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This paper tries to unravel a few important connections among economic efficiency, worker management of the enterprise, democratic governance, and the history of financial relationships within firms. We begin with a definition of democratic firms and then present one way (our "RICE" nexus) of addressing crucial internal economic relations of viable enterprises. The paper briefly examines traditional capital-controlled firms and the internal changes they have adopted. Next, we turn to worker-managed firms in this same framework and discuss why they tend to revert to capital-controlled enterprises over time. A review of some means of averting this degeneration is presented before concluding. The conclusion addresses the broader question of whether there is much hope for the spontaneous creation of democratic firms in coming years without additional institutional changes in the economic environment.

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Democratic Firms as Political Institutions

A minimum definition of a democratic, worker-managed firm requires that the workers govern the enterprise as equals, excluding no member, and as a sovereign body. This definition implies that all permanent workers each have one vote in the governance mechanism. The work force should also have the power to decide on the fate of the enterprise and should not be subservient to another outside decisionmaking authority. This minimum definition does *not* imply that each worker's income is equal, that hierarchy is absent, and that a management group is not delegated authority over day-to-day decisions. It simply means that the work force holds ultimate authority and is the final arbiter within the firm.

Economic Efficiency

To survive in a decentralized, competitive market economy with many opportunistic individuals, an enterprise needs to be organized to respond to both internal and external pressures. Internally, the firm needs to address what we choose to call the "RICE nexus" (risk, incentives, control, effort) problem. This complex of interrelated issues addresses, we believe, the major economic questions to be answered in the internal institutional organization of successful firms. Successful firms solve problems by creating internal incentives to motivate individuals to produce adequate economic efforts. The "institutionalization of firms" allocates risks and control rights, which also affects enterprise viability. When opportunism and uncertainty co-exist, there is no a priori first best enterprise design solution for resolving these issues.

There are many other methods for posing the problem of internal organization of the firm. These methods focus on issues of monitoring, shirking, implicit/efficient contracts, and so on. They can all be subsumed within the RICE complex. Some issues, however, such as the external boundary of the firm (the focus of the transactions cost approach), exogenous technological change, and social and legal environments are external to this analytic nexus and are addressed only at the paper's end.

Evolving Internal Arrangements in Traditional Capital-Controlled Firms

In a monetary economy, providing finance normally gives the provider control of an enterprise, at least if the financier carries the primary risk in the case of bankruptcy. Some authors insist that capital "naturally" assumes the role of government of the firm because of this burden of risk [Bonin and Putterman 1987]. Moreover, some add that capital holders also have a natural incentive to control in such a manner as to promote the best possible results for any economic enterprise taken as a whole. A natural evolution produces capitalist enterprises.

In modern capitalism, however–as Berle and Means revealed some 60 years ago–capitalist-owners have become separated from the direct control of most sizeable enterprises. A hired management has become the dominant force in firm decisions. This kind of management may not always act in the owner-capitalists' best interests [Klinedinst 1991], and to reduce this problem a variety of management compensation programs have been developed to create incentives for control of corporations in accord with the goals of absentee owners.

In recent years, the inadequate incentive to good effort provided by either hourly wages or even piece-rate wages for the employees in enterprises has received attention [Putterman 1984]. Contracts for a fixed hourly wage make it rational to minimize effort (at least within the limits of avoiding risks of job loss). In many cases, piece-rate work may create perverse incentives for workers that do not coincide with the goal of either management or owners. In recent years, we have witnessed a growing concern with "alternative compensation systems" for employees [Blinder 1990].

Profit-sharing, bonus, and gains-sharing plans have increased the theoretical variability of workers' compensation. These plans attempt to increase the connection between effort and incentive, while stopping short of any significant increase in the control exercised by workers.

In some enterprises, management and labor have focused to some extent on the control aspect of the nexus. By involving workers in decisions, better effort has been hoped for [Rooney 1988]. These firms seem more likely to have longer term "implicit" (or even explicit) contracts with workers, so that the financial incentives are also greater.

