THE DEMOCRATIC FIRM

David P. Ellerman*

The World Bank
Washington, DC

The original book is long out-of-print. This is a revised version that was published in Chinese as: *The Democratic Corporation* 1997, Xinhua Publishing House, Beijing.

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Introduction

Capitalism, Socialism, and Economic Democracy

The socialism of state ownership—state socialism—is no longer considered a worthy goal in almost all the countries that used to be "socialist". Central planning has been abandoned in favor of the market. There are many types of market economy. The Anglo-American type of a capitalist market economy is one widely studied and highly acclaimed model. There are, however, alternative forms for a market economy. For example, the Japanese economy is today more and more recognized as representing an alternative to the Anglo-American model (rather than just an "imperfect" imitation of the Anglo-American model). China is currently evolving towards a model referred to as a "socialist market economy."

This book argues that the Anglo-American model of a capitalist economy is not an ideal type. Indeed, the book argues that Anglo-American capitalism (hereafter referred to simply as "capitalism") suffers from a deep-lying inconsistency wherein it violates the basic principles of democracy and private property—principles often but mistakenly thought to be fundamental to capitalism. There is an alternative form of a market economy based on democracy and justice in private property. This book is about that alternative form of a market economy.

A *democratic firm* (also “democratic worker-owned firm” or “labor-based democratic firm”) is a company “owned” and controlled by all the people working in it—just as a democratic government at the city, state, or national level is controlled by all of its citizens. In each case, those who manage or govern are ultimately responsible not to some absentee or outside parties but to the people being managed or governed. Those who are governed vote to directly or indirectly elect those who govern.

A market economy where the predominant number of firms are democratic firms is called an *economic democracy* (see Dahl, 1985; Lutz and Lux, 1988; Ellerman, 1992).

This book is about the ideas, structures, and principles involved in the democratic firm and in economic democracy. The book develops new concepts or, rather, applies old concepts to new situations—such as the “very idea” of applying democratic principles to the workplace. The material is not technically demanding in terms of economic theory but it may occasionally be conceptually demanding.

Old words may be used in new ways. For instance, “capitalism” is often taken as referring to a private property market economy—but an “economic democracy,” where most firms are

democratic firms, is also a private property market economy. The distinguishing feature of a capitalist economy *vis-à-vis* an economic democracy is the *employer–employee relation*—the legal relation for the voluntary renting or hiring of human beings.

> The commodity that is traded in the labor market is labor services, or hours of labor. The corresponding price is the wage per hour. We can think of the wage per hour as the price at which the firm rents the services of a worker, or the rental rate for labor. We do not have asset prices in the labor market because workers cannot be bought or sold in modern societies; they can only be rented. (In a society with slavery, the asset price would be the price of a slave.) [Fischer, et. al. 1988, p. 323]

In a democratic firm, work in the firm qualifies one for membership in the firm. The employment relation is replaced by the membership relation.

In ordinary language, "capitalism" is not a precisely defined technical term; it is a molecular cluster concept which ties together such institutions and activities as private property, free markets, and entrepreneurship as well as the employer–employee relationship. There has also been a rather far-fetched attempt to correlate "capitalism" with "democracy." But this does not result from any serious intellectual argument that the employer–employee relation (which used to be called the "master–servant relation") embodies democracy in the workplace.

Our normative critique is not of "capitalism" *per se* but of the employment relation or contract, so it must be sharply distinguished from a critique of private property (quite the opposite in fact), entrepreneurship, or free markets. In an economic democracy, there would be private property, free markets, and entrepreneurship—but "employment" would be replaced by democratic membership in the firm where one works.

The more subtle point is that the abolition of the employment relation does, nevertheless, make a change in property, markets, and entrepreneurship. This point can be illustrated by considering the related abolition of the master–*slave* relationship as an involuntary *or voluntary* relation. In a slavery system, "private property" included property in human beings and property in slave plantations. "Markets" included slave markets and it even included voluntary self-sale contracts. "Entrepreneurship" meant developing more and better slave plantations. Thus slavery could not be abolished while private property, free markets, and entrepreneurship remained unchanged. The abolition of slavery did not abolish these other institutions but it did change their scope and nature.

In the same fashion, we will see that the abolition of the employment relation in favor of people being universally the owners/members of the companies where they work would not abolish private property, free markets, or entrepreneurship—but it would change the scope and nature of these institutions.

This leaves us with a linguistic problem. How do we refer to the economic system we are recommending to be changed in the direction of economic democracy? The word “capitalism” evokes private property, free markets, and entrepreneurship which are not being criticized here. Yet there is no other widely accepted word that focuses attention specifically on the employment relation. Expressions such as “wage slavery” or “wagery” are too rhetorical. “Wage system” is currently used to refer to fixed wages as opposed to so-called “profit-sharing.” But “profit-sharing” is only a variable wage rate geared to a measure of performance, and it, like a piece-rate, is well within the confines of the employer–employee relationship.

We will therefore use bland expressions such as “employment system” or “employer-employee system”—when we are being careful—to refer to the system where work is legally organized on the basis of the employer-employee relation (with a private or public employer). Since the employment relation is so widespread (e.g., part of both capitalism and socialism), “employment” has also become synonymous with “having a job.” We assume the reader understands that when we argue against the employment relation (in favor of universal membership in the firm) we are not arguing that everyone should be “unemployed”!

Linguistic habits die hard—for the author as well. When the word “capitalism” is nonetheless used in this book, it will be used *not* as a cluster concept to include private property, free markets, and entrepreneurship, but as a technical term to refer to an economy where almost all labor is conducted under the employment contract.

Outline of the Approach

This book takes a comprehensive approach to the theory and practice of the democratic firm—from philosophical first principles to legal theory and finally down to some of the details of financial structure. The topics covered include:

— a descriptive analysis of the property rights involved in capitalist production, and a prescriptive application of the *labor theory of property* arguing for a democratic firm, since in such a firm people jointly appropriate the positive and negative fruits of their labor;

— a descriptive analysis of the governance rights involved in a capitalist firm, and a prescriptive application of *democratic theory* arguing for a democratic firm, since in such a firm people realize the right of democratic self-determination in the workplace;

— an extended discussion of the legal structure of the *democratic firm*—particularly of the system of *internal capital accounts* which corrects one of the central flaws in existing worker self-managed firms as in the former Yugoslavia;

— description and analysis of the system of *Mondragon worker cooperatives*;

— description and analysis of the American phenomena of employee stock ownership plans or *ESOP*s;

— a description of a *hybrid democratic firm* that combines some of the best ideas from Mondragon-type worker cooperatives and from the American ESOPs in a simple form that can be transplanted to other countries; and

— an analysis of the foremost example of firms today based on employee sovereignty, namely the large Japanese company.

The overall perspective is that a new type of economic enterprise, the democratic firm, is at last coming into clear focus. It is different from both the traditional capitalist and socialist firms. Indeed, there are forces and principles at work in both systems that are pushing towards convergence on the common ground of economic democracy.

Chapter 1: *The Labor Theory of Property*

Property Rights and the Firm

This book presents a new analysis of capitalism. The analysis is new to the conventional stylized debate between capitalism and command-socialism. But the ideas are not new. The labor theory of property, democratic theory, and inalienable rights theory are part of the humanist and rationalist tradition of the Enlightenment.

The theory of the democratic worker-owned firm walks on two legs. That is, it rests on two principles.

> (1) The property structure of the democratic firm is based on the principle that people have a natural and inalienable right to the fruits of their labor.
>
> (2) The governance structure of the democratic firm is based on the principle that people have a natural and inalienable right to democratic self-determination.

This chapter deals with the *labor theory of property* (the fruits-of-their-labor principle) while the next chapter deals with the application of *democratic theory* to the firm.

The Fundamental Myth about Private Property

The understanding of what private property is and what it is not—is clouded in both capitalist and socialist societies by a "Fundamental Myth" accepted by both sides in the capitalism-socialism debate. The myth can be crudely stated as the belief that "being the firm" is a structural part of the bundle of property rights referred to as "ownership of the means of production." A better statement and understanding of the myth requires some analysis.

Consider any legal party that operates as a capitalist firm, e.g. a conventional company in the United States or the United Kingdom that produces some product. That legal party actually plays two distinct roles:

— the *capital-owner role* of owning the means of production (the capital assets such as the equipment and plant) used in the production process; and

— the *residual claimant role* of bearing the costs of the inputs used-up in the production process (e.g. the material inputs, the labor costs, and the used-up services of the capital assets) and owning the produced outputs. The "residual" that is claimed in the "residual claimant" role is the economic profit, the value of the produced outputs minus the value of the used-up inputs.

The Fundamental Myth can now be stated in more precise terms. It is the myth that the residual claimant's role is part of the property rights owned in the capital-owner's role, i.e. part of the "ownership of the means of production." The great debate over the public or private ownership of the residual claimant's role is quite beside the point since there is no "ownership" of that role in the first place.

It is simple to show that the two roles of residual claimant and capital-owner can be separated without changing the ownership of the means of production. *Rent out the capital assets*. If the means of production such as the plant and equipment are leased out to another legal party, then the lessor retains the ownership of the means of production (the capital-owner role) but the leasee renting the assets would then have the residual claimant's role for the production process using those capital assets. The leasee would then bear the costs of the used-up capital services (which are paid for in the lease payments) and the other inputs costs, and that party would own the produced outputs. Thus the residual claimant's role is *not* part of the ownership of the means of production. The Fundamental Myth is indeed a myth.

