

**The Economics of the Labor-Managed Firm:
An Informal Survey**

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1. Introduction

I am an economist at Simon Fraser University. I have been interested in labor-managed firms (LMFs) for about 40 years.

More specifically, I am an applied microeconomic theorist. My focus is on developing formal models of LMF behavior and trying to explain why LMFs are relatively rare.

I base my theoretical models on empirical evidence and think about policy implications.

I have two books on the subject, both from Cambridge University Press:

"Governing the Firm: Workers' Control in Theory and Practice" (2003).

"The Labor-Managed Firm: Theoretical Foundations" (2018a).

The 2003 book has very little math and is meant for a broad audience. It discusses normative perspectives, provides case studies, describes economic views of the labor-managed firm, and concludes with a policy proposal to facilitate employee buy-outs of conventional firms.

The 2018 book is aimed more at economists and does use quite a bit of math. However, some chapters are entirely verbal and should be widely accessible. This book also concludes with a chapter about policy ideas.

2. Background

When I use the term 'labor-managed firm' (LMF), I mean any firm where ultimate control over managerial decisions rests with labor suppliers.

In practice I will often be referring to workers' cooperatives, although I also think of professional partnerships like law firms as examples of LMFs.

When I use the term 'capital-managed firm' (KMF), I mean any firm where ultimate control over managerial decisions rests with capital suppliers.

This category includes conventional corporations controlled by shareholders or similar investors.

There are also various hybrid forms involving employee stock ownership, codetermination, and other structures. We may want to discuss these subjects later, but for the moment I will simplify by focusing on the contrast between LMFs and KMFs.

3. Empirical Asymmetries

A striking empirical asymmetry between KMFs and LMFs is that KMFs are common while LMFs are rare, especially among large firms.

In advanced economies, workers' cooperatives generally account for at most 3-4% of economic activity (sales, employment, assets, etc.), and often considerably less.

Adding professional partnerships would increase the fraction a bit, but not by much.

Given the attractiveness of LMFs on grounds of democracy, equality, and community, this is a puzzle: if LMFs are so great, why are they so rare?

Although this is the most important empirical asymmetry, there are others, including differences in distribution of KMFs and LMFs across industries; differences in their responses to economic shocks; differences in productivity and survival rates; and so on.

A good economic theory about LMFs should account for the full range of asymmetries between KMFs and LMFs in a systematic way.

4. The Economic Theory of the LMF: Older Views

When I was an assistant professor in the early 1980s, the economic literature on LMFs was dominated by three main ideas:

- (a) LMFs maximize income per worker (rather than profit).
- (b) LMFs invest less and grow less rapidly than KMFs.
- (c) LMFs are rare because they have problems with work incentives.

All three ideas are now obsolete and should be abandoned by serious researchers in the field.

- (a) The hypothesis about maximization of income per worker does not make theoretical or institutional sense, and it is contradicted by empirical evidence on LMF behavior.
- (b) There is not much evidence that LMFs and KMFs operating in the same industry differ in their rate of investment, perhaps because workers' coops often have institutional rules mandating minimum levels of re-investment out of current income.
- (c) The idea that LMFs are dysfunctional due to problems with work effort, monitoring, or similar operational flaws is now discredited. Empirical research indicates that when KMFs and LMFs compete in the same industry, the LMFs tend to have productivity that is at least as high as KMFs, and sometimes higher. They also have fewer supervisors.

For a history of economic thought about LMFs, see Dow (2018b).

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5. The Economic Theory of the LMF: Modern Views

Suppose we lived in a world of complete and competitive markets (a theoretical benchmark).

In such a world, economic theory predicts no asymmetries between KMFs and LMFs.

Specifically, both firm types would maximize profit, they would be equally common, and they would be randomly distributed across industries.

Therefore, if we want to explain the real asymmetries between KMFs and LMFs, we will need a theoretical framework that includes market imperfections.

Economists have a standard list of potential market imperfections. These include externalities, public goods, informational asymmetries, incomplete contracts, limited ability to make credible commitments about future behavior, and so on.

The trick is to figure out which imperfections are most relevant for LMFs.

BUT: it is not enough just to have some sort of market imperfection.

We must also identify some difference between capital and labor, so that it matters whether the firm is controlled by capital suppliers or labor suppliers.

Without a difference of this kind, market imperfections would have symmetric effects on the two types of firms.

My suggestion: capital is alienable while labor is inalienable.

For non-human assets (machines, buildings, patents), ownership can be easily transferred across individuals or groups.

For human assets (time, talents, skills, knowledge, experience), ownership cannot be transferred from one person to another.

This difference has many economic implications. For example, firms can own non-human assets but they cannot own human assets.

In "The Labor-Managed Firm: Theoretical Foundations" (2018a), I attempt to show how market imperfections and the alienability difference between K and L interact in ways that help explain the empirical asymmetries between KMFs and LMFs.

6. What Do We Know Empirically?

We have high-quality econometric research on several important empirical issues. The best data tend to come from Italy, France, Spain, and Uruguay.

