considers only when they operate through "'social pressure,'" *id.* at 60, and insists that they be analyzed "in much the same way as monetary incentives," *id.* at 61. He mentions "moral incentives" in a footnote, *id.* at 61 n.17, stating that they "can be analyzed in much the same way," *Id.* He states, however, that insofar as these are what he calls "selective incentives" that create social pressure, *id.* at 61 & n. 17, they may overcome the disincentives that create the collective action problem, and are consistent with Olson's analysis. Olson's characterization of action from morality and honor or respect as motivation by desire for "personal gain," analyzed similarly to "monetary incentives, reflects the typically jaundiced perspective of an economist. It is bizarre to reduce the inclination to do the right thing to something like the satisfaction one gets from feeling that one has done the right thing, much less to treat it as if the benefit to oneself were something like the acquisition of monetary gain. It is flatly false that such nonmonetary motivations operate only through social pressure. *See infra* note 258 and accompanying text for discussion; *see also infra* Part III(C).

or maintenance of the good, or at least not to the optimal level for each.[243] Rather the incentive to provide any more of the collective good ceases once the amount of the good that would be obtained by the individual with the largest fractional contribution is reached.[244] Each member has an incentive to take advantage of the actions of others in providing amount the public good by enjoying it with contributing, or contributing as much -- to be, in short, a "free rider." The likelihood and seriousness of such opportunistic behavior, Olson thought, varied inversely with the size of the group,[245] declining with smaller groups. The upshot, however, is that with "even the smallest group, the good will not be provided on an optimal scale. . . . [T]he members of the group will not provide as much of the good as it is in their common interest to provide."[246] This is because, Olson says, any member will capture only part of his expenditure towards provision of the good, and every member will benefit by the efforts of others to provide it regardless of whether he contributes.[247] With larger groups, the contribution of any member makes less difference and the share of benefit to any members also declines.

The strategic structure of the logic of collective action is that of the *n*-person prisoner's dilemma.[248] The classic two person prisoner's dilemma,[249] shows that in a one-off encounter with no opportunity to coordinate, the strategic interaction between rational players who seeking their best outcome will result in a suboptimal outcome for each and a worse outcome overall than

---

[243] *Id.* at 28. In the economist's characteristic manner, Olson assumes economic rationality with egoistic, selfish motivation; but as explained *see infra* Part III(C), he need not do so to generate the problem.
[244] Olson, *supra* note 13, at 28.
[245] *Id.* at 35.
[246] *Id.* at 34.
[247] *Id.* at 35.
[248] Russell Hardin , *Collective Action as an Agreeable* n-*Prisoners' Dilemma*, 16 BEHAVIORAL SCI. 472 (1971), and COLLECTIVE ACTION, *supra* note 13, at 2; *See also* the "tragedy of the commons," a famous informal *n*-person version developed by Garrett Hardin (no relation), *see* Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE, 1243-1248 (arguing that individual rationality will degrade common resources, such a shared field in which farmers graze their cattle).
[249] Anatol Rapaport, PRISONER'S DILEMMA (1965) is the classic study. The paradox seems to have been first formally expressed in a study by RAND Corporation analysts Merrill M. Flood in 1950, and named the "prisoner's dilemma" by RAND consultant Albert W. Tucker. *See* William Poundstone, PRISONER'S DILEMMA 8, 100-105 (1992).

if they did not seek their best outcome. In the standard illustration,[250] the police have You and Me in custody for a crime we committed jointly. Each of us would prefer do less time, and neither cares how much time the other does. The amount of time translates directly into ordinal preference rankings for outcome, with 1 being the highest ranked preference and 4 the lowest for each of us. If we both stay silent, the prosecution can convict us of a crime punishable by two years. If I confess, implicating You, You can be sentenced to four years, while I receive only one year; the same hold with You and Me. If we both confess, however, we will each be eligible for three years. It might seem that the rational thing to do is to remain silent, in which case we each receive our second best outcome. But I can do better if I talk and You don't, and vice versa. Knowing this, it is rational for Me to confess ("defect" in the language of game theory), but it is likewise rational for You to do the same. If we both confess, however, we each receive our third best outcome, a suboptimal result. The dilemma can be represented by the following famous matrix:

FIGURE 1: The Prisoner's Dilemma

		You	
		You stay silent	You confess
Me	I stay silent	2,2	4,1
	I confess	1,4	3,3

The strict logic of the dilemma applies to the two-person case with the stated assumptions.