Who is to be the residual claimant? How is the identity of that party legally determined—if not by the ownership of the means of production? The answer is that it is determined by the direction of the contracts. The residual claimant is the hiring party, the legal party who ends up hiring (or already owning) all the necessary inputs for the productive operations. Thus that party bears the costs of the inputs consumed in the business operations, and thus that party has the legal claim on the produced outputs. The residual claimant is therefore a *contractual role*, not an ownership right that is part of the ownership of the means of production.

The ownership of the capital assets is quite relevant to the question of *bargaining power*; it gives the legal party with the capital-owner's role substantial bargaining power to also acquire the contractual role of residual claimancy. But there is no violation of the "sacred rights" of private property if other market participants change the balance of bargaining power so that the capital assets can only be remuneratively employed by being leased out. Markets are double-edged swords.

Understanding the Fundamental Myth forces a re-appraisal of certain stock phrases such as "ownership of the firm." That usually refers to the *combination* of the capital-owner's role and the residual claimant's role. But residual claimancy isn't something that is "owned"; it is a contractual role. What actually happens when party A sells the "ownership of the firm" to party B? Party A sells the capital assets owned in the capital-owner's role to B, and then B tries to take over A's contractual role as the hiring party by re-negotiating or re-assigning all the input contracts from A to B. Party A cannot "sell" the willingness on the part of the various input suppliers to re-negotiate or renew the contracts. Thus A's contractual role as the previous residual claimant cannot be "sold" as a piece of property like the capital assets. If B could not successfully take over the contractual role of residual claimancy, then it would be clear that by "buying the firm," B in fact only bought the capital assets. Thus buying the capital assets is not a sufficient condition to "become the firm" in the sense of becoming the residual claimant.

Buying the capital assets is also not a necessary condition for becoming the firm. A rearrangement of the input contracts could result in a new party becoming the residual claimant of the production process using the capital assets without there being any sale of the capital assets. The prime example is a *contract reversal* between the owners of the capital and the workers. We will later discuss examples where worker-owned firms are established by leasing the capital assets from the legal party that previously operated as the residual claimant in the production process using those assets. For example, this sometimes happens in distressed companies when the capital-owner no longer wants the residual claimant's role. It also happened in the Former Soviet Union and China when the means of production in certain enterprises were leased to the collectivity of workers.

The "ownership of the means of production" is neither necessary nor sufficient to being the firm in the sense of being the residual claimant in the production process using those means of production. Contrary to the Fundamental Myth, being the firm is not part of the ownership of the means of production.

Ownership of a Corporation is not "Ownership of the Firm"

The logical structure of the above argument is, of course, independent of the legal packaging used by the capital owner, e.g. is independent of whether the capital is owned by a natural person or by a corporation. Thus understanding the Fundamental Myth also allows us to understand what is and what is not a part of the bundle of property rights called "ownership of a corporation."

Suppose an individual owns a machine, a "widget-maker." It is easy to see how that ownership is independent of the residual claimant's role in production using the widget-maker.

The capital owner could hire in workers to operate the widget-maker and to produce widgets—or the widget-maker could be hired out to some other party to produce widgets.

That is a simple argument to understand. But it is amazing how many economists and lawyers suddenly cannot understand the argument when the individual is replaced by a corporation. Indeed, suppose the same individual incorporates a company and issues all the stock to himself in return for the widget-maker. Now instead of directly owning the widget-maker, he is the sole owner of a corporation that owns the widget-maker. Clearly this legal repackaging changes nothing in the argument about separating capital ownership and residual claimancy. The corporation has the capital-owner's role and—depending on the direction of the hiring contracts—may or may not have the residual claimant's role in the production process using the widget-maker. The corporation (instead of the individual) could hire in workers to use the widget-maker to manufacture widgets, or the corporation could lease out the widget-maker to some other party.

The legal ownership of the corporation only guarantees the capital-owner's role. The residual claimant's role could change hands through contract rearrangements or reversals without the ownership of the corporation changing hands. Therefore the ownership of the corporation is not the "ownership of the firm" where the latter means the residual claimant's role in the production process using the corporation's capital assets (e.g. the widget-maker). The idea that the repackaging of the machine-owner's role as corporate ownership is a transubstantiation of capital ownership into "ownership" of the residual claimant's role is only another version of the Fundamental Myth.

The Appropriation of Property

Property rights are born, transferred, used, and will eventually die. In *production*, old property rights die and new property rights are born; in *exchange*, property rights are transferred. In production, the new property rights to the outputs are born or initiated. The acquisition of the initial or first-time property right to an asset is called the "appropriation" of the asset. Property rights die (i.e. are terminated) when the property is consumed or otherwise used up. In production, it is the property rights to the inputs (materials and services of capital and labor) that are terminated. When a property right is terminated that is a negative form of appropriation; it can be termed the appropriation *of the liability* for the used-up property.

In production, there is the appropriation of the assets produced as outputs and the appropriation of the liabilities for the used-up inputs. Some symbolism can be used to capture the idea. Consider a simple description of a production process where the people working in the enterprise perform the labor services L that use up the inputs K to produce the outputs Q. Thus

the produced outputs are Q and liabilities for the inputs could be represented by the negative quantities –K and –L. Let us represent these three quantities in a list where the quantities are given in the order:

(outputs, inputs, labor).

Then the list (or "vector") giving the assets and liabilities appropriated in the production process is given by what will be called the:

whole product = (Q, –K, –L)

("whole" because it includes the negative as well as the positive results of production).

There is a descriptive and a normative question about property appropriation:

— *Descriptive Question*: In a private property market economy, how is it that one legal party rather than another legally appropriates the whole product of a technically-described production process?

— *Normative Question*: Which legal party ought to legally appropriate the whole product of a technically-described production process?

We have already answered the descriptive question. "Legally appropriating the whole product" is a property-oriented description of the residual claimant's role: Whole Product Appropriator = Residual Claimant. We saw that residual claimancy was contractually determined by being the hiring party. The hiring party hires or already owns all the inputs services used up in production (i.e. K and L) so that party, as it were, appropriates the liabilities –K and –L. Hence that party certainly has the legally defensible claim on the produced outputs (i.e. Q). In that manner, the contractually determined hiring party legally appropriates the whole product (Q, –K, –L) of the production process.

Perhaps the only surprise in the above argument is that the property rights to the whole product (i.e. the property rights behind residual claimancy) are *not* part of the ownership of the means of production, i.e. are not part of the capital-owner's role. The capital owner may or may not legally appropriate the whole product (i.e. be the residual claimant) depending on the direction of the hiring contracts.

For example, let K be the services of the widget-maker per time period, let L be the labor that uses up the services K to produce the widgets Q. If the corporation that owns the widget-maker hires in the labor services L, then it will have the claim on the widgets Q, so the corporation will appropriate the whole product (Q, –K, –L). If the corporation leases out the

widget-maker (i.e. sells the services K) to some other party who hires or already owns the labor L, then that party will be able to claim Q and thus legally appropriate the same whole product (Q, –K, –L). The idea that the appropriation of the whole product is somehow an intrinsic part of the ownership of the widget-maker is only another version of the Fundamental Myth.

The Normative Question of Appropriation

What is the traditional *normative* basis for private property appropriation? The natural basis for private property appropriation is *labor*—people's natural and inalienable right to the (positive and negative) fruits of their labor (see Ellerman, 1992 for a discussion of John Locke's theory of property). That is the traditional labor theory of property (see Schlatter, 1951).

We will develop the argument that in any given productive enterprise, the liabilities for the used-up inputs are the negative fruits of the labor of the people working in the enterprise (always including managers). The produced outputs are the positive fruits of their labor. The democratic worker-owned firm is the type of enterprise where the people working in it are the legal members of the firm so they then legally appropriate the positive and negative fruits of their labor. Hence we will argue that the labor theory of property—the natural basis for private property appropriation—implies democratic firms, not traditional capitalist firms.

We previously saw that as a matter of descriptive fact, the appropriation of the was not part of the private ownership of the means of production. We now will argue that as a matter of normative principle, the whole product should be appropriated by the people who produced it, the people working in the enterprise. Thus, it is private property itself—when refounded on its natural basis of labor—that implies democratic worker-ownership.

