A Socialist Shortcut to Capitalism - The Role of Worker Ownership in Eastern Europe's Mass Privatizations

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A Socialist Shortcut to Capitalism? The Role of Worker Ownership in Eastern Europe’s Mass Privatizations

Robert Wisnewski

Table of Contents

I. INTRODUCTION ........................................... 123

II. WORKER OWNERSHIP IN EASTERN EUROPE .............. 125
   A. Current Proposals for Reform .......................... 125
   B. The History of Worker Control in Eastern Europe ...... 127

III. THE ECONOMICS OF THE FIRM AND THE ECONOMIC TRANSITION .................................................. 129
   A. The Strategy of Economic Transition ................... 129
      1. The “Cold Shower Approach” .......................... 130
      2. The Evolutionary Approach ............................ 131
   B. The Behavior of the Worker-Owned Firm ............... 132
      1. Capital Market Problems ............................. 132
      2. Labor Market Adjustment Issues ...................... 134
      3. Organizational Efficiency ............................. 136

   A. Worker Ownership and Democracy ........................ 138
   B. Worker Ownership and the Politics of Transition ... 140
      1. The Fairness of Worker Ownership .................... 140
      2. Worker Ownership and the Democratic Transition .... 141

V. CONCLUSION ............................................. 142

I. Introduction

After the collapse of communist regimes in Eastern Europe in the fall of 1989, a new political joke began to circulate through the region. It went as follows: What is the definition of socialism? It is the longest road from capitalism to capitalism. The thesis of this paper may strike
some readers as being equally absurd. This thesis is that the shortest road from a centrally planned economic system to some form of capitalism is via another form of socialism—market socialism.

The form of market socialism that this Article advocates is a system of worker-owned firms as opposed to a system of decentralized public ownership. The introduction of market forces into a system of public ownership has already been tried in Eastern Europe and has been an unambiguous failure. This form of market socialism no longer has any political support in these countries, even though innovative new versions of it continue to be proposed by some Western intellectuals.

By contrast, as will be discussed in the first part of this paper, the verdict on the performance of worker-owned firms in Eastern Europe is not yet in. As a result, the idea of worker ownership appears to be a popular one and is an important element of several privatization schemes that are currently being implemented. “Privatization,” in this sense, is compatible with market socialism as it refers to the creation of property rights in a firm and their transfer to its employees.

Influential Western business periodicals have denounced the idea of privatization through worker ownership on the grounds that “markets need capitalists.” Some professional economists agree, claiming that “[i]f employee-owned firms become the dominant form of ownership, . . . their deficiencies, known from property rights and agency theory, will leave a strong imprint upon their performance—and on that of the economy as a whole.” Yet, as this Article will argue in Part III, economic theory does not prove that such firms can never work. Instead, the literature suggests that worker-owned firms have both advantages and disadvantages relative to capitalist firms. Furthermore, this Article will show that in the context of Eastern Europe’s economic transition, many of the long-run problems of worker ownership are short-run virtues. Worker ownership may therefore outperform capitalist ownership during the transition period, and, later, when the economic climate has stabilized, possibly be replaced by it.

However, the most decisive arguments in favor of worker owner-

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3 See infra notes 11-26 and accompanying text.
4 If the transfer results in only employees holding equal shares in the firm, a pure worker cooperative has been created. However, many other forms of worker ownership are also possible, including those which bring no control whatsoever, e.g., American employee stock ownership plans (ESOPs). See Jon Elster & Karl Ove Moene, Introduction to Alternatives to Capitalism 1, 22-25 (Jon Elster & Karl Ove Moene eds., 1990).
7 See infra notes 62-98 and accompanying text.
Worker Ownership in Eastern Europe

A. Current Proposals for Reform

Any claim on behalf of some form of socialism as a solution to the economic problems of Eastern Europe is likely to encounter a high degree of (justified) skepticism. After all, the people of this region have made it abundantly clear that they no longer want to be guinea pigs in a grand social experiment. As one commentator has said:

That the absurdist aspect of contemporary Western academic discourse about economic systems is lost on its practitioners is convincingly confirmed by the most recent issue of the journal, *Ethics*, in which a group of Western academics gravely discusses various aspects of market socialism—a conception exposed to universal derision in the transitional societies of the post-communist world where it originated decades ago. The contributors to *Ethics* might have done better to discuss the prospects of the restoration of [the] monarchy in Russia—far less of an exercise in anachronism and conceivably a topic of some interest to those whose fates it might affect.8

Yet, this reaction to market socialism is misguided with respect to both the origins of the idea and its prospects in contemporary Eastern Europe.

First, the vision of an economic system made up of worker cooperatives dates back to long before the breakdown of central planning in Eastern Europe. It was popular during Karl Marx's lifetime, but he thought little of it and called its supporters "Utopian socialists."9 This label is doubly misleading. Not only is the idea distinctly non-utopian, it may not even be socialist. Leading liberal philosophers, from John Stuart Mill to John Rawls,10 have also been attracted to it.