Here are some facts that seem reasonably robust, along with a few citations to the literature. See Dow (2018a, chs. 6-8) for details and further citations.

- (a) When they compete in the same industry, LMFs typically have productivity levels at least as high, and sometimes higher, than KMFs (Fakhfakh et al., 2012).
- (b) When they compete in the same industry, LMFs typically have survival rates at least as high, and sometimes higher, than KMFs (Burdin, 2014).
- (c) LMFs respond to economic shocks by keeping employment more stable and accepting larger fluctuations in individual worker incomes as compared to KMFs (Pencavel et al., 2006).
- (d) LMFs are less likely to enter industries that are more capital-intensive or have more risk (Podivinsky and Stewart, 2007, 2009).
- (e) New LMFs are more likely to be created in regions and industries where a large number of LMFs already exist, i.e., positive agglomeration effects (Arando et al., 2012).

A caveat: we need replications of such research across additional countries and time periods.

7. Why Are LMFs Rare? A Demographic Approach

The population of LMFs is determined by the following demographic factors:

- (a) The LMF birth rate
- (b) The rate at which KMFs are converted into LMFs
- (c) The rate at which LMFs are converted into KMFs
- (d) The LMF death rate

The evidence indicates that once LMFs exist, they have high survival rates. The productivity evidence is consistent with this. The problem is not a high death rate compared to KMFs.

Some LMFs have been converted into KMFs (for example, plywood coops in the northwestern U.S.). However, in Europe institutional rules tend to prevent such conversions. The problem is not that LMFs are routinely converted into KMFs after they have been created.

The LMF birth rate is vastly lower than the KMF birth rate (by a factor of 100 to 1000 on an annual basis in countries where we have data). This is a crucial part of the story.

It is also clear that very few KMFs are converted into LMFs. When employees buy out KMFs, this typically involves firms in financial distress where the motivation is to preserve jobs.

Given the enormous population of KMFs, even a small increase in the conversion rate would expand the LMF population dramatically.

8. Why Are LMFs Rare? An Economic Approach

My reading of the evidence is that once they exist, LMFs perform well in many industries. For example, worker cooperatives have been able to thrive in Italy, France, Spain, and elsewhere.

But even in these countries, LMFs are a small part of the overall economy, and in some countries their role is negligible.

(a) What are the barriers to entry for LMFs created from scratch?

Two traditional arguments involve

- (i) Access to capital (especially for capital-intensive industries)
- (ii) Financial diversification by workers (especially for high-risk industries).

Both are probably important. Note that access to capital could be limited either due to standard informational asymmetries (adverse selection, moral hazard), or due to difficulties in making a credible commitment to repay outside investors.

I would add a third point:

- (iii) Imperfect worker knowledge about the value of projects proposed by entrepreneurs. This makes workers less willing to pay for membership rights in LMFs even when workers do not face wealth constraints and are risk neutral. Thus, entrepreneurs tend to create KMFs instead, even if an LMF would have had higher productivity.

(b) What are the barriers to conversion of existing KMFs into LMFs?

For financially successful KMFs, capital constraints and risk attitudes may again play a role.

I would add at least three more factors:

- (i) Imperfect worker knowledge about the value of the firm as an LMF (for example, the size of the productivity gains resulting from conversion, if any).
- (ii) Free rider problems for employee buyouts (costs are concentrated on individuals or small groups while the benefits are widely diffused across the entire workforce).
- (iii) Workers tend to have heterogeneous preferences about risk, consumption versus saving, working conditions versus income, and so on.

Workers' control is a public good from the standpoint of individual workers in a firm, who may differ in their willingness to 'tax' themselves in order to pay for it.

9. Policy Ideas

If this diagnosis is correct, what is the prescription?

I think it makes sense to focus on two main strategies:

- (a) Facilitating the conversion of KMFs into LMFs through gradual worker accumulation of equity shares, with subsidy mechanisms like those used in the U.S. for ESOPs but with rules ensuring that the result will be full workers' control with one vote per worker.
- (b) Encouraging formation of LMF federations like those in Italy and Spain, where central agencies can supply capital for creation of new LMFs and conversion of existing KMFs. Such federations also help spread risk, provide technical support, and overcome problems caused by informational asymmetries.

Government involvement will normally be required to create such federations and provide them with seed financing. Subsidies are justified due to the prevalence of market failures.

Differences in the size of the LMF sector across countries suggest that such institutions matter.

We need careful institutional design to deal with free-rider issues, informational issues, and credible commitment issues.

The literature suggests that LMFs need certain kinds of rules to avoid predictable problems. For instance: rules limiting the use of non-member labor, mandating minimum re-investment rates, and preventing sales of LMF shares to outside investors.

We also need rules about entry of new workers (membership fees) and the departure of existing workers (repurchase of membership rights by the firm at a price that reflects the present value of future membership).

We need to target resources on industries where LMFs are most likely to prosper, and we need more empirical research aimed at identifying the characteristics of such industries.

We might need to focus resources geographically in order to exploit agglomeration effects.

For more thoughts on policy issues, see Dow (2003, Ch. 12) and Dow (2018a, Ch. 20).

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