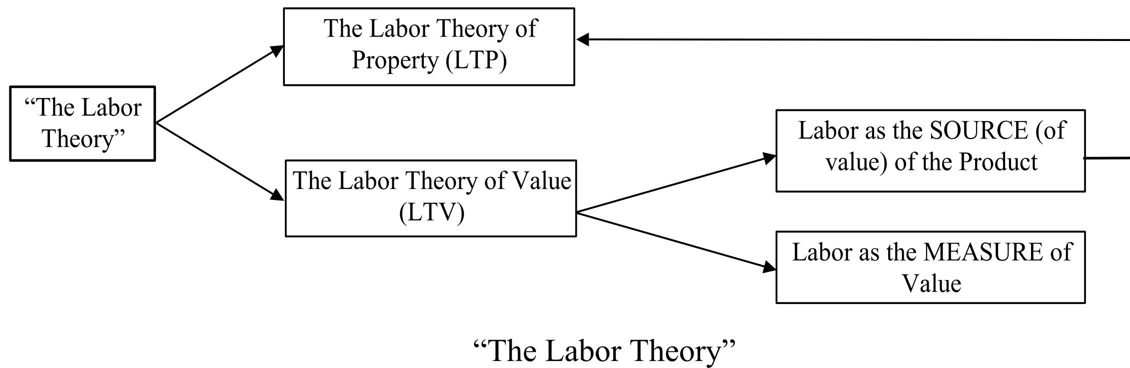
This labor theoretic argument finds a resonance in both capitalist and socialist thought. That dual resonance has always been associated with John Locke's theory of property. Some interpreted it as the foundation of private property, while others took it as a forerunner to radical theories arguing for some form of "socialism" based on worker self-management. There is merit in both interpretations. We turn now to the labor theory of property as it has been interpreted and misinterpreted in socialist thought.

"The Labor Theory" of Value—or of Property

At least since Marx's time, any discussion of the labor theory of property in socialist thought has been dominated by Marx's labor theory of value and exploitation. The labor theory of property simply has not had an independent intellectual life. Yet many of the ideas underlying the support and interpretation of the "labor theory of value" actually are based on the labor theory of property. Hence it is best to speak firstly of "The Labor Theory" (LT) as a primordial theoretical

soup without specifying "of Value" or "of Property." Then the various overtones and undercurrents in LT can be classified as leaning towards *the labor theory of value* (= LTV) or *the labor theory of property* (= LTP).

Since so much of the literature is formulated in terms of LTV, it is further necessary to divide treatments of LTV that are really veiled versions of the labor theory of property from treatments that are focused on value theory as a quasi-price theory.



"The Labor Theory"

The property-oriented versions emphasize labor as the *source* or *cause* of (the value of) the product, while the price-oriented versions consider labor as the *measure* of value. The arrow from the "Labor as the SOURCE (of Value) of the Product" box back to the "labor theory of property" box indicates that (as will be explained below) the source-versions of LTV are essentially veiled versions of LTP.

Is Labor Peculiar?

It is remarkable that the human science of "Economics" has not been able to find or recognize any fundamental difference between the actions of human beings (i.e. "labor") and the services of things (e.g. the services of the widget-maker machine). Neoclassical economics uses two pictures of the production process—an *"active" poetical picture* and a *passive engineering picture*—both of which view labor as being symmetrical with the services of things.

The poetic view animistically pictures land and capital as "agents of productions" that (who?) cooperate together with workers to produce the product. Land is the mother and labor is the father of the harvest. This personification of land and capital is an example of the *pathetic fallacy*. It has long been criticized by radical economists such as Thomas Hodgskin:

> ...the language commonly in use is so palpably wrong, leading to many mistakes, that I cannot pass it by altogether in silence. We speak, for example, in a vague

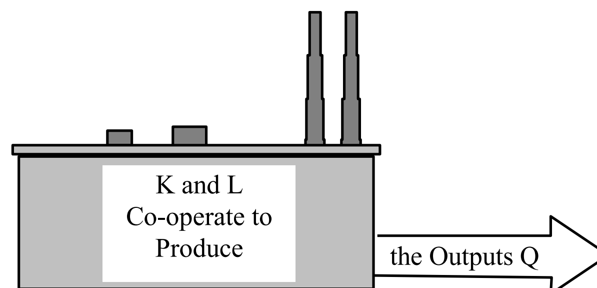
manner, of a windmill grinding corn, and of steam engines doing the work of several millions of people. This gives a very incorrect view of the phenomena. It is not the instruments which grind corn, and spin cotton, but the labour of those who make, and the labour of those who use them... . (Hodgskin, 1827, pp. 250–1)

> All capital is made and used by man; and by leaving him out of view, and ascribing productive power to capital, we take that as the active cause, which is only the creature of his ingenuity, and the passive servant of his will. (Hodgskin, 1827, p. 247; quoted in King, 1983, p. 355)

For instance, the name "widget-maker" pictures the machine as making widgets. Marx was later to ridicule the same animism in capitalist economics.

> It is an enchanted, perverted, topsy-turvy world, in which Monsieur le Capital and Madame la Terre do their ghost-walking as social characters... . (Marx, 1967, p. 830)

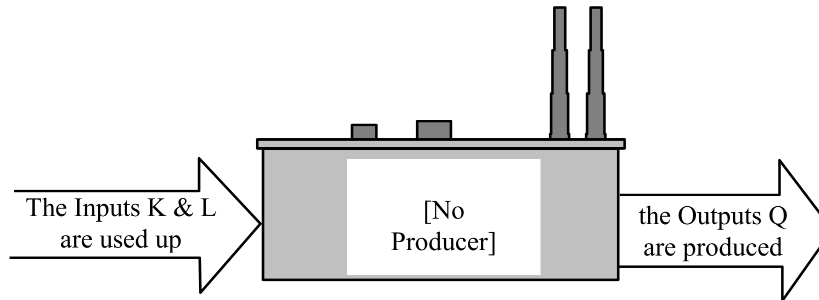
This *active poetic view* can be represented as follows.



The Active Poetic View of Production

The other view favored in capitalist economics (particularly in technical contexts) is the *passive engineering view*. Human actions are treated simply as causally efficacious services of workers alongside the services of land and capital.

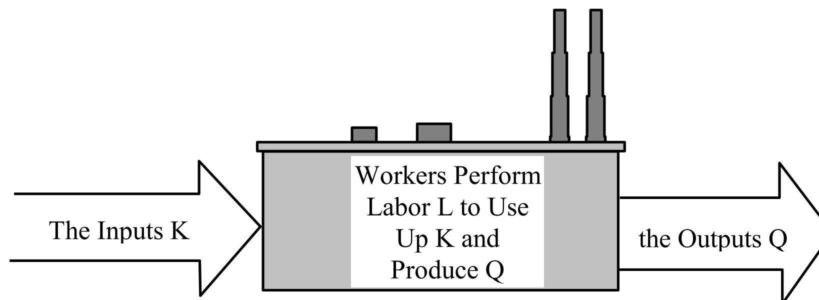
The engineering view switches to the passive voice: "Given input K and L, the outputs Q are produced."



The Passive Engineering View of Production

The question "Produced by who?" is off-limits because the "who" (the workers of the enterprise) has been reconceptualized as just another input, the labor input, in an engineering description of the production process. There is no active agent who uses up the inputs to produce the outputs. Production is pictured as a technological process that just takes place.

There is a third view, the *humanistic view* of production. Neo-classical economics does not emphasize this view. The humanistic view portrays human beings as using capital and land to produce the outputs. It treats human beings as persons who are not symmetrical with things like capital and land. Human actions, or "labor services," use up the services of capital and land in the process of producing the product.



The Humanistic View of Production

Radical economists have also attempted to find a unique and relevant characteristic of labor ("Only labor is the source of value") that would differentiate it from the other factor services. These attempts have not been particularly fruitful.

Marx attached great importance to his "discovery" of the distinction between labor power and labor time. Yet that distinction is not even unique to labor. When one rents a car for a day, one buys the right to use the car ("car power") within certain limits for the day. The actual services extracted from the car are another matter. The car could be left in a parking lot, or driven continuously at high speeds. To prevent being "exploited" by heavy users of "car time,"

car rental companies typically charge not just a flat day rate but have also a "piece-rate" based on the intensity of use as measured by mileage.

The labor-power/labor-time distinction gets heavy play in literary presentations of Marxian exploitation theory. That distinction, aside from being non-unique to labor, plays no role whatsoever in the modern mathematical development of the Marxian labor theory of value and exploitation using input-output theory (see Ellerman, 1992). There "is in fact no place in the formal analysis at which the labor/labor power distinction gets introduced" (Wolff, 1984, p. 178). But the relevant point here is that the development of the whole labor theory of value and exploitation is not based on any unique property of labor. One could just as well develop (say) a theory of corn value which would show how corn is "exploited" in a productive economy (see Wolff, 1984).

Thus we have the twofold situation wherein conventional economics does not recognize any fundamental and relevant differentiation of the actions of human beings from the services of things, while Marxian economics tries to isolate a unique and relevant property of labor (labor time versus labor power) as a basis for its theory of value and exploitation—but it fails to do so successfully.

Marx touched on deeper themes when he differentiated human labor from the services of the lower animals (and things) in his description of the labor process.

> We presuppose labour in a form in which it is an exclusively human characteristic. A spider conducts operations which resemble those of the weaver, and a bee would put many a human architect to shame by the construction of its honeycomb cells. But what distinguishes the worst architect from the best of bees is that the architect builds the cell in his mind before he constructs it in wax. At the end of every labour process, a result emerges which had already been conceived by the worker at the beginning, hence already existed ideally. (Marx, 1977, pp. 283–4)

This conscious directedness and purposefulness of human action is part of what is now called the *intentionality* of human action (see Searle 1983; Ellerman, 1995, Chapter 7). This characterization does have significant import, but Marx failed to connect intentionality to his labor theory of value and exploitation (or even to his labor-power/labor-time distinction). This is in part because Marx tried to develop a labor theory of value as opposed to a labor theory of property.

