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A Brief Root Cause Analysis of the Dearth of Labor Managed Firms in Developed Countries

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Abstract

The aging workforce and population decline give opportunity to increase the share of labor managed firms in the U.S., such as employee stock ownership plans. Yet why are labor managed firms not a natural and organic solution to the above workforce and population challenges, instead becoming a contemporary political talking point for the likes of Senator Bernie Sanders? At a minimum, labor managed firms are economically equal and socially preferable to conventional firms. Yet labor managed firms exist in far fewer numbers than conventional firms. Why is this? Earlier arguments that labor managed firms were less efficient, less productive, and less survivable have been convincingly countered. So, deduction suggests they are simply created far less frequently than conventional firms. This author finds three primary hypotheses for why this imbalance exists. First, that there is broad lack of awareness of labor managed firm options and benefits. Second, that entrepreneur self-interest shows preference for conventional firms over labor managed firms. And third, that co-determination complicates labor managed firm creation, in turn promoting conventional firm creation. This piece follows a logical form to engage a subset of relevant literature in investigation of the dearth of labor managed firms.

I. Introduction

The aging workforce and population decline give opportunity to increase the share of labor managed firms in the U.S., such as employee stock ownership plans. Yet why are labor managed firms not a natural and organic solution to the above workforce and population challenges, instead becoming a contemporary political talking point for the likes of Senator Bernie Sanders? At a minimum, labor managed firms are economically equal and socially preferable to conventional firms. Yet labor managed firms exist in far fewer numbers than conventional firms. Why is this? Earlier arguments that labor managed firms were less efficient, less productive, and less survivable have been convincingly countered. So, deduction suggests they are simply created far less frequently than conventional firms. This author finds three primary hypotheses for why this imbalance exists. First, that there is broad lack of awareness of labor managed firm options and benefits. Second, that entrepreneur self-interest shows preference for conventional firms over labor managed firms. And third, that co-determination complicates labor managed firm creation, in turn promoting conventional firm creation.

This piece follows a logical form to engage a subset of relevant literature in investigation of the dearth of labor managed firms. This logical form is summarized below as 'Outline of Argument Structure' and is discussed in sequential fashion in the following narrative. Works referenced are cited parenthetically and listed in full at the end. For the scope of this work, labor managed firms (LMF) will be viewed interchangeably with worker co-operatives and employee stock ownership plan (ESOP) firms. Similarly, conventional firms (CF) will be viewed inclusive of for-profit corporations, legal partnerships, and sole proprietorships. While there are distinctions on both LMF and CF, they are not considered critical to the inquiry at hand. Public policy options to address the imbalance between LMF and CF will be entertained only colloquially, as the focus of this piece is arriving at logical explanation for the dearth of LMF in developed countries.

II. Outline of Argument Structure:

Lemma 1: LMF are at minimum equal, or arguably preferable, to CF. Empirically shown.

Lemma 2: LMF exist in far fewer numbers than CF. Empirically shown.

Question 1: *Why are LMF significantly outnumbered by CF?*

Hypothesis 1: LMF are less efficient than CF. False (see Lemma 1).

Hypothesis 2: LMF are less resilient than CF. False (see Lemma 1).

Hypothesis 3: LMF are created far less frequently than CF. Deduced (Lemma 2).

Question 2: Why are LMF created less frequently than CF?

Hypothesis 4: Entrepreneur self-interest shows preference for CF over LMF.

Hypothesis 5: Co-determination complicates LMF creation, promoting CF.

Hypothesis 6: There is broad lack of awareness of LMF options and benefits.