Second, and more importantly, this vision currently has significant political support in the former Eastern Bloc. Worker ownership is an important part of recent privatization legislation in the region. For example, Russia's privatization scheme has three parts that can be

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loosely described as follows: (1) corporatization; (2) choice of employee ownership plans; and (3) stock purchase plans.\textsuperscript{11}

In the first step, taken in July 1992, large- and medium-sized enterprises were corporatized by establishing boards of directors on which workers sit alongside management and government officials.\textsuperscript{12} This step was a prerequisite to privatization because Russian firms formerly existed merely as units of the central plan and had none of the normal methods of corporate control.\textsuperscript{13}

In the second step, the new companies could choose between two proposals. Under the first of these proposals, workers would be given twenty-five percent of the company's non-voting shares and an option to buy ten percent of voting shares at a thirty percent discount. Managers would then receive an option on five percent of the shares and the remaining sixty percent would be sold to the public.\textsuperscript{14} The second proposal would involve even greater worker control. It would allow workers to buy fifty-one percent of assets at 1.7 times their book value as of January 1992.\textsuperscript{15} The premium above book value was probably meant to reflect the fact that assets appreciate over time and are usually worth more than their historical cost (a questionable assumption in the Russian context).

The third step of the scheme, taken in October 1992, involved the distribution to all citizens of tradeable vouchers that could be spent at auctions of stock in newly privatized enterprises. Citizens who did not want to buy stock could sell their vouchers for cash.\textsuperscript{16} Not only did this third step broaden the political support for privatization, but it also created a liquid market in the shares that workers received during the second step of the process.\textsuperscript{17}

Admittedly, Russia's program involves more worker ownership than that of other former Eastern Bloc countries. Aside from Russia, Poland has the most powerful lobby for self-management, due to the role of Solidarity in bringing about the events of 1989.\textsuperscript{18} Yet, despite Solidarity's efforts, proposed legislation grants Polish workers only ten percent of the initial share distribution, with no further option to buy.\textsuperscript{19} In other countries, worker participation plays no part in the share distribution process, even though workers are granted representation on some corporate boards.\textsuperscript{20}

\begin{itemize}
\item \textsuperscript{11} Russia Under the Hammer, ECONOMIST, Nov. 28, 1992, at 69.
\item \textsuperscript{12} Id.
\item \textsuperscript{13} Id.
\item \textsuperscript{14} Id.
\item \textsuperscript{15} Id.
\item \textsuperscript{16} Id.
\item \textsuperscript{17} Id.
\item \textsuperscript{18} Market Economies, supra note 6, at 273.
\item \textsuperscript{19} Stanley Fischer, Privatization in Eastern European Transformation, in Market Economies, supra note 6, at 227, 236.
\item \textsuperscript{20} Id. at 254.
\end{itemize}
Although a wide political consensus in favor of worker ownership has not yet emerged, Russia's plan nonetheless clearly demonstrates that there is a significant constituency supporting it. Furthermore, even where workers are not given an initial share distribution, they can achieve de facto control by bidding their vouchers on their own firms. The wide dispersion of share ownership means that such worker buyouts will be frequent. Early anecdotal reports even suggest that some Russian workers are bidding on firms in which they already have a controlling interest.

The Russian plan also illustrates how the standard approach to mass privatization can be easily modified so as to create a large sector of worker-owned firms. The standard approach involves the quick sale of small enterprises to the private sector, combined with a distribution or sale of vouchers for stock in the "core" medium- and large-sized companies. Some role is also played by holding companies or mutual funds. Although these mass privatization plans have had some problems (such as vouchers not indexed to inflation), they have allowed thousands of firms to be privatized at a rate much higher than that of the traditional single firm auction approach.

B. The History of Worker Control in Eastern Europe

The Russian privatization plan is not the first experiment with worker control in the former Eastern Bloc. One form of privatization has already been tried, beginning with the Yugoslavian reforms of the 1960s. The disastrous Yugoslavian experience of debt and stagflation was repeated in Poland and Hungary in the early 1980s after attempts at decentralization led to a similar system. This common experience


23 Fischer, supra note 19, at 229-237.

24 Id. at 239-41. The Hungarian "bottom-up" approach is an exception to this form of privatization. See id. at 237-38. Of course, Germany is also a special case. See Norbert Horn, The Lawful German Revolution: Privatization and Market Economy in a Re-unified Germany, 99 AM. J. COMP. L. 725 (1991); Michael J. Thomerson, German Reunification—The Privatization of Socialist Property on East Germany's Path to Democracy, 21 GA. J. INT'L & COMP. L. 123 (1991). The rapid pace of events means most analyses are now somewhat obsolete, but for details on various pieces of legislation, see Vladimir K. Andreev, Privatization of State Enterprises in Russia, 18 REV. CENT. & E. EUR. L. 265 (1992); Symposium, Trade and Foreign Investment in Eastern Europe and the Soviet Union, 24 Vand. J. TRANSN'L L. 205 (1991).


26 Russia Under the Hammer, supra note 11, at 70.


may be one reason why some reformers have assigned worker ownership only a minor role in existing privatization plans.

In Yugoslavia, workers possessed ownership rights in their firms, but these rights were nontransferable. This created perverse incentives, such as short time horizons leading to under-investment. Given that the condition of their firm after their own retirement was of no interest to them, workers heavily discounted the future benefits of most investments.