N-person games are far more difficult to analyze. Robert Axelrod has shown that if the parties engage in repeated interactions, reciprocity and cooperation are stable and rational

[250] Formulated by RAND consultant Albert Tucker of Princeton. *See* Poundstone, *supra* note 249.

outcomes.[251] One explanation for Olson's result that suboptimality increased with group size is that large, increasingly anonymous groups are closer to the one-off, single interaction situation of the classic prisoner's dilemma. The prisoner's dilemma is generally thought to presuppose egoism,[252] but even Olson observed at one point that the prisoner's dilemma-like logic of his argument required no such assumptions when the group was large enough that the contributions of even the most altruistic, collective minded member "would not be perceptible."[253]

Moreover, and this is crucial, the problem can be overcome in at least two ways. One is to change the incentive structure, for example, by making cooperation compulsory, as governments may by enacting law.[254] Informal social pressure often takes the place of law in giving people an incentive to cooperate.[255] Another, as Olson expresses it, is for at least one member of a group to "find his personal gain from having the collective good exceed[] the total cost of providing [it]."[256] Olson seems to view "personal gain," broadly to include, *e.g.*, moral or other nonmaterial benefits sufficient to motivate individual action.[257] The idea that moral and other nonmaterial benefits are understood as "personal gain" analyzed analogously to monetary gain is an implausible reductionist perspective.[258] It also creates a public goods issue for morality

---

[251] *See, e.g.,* Robert Axelrod, THE EVOLUTION OF COOPERATION (1984) (showing by computer modeling that it is rational to cooperate in repeated interactions unless the other person defects – the strategy of TIT for TAT, that is, to do what the other player did on the last round, a strategy devised by Anatole Rapaport. For informal discussion, *see* Poundstone, *supra* note 249, at 236-55.).

[252] It does not, as can be seen from the fact that altruistic or other moral motivations can be rank-ordered the same way in the matrix. Suppose my first choice is that I suffer fully for my crime, but you go free, and my choices are rank ordered I prefer that I get, in general, more time and you get less, the prosecution will reward us for both talking with less time. If your motivations mirror mine, the same suboptimal result occurs, in this case, we each get the our third ranked result, and do the least amount of time consistent with our doing any time at all.

[253] Olson, *supra* note 13, at 64. The need to overcome collective action problems and provide public goods is a standard explanation of and justification for the existence of government and its coercive power.

[254] *Id.* at 13.

[255] *See id.* 60-61;

[256] *Id.* at 34 (small group context).

[257] *See id.* at 61 n.17.

[258] *See, e.g.,* Elizabeth Anderson, VALUE IN ETHICS AND ECONOMICS (1993) (critiquing *inter alia,* egoistic assumptions underlying economic rationality as a theory of behavior); Eliott Sober & D. S. Wilson, UNTO OTHERS, 1998 (same, *see* especially chap. 10); Martha C. Nussbaum, *Flawed Foundations: The Philosophical Critique of a Particular Type of) Economics,* 64 U. CHI. L. REV. 1197 (1997).

itself.[259] This assumption is, in addition, unnecessarily strong. As we shall see, we can maintain the public goods explanation while granting that people are motivated by other than narrowly selfish motives.[260] With regard to overcoming a collective action problem, the real point is that at least one person have a motivating reason, independent of the collective good, to achieve it.

E. The Theory Applied to The Formation of the Labor Managed Firm

The literature on collective action and prisoner's dilemmas is almost inconceivably vast and metastasizing rapidly.[261] However, for my purposes I need not attempt to address the complexities. As stated, a labor managed firm is a public good in the precise sense that it offers benefits for its members from which none can be excluded – here the advantages of participation, egalitarianism, job security, and other benefits of self-management, as well as, nonpublic goods like profits that do not have to be shared with capitalists or (perhaps) investors. This raises specter of a collective action problem. Forming a labor managed firm involves individuals pooling their resources and come to a mutually satisfactory agreement about how to set up and manage a business – an agreement in which each must trust the others and where enough of them actually follow through to provide the public good. Insofar as economic rationality impinges on

[259] The problem is ancient. *See* Plato, THE REPUBLIC, 35 at 2.359a-2.360d (G.M.A. Grube trans., Hackett Publishers 1992) (suggesting that, if a "just" person possessed a ring that made him invisible so he would never be caught or punished for whatever malfeasance he committed, he would cease to act justly). On rational choice theoretic assumptions, as a number of modern writers have observed, to say that "doing the right thing" is a matter of "personal gain" makes morality a public good that generates a collective action problem. Advocates of that approach have struggled mightily but without success to derive morality from economically rational self-interest. *See, e.g.*, David Gauthier, MORALS BY AGREEMENT (1986); Russell Hardin, ETHICS WITHIN THE LIMITS OF REASON (1988). The collective goods problem can be avoided if morality is not viewed as a product of the actions of egoistic agents.

[260] *See supra* note 252 for a short proof that prisoner's dilemmas do not require egoism but are consistent with altruistic and impartial motivation; *see also infra* Part III(C) and accompanying text for explanation of how the collective action problem can be generated without the unrealistic assumption of economic rationality. We have observed that Olson admits this with regard to infinitesimal contributions to the activities of large groups. *See supra* note 253.

[261] According to Christian Donninger, over a thousand articles on the prisoner's dilemma alone were published in the 1960s and 1970s. *See* Steven Kuhns, *Prisoner's Dilemma*, STAN. ENCYCLOPEDIA OF PHIL. (rev. ed. Oct. 22, 2007), http://plato.stanford.edu/entries/prisoner-dilemma/, accessed June 26, 2011) (itself 49 pages printed out single spaced in twelve point type).

their motivation,[262] or their behavior tracks such rationality whatever their motivation, it creates incentives for free riding and opportunistic behavior.