Only Labor is Responsible

If we move from the artificially delimited field of "economics" into the adjacent field of law and jurisprudence, then it is easy to recognize a fundamental and unique characteristic of labor. *Only labor can be responsible*. The responsibility for events may not be imputed or charged against non-persons or things. The instruments of labor and the means of production can only serve as conductors of responsibility, never as the source.

> An instrument of labour is a thing, or a complex of things, which the worker interposes between himself and the object of his labour and which serves as a conductor, directing his activity onto that object. He makes use of the mechanical, physical and chemical properties of some substances in order to set them to work on other substances as instruments of his power, and in accordance with his purposes. (Marx, 1977, p. 285)

Marx did not *explicitly* use the concept of responsibility or cognate notions such as intentionality. After Marx died, the genetic code of Marxism was fixed. Any later attempt to introduce these notions was heresy.

While Marx did not use the word "responsibility," he nevertheless clearly describes the labor process as involving people as the uniquely responsible agents acting through things as mere *conductors* of responsibility. The responsibility for the results is imputed back through the instruments to the human agents using the instruments. Regardless of the "productivity" of the burglary tools (in the sense of causal efficacy), the responsibility for the burglary is imputed back through the tools solely to the burglar.

The natural sciences take no note of responsibility. The notion of responsibility (as opposed to causality) is not a concept of physics and engineering. The difference between the responsible actions of persons and the non-responsible services of things would not be revealed by a simple engineering description of the causal consequences of the actions/services. Therefore when economists choose to restrict their description of the production process to an engineering production function, they are implicitly or explicitly deciding to ignore the difference between the actions of persons and the services of things.

The various pictures of production—the active poetic view, the passive engineering view, and the humanistic view—can be illustrated by three possible confessions from George Washington after he used an ax to chop down the cherry tree.

— *Active Poetic View*: I cannot tell a lie; an ax cooperated with me to chop down the cherry tree.

— *Passive Engineering View*: I cannot tell a lie; given an ax and some of my labor, the cherry tree was chopped down.
— *Humanistic View:* I cannot tell a lie; I used an ax to chop down the cherry tree.

What is the difference? There is no difference from the viewpoint of the natural sciences. The difference concerns *responsibility*; each confession gives a different shading to the question of responsibility. The inability of capitalist economics to recognize that unique and relevant characteristic of labor is an ideological blindspot which reflects the symmetrical fact that both labor services and the services of land and capital are salable commodities in a capitalist economy. To analytically treat labor as being fundamentally different—when the capitalist system treats labor as a salable commodity like the services of capital and land—would be a perversity as abhorrent as preaching abolitionism in the middle of the Ante-bellum South.

Juridical Principle of Imputation = Labor Theory of Property

The pre-Marxian Ricardian socialists (or classical laborists) such as Proudhon, William Thompson, and Thomas Hodgskin tried to develop "the labor theory" as the labor theory of property. The most famous slogan of these classical laborists was "Labour's Claim to the whole product" (see Hodgskin, 1832 or Menger, 1899).

This claim was hindered by their failure to clearly include the liabilities for the used-up inputs in their concept of the "whole product." This allowed the orthodox caricature, "all the GNP would go to labor and none to property" (Samuelson, 1976, p. 626), *as if* there were no liabilities for the used-up inputs to be appropriated along with the produced outputs. If Labor appropriated the whole product, that would include appropriating the liabilities for the property used up in the production process in addition to appropriating the produced outputs. Present Labor would have to pay input suppliers (e.g. past Labor) to satisfy those liabilities.

The Ricardian socialists' development of the labor theory of property was also hindered by their failure to interpret the theory in terms of the juridical norm of legal imputation in accordance with (*de facto*) responsibility. LTP is concerned with responsibility in the ex post sense of the question "Who did it?", not with "responsibilities" in the ex ante sense of one's duties or tasks in an organizational role. A person or group of people are said to be *de facto or factually responsible* for a certain result if it was the purposeful result of their intentional (joint) actions. The assignment of *de jure or legal responsibility* is called "imputation." The basic *juridical principle of imputation* is that *de jure* or legal responsibility is to be imputed in accordance with *de facto* or factual responsibility. For example, the legal responsibility for a civil or criminal wrong should be assigned to the person or persons who intentionally committed the act, i.e. to the *de facto* responsible party.

In the context of assigning property rights and obligations, the juridical principle of imputation is expressed as the *labor theory of property* which holds that people should appropriate the (positive and negative) fruits of their labor. Since, in the economic context, intentional human actions are called "labor," we can express the *equivalence* as:

The Juridical Principle of Imputation:	=	The Labor Theory of Property:
People should have the legal responsibility for the positive and negative results of their intentional actions.		People should legally appropriate the positive and negative fruits of their labor.

In other words, the juridical principle of imputation is the labor theory of property applied in the context of civil and criminal trials, and the labor theory of property is the juridical principle applied in the context of property appropriation.

De facto responsibility is *not* a normative notion; it is a descriptive factual notion. The juridical principle of imputation is a normative principle which states that legal or de jure responsibility should be assigned in accordance with *de facto* responsibility. In the jury system, the jury is assigned the *factual question* of "officially" determining whether or not the accused party was *de facto* responsible for the deed as charged. If "Guilty" then legal responsibility is imputed accordingly.

Economics is always on "jury duty" to determine "the facts" about human activities. These are not value judgments (where social scientists have no particular expertise). The economist–as–juror is only required to make factual descriptive judgments about *de facto* responsibility. The normative and descriptive questions should be kept conceptually distinct. That separation is difficult since, given the juridical principle, *de facto* responsibility implies de jure responsibility.

In a given productive enterprise, the economist-as-juror faces the descriptive question of what or, rather, who is *de facto* responsible for producing the product by using up the various inputs? The *marginal productivity* of tools (machine tools or burglary tools) is not relevant to this factual question of *responsibility* either inside or outside the courtroom. Only human actions can be responsible; the services provided by things cannot be responsible (no matter how causally efficacious). The original question includes the question of who is responsible for using up those casually efficacious or productive services of the tools.

One of the original developers of marginal productivity theory in economics, Friedrich von Wieser, admitted that of all the factors of production, only labor is responsible.

> The judge,... who, in his narrowly-defined task, is only concerned with the legal imputation, confines himself to the discovery of the legally responsible factor,—that person, in fact, who is threatened with the legal punishment. On him will rightly be laid the whole burden of the consequences, although he could never by himself alone—without instruments and all the other conditions—have committed the crime. The imputation takes for granted physical causality.
> ... If it is the moral imputation that is in question, then certainly no one but the labourer could be named. Land and capital have no merit that they bring forth fruit; they are dead tools in the hand of man; and the man is responsible for the use he makes of them. (Wieser, 1930, pp. 76–9)

These are remarkable admissions. Wieser at last has in his hands the correct explanation of the old radical slogans "Only labor is creative" or "Only labor is productive," which even the classical laborists and Marxists could not explain clearly.

Wieser's response to his insights exemplifies what often passes for moral reasoning among many economists and social theorists in general. Any stable socio-economic system will provide the conditions for its own reproduction. The bulk of the people born and raised under the system will be appropriately educated so that the superiority of the system will be "intuitively obvious" to them. They will not use some purported abstract moral principle to evaluate the system; the system is "obviously" correct. Instead any moral principle is itself judged according to whether or not it supports the system. If the principle does not agree with the system, then "obviously" the principle is incorrect, irrelevant, or inapplicable.

The fact that only labor could be legally or morally responsible therefore did not lead Wieser to question capitalist appropriation. It only told him that the usual notions of responsibility and imputation were not "relevant" to capitalist appropriation. Capitalist apologetics would require a new metaphorical notion of "economic imputation" in accordance with another new notion of "economic responsibility."

> In the division of the return from production, we have to deal similarly ... with an imputation,—save that it is from the economic, not the judicial point of view. (Wieser, 1930, p. 76)

By defining "economic responsibility" in terms of the animistic version of marginal productivity, Wieser could finally draw his desired conclusion that competitive capitalism "economically" imputes the product in accordance with "economic" responsibility.

In spite of Wieser's candid admission a century ago that "no one but the labourer could be named" and that the assignment of legal responsibility "takes for granted physical causality," the author has not been able to find a single contemporary economics text, elementary or advanced, which similarly admits that among all the causally efficacious factors, only labor is responsible. The legal system's treatment of "labor" as the only responsible "input service" is apparently a forbidden topic in economics. Contemporary texts cannot use the R-word. The same texts express their "puzzlement" at how so many earlier political economists could "overlook" land and capital, and believe that "labor was the only productive factor." A closer reading of Wieser, not to mention common sense, would suggest another interpretation of the "labor theory."

What is Labor's Product?

Given a group of apple trees, consider the human activity of Adam picking apples for an hour to produce a bushel of apples. The human activity of picking the apples for an hour is reconceptualized in economics as another "input," a man-hour of apple-picking labor, to the now subjectless production process. Given a group of apples trees and a man-hour of apple-picking labor as inputs, a bushel of apples is produced as the output. The question of *who* uses the inputs to produce the outputs has no answer because the actions of the people carrying out the process are construed as just another input in the engineering description of a technological input-output process.