The topic is timely, as evidenced by recent US Presidential candidate Bernie Sanders, who asserts that, "Study after study has shown that employee ownership increases employment, increases productivity, increases sales, and increases wages in the United States. This is in large part because employee-owned businesses boost employee morale, dedication, creativity and productivity, because workers share in profits and have more control over their own work lives." (Rodgers, 2019) These contemporary observations are not limited to the US alone, but are shared in many developed countries. Guinan and O'Neill state that Corbyn's Labour Party in the UK recognizes, "These deepening problems – wage stagnation, underinvestment, low productivity, widening inequalities of income and wealth, not to mention the looming effects of climate change – are not simply accidental or the result of poor policy choices, but the predictable outcomes of the basic organization of the economy." (Guinan and O'Neill, 2018) And the benefits of implementing a LMF are not pecuniary alone, with strong evidence for moral and social improvements in workers lives resulting also. Guinan and O'Neill continue, "Instead of the extractive forces of corporate capitalism, the emerging new political economy is circulatory and place-based, decentralizing economic power, rebuilding and stabilizing regions and local communities, allowing for the possibility of real democracy and participation, and providing the long-run institutional and policy support for a new politics dedicated to achieving genuine social change." They continue, citing Nobel Laureate Robert Solow's comments "on a 2014 panel on Piketty's book in Washington, D.C. Among the 'things we can do', Solow observed, 'democratising the ownership of wealth is perhaps the most obvious'." (Guinan and O'Neill, 2018)

III. Lemma 1

LMF are at minimum equal, or arguably preferable, to CF. Empirically shown. Olsen and Poznik position potential comparative advantages of LMF over CF as "one of the more interesting questions in economics, it is also potentially one of the most important economic questions of the current moment. Advocates for worker cooperatives often cite the following potential advantages over conventional corporations: reduction in income inequality; wealth creation for worker-members; extension of democracy to the workplace; grounding businesses more fully in their communities; increased productivity." Olsen and Poznik continue, explaining that, "...cooperatives that do have wage differentials, the ratio between the highest and lowest paid worker-members averages 5-to-1 rather than the 300-to-1 ratio that is the average for large corporations in the U.S. (Herrera 2004; Mischel and Davis 2015)." (Olsen and Poznik, 2018)

Contributing to both resiliency or survivability of the LMF and worker satisfaction, Olsen and Poznik explain that, "Worker cooperatives are also much less likely to have lay-offs during recessions, choosing instead to reduce the work hours of all worker-members rather than completely idling some of them (Perotin 2016, Pencavel 2001). This gives members of a successful worker cooperative employment security, and allows them to avoid periodic bouts of unemployment with dramatically reduced income." But this not only benefits the worker-members, but also the LMF efficiency, productivity, and resiliency, as Olsen and Poznik explain that the LMF "can increase production when business conditions improve without the cost of recruiting and training new skilled workers." (Olsen and Poznik, 2018) Contributing to the level of worker-member satisfaction, commitment to the local community, and the survivability of the LMF, are the equity shares in the going concern held by worker-members.

Traditionally, two primary arguments have been broadly distributed for why LMF might be less efficient, and ultimately less survivable, than CF. First, and commonly known as the '1/n problem', is the position that each additional worker-member's ownership share dilutes the equity and incentive of a principal worker-member. Second, and typically referred to as the 'monitoring problem', is the similar criticism that

supervisors will have insufficient incentive to drive LMF productivity and efficiency. Historically, these two primary arguments have held sway over queries into why firms organize themselves in the fashion they do. Both the 1/n and monitoring problems are argued to result in a less competitive LMF. However, research into both is ongoing and the position of this piece is that their popular acceptance is in error. According to Olsen and Poznik, "case studies of actual worker cooperatives do not find that shirking or free riding is perceived to be an important problem facing these enterprises (Greenberg 1986; Bonin, Jones and Putterman 1993). Furthermore, surveys and studies of businesses that share profits broadly indicate that profit sharing encourages workers to engage in co-monitoring, with more decentralized supervision done by the workers themselves." (Olsen and Poznik, 2018)

Mainstream neoclassical economic thought has typically incorporated the 1/n and monitoring problems. Olsen succinctly explains the former saying, "it implies that the incentive to increase work intensity in a cooperative enterprise is decreasing in n, and hence large-scale cooperatives would effectively eliminate any incentive effects for workers." (Olsen, 2014) On the latter, Alchian and Demsetz state that, "The economic organization through which input owners cooperate will make better use of their comparative advantages to the extent that it facilitates the payment of rewards in accord with productivity." They summarize that, "1) It is possible to increase productivity through team-oriented production, (and) 2) It is economical to estimate marginal productivity by observing or specifying behavior." (Alchian and Demsetz, 1972) They suggest that metering is not limited to monitoring work inputs to production, but also includes metering of rewards for output achieved. If both are not monitored and metered, then rational actors will not be properly incentivized. Accurately monitoring and metering becomes increasingly complex with scale, as the divisions of labor in teams blur; which is why CF are want to install layers of supervision, to protect the vested interests of non-worker shareholders. As Jossa puts it, "But who will monitor the monitor? In 'classical' capitalistic firms this problem is solved by empowering the central agent to appropriate the balance between revenues and costs, for this creates an incentive for the entrepreneur to discipline team work at a high level of efficiency." (Jossa, 2009)