At the limit case, there will be no collective action and the public good, that is the labor managed firm, will not be provided at all. As Olson notes, the problem becomes more difficult as more people are involved. It is therefore not surprising that most of the few labor managed firms are small. In contrast, setting up as a small capitalist avoids the problem altogether. So workers who are discontented "with the condition of laboring for wages as their ultimate state"[263] (Mill), are far more likely to start their own businesses. According to the Small Business Administration, approximately 627,200 new employer firms began operations in 2008, and 595,600 firms closed that year, roughly a 10 percent annual turnover.[264] The number of labor managed firms in the U.S. is barely even inconsequential.

Schweickart, far too briefly, raises such a hints that something like a collective action may be involved in accounting for why such enterprises are rarely formed: "Each new cooperative venture (in capitalist society) requires a new wealthy radical or new group of affluent workers who are willing to experiment. Such people are in short supply . . . ."[265] As expressed, this is not quite right. Start-up capital is necessary, but we have seen, in addressing Dow's capital shortage explanation, that "affluence" is too strong. Buy-in costs of existing

---

[262] For objections to the dubious assumption that people actually are economically rational actors, *see supra infra* note 200, 222, 258.
[263] Mill, POLITICAL ECONOMY, *supra* note 4, at 760.
[264] http://www.sba.gov/advocacy/7495/8423 (accessed June 26, 2011).
[265] Schweickart, AGAINST¸ *supra* note 5, at 239. Schweickart ties this analysis to the "Ward effect" of the "Illyrian firm," which modeling on neoclassical assumptions shows is self-limiting in size because "enterprise growth would bring in new workers with whom wealth would have to be shared. Cooperatives, even when prosperous, do not spontaneously grow." *Id.* at 239. *See* Ward, *supra* note 8, at 196, whom Schweickart does not explicitly cite for this proposition. However, Schweickart does not require the Ward effect (valid or not) to make his point about the need for cooperative entrepreneurs. Olson's collective action problem, to which Schweickart barely alludes, *see* Schweickart, *supra* at 239, is a sufficient basis for this prerequisite.

cooperatives may be high.[266] However, the case of ESOPs shows that workers throughout the U.S. economy are able to raise the capital to take very substantial or total ownership shares in large corporations; the workers who owned United Airlines during its ESOP period were not especially affluent.[267] In addition, although again it is quite rare, there is no rational economic obstacle to labor managed firms obtaining start up funds from bank loans or stock or bond issues.[268] An individual or group who starts a cooperative need not be radical; the founder of the ESOP, Louis Kelso, was anything but; its main legislative sponsor, Senator Russell Long, was a populist, but in no sense a militant.[269] Given the cold facts about the economic efficiency advantages of labor management, a businessperson or investor might simply look at financing such an enterprise as good business and even act as an entrepreneur.[270] Or an entrepreneur might have nonmonetary motivations. Don Jose Maria Arizmendiarrieta (commonly called Arizmendi), the priest who founded Mondragon, initially as a school in the early 1940s, was in some sense a radical, [271] although anything but wealthy. In addition to self-funding by the cooperators,[272] he

[266] The first plywood coop was established in 1921 by 125 workers who each contributed $1,000, Gunn, *supra* note 50, at 100, a substantial sum in that era. They then secured a bank loan. *Id.* In the mid 1980s, membership shares in the existing plywood cooperatives sometimes sold for $100,000. *Id.* at 112 According to Gunn, shares of that value required roughly a $20,000 down payment, and payments on the balance of about $500 a month at 7-10 percent interest in 1979-82. *Id.* Shares in less successful cooperatives sold in the range of $10,000-$25,000. *Id.* Becoming a member of a Mondragon cooperative requires payments that vary, but whose limits are set by the cooperative's bank, the Caja. Whyte & Whyte, *supra* note 16, at 70. Initial payments of new members rose from $2,000 in 1975 to about $5,000 in 1981, with a repayment period at the time of two years. *Id.* at 74, a significant contribution. In 2002, average disposable income per worker in Spain was $18,723 in real 2005 U.S. dollars. http://www.worldsalaries.org/spain.shtml (accessed June 26, 2011). In 1975, individual members provided 20 percent of the startup costs of a new cooperative, the Caja provided 60 percent, and 20 percent was provided by government loans.

[267] *See supra* notes 227-31 discussing why self-financing need not be a serious limitation on forming a labor managed firm or converting a capital managed firm to a labor managed one.

[268] The early plywood coops "had no difficulties in arranging short-term loans to cover raw materials, inventories, or operation expenses." Dow, supra note 7 at 21. These were collateralized by coop assets. *Id.*

[269] *See supra* note 55 (sketching the ideological and legislative history of the ESOP).

[270] It may be that something like this may have played a role in the establishment of the plywood cooperatives. *See infra* note 283.