Prior to conceptualizing the human activity of production as an "input" to a dehumanized technological conception of production, we could use two-component lists (or vectors),

$$(\text{outputs, inputs}).$$

The productive activities of all the people working in the given production example produce Q by using up K, so (Q, –K) is *Labor's product*. The labor L performed by the people working in the enterprise is simply a way to refer to the human activity of producing (Q, –K).

Labor L = Human Activity of Producing (Q, –K)

But then that activity L is reconceptualized as another "input," an input to the now subjectless production process. Using this artificial reconceptualization, the people working in the production process produce the labor services L and then use up K as well as L in the production of Q. Using the vector notation, they produce the labor (0, 0, L) and they produce the *whole*

product (Q, –K, –L) which add together (by adding the corresponding components) to yield the three-component version of Labor's product.

Labor's product = (Q, –K, 0)	= (Q, –K, –L)	+ (0, 0, L)
	= whole product	+ labor services.

In capitalist production, the people working in the firm, i.e. the party herein called "Labor," appropriate and sell only their labor services to the employer who, in turn, appropriates the whole product. In a democratic firm, Labor appropriates Labor's product (which is the sum of the whole product and the labor services). The difference between the two forms of production lies in who appropriates the whole product which consists of the produced outputs Q and the liabilities –K and –L for the used-up inputs and labor activity. Under capitalist production, the workers still produce Labor's product (since that is a question of fact unchanged by the legal superstructure) but only appropriate their labor services as a commodity. Hence the assets and liabilities that they produce but do not appropriate constitute the whole product (subtract corresponding components in the lists).

	Labor's Product	= (Q, –K, 0)
Minus:	Labor as a Commodity	= –(0, 0, L)
Equals:	Whole Product	= (Q, –K, –L).

In words, the equation is as follows.

	What Labor Produces
Minus:	What Labor Produces and Appropriates
Equals:	What Labor Produces and Does Not Appropriate.

The labor theory of property holds that the people working in every enterprise should appropriate the positive and negative fruits of their labor which in the vector notation is Labor's product (= whole product + labor services). Thus in the comparison with the capitalist firm, the labor theory of property implies that Labor should appropriate the whole product. We saw before that "appropriating the whole product" was a property-oriented description of being the

residual claimant, i.e. being the firm. In short, the labor theory of property implies that Labor should be the firm, i.e. that the firm should be a democratic worker-owned firm.

It is important to understand what this argument does *not* imply. We have already taken some pains to separate the residual claimant's role from the capital-owner's role. The labor theory of property implies that Labor should have the residual claimant's role. It does not imply that the current workers in any enterprise should own the capital assets of that enterprise which have been accumulated from the past. The argument does imply that the current workers are *de facto* responsible for and should be legally responsible for using up the services of those capital assets (i.e. should be legally responsible for the input-liabilities –K).

Property Theoretic Themes in Marxian Value Theory

We turn now to the task of intellectual reclamation—trying to salvage some of Marx's "labor theory"—a task that is little appreciated by both conventional and Marxist economists. Marx's labor theory of value—as a theory to measure value—is one of the most spectacular failures in the history of economic thought (see Ellerman, 1992 for analysis and criticism). There is, however, the alternative interpretation of Marx's theory which emphasizes labor-as-source instead of labor-as-measure. That turns out to be a disguised version of the labor theory of property, not a value theory at all. In this section, we try to tease out these property-theoretic themes in Marxian thought.

Marx started by singling out human action as the unique activity that acted upon the world to endow it with intents and purposes—even though Marx and latter-day Marxists do not use the notion of responsibility to differentiate human actions from the services of things (Marxists have been as unable as capitalist economists to find the R-word).

> But although part of Nature and subject to the determinism of natural laws, Man as a conscious being had the distinctive capability of struggling with and against Nature—of subordinating and ultimately transforming it for his own purposes. This was the unique rôle of human productive activity, or human labour, which differentiated man from all (or nearly all) other animate creatures ... (Dobb, 1973, pp. 143–4)

Marx clearly saw that physical causal processes can never be co-responsible with human agents; the causal processes serve only as "conductors" to transmit human intentions. Hence the

assignment of legal responsibility in accordance with *de facto* responsibility "takes for granted physical causality."

Marx also was by no means exclusively concerned with developing the labor-as-a-measure version of LTV. It was not simply that value is a function of labor, but that direct labor *creates* the value added to the material inputs.

> For the capitalist, the selling price of the commodities produced by the worker is divided into three parts: *first*, the replacement of the price of the raw materials advanced by him together with replacement of the depreciation of the tools, machinery and other means of labour also advanced by him; *secondly*, the replacement of the wages advanced by him, and *thirdly*, the surplus left over, the capitalist's profit. While the first part only replaces *previously existing values*, it is clear that both the replacement of the wages and also the surplus profit of the capitalist are, on the whole, taken from the *new value created by the worker's labour* and added to the raw materials. (Marx, 1972, p. 182)

We previously drew a conceptual road map of "The Labor Theory" which saw it divide into LTP and LTV. Then LTV divided into "labor as source" and "labor as measure" theories. The source versions of LTV are best understood as (confused) value-theoretic renditions of the labor theory of property.

The source/measure dichotomy should not be confused with a prescriptive-descriptive dichotomy. "Responsibility for" (or "source of") has a descriptive (*de facto*) and a normative (de jure) interpretation. The descriptive question of who is *de facto* responsible for committing a burglary is distinct from the normative question of who should be held de jure responsible for the burglary. The imputation principle—that de jure responsibility should be assigned according to *de facto* responsibility—provides the link between the two questions.

The source version of LTV and LTP also have both a descriptive and a prescriptive side. The controversy lies largely on the descriptive side although the normative parts are necessary to complete any critique of capitalist production. The descriptive side of neo-classical economics (e.g. marginal productivity theory) resorts to metaphor (pathetic fallacy) to picture causality as "responsibility"—to picture each causally efficacious factor as being responsible for producing a share of the product.

Classical laborists, such as Thomas Hodgskin, as well as Marx criticized this personification of the factors. They based the source-LTV and LTP on the unique attribute of labor that it is the

only "creative" factor. That attribute of *de facto* responsibility is not a concept of the natural sciences. But it is central to the descriptive side of the source-LTV.

> The crucial descriptive aspect remains the capturing of the human dimension of production and distribution in the labour theory of value viewed as a category of descriptive statements, rather than the possibility of "determining" or "predicting" prices on the basis of values,... (Sen, 1978, p. 183)

Economists who seem to take as their professional mission to rationalize an economy that treats persons as things (by allowing them to be hired or rented), may well tend to adopt the science of things (physics and other natural sciences) as the scientific model for "economics." Attempts to use notions unique to the human sciences—such as the notions of "responsibility" or "intentionality"—to differentiate labor from the services of things are thus deemed inappropriate in the "science" of economics.

Marx did take labor as the unique source of the value-added so Marx played both sides of the source/measure dichotomy. It was not simply that direct labor was a measure of the value of the surplus product but that direct labor was the *source* of the surplus product. Indeed, Marx's whole exploitation analysis only makes sense under the labor-as-source interpretation of the labor theory of value. The point was *not* that labor created *the value of* the product, but that labor *created the product itself*.

> And it is this fairly obvious truth which, I contend, lies at the heart of the Marxist charge of exploitation. The real basis of that charge is not that workers produce value, but that they produce what has it. (Cohen, 1981, p. 219)

In the assertion that "labor created *the value of* the product," the phrase "the value of" can be deleted and thrown, along with the measure-LTV, into the dustbin of intellectual history.

Some economists have been quite explicit about the (non-orthodox) property-theoretic interpretation of Marx's value theory. Thorstein Veblen was never a slave to the standard or orthodox interpretation of any theory. Veblen saw natural rights arguments standing behind the general thrust of Marx's theory. Veblen sees the claim of Labor's right to the whole product implicit in Marx and traces it to the classical laborists or Ricardian socialists.

> Chief among these doctrines, in the apprehension of his critics, is the theory of value, with its corollaries: (a) the doctrines of the exploitation of labor by capital; and (b) the laborer's claim to the whole product of his labor. Avowedly, Marx traces his doctrine of labor value to Ricardo, and through him to the classical economists. The laborer's claim to the whole product of labor, which is pretty constantly implied, though not frequently avowed by Marx, he has in all probability taken from English writers of the early nineteenth century, more particularly from William Thompson. (Veblen, 1952, p. 316)

Recent scholarship would, however, emphasize the influence on Marx of Hodgskin and Bray more than Thompson (see King, 1983 and Henderson, 1985).

Gunnar Myrdal finds a similar reason behind even Ricardo's use of labor as the basis for his value theory in spite of criticism from Malthus, Say, and Bentham.

> The solution of this puzzle may be found in the natural law notion that property has its natural justification in the labour bestowed on an object. (Myrdal, 1969, p. 70)

But the implications of the labor theory inevitably conflict with classical liberalism which fully accepted wage labor.

The foundation of the theory is the uniqueness of labor; of all the causally efficacious factors, labor is the only responsible agent.