In Poland and Hungary, the state retained nominal ownership following the reforms, but de facto control passed to managers and workers. This ownership structure, combined with prospects of upcoming layoffs and restructuring, only magnified the same perverse incentives as existed in Yugoslavia. One observer described the process as follows:

Workers and state managers, freed from communist suppression, collude to raise wages and salaries sufficiently to absorb the cash flow of the enterprise, absorbing profits, depreciation funds and so on. Since there are no real representatives of capital income at the firm level, the process runs virtually unabated.

These problems were compounded by the process of “spontaneous” privatization in which self-dealing managers sold the firm’s assets to foreigners or entered into joint ventures with them. Such transactions were quite common in Hungary, where they called the entire reform process into question.

Some observers have concluded that the disastrous performance of state enterprises governed by workers and managers is proof of the failure of market socialism. Yet, such conclusions draw the wrong lessons from Eastern Europe’s recent experience. The failure of the self-management system had two main causes—one political, the other economic. First, there continued to be a high degree of state intervention as governments were empowered to intervene in every aspect of economic life. The system thus bore greater resemblance to a planned economy than to a market one. Second, ownership rights were either nontransferable or nonexistent. No one, not even workers, genuinely owned the firms.

Conclusions based on Eastern Europe’s recent experience ignore the difference between a system in which workers control assets owned by the state and one in which they are owners themselves. Markets do need active owners, but why can’t these owners be workers? It also is important to emphasize that the imposition of a single ownership structure is not being advocated in this Article. Under a privatization

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30 Perestroika, supra note 5, at 14-15.
32 Blanchard et al., supra note 29, at 33.
33 Hinds, supra note 28.
34 Estrin, supra note 27, at 349.
scheme such as the Russian one, workers may begin with both ownership and control, then give up control and retain ownership as in an employee stock ownership plan (ESOP), or then completely sell out to a private investor or pursue a number of other alternatives.

Furthermore, worker ownership in Russia appears to have had a more promising track record than in other parts of Eastern Europe, although its history is much shorter. The first elements of worker self-management were introduced by Gorbachev's Law on State Enterprise of 1987, but these were mostly window dressing and did not change the structure of the command economy. The Law on Cooperatives of 1988 was a more fundamental relaxation of state control and even observers skeptical of worker ownership saw it as an improvement: "Despite the difficulties, the new businesses are thriving. In the first half of 1989 the total number of cooperatives in the Soviet Union almost doubled, from 78,000 to 133,000 . . . . So, by any standard, Mr. Gorbachev's law on cooperatives has been a greater success than his law on state enterprises."

Unfortunately, the uncertain legal status of most cooperatives, combined with their need to purchase inputs from state enterprises, meant that many of them "operated on the borderline of illegality" and made their profits through superior access to state-produced goods.

True worker ownership in Russia only began in 1990 when enterprises were allowed to opt out of the state plan if worker collectives purchased their assets. It is too early to systematically assess the performance of these firms, but the anecdotal evidence suggests that many have experienced significant increases in productivity. Consequently, it appears that sweeping judgments about the failure of cooperative-based market socialism in Eastern Europe are unwarranted.

III. The Economics of the Firm and the Economic Transition

A. The Strategy of Economic Transition

Before discussing the economic merits of worker ownership, it is important to set the issue of privatization in the broader context of the debate over the appropriate speed of economic reform. Economic opinion on this issue is spread out along a continuum with those who

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36 Id. at 38-40, 58-59. Cooperatives were also allowed to issue shares and enter into joint ventures. Id.
37 Perestroika, supra note 5, at 12.
38 Id.
39 John Logue & Dan Bell, Worker Ownership in Russia, 1992 Dissent 199, 200.
advocate a "cold shower" approach (such as a rapid move to a free market) at one end and those who would take a slow evolutionary approach at the other. While many argue for rapid reform on some issues and slower progress on others, a review of the more extreme opinions is the best way to understand the issues at stake.

1. The "Cold Shower" Approach

Among the advocates of the "cold shower" approach, Jeffrey Sachs, an advisor to both the Polish and Russian governments, is perhaps the best known. According to Sachs, the reform process is a "seamless web":

Structural reforms cannot work without a working price system; a working price system cannot be put in place without ending excess demand and creating a convertible currency. At the same time, the macroeconomic shock must be accompanied by other measures, including selling off state assets, freeing up the private sector, establishing procedures for bankruptcy, preparing a social safety net and undertaking tax reform. Clearly, the reform process must be comprehensive.

Sachs supplements this economic case for rapid reform with a variety of political arguments. He notes the danger of populist pressures if results are not seen quickly and points to the inability of the bureaucracy to correct any market failures.