[271] Arizmendi supported the Spanish Republic against Franco during the Spanish Civil War, working as a journalist. Whyte & Whyte, *supra* note 16, at 27-28. In his preaching he stressed the need for cooperation and solidarity, and the dignity of labor. *Id.* at 29. The people of Mondragon thought of him as a socialist, *id.*, but while he was familiar with and sympathetic to Marxism, he was not a Marxist. *Id.* at 231. He called his ideology "cooperativism," *id.* at

and his collaborators had to obtain outside funding in the form of loans and charitable contributions.[273]

The origin of Mondragon and of the few labor managed enterprises in the U.S. illustrate the factors Olson invokes as relevant to overcoming the problem and creating the public good in the absence of coercion. An abbreviated historical account shows three of Olson's conditions for effective collection action, and a fourth, which should be distinguished. Mondragon was founded as a small technical school in 1943.[274] The first productive enterprise in what was to become the Mondragon complex was Ulgor, which made domestic appliances,[275] was established in 1954 by five graduates of the school and Arizmendi.[276] It employed 24 workers.[277] We should observe, (1) The small size of the initial founding group supported one of Olson's key conditions for creating a public good. (2) the role of Arizmendi, who was motivated by moral, political, and religious considerations.[278] If we insist on Olson's assumption of economic rationality, he might be regarded as exemplifying the case where "his personal gain from having the collective good exceeds the total cost of providing some amount of that good."[279] In this case the "personal gain" was the realization of his ideals. To put things in a more psychologically realistic, less strained way that involves no such commitments, we may say that Arizmendi's idealistic radicalism put him outside the sphere of economically rational calculation. (3) "Social pressure," another

237, and viewed it as "equidistant from individualistic capitalism and soulless collectivism," *id.* For an account of his moral and political views, *see id.* at 225-53.
[272] *See id.* at 33.
[273] *Id.* at 34
[274] *Id.* at 30
[275] Thomas & Logan, *supra* note x16, at 20. Ulgor involved conversion of an existing plan to a cooperative.
[276] *Id.*
[277] *Id.* at 21.
[278] Arizmendi supported the Spanish Republic against Franco during the Spanish Civil War, working as a journalist. Whyte & Whyte, *supra* note 16, at 27-28. In his preaching he stressed the need for cooperation and solidarity, and the dignity of labor. *Id.* at 29. The people of Mondragon thought of him as a socialist, *id.*, but while he was familiar with and sympathetic to Marxism, he was not a Marxist. *Id.* at 231. He called his ideology "cooperativism," *id.* at 237, and viewed it as "equidistant from individualistic capitalism and soulless collectivism," *id.* For an account of his moral and political views, *see id.* at 225-53.
[279] Olson, *supra* note 16, at 24.

Olsonian condition,[280] was shown by the circumstances in which the founders of Ulgor raised the initial capital, relying on relatives, others ideologically sympathetic, and some who viewed the cooperative as good investment.[281] To Olson's conditions, we may add (4) the role of the entrepreneur, here Arizmendi. I set this off as a distinct condition from (2), "greater personal gain" or non-economic motivation, because an entrepreneur needs vision, talents, and energy as well as motivation. [282] Schweickart is therefore right to emphasize the need for entrepreneurship in getting a labor managed firm up and running, but Arizmendi shows that the entrepreneur may be creative or idealistic rather than merely personally wealthy. Similar factors can be seen with the first plywood cooperative, the Olympia Veneer Company, which faced somewhat similar challenges and circumstances.[283]

---

[280] *Id.* at 61 n.17.

[281] Thomas & Logan, *supra* note 16, at 20-21.[281] Family connections, friendship, and social connections through the "old and established social custom" of gathering after work to drink and talk to friends (the *chiqueto*), Whyte & Whyte, *supra* note 16, at 24, through which the five founders gathered support for their idea, are instances of Olson's "social pressure." The small size factor – 96 individual lenders – comes into play again. None of the lenders or initial equity investors (apart from the five founders) had any part in managing enterprise affairs. If they expected only return on their investment or repayment of the loan, that was an individual and not a public good, this evidence may be irrelevant. However, insofar as their contribution to the enterprise realized Arizmendi's ideals, they might be characterized, if one wished to speak in this curious way, as persons whose "personal gain from having the collective good exceeds the total cost of providing some amount of that good." Olson, *supra* note 16, at 24.

[282] *See* Jonathan Hughes, THE VITAL FEW: THE ENTREPRENEUR AND AMERICAN PROGRESS (expanded ed. 1984). Arizmendi fits Hughes' model of the "idealistic" entrepreneur (Hughes' examples is William Penn, the Quaker founder of Pennsylvania) and to some extent Mary Switzer, an important architect of the welfare state during the 1930s-50s, and an institutional innovator.