> Man alone is alive, nature is dead; human work alone creates values, nature is passive. Man alone is *cause*, as Rodbertus said later, whilst external nature is only a set of *conditions*. Human work is the only active cause which is capable of creating value. This is also the origin of the concept "productive factor". It is not surprising that the classics recognized only *one* productive factor, viz., labour. The same metaphysical analogies that were used to establish natural rights were also used to expound the idea of natural or real value. It is an example of the previously mentioned attempt of the philosophy of natural law to derive both rights and value from the same ultimate principles. (Myrdal, 1969, p. 72)

Thus the Janus-headed "labor theory" has long served as both a property theory and a value theory—even though orthodox economists only *want* to see it as a (fallacious) price theory in Marx.

> They tend to focus attention on the theory of exchange value [and] neglect its foundations ... Marx was right in saying that his surplus value theory follows from the classical theory of real value, admittedly with additions from other sources. Moreover, Marx was not the first to draw radical conclusions from it. All pre-Marxist British socialists derived their arguments from Adam Smith and later from Ricardo. (Myrdal, 1969, p. 78)

It is time to step back for a moment and consider Marx's value theory in a larger context.

> [T]he "naturalness" of labour as the moral title to what is created by that labour has been a commonplace of political and economic radicalism for three hundred years; and political and economic conservatism has had a continuous struggle to defuse the revolutionary implications of it. (Ryan, 1984, p. 1)

> The central point of the labour theory as a theory of exploitation is that *labour is the only human contribution to economic activity, and the exercise of labour power should be the only way in which a claim to the net product of a nonexploitative economic system is acquired.* (Nuti, 1977, p. 96)

A typical response by Marxists is "None of this, by the way, implies that Marx intended the labor theory of value as a theory of property rights, à la Locke or even Proudhon" (Shaikh, 1977, p. 121) as if the question of what "Marx intended" was relevant beyond the confines of Marxology.

The Employment Contract vs. *de facto* Inalienability

"Private ownership of the means of production" is not the culprit. We have seen enough of the plot to ferret out the true villain of the piece. The labor theory of property normatively implies that Labor (the workers including managers) in each enterprise ought to be the residual claimant for that enterprise. We previously noted the descriptive fact that any legal party could be the residual claimant by becoming the hiring party, the party who hires (or already owns) all the inputs to be used up in production. The workers' claim to the positive and negative fruits of their labor is thus legally defeated by the workers being hired, i.e. by the employment contract. It is

thus the employment contract that defeats the legal implementation of the labor theory of property.

The employer-employee contract inherently conflicts with people's right to the fruits of their labor. The employment contract is the contract for the voluntary hiring or renting of human beings. When a person is legally rented or "employed," then the person has no legal responsibility for the positive or negative results of his or her actions; that legal responsibility goes to the employer. Renting capital gives financial leverage ("gearing" in the UK); it multiplies the effect of the equity capital. Similarly, renting people creates *human leverage*; it multiplies the effect of the employer—*as if* all the results were the fruits of solely the employer's labor.

This conflict between "employment" and *de facto* responsibility has long been apparent in the law. We noted previously that the labor theory of property was only a property-theoretic rendition of the usual juridical principle of imputing legal responsibility in accordance with *de facto* responsibility. We also saw that—unlike the services of things—the actions of persons are *de facto* responsible. That *de facto* responsibility is independent of legal contracts, i.e. people do not suddenly become non-responsible tools or instruments when they sign an employment contract. The legal authorities only explicitly apply the juridical principle when a human activity ends up in court, i.e. when a criminal or civil wrong has been committed. When an employee—even within the context of a normal employment relation—commits a crime at the behest of the employer, then the employee suddenly becomes a partner in the enterprise.

> All who participate in a crime with a guilty intent are liable to punishment. A master and servant who so participate in a crime are liable criminally, not because they are master and servant, but because they jointly carried out a criminal venture and are both criminous. (Batt, 1967, p. 612)

The legal authorities will not allow an employment contract to be used by an employee to avoid the legal responsibility for his or her *de facto* responsible actions.

But when the "venture" being "jointly carried out" is a normal capitalist enterprise, the workers do not suddenly become *de facto* non-responsible tools or instruments. They are just as much *de facto* responsible together with the working employer as when "they jointly carried out a criminal venture." It is the reaction of the law that suddenly changes. Now the employment contract for the renting of human beings is accepted as a "valid" contract. The *de facto* responsibility of human action is nevertheless not factually transferable even though the legal authorities now accept the employment contract for the sale of labor as a commodity as "valid."

The legal system faced the same internal contradiction when it treated slaves as legal chattel in the Ante-bellum South. The legally non-responsible instrument in work suddenly became a responsible person when committing a crime.

> The slave, who is but "*a chattel*" on all *other* occasions, with not one solitary attribute of personality accorded to him, becomes "*a person*" whenever he is to be *punished*. (Goodell, 1969, p. 309)

As an Ante-bellum Alabama judge put it, the slaves in fact

> are rational beings, they are capable of committing crimes; and in reference to acts which are crimes, are regarded as persons. Because they are slaves, they are ... incapable of performing civil acts, and, in reference to all such, they are things, not persons. (Catterall, 1926, p. 247)

It should be no surprise that the legal system involves the same contradiction when workers are rented instead of being owned. The rental relation is voluntary (unlike traditional slavery) but *de facto* responsibility is not voluntarily transferable. A person would not become a *de facto* non-responsible entity if he or she voluntarily agreed to the legal condition of slavery. And the hired criminal would certainly voluntarily agree to give up any and all responsibility for the results of his actions. But regardless of the language on the contract and regardless of the reaction of the legal system, the fact is that he remains a *de facto* responsible person.

It is useful in this connection to consider the *de facto* alienability of things. We *can* voluntarily give up and transfer the temporary use of a tool or instrument to another person so the other person can employ it and be solely *de facto* responsible for the results of that employment. The legal contract that fits the transfer is the lease or rental contract; the owner of the instrument rents, leases, or hires out the instrument to be used by someone else. The same facts do *not* apply to our *selves*. We cannot voluntarily give up and transfer the temporary use of our own persons to another person so the other person can "employ" us and be solely *de facto* responsible for the results of that employment. Our own *de facto* responsibility intrudes. From the factual viewpoint, we are inexorably partners. The so-called "employees" can only co-operate together with the worker employer but then they are jointly *de facto* responsible for the venture they "jointly carried out." But the law still treats the legal contract for the hiring of human beings as a "valid" contract even though human actions are not *de facto* transferable like the services of a tool or instrument.

The nice word for this is "legal fiction." The law will accept the *de facto* responsible co-operation of the "employees" *as if* that fulfilled the hiring contract. Or, at least, the law will do that if no crime has been committed. If a crime has been committed, then the law will not allow the labor theory of property (i.e. the juridical principle of imputation) to be defeated by the employment contract. The law will not allow this "fictional" transfer of labor to shield the criminous servant from legal responsibility. Then the fiction is set aside in favor of the facts; the enterprise is legally reconstructed as a partnership of all who worked in it.

The not-so-nice word for this is "fraud." When the legal system "validates" the contract for the renting of human beings, that is a fraud perpetrated on an institutional scale. It is our own peculiar institution.

This argument is an application to the employment contract of the *de facto theory of inalienable rights* that descends from the history of anti-slavery and democratic thought (see Ellerman, 1992). *De facto* responsibility is factually inalienable, and thus without having a legalized form of fraud, it must be legally inalienable. The legal contract to alienate and transfer that which is *de facto* inalienable is inherently invalid. The natural-law invalidity of the voluntary self-enslavement contract (to sell all of one's labor) is already legally recognized; the invalidity of the contract to rent or hire human beings should be similarly legally recognized.

The chapter began with an analysis of the Fundamental Myth of capitalism, that the residual claimant's role was part of the property rights of "ownership of the means of production." A frequent reply is that while it is "formally" true that residual claimancy is not part of capital ownership, the bargaining power of capital ownership is sufficient that "Capital hires Labor" at will. Thus residual claimancy is said to be "*in effect* part of the ownership of capital."

The rejoinder is that we are not arguing that the determination of the hiring party should be left to marketplace bargaining power (any more than the question of the ownership of human beings should be left to market transactions). The argument for the invalidity of the hired-labor contract completes the argument. With the contract for the renting of human beings ruled out as invalid, it would not be a question of bargaining power. All industry would be organized on the basis of people renting (or already owning) capital instead of the owners of capital renting people. Thus the capital suppliers—as capital suppliers—are denied the residual claimant's role (they might also work and be part of the residual claimant in that role). Since the residual claimant's role was never part of their property rights, this is no violation of their actual (as opposed to imagined) property rights. They are only denied the "freedom" to make the naturally invalid contract to rent other human beings.

There is no need to "adopt" the labor theory of property; it is already adopted. It is the fundamental juridical principle of imputation. Our argument is to "dis-adopt" the inherently invalid contract for the renting of human beings—the contract that defeats the application of the labor theory of property (when no crime has been committed). The facts of human are the same whether the venture is criminal or not. Every enterprise should be legally reconstructed as a partnership of all who work in the enterprise. Every enterprise should be a democratic firm.