It is unfortunate that Alchian and Demsetz's work has been viewed as foundational for so long. As elegant as their explanation for efficiency as the progenitor of CF may be, it is gross over-simplification and not empirically sound. Jossa argues against Alchian and Demsetz saying, "compared with the central monitor cashing the whole of the residual, individual workers will doubtless have a lesser incentive to perform their monitoring functions at a high level of efficiency, but whereas in a capitalistic firm this function is vested in one or a few specialized monitors, in a cooperative it lies with all the members - and a hundred pairs of eyes are better than one." Jossa goes further, suggesting that, "those making decisions jointly with others feel responsible for such decisions and tend to maximize their commitment out of a feeling of loyalty (see, inter alia, Oakeshott, 1978; Horvat, 1982)." As evidence, Jossa cites Mayo and Akerlof saying, "The direction in which our line of reasoning leads us to head runs counter to AD's approach. It is often argued that team participation generates joint team interests. In line with Akerlof's so-called 'sociological model' (which Akerlof contrasts with the neoclassical standard model upheld by most economists), the members of any firm (be it a capitalistic company or a cooperative) 'develop a feeling' that binds them to each other and the firm, inducing them to exchange 'gifts'." (Jossa, 2009) Hence the logical efficiency of LMF, who are more likely to rely on efficient monitoring of vested worker-members, both of themselves and their peer workers.

IV. Lemma 2: LMF exist in far fewer numbers than CF. Empirically shown.

When seeking a suitable sample of LMF for comparison to CF, Olsen states that, "Worker cooperatives are the most comprehensive form of employee ownership, combining both control rights with residual claimancy (Ben-Ner and Jones 1995, Table 1), and would provide an ideal population to study the effect of EO on labor effort and supervision. But they are relatively rare in most countries, and in the U.S. not only are they small in number, they are also generally small size and concentrated in just a few industries (Deller, et al, 2009, Table 2-2). The most prevalent form of EO in the U.S. is through an employee stock ownership plan (ESOP) and there are roughly 10,500 of these plans in place." Olsen continues later, "There are an estimated 3,000 ESOP companies in which the employee trust owns a majority of the outstanding shares of the firm (NCEO 2011a, 2011b), with an unknown number of these owning one hundred percent of equity." (Olsen, 2014)

Kruse finds that, "In the US about 20% of private sector employees report owning company stock, while about 32% of British employees had some form of employee ownership scheme in 2004 [3]. Data from the European Working Conditions Survey data show 5.2% of companies offered employees share

ownership in 2013, and European Working Conditions Survey data show that 3.3% of employees participated in employee ownership in 2010 [2].” (Kruse, 2016)

V. Question 1: Why are LMF significantly outnumbered by CF?

Olsen and Poznik helpfully categorize the explanations typically offered for the disproportionate share of LMF into "(i) those based on some type of inefficiency or competitive disadvantage for worker cooperatives, and (ii) those based on the difficulties in creating worker cooperatives.” (Olsen and Poznik, 2018) Kruse states succinctly, “There is clearly no simple automatic relationship between employee ownership and performance – while the average performance effect of adopting employee ownership is positive, there is dispersion around the average. . . ” (Kruse, 2016)

i. Hypothesis 1: LMF are less efficient than CF. False (see Lemma 1).

As posited by Lemma 1 and based on empirical evidence, we reject the colloquial suggestion that LMF are less efficient than CF. Olsen and Poznik assert that "research consistently finds that (a) worker cooperatives are at least as productive as similar conventional businesses, if not more so (Perotin 2012 and 2016), and (b) once established they survive as well as or better than conventional businesses (Olsen 2013).” (Olsen and Poznik, 2018) Kruse states generally that, "Employee ownership has attracted growing attention for its potential to improve economic outcomes for companies, workers, and the economy in general, and help reduce inequality. Over 100 studies across many countries indicate that employee ownership is generally linked to better productivity, pay, job stability, and firm survival. . . ” (Kruse, 2016)

ii. Hypothesis 2: LMF are less resilient than CF. False (see Lemma 1).