Privatization plays a key role in the "cold shower" approach for a number of reasons. First, it is one way of hardening the "soft budget constraint" of inflationary state subsidies. Second, it is a necessary condition for firms to stop asset-stripping and to react efficiently to market signals. Sachs realizes that the existing ownerless enterprises are not genuine cooperatives. Yet, he argues that privatization should aim only at creating private corporations on the grounds that "[w]orker-managed firms (except for small-scale, labor-intensive operations) put workers at excessive risk and cut the firms off from the capital markets, because outside investors know that the workers can vote to pay themselves higher wages out of the company's profits." Consequently, Sachs is only prepared to countenance allowing workers a token share of the company's stock and some representation on its

41 See infra notes 44-49 and accompanying text.
42 See infra notes 50-61 and accompanying text.
43 See, e.g., BLANCHARD, supra note 29, at 50 (arguing for rapid privatization, but slower restructuring).
44 David Lipton & Jeffrey Sachs, Creating a Market Economy in Eastern Europe: The Case of Poland, 1990 BROOKINGS PAPERS ON ECON. ACTIVITY 75, 99.
45 Id. at 87-88.
46 The term "soft budget constraint" captures the myriad ways in which prices, taxes, and credit are manipulated under central planning to subsidize firms. See Perestroika, supra note 5, at 14.
47 Lipton & Sachs, supra note 44, at 101.
48 Id. at 128.
board of directors.49

2. The Evolutionary Approach

Other observers of the transition process are much less sanguine about the possibilities of rapid reform. For example, Janos Kornai, who agrees with all of Sachs' substantive proposals,50 believes that a dual economy will nonetheless persist for two decades.51 Others warn that "an unfettered market process could lead to too many bankruptcies and too much labor shedding" and therefore advocate temporary tariff protection.52

Peter Murrell goes even further in criticizing the "cold shower" approach.53 According to Murrell, this emphasis on improving incentives is a misdiagnosis of the problems of centrally planned economies.54 In his opinion, uncertainty and the limits of economic agents' information-processing abilities lead even capitalist firms to react much more slowly to new incentives than neoclassical theory predicts.55 As a result, the true advantages of a market system over planning do not stem from superior incentives but from the pressures to adapt created by free entry and exit. These pressures counteract the inertial tendencies of large organizations and force them to search for better technologies.56 The problems of Eastern Europe are thus mainly due to a lack of innovation (dynamic inefficiency) rather than a lack of allocative (static) efficiency.

The main policy implication of this theory is that we should expect a high degree of persistence in organizational behavior, even after changes in ownership. Murrell warns:

Whereas in the long run a market system might be the most productive economic environment, in the short run, when routines and expectations are still adapted to the bureaucratic environment of central planning, a swift changeover to the market could be very destructive of the capacity of the existing firms to produce output.57

Therefore, instead of the "cold shower" approach, he prefers a gradual phasing out of state control combined with a policy fostering the development of new private sector firms.58

What are the implications of the evolutionary view for privatization? Given the inertia of firm behavior, Murrell believes that "too

49 Id.
50 Janos Kornai et al., Comments and Discussion, 1990 Brookings Papers on Econ. Activity 138 (discussing Lipton & Sachs, supra note 44).
52 Blanchard et al., supra note 29, at 93-94.
53 Peter Murrell, Evolution in Economics and in the Economic Reform of the Centrally Planned Economies, in Market Economies, supra note 6, at 85.
54 Id. at 38.
55 Id. at 38-39.
56 Id. at 40.
57 Id. at 42.
58 Id. at 43-46, 52.
many hopes have been invested in privatization and rather too much intellectual, social and political capital is being consumed in the process . . . .”59 Furthermore, Murrell points out that existing organizations may have efficiently adapted over time to their economic environment.60 Changing the ownership structure may only waste existing organizational capital without providing any knowledge about how to function in a new environment. Thus, due to the slow entry and growth of more efficient firms, a dual economy is desirable during the transition period.61

B. The Behavior of the Worker-Owned Firm

The preceding discussion indicates how the idea of worker ownership is attacked from both sides of the debate over the speed of economic reform. On the one hand, those advocating the “cold shower” approach fear that these firms will undertake too little investment and even engage in decapitalization due to the short time horizons of workers or their inability to borrow. They also fear that workers will bear too much risk. Most importantly, they worry about a sluggish response to the new price signals created by rapid reform.

Partisans of the evolutionary approach, on the other hand, view a slow response to new incentives either as desirable or inevitable. However, they see little benefit in any form of rapid privatization and worry about its potential costs. Instead of privatization, they stress the need to improve organizational efficiency and innovation via the entry of new firms. From this perspective, capitalist firms are seen as survivors of a natural selection process that weeds out inefficient organizations, so that any attempt to foster cooperatives would be futile and succeed only in slowing down the growth of innovative new firms. Thus, the evolutionary approach adds objections related to organizational inefficiency to those based on capital market problems and labor adjustment issues.

1. Capital Market Problems

There is a long strand of economic literature arguing that worker-controlled enterprises can never succeed without state assistance.62 According to this view, worker-owned firms differ from traditional capitalist firms because they adopt the objective of maximizing net income per worker instead of profits.63 Workers are assumed to take no direct interest in the value of the firm as opposed to the income that it gener-

59 Id. at 45.
60 Id. at 50-51.
61 Id. at 52.
62 Perestroika, supra note 5, at 13, provides an exceptionally clear statement of this view.
ates. Moreover, even this interest in future income is heavily discounted since workers cannot cash in on the value of their firm when they leave. As a result, the firm will suffer from a horizon problem in which workers vote to increase wages at the expense of investment.\(^{64}\) If workers are then allowed to borrow, this problem of underinvestment turns into the opposite problem of choosing excessively capital-intensive techniques.\(^{65}\) Workers will borrow as much as they can because the assets from their investments can later be drained to pay higher wages. Fortunately, outside investors will realize that such firms have poor prospects and will refuse to provide them with additional funds, unless they receive very high interest rates (or they are subsidized).\(^{66}\)

The only place in the world where worker-controlled firms actually behave like this is Eastern Europe. The empirical literature on employee-owned firms in the West does not reveal similar horizon problems: if anything the opposite is true.\(^{67}\) While worker-controlled firms in the West are relatively rare, those that do exist appear to be fairly stable and can sometimes attain large sizes.\(^{68}\)

Why do we see such a difference between East and West? One possibility is that Western cooperatives seek to maximize their “income-employment security” instead of net income and are thus more far-sighted.\(^{69}\) Eastern European firms by contrast, faced with the possibility of massive restructuring, are caught in an “end period” problem,\(^{70}\) and thus their employees are grabbing what they can before the firm goes under.