Chapter 2: *Democratic Theory*

Democracy in the Firm

The Enterprise as a Governance Institution

Is a company an organization for the governance of people or only for the administration of things? If a company carries out any productive or service operations, then the people conducting those operations are governed by the company within the scope of those operations.

As a legal technicality, there could be an "uninhabited corporation" that served only a holding bin for assets that stood idle or were leased out to other companies or individuals. No one would *work* in such an "uninhabited company"; the shareholders would then only be concerned with "the administration of things."

Any company with people *working* in it is an institution of governance—so the question of democracy arises.

Stakeholders: the Governed and the Affected

Democracy is a structure for the governance of people, not the management of property. It is the structure wherein those who govern are selected by, and govern as the representatives of, the governed. In an economic enterprise, the managers are those who govern, but who are "the governed"?

The *stakeholders* in an enterprise are all those people who are either governed by the enterprise management or whose interests are affected by the enterprise. Thus the stakeholders would include:

The Governed	• The Workers (including Managers)
The Affected	• The Shareholders • The Input Suppliers, • The Customers, and • The Local Residents.

Stakeholders

But there is a crucial partition of this broad group of stakeholders into two groups which will be called "the governed" and "the affected."

"The governed" are those who (within certain limits) take orders from the enterprise management, i.e. who are under the authority of the managers.

"The affected" are those whose person or property are *only* affected by the activity of the enterprise but who are not personally under the authority of the management.

The shareholders are not under the authority of managers; neither are the suppliers of the material inputs, the customers, nor those who live in the vicinity of the enterprise's operations. All those people might have their interests affected by the activities of the firm, but they don't take orders from the firm. The workers do. Only the people who work in the firm are "the governed."

The employment system promotes the mental acrobatics of dividing a person into two different legal roles: (1) the owner and seller of labor services (the labor-seller role), and (2) the person who performs the labor services (the worker role). Under slavery, different people might play the two roles as when a master hired out some of his slaves to work for someone else during slack times. In modern times, there has even developed a labor resale market—called "employee leasing"—which separates the two roles. A person rents himself or herself to company A and then company A rents or leases the person to company B. In the second labor-sale contract, the legal party selling the labor services (company A) is distinct from the person performing the labor.

In the normal capitalist firm, the employee plays both roles. Economists are fond of only considering the employee in his or her labor-seller role—just another input supplier. Then they can mentally treat the workers as external input suppliers who indeed do have direct control over their labor-selling activities. They are not "governed" *in that role*. Management has no legal authority to tell them the price and quantity involved in their labor-selling decision. It is in the employee's worker role that the person is governed by management, *not* in the employee's labor-seller role.

Direct versus Indirect Control

Discussions of corporate governance are often clouded by insufficient attention to the distinction between those who are governed by the corporation and those whose interests are only affected by the firm. Vague statements are made about all the stakeholders having the right to "control" the company to protect their affected interests. But such broad assertions about "control rights" are not too helpful since the control rights legally held by shareholders are fundamentally different from the control rights held by, say, suppliers and customers. In particular, there is a basic distinction between direct control rights (positive decision-making rights) and indirect

control rights (negative decision-constraining rights) that should run parallel to the earlier distinction between the governed and those only affected by an enterprise.

We are discussing the decisions of a given enterprise, not the decisions of outside parties. The direct control rights are the rights to ultimately make the decisions of the enterprise. The managers make day-to-day decisions but they do so as the representatives of those who ultimately hold the direct control rights. In a conventional capitalist corporation, the common stockholders hold those direct control rights.

Outside parties, such as supplier or customers, have the direct control rights over their own decisions, but—relative to the enterprise's decisions—they have only an indirect or negative decision-constraining role. "No, I will not sell the firm these inputs at that price." "No, I will not buy that output on those terms." Even the worker in his or her labor-seller role can say "No, I will not sell that amount of labor at that price without this benefit."

The Affected Interests Principle

Those who are potentially affected by the operations of the enterprise should have an effective means to exert indirect control on the enterprise operations to protect their legitimate interests. This could be stated as the:

> AFFECTED INTERESTS PRINCIPLE. Everyone whose rightful interests are affected by an organization's decisions should have a right of indirect control (e.g. a collective or perhaps individual veto) to constrain those decisions.

It is difficult to effectively implement this principle. The market is the customary means of protecting outside interests in a market economy. But even then, there are a host of externalities where outside interests are affected without the benediction of a market relationship. And within market relations, there could be monopolistic power on one side of the market so that there is "consent" but little choice. Or there could be such large informational asymmetries that "consent" is not meaningfully informed. In such cases, the government often intervenes to regulate the market and attempt to offer better protection of the affected interests. These acknowledged difficulties in the implementation of the affected interests principle need not detain us here. Our concern is the assignment of the direct control rights over the enterprise.

There is a related argument that should be mentioned. Pressure groups for particular sets of affected interests (e.g. consumers) sometimes argue that they should have voting seats on the corporate board of directors to protect their interests. Leaving aside the fallacious assumption

that the role of the board should be to protect *outside* affected interests, it is nevertheless difficult to see how this tactic can work. It runs up against the "law of one majority"; each different and opposing group of external affected interests cannot have a majority on the board of directors. A minority board position may have some informational value but the vote then has little control value. To protect their affected interests, the minority outside interests must fall back on indirect control rights (e.g. negative covenants in market contracts or government regulations) which they had independently of the voting board seats.

The board of directors is the locus for the exercise of direct decision-making control rights, whereas the affected interests principle is only concerned with assigning indirect decision-constraining rights to the outside affected interests. The assignation of the direct control rights requires another principle, the democratic principle.

The Democratic Principle

Who ought to have the ultimate direct control rights over the decisions of the enterprise? Democracy gives an unequivocal answer: *the governed*.

> THE DEMOCRATIC PRINCIPLE. The direct control rights over an organization should be assigned to the people who are governed by the organization so that they will then be self-governing.

The shareholders, suppliers, customers, and local residents are not under the authority of the enterprise; they are not the governed. Only the people working in the enterprise (in their worker role) are "the governed" so only they would be assigned the ultimate direct control rights by the democratic principle. Needless to say, the same person can have several functional roles, e.g. as worker, as consumer, or as capital supplier. The democratic principle would assign direct control rights to the person qua worker in the enterprise, not *qua* consumer or *qua* capital-supplier.

Self-determination within a democratic framework does not include the right to violate the rights of outsiders. A democratically governed township does not have the right to do what it wants to neighboring towns. Direct control rights are to be exercised within the constraints established by the indirect control rights of the external affected interests. In that manner, each group can be self-governing. The workers can self-manage their work and the consumers can self-manage their consumption—with each abiding by the constraints established by the other and with neither having direct control rights over the other.

"Shareholders' Democracy"

In a capitalist corporation, the shareholders (absentee or not) have ultimate direct control rights over the operations of the corporation. They are the "citizens" who exercise these control rights by electing the corporate directors, the "legislators," who are supposed to act as the representatives of and in the interests of the shareholder-citizens.

> The analogy between state and corporation has been congenial to American lawmakers, legislative and judicial. The shareholders were the electorate, the directors the legislature, enacting general policies and committing them to the officers for execution. (Chayes, 1966, p. 39)

The board of directors selects the top managers who, in turn, select the remainder of the management team that manages the day-to-day operations of the corporation.

The direct control rights of shareholders are more nominal than effective in the large corporations with publicly traded shares—as was pointed out long ago by Adolf Berle and Gardner Means (1967 [1932]). Public stock markets have effectively disenfranchised the common stockholders. Each shareholder has a minuscule amount of the vote, and huge transaction costs block the self-organization of shareholders into "parties." Most investors buy shares for the investment potential; the voting rights are only a vestigial attachment.

This "separation of ownership and control" creates a problem of legitimacy—legitimacy by *capitalist* standards. Corporate reformers dream of "real shareholders' democracy" wherein the shareholders effectively exercise their control rights. The difficulty in this call for "democracy" is that the shareholders never were "the governed."

> Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporation whose consent must be sought. (Chayes, 1966, p. 40)

Perhaps an analogy is appropriate. A set of shareholders in England start off voting to elect the government of the American Colonies. Then their voting rights fall into disrepair so the autocratic government of the Colonies rules as a self-perpetuating oligarchy that is not answerable to the English shareholders (not to mention the American people). How can democracy be restored to America? Not by re-establishing the direct control of the outside shareholders but by reassigning the direct control rights to the governed.

How do corporate lawyers and legislators manage to avoid these none-too-subtle points? One popular method is to think of the corporation solely as a piece of property to be administered, not as an organization for the management of people. But that image would only be accurate if the corporation was "uninhabited," if no one worked in the corporation.

It is the employment contract that turns the capitalist corporation-as-property into an organization of governance. That organization is not democratic in spite of the "consent of the governed" to the employment contract. The employees do not delegate the governance rights to the employer to govern as their representative. In the employment contract, the workers alienate and transfer their legal right to govern their activities "within the scope of the employment" to the employer. The employment contract is thus a limited workplace version of the Hobbesian *pactum subjectionis*. The argument for applying the democratic principle to the workplace is thus an argument which implies disallowing the employment contract just as we currently disallow any such Hobbesian contract to alienate democratic rights in the political sphere (for an extended analysis of the employment contract, see Ellerman, 1992).