As also posited by Lemma 1 and based on empirical evidence, we reject the suggestion that LMF are less survivable than CF. In fact, Olsen and Poznik assure us that "empirical research finds that they do not fail at a rate exceeding that of conventional businesses.” (Olsen and Poznik, 2018) Colloquially and ironically, Craig and Pencavel share that, “It is evident from the fact that a number of producer cooperatives were formed to save the jobs of employees in conventional, unprofitable plants that employment has been a primary goal of the organizations.” (Craig and Pencavel, 1992) Kruse found that, "Employee ownership firms also appear to have higher survival rates [1]. Publicly traded US companies with employee ownership are about 20% more likely than closely matched comparable firms to survive over a 12-year period, and closely held companies with employee ownership plans are only half as likely as comparable firms to go bankrupt or close down over a 12-year period. In addition, studies of worker cooperatives have found high survival rates compared to conventional firms in the UK, France, Uruguay, and other countries.” (Kruse, 2016)

iii. Hypothesis 3: LMF are created far less frequently than CF. Deduced (Lemma 2).

And so we are left with the general premise that LMF have been created with far less frequency than CF. They are not less efficient. They are not less resilient. But they exist far less frequently. Therefore, they are created far less frequently. In the words of Olsen and Poznik, "explanations that assume some inefficiency inherent in the worker cooperative business form is the cause of their scarcity should be discounted, and the answer for why worker cooperatives are relatively rare should be found instead in explanations focusing on the difficulties of forming them.” (Olsen and Poznik, 2018)

VI. Question 2: Why are LMF created less frequently than CF?

One strategic option for creation of LMF, is the conversion of existing CF into LMF, as entrepreneur owners retire. Olsen explains, "This process often takes place over time, with a CO firm first becoming partially EO, becoming MEO after some number of years, and finally becoming one hundred percent EO after another period of years.” (Olsen 2014) In the UK, Guinan and O’Neill state that according to "one estimate, 400,000 such businesses could close in the next five years if the retiring owners are unable to find a buyer, putting between two and four million jobs at risk.” (Guinan and O’Neill, 2018) Olsen states that "The factors tending to inhibit the formation of WCs are greatly reduced when the creation occurs through the conversion of an existing firm. Credit constraints are reduced because the equity of a successful existing firm provides collateral; the elevated hazard associated with new firms is greatly reduced because a WC created through a conversion is not a new firm. . . ” (Olsen, 2013) Yet, why is this likely to be missed opportunity? Why are entrepreneurs not convinced of the benefits of LMF and interested in conversion of their going concerns, as opposed to closure of operations?

i. Hypothesis 4: Entrepreneur self-interest shows preference for CF over LMF.

In the oft quoted words of the fictional Gordon Gekko, "greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit." (Stone, 1987) As entertaining as the character was, self-interest is not limited to negative morality embodied in greed. Foundational to entrepreneurial self-interest, is that the entrepreneur is the progenitor of the going concern and therefore entitled to the residuals. Ellerman suggests "The 'standard' answer is that the right to the product is included in or attached to the ownership of some asset, the use-rights, are distinguished from the right-to-the-product or right-to-the-fruits." Ellerman goes on to explain that "The owner of any one of the inputs could purchase the complementary inputs…" (Ellerman, 1986) Jossa eloquently posits that, "Whenever a group of people resolve to work as a team – we may add – the member who outperforms the others in initiative and organizational skills will inevitably take the lead. The crux of the matter is that such a person has no incentive to establish a cooperative and share power and earnings with others. He or she will prefer to found a capitalistic firm, where he or she will hold all authority and, if sole owner, appropriate the whole of the surplus (Jensen and Meckling, 1979; Abell, 1983; Leete-Guy, 1991, p. 69; George, 1997, pp. 59-60; Jossa and Cuomo, 1997, p. 317)." (Jossa, 2009)

ii. Hypothesis 5: Co-determination complicates LMF creation, promoting CF.