[283] *See* PLYWOOD IN RETROSPECT: OLYMPIA VENEER COMPANY (1969), http://www.apawood.org/PPA_StructuralWoodSociety/pdfs/PPA_07.pdf (accessed June 26, 2011); Dow, *supra* note 7, at 50-51. The lesser-known entrepreneurs who started the first plywood coop were Ed Westman and J.J. Lucas, who saw a business opportunity in a plywood mill "which they themselves could own and operate." *Id.* It is unclear why, instead of attempting to start a conventional capitalist firm, they chose a cooperative model with labor management and ownership. Sympathy with Marxist or radical ideals is highly unlikely to have had anything to do with it. Olson's condition of the small size of the founding group can also be seen in the 125 members who bought shares in Olympia Veneer – granted that this is a substantially larger group than five workers and a priest. Subsequent plywood cooperatives involved starting groups of 250-300 workers, Dow, *supra*, at 51, and were often organized by "members or organizers of already existing coops," *id.* at 552, as well as entrepreneurial initiations from "workers seeking self-employment, local businessmen interested in the economic vitality of the region and individual promoters . . . [who] hoped to achieve quick capital gains." *Id.* Two of the latter were convicted of securities and mail fraud, "[bringing] the formation of new coops to an abrupt halt." *Id.*

To the collective action problem should be added, as part of my explanation, the "mere exposure" or familiarity effect.[284] On this effect, what is familiar tends to be regarded favorably. Labor management in market societies is, to say the least, unfamiliar – the mere exposure effect predicts that it would be rare in part merely because it is unfamiliar. In contrast, capital management is highly familiar, indeed predominant. Most workers do not know about cooperative organization, while self-employment or small capitalist business is widely known and moderately well understood. For workers the idea of cooperatives or other forms of worker ownership typically arises, when it does, only in extreme situations such as the threat of a plant closure. It is therefore to be expected that workers with an entrepreneurial frame of mind or a desire to be their own bosses turn to small business – over half a million such enterprises started every year – even though the risk of failure are very high.[285] Not only need they not confront collective action problems – at least not on a scale or to the degree that they would in forming a cooperative, but they can operate within a familiar, therefore attractive organizational form.

F. Collective Action Problems without Taking Rational Choice Theory too Far.

My proposed public goods explanation of the rarity of cooperatives faces the following major problem: the classic versions of collective action problems, such as Olson's depend on the egoistic assumptions of economic rationality that analyses even noneconomic motivations in "much the same way" as "monetary incentives."[286] But in their full blown version, used, for example, by Olson, these assumptions are empirically indefensible. Both common observation noted by philosophers and social theorists for centuries and modern cognitive psychology

[284] *See supra* notes 222, 223 and accompanying text (psychological studies of the effect in various contexts).
[285] *See supra* note 263 and accompanying text (showing that the number of small capitalist enterprise failures almost matches the number of startups every year).
[286] Olson *supra* note 16, at 61.

strongly support the proposition that people are not economically rational actors.[287] Now, under special conditions the sort of prisoner's dilemma of which the collective action problem is a generalization can be constructed without these assumptions.[288] These conditions are somewhat artificial, however, and it is highly doubtful that they can be effectively deployed to account for the rarity of cooperatives. So if people are not egoistic "economically rational" agents, why think that Olson has given us the tools to solve this problem?

The short answer is that Olson's collective action problem, and its underlying assumption of economic rationality, is *right enough in the circumstances*, as long as we retain appropriate modesty about the scope and ambitions of the theory, and in view of the range of alternative explanations as well as further historical, and psycho-sociological evidence. This is not the place for an elaborate methodological discussion of idealization in social scientific theories. However, an analogy may be helpful. The Debreau-Arrow model of the perfectly competitive market that formalizes Adam Smith's insight that the operation of the "invisible hand" through coordinating the selfish actions of market agents to the benefit of all involves counterfactual assumptions as well as omitting much that is important for some purposes, [289] such as transactions costs. A richer

---

[287] *See, e.g., supra* note 200, 222 (discussing empirical tests of rational choice theory and the development of behavioral law and economics), and note 241, 258 (critiquing the assumption that moral behavior is reducible to rational self-interest). I should say that Milton Friedman's positivism, *see* Milton Friedman, *The Methodology of Positive Economics* 3, *in* ESSAYS IN POSITIVE ECONOMICS 3 (1984)(1953), on which it does not matter whether people really are economically rational as long as the theory is predictive, is based on a conception of science as mere organization of observed results (logical empiricism) that has been utterly discredited for almost half a century, *see, e.g.*, Richard W. Miller, FACT AND METHOD: EXPLANATION AND CONFIRMATION IN THE NATURAL AND SOCIAL SCIENCES (1987) (setting forth, *inter alia*, the now generally accepted critique of logical empiricism).

[288] *See supra* note 252.

[289] *See supra* note 6 (summarizing the theorem); Adam Smith, 1 AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 456 (R.H. Campbell & AS. Skinner ed. Liberty Classics 1976) (1776) (remarking on how every individual "intending only his own gain . . . [is] . . . led by an invisible hand to promote an end that was no part of his intention," "to render the annual revenue of society as great as he can"). Without having a glimmer of the Debreau-Arrow formalization, no one knew this better than Smith himself; who loaded his masterwork with warnings about the malign motivations of businesspeople and their bad effect on society," *see, e.g., id.* at 267 ("The interest of the dealers, however, in any particular branch of trade or manufactures, is always to some respects different from, and even opposite to, that of the publick [sic]") (warning of dangers of monopoly). Nor did he deny altruistic motivations " in asserting that it is "vain [for an individual to "obtain [] the help of his brethren from their benevolence *only* . . . [without] interest[ing] their self-love in his favour [sic]," *id.* at 26 (emphasis added). Smith

and more realistic economic model may be necessary to explain much that concerns us – such, perhaps, why there are any firms at all.[290] But the idealization helps explain other things that matter, such as key aspects and effects of the operation of markets and the counterintuitive result that in certain circumstances and up to a limit Gordon Gekko was right that "Greed is good." We do not have to go whole hog with Gary Becker[291] and accept rational choice theory as a universal skeleton key to every social phenomenon to see that it has something to teach us about markets – or groups.[292]