However, a more important explanation of this difference seems to be the role of capital markets in the West. While their Eastern European counterparts draw upon subsidies from state banks, Western worker-controlled firms must borrow at competitive rates from private banks or issue nonvoting equity through public offerings (if control is to be retained).\(^{71}\) They are therefore likely to bear the costs of any opportunistic behavior.

Some commentators worry that external financing is difficult to obtain for worker-controlled firms and have proposed ingenious alter-

\(^{64}\) Perestroika, supra note 5, at 13.
\(^{65}\) Id.
\(^{66}\) Id.
\(^{68}\) Hyde, supra note 63, at 168.
\(^{69}\) This assumption is suggested by Hajime Miyazaki & Hugh M. Neary, The Ilyrian Firm Revisited, 13 BELL J. ECON. 259 (1983) (cited in Hyde, supra note 63, at 167 n.22).
\(^{70}\) A situation in which future gains are heavily discounted and therefore do not provide strong incentives.
\(^{71}\) In the real world, as opposed to some economic models, employees can and do sell shares in any form they like. For example, Weirton Steel has diluted the level of worker ownership through public offerings. See Hyde, supra note 63, at 168 n.23.
natives. One such scheme would “establish tradeable nonvoting equity shares that would be purchased by each worker as he or she joins the enterprise and owned or sold by each worker as he or she leaves the enterprise.” However, the difficulties of obtaining external finance should not be exaggerated. As Howse and Trebilcock point out, “since workers are fixed as well as residual claimants on the firm, they are likely to favor less risky investments than non-worker shareholders.” Consequently, the agency costs of debt are lower for a worker-controlled firm than for a capitalist one. Unfortunately, the converse of this proposition is that the pool of equity finance is likely to be limited to low risk/low return investors.

Howse and Trebilcock also raise the possibility that employees may “choose to vote themselves higher salaries rather than paying dividends to shareholders or reinvesting profits to maintain and enhance the value of the firm and hence its capacity to make good on both the claims of debtholders and majority shareholders.” Although such problems may be particularly severe in the Eastern European context, they do not appear to be insoluble. For example, majority shareholders may be deemed to owe a fiduciary duty of fairness to the minority. A mechanism similar to the oppression remedy of corporation statutes in some jurisdictions could also deter some forms of opportunistic behavior.

Finally, it is always possible for workers in a newly privatized cooperative to abandon control either by having the shares held in trust (as in an ESOP) or simply by selling out to a private investor. If such an investor could indeed manage the firm more efficiently, he or she should be able to buy out the workers and the effect of the initial free offering of shares would be purely redistributional. By contrast, credit rationing and collective action problems may make it difficult for workers to buy out their company even if it would be efficient for them to do so.

2. Labor Market Adjustment Issues

Assuming that the problems of capital accumulation and financing are solvable, there is still a danger that worker ownership could actually hurt the very people it is meant to help. One mechanism through which this may happen is workers’ risk aversion. The other is

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72 Thomas E. Weisskopf, Challenges to Market Socialism: A Response to Critics, 1992 DISSERT 250, 256 (citing Gregory Dow, Control Rights, Competitive Management, and the Labor Management Debate, J. COMP. ECON. 10 (1986)).
74 Id. at 56.
75 Id. at 57.
the possibility that worker ownership will create labor market rigidities and thereby increase unemployment. As we shall see, the two issues are in fact related.

Even staunch defenders of worker ownership concede that "risk aversion is the single greatest problem with employee ownership and the single greatest obstacle to its wider spread." This problem is twofold. First, employees are bundling their risks in one type of investment instead of spreading their assets. Second, and far more serious, the return on employees' shares is highly correlated with that of their firm-specific human capital. In other words, if a worker-owned firm goes bankrupt, employees not only lose their jobs, they also lose their savings.

In the Eastern European context, the first aspect of this problem is likely to be negligible since capital markets are not sufficiently developed to allow full portfolio diversification. Though this may become a more serious problem in the future, the more immediate fear is that restructuring will leave a large part of the working class unemployed and holding on to worthless shares. It is easy to imagine the potentially disastrous social and political effects of such an outcome.

If worker ownership reduces the likelihood of unemployment, however, the risk allocation argument against it loses some of its force. As Howse and Trebilcock point out,

where the risk of displacement is high, the future fixed claim on the firm . . . may need to be heavily discounted. This explains why, precisely when they are most in risk of losing their jobs, workers may exchange future wage concessions for share ownership. If the firm fails, they are likely to lose both their fixed and residual claims. If the wage concessions do in fact succeed in turning the firm around, then workers will have managed both to reduce the riskiness of their future fixed claim on the firm, as well as to make a profit on the shares. Therefore, the question of risk allocation is intimately connected to the employment effects of worker ownership.