Workers' Production Cooperatives in the United States

In the United States, production workers have only infrequently created cooperatives. Sometimes it happened by necessity, when strikes or lockouts occurred. Workers set up cooperative production, which also allowed them to allocate risks and incentives among themselves to promote successful effort.

In the nineteenth century, such autonomous worker-controlled activity brought on hostility from traditional firms. This situation was especially true if the cooperative competed in the same markets. Lacking an authoritative history of workers' cooperatives, we only have anecdotal evidence of active subversion. More evidence is available about financial deprivation. Finance capital seems to have been largely unavailable to workers' production cooperatives, and during the last hundred years advocates of cooperatives have always included the lack of finance capital as one of the difficult obstacles to overcome in creating these firms. In any case, almost all the workers' production cooperatives of the nineteenth century disappeared quickly.

Despite these problems, since 1890, a few hundred workers' production cooperatives have been created, and a few have remained in operation for a generation. However, economically successful firms have tended to revert to traditional capitalist ownership. Even when the RICE nexus complex of problems had apparently been solved, degeneration occurred. This degeneration could occur gradually as a greater proportion of the work force was hired simply as employees–without membership in the governing group. The voting members of the collective–those who had created the firm, and were now "first class workers"–shared control and incentives of potential capital gains and could be relied on to make efforts coinciding with both individual motives as well as goals of the enterprise as a whole. These members carried risk of both job loss and capital gain loss if the cooperative failed. The second-class workers risked job loss but not finance capital.

In these and other cases, successful workers' production cooperatives have reverted to capitalist ownership by outright sale of the entire enterprise. This situation was one way owner-workers could cash in on equity accumulation. In the case of some workers' cooperatives (e.g., U.S. plywood firms), individual memberships were sold in order to realize the capital gain, but when the appreciation was large, it became more and more difficult to locate individuals who would "buy a job" (a voting membership share) at a high price. Analogous problems of unrealizable equity have faced independent producers' (farmers') co-ops and sometimes even consumers' cooperatives. In some of these cooperatives, the members have voted to resolve the capital gains problem by jettisoning the democratic principle of one person/one vote or by selling the firm as a unit to another owner.

Financial Relations for Maintaining Democracy in Worker-Managed Enterprises

One solution to this problem has been the creation of equity-like instruments with fluctuating returns within the firm that are unrelated to the exercise of control rights. The well-known Mondragon system of cooperatives has succeeded in part because of this creative innovation in financing, which has allowed the RICE problem to be solved while maintaining democratic control by the work force. In effect, Mondragon worker cooperatives have individualized internal equity funds as part of their capital structure [Thomas and Logan 1982]. The major economic problem with these came in capital intensive firms, where most workers could be expected to retire in the same period, which would drain too many funds all at once. This dilemma was partially resolved by having a varied age structure of the work force. Mondragon has another unique feature that may be even more important at least for the successful expansion of the number of cooperatives in the system as a whole. This resource is the bank (Caja Laboral Popular), which provides start-up capital and technical assistance to new cooperatives.

A technical assistance group for democratic firms, the Industrial Cooperative Association of Boston, adapted the Mondragon internal equity approach to cooperative laws of the United States. Through the ICA's initiatives, beginning in the early 1980s, special workers' production cooperative laws, modeled on Mondragon, were passed in several states. These new laws avoided the cumbersome procedure of incorporating under traditional cooperative laws (oriented to consumers' and farmers' cooperatives), which had certain restrictions that could complicate the use of the internal capital accounts. Again, during the 1980s, the highly decentralized U.S. movement for workers' cooperatives created numerous small technical assistance groups [Rock 1988].

Nevertheless, the new, specially-designed, American worker cooperative laws seem little used. They appear adequate for incorporating small firms democratically, but firms with with any significant number of employees are driven by another legal constraint (or "opportunity"). This opportunity is the generous tax relief, beginning in 1974, for joint-stock corporations with Employee Stock Ownership Plans. To benefit from these tax breaks, it is necessary to incorporate legally as a capital-controlled firm. Stock ownership has usually precluded a one-worker/one-vote system unless the stock is distributed equally among the work force. Even when this is the case, as workers leave the firm, they may sell their stock to outside investors.