Rational choice theory or any strong theory committed to universal egoism is implausible. Only, perhaps, a modern economist would deny what was obvious to Mill, that "the social feelings of mankind, the desire to be unity with our fellow creatures" is "a powerful natural sentiment."[293] However, as Hume insisted "the qualities of the mind [include both] *selfishness* and *limited generosity*."[294] Hume correctly rejects the hypothesis of universal selfishness.[295] "[G]enerosity and benevolence . . . sufficiently engage every heart."[296] Rebuking

---

wrote an entire book on the complexities of motivation, emphasizing sympathy and benevolence. *See* Adam Smith, THE THEORY OF THE MORAL SENTIMENTS (Arlington House 1969)(1759);

[290] *See supra* notes 99-101 and accompanying text (discussing Coase's account of the firm-market boundary) – a issue ignored by Smith). Adding in other more realistic features, such as the conflict of interest between classes, *see, e.g.,* Marx's view, *supra* note 25, may help us understand negative why the beautiful Smithian world of Arrow-Debreau often produces results that many be counterintuitive and undesirable, such as less productivity and more unpleasant work. *See* Schwartz, *Voice without Say*, *supra* note 2 (discussing why capitalist firms are not more participatory) (citing Stephen Marglin, *What Do Bosses Do? The Origins and Function of Hierarchy in Capitalist Production, Part 1*, 6 REV. RADICAL POL. ECON. (1974)).

[291] *See* Gary S. Becker, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR (1976) (arguing that rational choice theory explains all aspects of human behavior).

[292] This is the course taken by Green & Shapiro, *supra* note 199, at 202-03) (arguing that "abandon[ing] pure universalist aspirations for more subtle and modest formulations [of rational choice theory] . . . is essential if a variant of [that] theory is to advance our understanding . . .).

[293] Mill, UTILITARIANISM, *in* UTILITARIANISM AND OTHER WRITINGS 251, 284 (Mary Warnock ed., Meridian 1962) (Mill was a distinguished "political economist" of his time.), *see also* Adam Smith, *supra* note 289; and Aristotle, POLITICS 1.2 1253a1-3 (Oxford University Press, Harris Rackham trans., 1972) (". . . [i]it is clear that the city state is a natural growth, and that man is by nature a political animal").

[294] David Hume, A TREATISE ON HUMAN NATURE 494 (1st ed. L. A. Selby-Bigge & P. H. Nidditch, eds., Clarendon Press 2nd ed. 1888) [hereinafter Hume, TREATISE]; *see also id.* at 586 (same). In citing Hume on this point I do not adopt the rest of his moral or psychological theory.

[295] David Hume, AN ENQUIRY CONCERNING THE PRINCIPLES OF MORALS, Apx. II [hereinafter Hume, ENQUIRY], *in* ENQUIRIES CONCERNING HUMAN UNDERSTANDING AND CONCERNING THE PRINCIPLES OF MORALS 298 (L. A. Selby-Bigge & P. H. Nidditch, eds., Clarendon Press 2d ed. 1962) (1777) (emphasis in original). He attributes the this

those who have "carried [selfishness] much too far,"[297] Hume insists that "'tis [as] rare [to meet] . . . one, in whom the kind affections, taken together, do not overbalance all the selfish."[298] But while we are not monsters of selfish maximization,[299] Hume thought that, nonetheless, "each person loves himself better than any single person . . . ."[300] Benevolence and generosity, while real, attenuate with remoteness of connection and increase distance. [301] Little in the market tends to counteract this motivation. On the contrary, market incentives for individually self-interested action tend to exacerbate it.[302]

The whole apparatus of rational choice theory together with its claim of universal selfish maximization, however, is not required to explain why workers so rarely form cooperatives because of collective action problems. The explanation I propose here deploys the rational-choice-theoretic underpinnings of the collective action problem in the most modest and minimal way, not as a universal theory of human behavior, nor even as exhausting human motivation under market conditions. All that is necessary to add the rarity of cooperatives to the long list of public goods problems that characterize our, and perhaps any society, is the claim that in market circumstances, without further alteration in incentive structures, self-interested motivations predominate *enough* over common and solidaristic concerns to inhibit collective action to create the public good of labor managed enterprise firms unless special circumstances obtain.

---

theory, so "contrary to common feeling," *id.* to a specious "love of *simplicity* that has been the source of much false reasoning in philosophy," *id.* (emphasis in original) – an observation that has lost of none of its power in general or aptness in the particular context of the seductive appeal of economic rationality regarded as universal and sovereign..

[296] *Id.* at 177 (II.I).

[297] Hume, TREATISE at 486 (perhaps Hume here thinks of Hobbes).