One of the strangest predictions of the early literature on the worker-controlled firm was that it would respond perversely to changes in demand, cutting back its workforce when demand increased so that the remaining members could enjoy higher incomes. The introduction of more realistic behavioral assumptions, such as equal treatment of all members, has led to the more plausible result that worker-con-
trolled firms will be slower both to cut back and to increase their membership.\textsuperscript{82}

To a true believer in the "cold shower" approach, this rigidity in hiring and firing would be a fatal flaw as it would slow down the restructuring process. However, anyone willing to recognize even slight imperfections in the labor market will see this as a positive aspect of worker-control. In the short run, for any number of reasons, the wages paid by capitalist firms tend to be rigid and excessive unemployment results. Moreover, such unemployment can be highly persistent\textsuperscript{83} and can have pernicious social and political consequences. Of course, new entrants into the labor force will have to rely more on expanding private firms, but the benefits of slower labor shedding during the transition process more than compensate for these costs and those created by inefficient risk allocation.

3. Organizational Efficiency

Partisans of the evolutionary approach may applaud the labor market inertia of worker-owned firms, but they may point out that existing state enterprises are also likely to shed labor slowly. Why waste time privatizing such firms when this time could be spent fostering the growth of new private sector enterprises? Also, why risk destroying the still valuable organizational capital of the state firms?

Neither of these objections should deter partisans of worker ownership. First, as we have seen, the process of privatization through worker ownership would be fairly simple, politically feasible, and inexpensively accomplished.\textsuperscript{84} Second, to the extent that existing firms possess valuable organizational capital, privatization through worker ownership should preserve it. Workers, unlike other owners, have substantial information about past practices and should be able to sustain any efficient norms of cooperation that emerged under central planning.

Perhaps one reason that the evolutionary approach has thus far neglected the worker ownership option may be its belief that capitalist firms are the result of a Darwinian process that weeds out inefficient firms. After all, if worker cooperatives are so good, why don't we see more of them? This point has been made in the Eastern European context by Janos Kornai: "[W]hile third forms (cooperatives, self-management and associative coordination) existed even at the peak of bureaucratic centralization, these forms did not experience a spectacular growth after the command system had been abolished. When forms other than centralized state-ownership were permitted, private owner-

\textsuperscript{82} Moene, supra note 81, at 86-87.
\textsuperscript{83} BANCHARD ET AL., supra note 29, at 85.
\textsuperscript{84} See supra notes 11-26 and accompanying text.
ship gained ground rapidly." This fact is particularly embarrassing to proponents of worker ownership because in this case the "third forms" appear to have started on an equal footing with private ownership.

The analogy between the social process of competition and the natural process of evolution, however, should not be pushed too far. Humans, unlike animals, are capable of strategic behavior that leads to suboptimal equilibria. The existence of mass unemployment during recessions is perhaps the most persuasive evidence of such suboptimal outcomes in capitalist economies. Yet, worker ownership may help to reduce unemployment by eliminating one of its most important causes, namely, the asymmetries of information that make firms pay "efficiency wages" that are above the market-clearing equilibrium.

The theory of efficiency wages begins by considering the problem of "shirking"—a catchall term that refers to a worker's reluctance to increase work effort, reveal information to management, or take any other action that might enhance productivity. A capitalist firm, being unable to monitor its workers directly, may attempt to pay a wage premium in order to induce higher productivity. The premium is designed to make any worker caught "shirking" pay a penalty in lost wages. Unfortunately, as all firms in an industry adopt this practice, the wage premium disappears. Yet, because all firms are now paying higher wages, their demand for labor has decreased and unemployment has been created. The risk of unemployment then plays the deterrent role for which the wage premium was intended. By contrast, as Alan Hyde has argued, the worker-owned firm's self-monitoring internal organization eliminates the need to pay such efficiency wages and thereby also eliminates their perverse consequences.

Some commentators are skeptical that cooperatives can solve the "shirking" problem that leads capitalist firms to pay efficiency wages. For example, Howse and Trebilcock suggest that professional managers will have to be introduced to deter "shirking." But this then raises the classic question of who will monitor the manager. Is the only solution to make the monitor a residual claimant, as Alchian and Demsetz argue? If so, is the evolutionary view of capitalism correct after all?

There are two reasons why we should not give up on cooperatives so easily. First, the Alchian and Demsetz "solution" does not work for the large, widely held corporations in capitalist countries. In most of

85 Kornai, supra note 50, at 144.
87 Id.
88 Id.
89 Hyde, supra note 63, at 176-78, 200-01.
90 Howse & Trebilcock, supra note 73, at 60.
these firms, managerial pay is only weakly related to firm performance. Second, if workers have had sufficient time to adapt to team behavior, they may be able to sustain a cooperative equilibrium based on self-monitoring instead of monitoring by a residual claimant.

Thus, worker control may bring substantial benefits by slowing labor shedding and improving organizational efficiency. Its disadvantages in terms of possible capital accumulation problems, risk aversion, and sluggish hiring will be felt mostly in the long term, by which time a sector of privately owned firms will have developed. The fundamental questions about worker ownership are therefore more political than economic.