Jensen and Meckling's share that, "The movement toward so-called 'industrial democracy' is currently receiving much attention in Western Europe. Legal developments there are institutionalizing it in two forms. First, firms are being required to seat voting labor representatives on their policymaking boards – a movement hereafter referred to as codetermination. Second, various new legal constraints are being imposed on the rights of management and owners of firms to make decisions, for example, on their right to dismiss or lay off employees, their right to modify production processes, and their right to close plants." (Jensen and Meckling, 1979) Though now four decades past, these comments still ring true today. For this piece, this author will use co-determination in the general sense to differentiate worker-member management control of firm activities, as separate from work-member property rights.

Jensen and Meckling, similar to Ward, Vanek, and Domar, proposition several perverse effects that lead to sub-optimized efficiency in LMF. In their 1979 work, Jensen and Meckling highlight the philosophical challenge in co-determination as either support or detractor in the LMF versus CF debate. They explain, "On the one hand, they want to reassure those who worry about the impact of codetermination on the rights of stockholders; on the other hand, they want to argue that codetermination bestows substantial benefits on labor. It is difficult to be on both sides of that fence simultaneously. If codetermination is beneficial to both stockholders and labor, why do we need laws which force firms to engage in it? Surely they would do so voluntarily." (Jensen and Meckling, 1979) Helpfully, Olsen states that "…the collective action problem involved in the transition of an existing firm is lower than that associated with founding a new firm…" (Olsen, 2013)

As follow-on and perhaps indirectly, but not to be discounted, the 'horizon problem' greatly complicates both LMF launch and later stage conversions. Various worker-members enter the LMF at different points in time, with different expectations for exit. As Jensen and Meckling summarize, "The horizon employees want used in the investment decisions of the firm is their expected employment termination date. To the extent that this date falls short of the productive life of potential assets, employees will use truncated flows in choosing investment projects including, for example, the investments in intangibles at start-up." They continue, "Economists who have analyzed these problems have never faced up to the fact that the real constraint on what the workers in a pure-rental or labor-managed firm can pay themselves as wages or perquisites (or more generally consume) at any point in time is the net cash balance available at that time. Therefore, the workers have strong incentives to behave in ways which maximize the near-term net cash flows of the firm." (Jensen and Meckling, 1979) Perotin posits that, "The under-investment hypothesis predicts that worker co-operatives that are collectively owned by their employees and depend on internal finance will under-invest because members' property rights are truncated. When they leave the firm they do not keep a claim on future profit as they would with shares that appreciate in value and reflect the present value of future profit if capital markets are efficient (see Furubotn and Pejovich 1970, Vanek 1977)." (Perotin) So, not only must an entrepreneur wrestle with consensus building in a democratic LMF; they must also recognize the revolving door of worker-members own pecuniary expectations will forever complicate investment decisions and challenge attempts to further

scale endeavors.

iii. Hypothesis 6: There is broad lack of awareness of LMF options and benefits.

Bernie Sanders alludes to the opportunity, need for, and public policy options, with proposals including, "Ownership funds: Large corporations would be 're-quired to provide at least 2 percent of stock to their workers every year until the company is at least 20 percent owned by employees.'... Employee ownership bank: Sanders would create a $500 million bank to provide below-market loans and technical assistance to facilitate ownership buyouts... Right of first refusal: When a company goes on the market, the Sanders proposal would give the employees the right to buy the company." But directly speaking to this final hypothesis, "Worker ownership centers: Sanders would create centers to educate business owners and workers in all 50 states." (Rodgers, 2019) Kruse suggests that, "If employee ownership enhances productivity there should be good private incentives for firms to adopt it, although public policy may be justified to spread information on performance enhancing practices." (Kruse, 2016) And this final observation from Kruse gets at what would seem to be an overly simplified and secondary causality. But as is so often the case, simplicity carries a message of truth. Implied in the general lack of awareness of LMF options, is the dearth of willing investors, lenders, and government programs in support. The neoclassical economists have been countered and empirical evidence suggests that economic and societal benefits support promotion of LMF. And colloquially this author suggests that broad public education of these facts is the logical first step to effect change. It is also likely the lowest cost action item identifiable, though the challenge of building sufficient leadership consensus to counter decades of thought and education will not be small.

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