Again, the ICA and its chief economist, David Ellerman, devised a partial solution–the creation of an ESOP-Trust [Ellerman 1990]. This device could hold the stock of employees jointly in a trust that could vote the entire block of stock at annual meetings to elect the governing board of directors. The work force could thus have a democratic vote, which would then direct (and by contract, bind) the trustees' vote of the holding trust's stock. This procedure was cumbersome and indirect. Moreover, ESOP arrangements require expensive initial and ongoing legal and accountancy help as well as education for employees regarding the control mechanism. ESOP plans are regulated by a complex law (ERISA and amendments) as well as by interpretation by the Department of Labor. Under U.S. law, some unresolved issues remain, such as the required distribution of stock to departing employees. The advantages of ESOP organization include the ability to gain effective control of a firm without buying all the stock, which is especially important in capital-intensive businesses. It also permits what Ellerman calls "gearing up" or the gradual acquisition of a controlling interest in joint-stock corporations. The results have been modest. Although there are over 12,000 firms with ESOPs, a mere handful qualify as democratic worker-managed firms as defined above [Rock 1991].

"Natural" Economic Evolution and Workplace Democracy

Political democracy is an unusual phenomenon and has only seemed to evolve "naturally" and unguided in smaller social groupings. Despotism, monarchy, oligarchy, and other inegalitarian political systems have more frequently been the choice of those with the power and unrestricted "liberty" to decide on how they will govern. Democracy has been created among polities more frequently by requiring certain behaviors, as well as proscribing other activities that emanate from egoism and power-seeking. Americans pride themselves on being a nation based on laws–institutionalized sanctions and rights.

Creating democratic institutions may be no less difficult–and "unnatural"–in the economic sphere [Bowles and Gintis 1986]. The U.S. tax regime already is a labyrinth of special provisions to promote or deter certain actions. Tax privileges for democratic enterprises could be added. Government agencies already promote a myriad of activities, so why not new (or modified) democratic businesses? A small advance in this direction has already occurred, albeit at a financially modest level, with the recent allocation to new state-level rural development centers to help promote cooperatives. These and similar urban centers might also help fund experimentation and innovation in the design of new ways of institutionalizing economically efficient and democratic enterprises. Financial intermediaries might be democratized as well [Gunn and Gunn 1991]. Credit unions already exist and have approximately $225 billion in assets, and some have reasonably democratic practices. They are severely restricted in their lending practices by federal regulators, yet there are ways of maintaining their security while expanding their business lending [Klinedinst and Rock 1991]. Beyond this, a new law to promote democratic investment banks hardly seems radical after the astonishing stories of banking finance in the 1980s. Pension funds, which are estimated to own 25 percent of all U.S. equity capital, could also be directed toward investments in worker-managed firms. Tax benefits for investors in democratically controlled enterprises could be adopted [Mygind 1990]. This situation would require serious thought as to how to maintain democracy in firms that accept outside capital [Vanek 1990]. Already there are many theoretical proposals regarding how to accomplish this compromise (and even experimentation with new debt/equity hybrid instruments in Europe) [Groupes de Travail 1991].

These prescriptions may be subverted by "dollarization" or international currency flows. Nevertheless, such policies may retain potential effectiveness in larger market areas such as the United States or the European Community. Certain sectors of any economy are likely to remain more domestically based because of the immobility of resources, labor, or physical capital.

Smaller-scale enterprises have received increased attention in the last two decades. Smaller, autonomous (although interconnected) firms are touted as having greater production flexibility. Environmentalists argue that having those who control the firm situated in the local community tends to make them more ecologically responsible. (Clearly, there is some debate about this belief since there are economies of scale in information and certain types of compliance with regulations.) Other analysts believe that democratic firms will tend to be smaller than nondemocratic ones for both economic and political (internal governance) motivations. In any case, there are good arguments to be made for subsidizing more choice for employees regarding the type of firm in which to work.

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