[298] *Id.* at 487.

[299] The term "monsters" is Hume's. *See id*. at 486.

[300] *Id.* at 487. Hume need not make so strong a claim, nor do we need one; a statistical partiality for perceived self-interest will suffice both for his purposes and mine.

[301] *Id.* at 602 ("The generosity of men, is very limited, and . . . seldom extends beyond their friends and family, or, at most their native country."), *see also id.* at 487 (same);.

[302] "The bourgeoisie . . . has left remaining no other tie between man and man than naked self-interest, than callous 'cash payment.'" Marx, *Manifesto*, *in* Tucker, *supra* note 20, at 475

An Olsonian account of the rarity of labor management needs no more than this. The broadly Humean account dovetails with Olson's theory of when collective action occurs, and is supported by the empirical facts in few instances in which workers have overcome these difficulties, such as Mondragon, the plywood cooperatives, or the kibbutzim. Further, as we have seen, none of the other explanations that I have surveyed can meet the factual and logical challenges that confront them. I have surveyed only the most important and influential of the possible explanations, but with necessary changes, I believe it would be shown than problems like the ones they face [303] infect virtually all the competitor theories. My collective action avoids the problems with such theories that I have adumbrated, and suitably scaled to an appropriately modest level, it does account for the observed phenomena. It should be supplemented by cross-cultural historical studies, based in realistic psychological theory, which, I believe, would support and enrich a collective action account.

CONCLUSION

Why modern market economies display the pattern or organizational forms that they do, in which capital managed firms are overwhelmingly predominant, is a puzzle. The puzzle derives from a pair of connected considerations. The first is Alchian's evolutionary hypothesis, that markets select for enterprises that embody or adopt the more efficient of the range of features available, specifically the most productive and, presumably, profitable ones. The second is the striking fact that labor management has a significant productivity advantage over capital management. If productivity is a proxy for profitability and a measure of efficiency, the cooperative or labor managed enterprise owned and operated by its employees should be the, or a predominant form in a market economy. John Stuart Mill, over a century and a half ago,

[303] Most of Dow, *supra* note 7, is developed to detailed discussion of the inadequacies of a wide range of alternative explanations, although, as noted, Dow does *not* consider a collective action explanation and his own capital formation account will not hold water.

predicted that this would be direction in which the economy would evolve over time, in no small part for the reasons just set forth. Mill was right about the reasons but wrong about the results. It would be a gross overstatement to say that the labor managed firm is even marginal in the market today.[304] Instead, the capital managed firm, either in the form of the classic capitalist firm or the open corporation, is the near universal form of enterprise organization. Why is that?

The standard accounts now in play draw on variations of transactions cost theory, which calls attention to the costs involved in economic interactions. We surveyed three such representative but very different accounts by leading analysts, and found each of them wanting logically and empirically. Two focused on purported inefficiencies due to internal transactions costs. Arnold, first, summarizing the work of some of the most important institutional economists, attributed the rarity of labor management to inadequate internal monitoring that permitted excessive shirking and opportunistic behavior by the workers who own the cooperatives. This account failed because its central claim is untrue: labor management provides effective monitoring, as is its central prediction, that labor managed firms will be less productive. Hansmann, second, correctly rejected monitoring as a problem, and attempted to explain the puzzle in terms of supposedly higher transaction costs of making management decisions, particularly about compensation, in enterprises with heterogeneous workforces. This account likewise lacked empirical support, because, while compensation decisions are contentious, there is no reason to think that the fairly flat pay scales cooperatives adopt fail to address the issue, and because the most successful cooperative enterprise in the world, Mondragon, is highly heterogeneous. Moreover both "internal" transaction cost theories ran aground because they could not explain why the purported problem (monitoring, conflict due to heterogeneity) did not

[304] If we concede Hansmann's claim that partnerships in professional services are labor managed firms, *see* Hansmann, ENTERPRISE, *supra* note 2, at 67, 70-71, we might diminish this characterization to a "great" overstatement, and qualify their marginality by sector. I have explained my skepticism above. *See supra* note 63.

favor cooperatives over open corporations. Finally each theory put its explanation in the wrong place, failing to account for why so few cooperatives are started at all and instead, predicted erroneously that they would suffer a higher failure rate than capitalist firms.

We then turned to external transactions costs, in particular the problems that Dow, third, claimed that workers would have raising sufficient external capital for labor managed firms. Dow correctly denied that labor management was inefficient, and in fact showed the contrary at length, and he located the problem I address at the right point, why, *ab initio*, do workers not form enterprises so organized. Dow put his finger on a puzzle in the empirical fact that most of the few such firms are indeed self-financed, but he failed to explain (1) why investors and lenders would regard more productive and efficient enterprises as being abnormally risky in view of the reckless behavior of capital managed firms to whom they gladly hand over their money, or (2) why workers did in fact lack the resources themselves in view of, *inter alia*, the proliferation of ESOPs, employee owned but capital managed enterprises, many of which are quite large. I concluded that Hansmann was right to reject Dow's general sort of explanation.