IV. The Politics of the Firm and the Political Transition

A. Worker Ownership and Democracy

Most of the ardent supporters of worker ownership base their case on political reasons rather than economic ones. As Alan Hyde explains, in this political science literature "[a] standard trope is the alleged disjunction between the economic and political realms. Democracy is justified for reasons standard in political theory since Aristotle . . . . The employee owned firm is painted very vaguely, but prominent in the palette are tones of participation and responsiveness." Obviously, only firms that are worker-controlled will have democratic features, mere ownership without control (as in an ESOP) is not enough to create economic democracy.

The political arguments in favor of worker control are often very moving. Writers in the neo-Marxist tradition, such as Bowles and Gintis, eloquently describe the aspect of domination and dependency inherent in the employment relationship. Jon Elster has also argued that economic democracy favors active self-realization over the passive consumption of capitalism.

Although there is certainly a good deal of truth to the neo-Marxist analysis of capitalism, its characterization of worker ownership has a somewhat utopian flavor. First, most successful worker cooperatives place restrictions on the extent to which workers can participate in the decision-making process. In fact, Hansmann's survey of cooperative

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93 Bentley MacLeod, Behaviour and the Organization of the Firm, 11 J. Comp. Econ. 207, 219 (1987). MacLeod's game-theory analysis of monitoring costs proves that the Alchian-Demsetz solution has only limited applicability. Surprisingly, the extensive literature survey in Hyde, supra note 63, omits this result.
94 The literature is surveyed in Hyde, supra note 63, at 165 n.17.
95 Hyde, supra note 63, at 165.
96 Samuel Bowles & Herbert Gintis, Democracy and Capitalism: Property, Community and the Contradictions of Modern Social Thought 64-91 (1986).
governance indicates that “worker ownership generally serves just to insure that a firm’s workers as a whole are not exploited by the firm, and not to provide a means for truly effective worker participation and representation.”98 Second, cooperative choices will still be constrained by market forces, so that the democratic decision procedure may make little substantive difference. Of course, these facts only mean that the political benefits of economic democracy are somewhat muted, not that they are nonexistent.

At the other end of the political spectrum, one finds arguments that any form of collective ownership will threaten political democracy. For example, Friedrich Hayek writes:

It is now often said that democracy will not tolerate “capitalism.” If “capitalism” means here a competitive system based on free disposal over private property, it is far more important to realize that only within this system is democracy possible. When it becomes dominated by a collectivist creed, democracy will inevitably destroy itself.99

If by “collectivism” Hayek means central planning, he is probably right. But why should a competitive system of worker cooperatives threaten democracy? Hayek claims that democracy must be limited “to fields where true agreement exists,”100 otherwise the range of issues to be decided will be so broad that democracy will become unstable and eventually collapse.101 In a planned system, the consequences of such a collapse are very serious. In a decentralized system, however, the worst that can happen is that democracy will collapse at the level of the firm, not the polity.

According to Henry Hansmann, the inherent instability of democratic decision making is the Achilles heel of worker ownership. Hansmann believes that worker-owned firms may bring substantial productivity gains and that the problems of capital accumulation and risk bearing are relatively minor.102 Yet, he argues that worker ownership will only succeed when there is a substantial homogeneity of worker interests so that the costs of decision making are low.103

Hansmann’s theory of worker ownership is somewhat puzzling. On the one hand, he argues that most cooperatives place some limits on worker participation to minimize the costs of decision making.104 On the other hand, he claims that the problems created by conflicts of interest among workers are usually insoluble. It is not clear, however, why the limits on participation that do exist are insufficient. Further-

98 Henry Hansmann, Worker Participation and Corporate Governance, 43 U. TORONTO L.J. (forthcoming 1993) (manuscript at 17, on file with author) (emphasis added).
100 Id. at 69.
101 This argument is presented in the language of public choice theory in DAN USHER, THE ECONOMIC PREREQUISITE TO DEMOCRACY (1981).
102 Hansmann, When Does Worker Ownership Work?, supra note 67, at 1773.
103 Hansmann, Worker Participation and Corporate Governance, supra note 98, at 11; Hansmann, supra note 67, at 1784.
104 Hansmann, Worker Participation and Corporate Governance, supra note 98, at 17.
more, simple conflicts of interest, as between workers and managers, are not enough to create voting cycles or other forms of instability. This will only occur where conflicts of interest are sufficiently complex.

The validity of Hansmann's claims are ultimately an empirical matter. Yet, as Hyde points out, most of the literature on worker ownership "does not suggest that devising internal governance structures is the big deal that Hansmann makes it." Another weakness cited by Hyde is Hansmann's failure to study Italian cooperatives, one of the few groups in the West large enough to be used for convincing comparisons. Such a study has been recently undertaken by Saul Estrin. He finds that while labor management skews employment in favor of the blue collar workers that are the median voters, it does not harm productivity or growth. Consequently, the collective choice problems created by democracy in the workplace do not appear to be serious enough to outweigh its benefits in terms of equality and self-realization.