I then proposed a novel account little discussed in the literature, that labor management is a public good subject to the sort of collective action problem identified by Olson, the obstacles to the formation of which are amplified by the mere exposure effect. In brief, goods that require a common contribution but from which no one can be excluded once they are provided will tend to be provided, if at all, to suboptimal amounts because each has a (selfish or "economically rational") incentive to contribute less or none than the share required to generate the optimal amount of the good, on the pattern of a *n*-person prisoner's dilemma. This problem can be minimized with smaller groups where some individual has a (selfish or other) incentive to provide the public good as well as entrepreneurial vision and ability, and social pressure exists to cooperate. This fit the formation, for example, of Mondragon extremely well.

Collective action explanations are problematic because they depend, in standard presentations, on a manifestly false theory of human action, rational choice theory, on which individuals are selfish maximizers. I argued that a more modest version of the theory would suffice to generate the problem in the appropriate circumstances if recast in Humean terms that granted our limited social and benevolent tendencies as well as our selfishness. The market, I urged, is paradigmatic of the circumstances where public goods problems arise. This, together with the established psychological result that people prefer what is familiar – in the real world of the market, capital and not labor managed enterprises – would combine to explain why so there are so few cooperatives formed despite their productivity and other advantages.

If this is correct, where Mill went wrong was in supposing that markets--atomizing, individualizing, competitive institutions--could promote cooperation. Cooperatives may do better (or as well) in the market as capitalist enterprises once they are established, but the market will not grow cooperatives. Creating the public good of labor management requires going beyond the market and finding strong sources of institutional support, *e.g*., in the unions, a powerful political party, or the government, to provide financial, legislative, and other incentives or resources to implement it. For those, and to lay my cards on the table, I am one, who would like to see more cooperatives, indeed, an economy in which the labor managed firm is predominant, this line of argument, if correct, points in a specific direction. That is an upside: the path is marked. The downside is that the path is steep.

The standard solution to a collective action problem is to find or create an institutional authority with the power to create the public good by changing the incentive structure.

Traditionally this thought to require an authority with coercive power, and typically the government.[305] It is the role (and in some cases a justification) of the state to provide public goods that the market will not.[306] The development of the ESOP through legislation is a case in point.[307] However, on the view that coercive power is key, state authority is not. Olson himself illustrates the idea through his discussion of the growth of the large U.S. labor union and its use of nonstate coercion to provide public goods of higher wages and better working conditions for its members.[308] Institutions like political parties may lack formal coercive powers and still change incentive structures through ability to offer or withhold rewards that are nonpublic goods. It is unclear whether coercion (a negative incentive) rather than reward might be a more effective way to change the incentive structure.[309] There is a question about whether changing incentives rather than other sorts of psychological influence are more effective ways of overcoming collective action problems.[310] Governmental provision of resources that it would otherwise withhold for compliance with nonmandatory guidelines is a case in point.[311] Other institutions like lobbying groups and other voluntary associations, including environmental groups like the Sierra Club, that are thoroughly voluntary, may lack any coercive powers or real power to provide significant rewards.[312] How effective they are is a matter of debate.

It is not necessary here to take a position on any of these questions given two basic points. The first point, and this is the upside, is that promoting the predominance of labor

---

[305] *See* Olson¸ *supra* note 16, at 96, 99.
[306] *Id.* at 12-16, 96-102,
[307] *See supra* note 55.
[308] Id. *at* 71 (citing Henry George and emphasizing the need for physical or moral coercion in labor organizing)
[309] Pamela Oliver, *Rewards and Punishments as Selective Incentives for Collective Action: Theoretical Investigations*. 85 AM. J. SOCIOLOGY 1373(1980) (discussing how negative incentives can ensure unanimity but undermine collective action if unanimity is not required).
[310] George Dent, *Race, Trust, Altruism, and Reciprocity*, 39 U. RICH. L. REV. 1001, 1012 (2005) ("Material incentives can even backfire. A person inclined to act out of altruism may come to view the act in terms of self-interest if offered a reward for so doing.")
[311] *See* South Dakota v. Dole, 483 U.S. 203 (1987) (upholding federal action in withholding federal highway funds that failed to impose an age limit of 21 on purchase of alcoholic beverages).
[312] Hardin, COLLECTIVE ACTION, *supra* note 13, at 101-24.

managed enterprise requires overcoming a collective goods problem by whatever means is most effective, whether that is coercive or noncoercive governmental action, the activities of voluntary groups and associations with or without political power or coercive abilities of their own, for example by lobbying effectively for legislation that supports cooperatives that is at least as effective as that which supported ESOPs, or creating a bank like Mondragon's Caja together with publicity and training to further this end. These are daunting propositions. They are more so when we realize that the development of any of these institutions itself involves at least one and in many cases several collective action problems of their own, because these are public goods themselves. But the creation of the ESOP, with all its limitations, or of Mondragon, in both cases created under the conditions Olson identified as optimal for overcoming a collective action problem, offers some basis for optimism. If, however, this Article has assisted in the identification of the problem by answering in outline the question posed in the title, while diverting us from the dead ends of the usual answers, I have achieved my end in the Article and put us at the start of the right road. Further articulation of how to build the road as we travel is a task for another time.