B. Worker Ownership and the Politics of Transition

Even if a system of worker ownership was unambiguously desirable, the issue of how to move to such a system would still remain. Though the political changes in Eastern Europe may present a unique opportunity to introduce worker ownership on a wide scale, there are two complicating factors. The first relates to the fairness of the initial distribution of shares. The second relates to the interactions between a move to worker ownership and the viability of the region's fragile political democracies.

1. The Fairness of Worker Ownership

Even economists who believe that worker-owned firms can be efficient often oppose them on the grounds that it would be unfair to give existing workers special claims on a firm's assets. For example, Stanley Fischer asks: "Why should industrial workers obtain larger claims on capital than workers in less capital-intensive industries, such as teaching? Or, why should workers in successful firms become wealthier than those in less successful firms?" This is perhaps the most powerful objection to privatization through worker ownership and at the very least a reason for distributing a noncontrolling share of stock equally among the rest of the population.

105 Hyde, supra note 63, at 170 n.35.
106 Id. The other large groups of cooperatives are in Spain and the northwestern United States. On the former, see Henk Thomas & Chris Logan, Mondragon: An Economic Analysis (1982). On the latter, see Craig & Pencavel, supra note 81.
107 See Estrin, supra note 27.
108 Id. at 364-65.
109 Blanchard et al., supra note 29, at 51-54.
110 Fischer, supra note 19, at 230.
Given that the efficiency aspects of worker ownership remain uncertain, the ultimate decision must be made on grounds of fairness. There are two reasons, however, for which the issue of fairness is not settled by granting an equal initial distribution of shares. First, workers in highly capital-intensive industries may bear the brunt of economic restructuring. Teachers, to use Fischer’s example, do not seem to be facing the possibility of mass layoffs. Ideally, only those workers that become unemployed would receive state assistance, but the cash-starved governments of Eastern Europe are unlikely to implement generous welfare programs in the near future. Second, there may be a trade-off between horizontal and vertical equity. To the extent that a worker-owned firm grants its employees a claim on its net income, the distribution of total income in society may be more egalitarian than under capitalism. Given that income redistribution through a welfare state is not in the cards, worker ownership may be the only means of realizing a relatively equitable society.

2. Worker Ownership and the Democratic Transition

The ultimate success of the reform process will depend on its political effects as well as its economic ones. The perceived fairness of the initial distribution of shares during privatization will be essential to ensure the success of future reforms. For example, the process of “spontaneous” privatization in Hungary imperiled the entire reform process since it permitted members of the nomenklatura to obtain larger profits. However, there is no evidence that the majority of the population in countries like Russia oppose the grants of shares to workers on preferential terms. Meanwhile, the Russian plan “has already begun to drive a wedge between industrial managers—who are often hostile to the idea—and workers, who have been largely in favour.”

Worker control may also strengthen the new democratic governments of Eastern Europe. For example, “[b]y increasing employee rights at the workplace and giving experience in decision making, self-management could be an important buttress to political democracy, of some importance in the early days of the new systems.” Governments may also benefit if difficult economic decisions are perceived as being more legitimate when they are made by workers instead of investors. Finally, workers themselves are more likely to understand the need for painful economic restructuring when they are also owners.

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111 This point is made with respect to a move from capitalism to market socialism in John Elster, Solomonic Judgments 216 (1989).
112 Fischer, supra note 19, at 297-38.
This understanding and trust is crucial to the survival of democracy. Without it, even well-intentioned governments "begin to vacillate between a technocratic style inherent in market-oriented programs and the participatory style needed to maintain political support. These vacillations erode confidence in reform and may threaten democratic stability."\textsuperscript{115}

V. Conclusion

This Article has attempted to make the case for moving from central planning to worker ownership. This proposal may strike some as being a move from a discredited form of socialism to an unproven one—yet another experiment that the people of Eastern Europe could do without. As Vaclav Havel has written, "I don't know exactly how anyone understands this 'third way,' ... but if it is meant to refer to some combination of the unproven and the proven, I must place myself on the side of the side of those who would rather not have anything to do with it."\textsuperscript{116}

It is easy to sympathize with Havel's desire to live in a normal democratic capitalist society. Unfortunately, this option is not immediately open to Eastern Europe. Instead, the region is forced to choose between different proposals for economic reform. All of these are, to some extent, unproven. There is as yet no tested way of moving from central planning to capitalism. Consequently, while we should not try to impose worker ownership, neither should we dismiss its potential.

This Article has argued that Eastern Europe's history tells us little about how a system of worker-owned firms would behave. We must therefore rely on economic theory. This theory suggests that worker-owned firms may have important advantages over capitalist firms in the short run, especially in terms of slowing labor shedding and improving organizational efficiency. Worker control is also attractive in political terms—partly for its potential to bring democracy to the workplace, but mostly because it may secure democracy at the level of the polity.

Of course, it may turn out that the long-run problems of worker-owned firms will cause the workers to sell out to private investors. If this is true, then privatization through worker ownership will only have delayed the inevitable. A more likely prospect, however, is that a uniquely Eastern European version of capitalism will emerge. Like Japanese capitalism, this system might place greater emphasis on collective rewards and cooperation than the North American system. In this case, Eastern Europe will have found its own road back from serfdom.


\textsuperscript{116} VACLAV HAVEL, SUMMER MEDITATIONS 125 (1992).