When the democratic principle is applied across the board, then workers would always be member-owners in the company where they work and never just employees. The employment relation would be replaced by the membership relation.

Democratic Socialism is not Democratic in the Enterprise

"Democratic socialism" refers to a political-economic system where the bulk of industry is state-owned and the state is a political democracy. Is a state-owned firm in a political democracy a democratic firm? For example, is the Post Office a democratic organization since the post office workers, as citizens, elect a President who appoints the Postmaster General? The answer is "No," but it is important to understand why such state-owned firms are undemocratic.

Democratic socialism is often criticized on grounds of scale. For instance, the workers in any one state-owned company are such a small portion of the total citizenry that they can have little real control over their enterprise. Hence democratic state-socialists become democratic municipal-socialists. If the enterprise was owned by the *local* government, then perhaps the workers would be less alienated. Or at least that seems to be the reasoning.

These practical problems in democratic socialism only veil the flaw in the theory of government ownership, regardless of whether the government is local or national. Citizenship in a democratic polity such as a municipality is based on having the functional role of residing within the jurisdiction of the polity, e.g. having legal residence in the municipality. Thus municipal socialism in effect assigns the ultimate direct control rights to the local residents.

Membership in a democratic enterprise is based on a different functional role, that of working within the enterprise. So-called “democratic socialism” assigns the ultimate control rights over the enterprise to the wrong functional role (the role that defines political citizenship) so it is not even democratic in theory—much less in practice—in the enterprise.

The Public/Private Distinction in Democratic Theory

Personal Rights and Property Rights

A *personal right* is a right that attaches to an individual because the person satisfies some qualification such as playing a certain functional role. Examples include basic human rights where the qualification is simply that of being human, and political citizenship rights in a polity (e.g. municipality) where the functional role is that of residing within the polity. In contrast, a person does not have to satisfy any particular functional role to hold a property right. A property right can be acquired from a prior owner or it can be appropriated as an initial right.

Personal rights are not transferable; they may not be bought or sold. If a personal right (that was supposed to be attached to a functional role) was treated as being marketable, then the buyer might not have the qualifying functional role. And if the would-be buyer did have the functional role, he or she would not need to “buy” the right.

In America, a person might have several quite different types of voting rights:

— a citizen’s political vote in a municipal, state, or federal election;

— a worker’s vote in a union;

— a member’s vote in a cooperative; or

— a shareholder’s votes attached to conventional corporate shares.

Which rights are personal rights and which are property rights?

Personal rights can be easily distinguished from property rights by the *inheritability test*. Since personal rights attach to the person by virtue of fulfilling a certain role, those rights would be extinguished when the person dies. Property rights, however, would pass on to the person’s estate and heirs. That is the contrast, for example, between the voting rights people have in a democratic organization (a polity, a union, or a cooperative) and the voting rights people have as shareholders in a capitalist corporation. Political voting rights are personal rights that are extinguished when the citizen dies whereas voting corporate stock passes to the person’s heirs.

When the direct control rights over an organization are attached to a certain functional role (e.g. the role of being governed by the organization) then that control is “tied down” and attached

in a non-transferable way to the set of people having that role. In contrast, the ultimate control rights over a capitalist corporation are property rights attached to the voting shares so that ownership can not only change "overnight," it can also become very concentrated in a few hands.

The ultra-capitalist ideal seems to be to have all rights as marketable property rights (see Nozick, 1974). Then society is like a ship with none of the cargo tied down. Even if the ship starts out with the cargo evenly distributed, any wave will start the cargo shifting to one side. Then the shifting weight will cause even more tilt—which in turn causes more cargo to shift to that side.

A similar social instability would result from having political voting rights as marketable property rights. Even with an equal initial distribution, one vote per person, any disturbance would result in some votes being bought and sold which begins the process of accumulation. Then the resulting political concentration would lead to capturing more wealth, more voting buying, and even more concentration. Soon most of the political votes and power would end up in a few hands. Democracy inherently avoids that sort of accumulation process by "tying down" the voting rights as personal rights attached to the functional role of being governed.

We have just this sort of instability in the economic sphere. Capitalism has structured the profit rights and control rights over corporations—where new wealth is created—as transferable property rights. The resulting instability has accordingly led to an incredibly lopsided distribution of wealth which continues to get worse.

The system of economic democracy ties down the profit and control rights over each firm to the functional role of working in that firm. Since those membership rights are non-transferable and non-inheritable, they cannot become concentrated. Workers come to a democratic firm and eventually leave or retire. They keep as property the profits they earn while working in the firm (even if the profits are retained and paid back to them later), but their membership in the firm is a personal right they enjoy only when they work in the firm.

Quarantining Democracy in the Public Sphere

Since the political democratic revolutions of the eighteenth and nineteenth centuries, the government has been the main provider and guarantor of personal rights. Those who own significant property tend to want as much of society as possible to be organized on the basis of property rights, not personal rights. Hence they want "less government." Well-intended advocates of extending democratic rights to economic issues want "more government." This

leads to "democratic socialism" where the government swallows the commanding heights of industry.

This "great debate" is ill-posed. It is based on a pair of false identifications: (1) that the sphere of government ("the public sphere") is the sole arena for personal rights, and (2) that the sphere of social life outside the government ("the private sphere") is solely based on private property rights. That is the traditional public/private distinction. Capitalism has used it to quarantine the democratic germ in the public sphere of government, and thus to keep the democratic germ out of industry. Instead of redefining those public/private identifications, democratic state-socialism compounds the error by holding that industry can only be democratized by being nationalized.

The rights to democratic self-determination will not remain forever quarantined in the sphere of government. It is an empirical fact of history that, as a result of the political democratic revolutions, the government was the first major organization in society to be switched over to treating its direct control rights (voting rights) as personal rights. There is otherwise no inherent relationship that restricts the idea of democratic self-determination to the political government. There are a host of other non-government organizations in society, corporations, universities, and a broad range of non-profit corporations, where people are also under an authority relation. The "unalienable rights" to democratic self-determination that we enjoy in the political sphere should not suddenly evaporate in the other spheres of life.

The democratic firm is a model of an organization that is democratic and yet is still "private" in the sense of being non-governmental. The membership rights in a democratic firm are personal rights assigned to the functional role of working in the firm.

Redefining "Social" to Recast the Public/Private Distinction

The old public/private distinction is supported by both capitalists and state-socialists. The former use it to argue that the idea of democracy is inapplicable to private industry, and the latter use it to argue that democracy can only come to industry by nationalizing it. But both arguments are incorrect, and the public/private distinction itself must be recast.

The word "private" is used in two senses: (1) "private" in the sense of being non-governmental, and (2) "private" in the sense of being based on private property. Let us drop the first meaning and retain the second. Similarly "public" is used in two senses: (1) "public" in the sense of being governmental, and (2) "public" in the sense of being based on personal rights. Let us use the second meaning and take it as the definition of "social" (instead of "public"). Thus we have the suggested redefinitions:

Social Institution	= Based on Personal Rights
Private Organization	= Based on Property Rights.

By these redefinitions, a democratic firm is a social institution (while still being "private" in the other sense of being not of the government), while a capitalist corporation is a private firm (not because it is also non-governmental but because it is based on property rights).

People-based versus Property-based Organizations

The inheritability test can be used to differentiate personal rights from property rights; personal rights are extinguished when a person dies while property rights are passed on to the heirs. The personal/property rights distinction can be used to classify organizations according to whether the membership rights such as the voting rights are personal or property rights. Consider the membership rights in the following organizations:

— democratic political communities (national, state, or local);
— democratic firms (e.g. worker cooperatives),
— trade unions;
— capitalist corporations; and
— condominium associations.

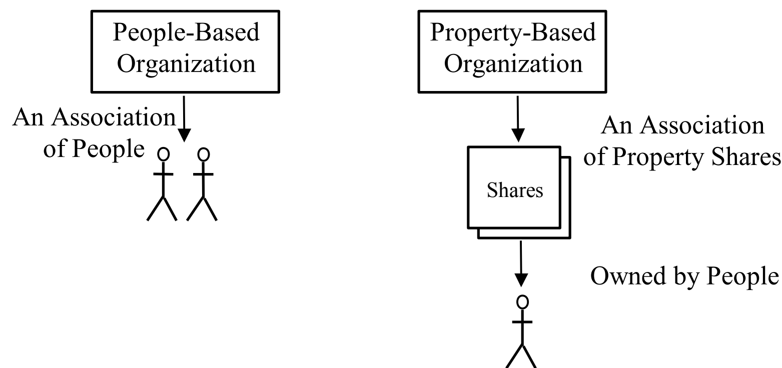
The membership rights in the first three organizational types are personal rights while the membership rights (also called "ownership rights") in the last two are property rights.

A condominium is an association for the partial co-ownership of housing units (often part of one structure such as an apartment building). The members are the unit-owners. Each unit-owner exclusively owns one or more units, and all the unit-owners through the association own the remaining property in common (e.g. the surrounding grounds). Each unit is assigned a certain percentage of the whole depending on its access to common resources and its drain on common expenses. A unit casts its percentage of the votes and pays that percentage of any common assessments.

A condominium and a capitalist corporation have the common feature that the membership rights are attached to property shares (the units in a condominium and the shares of stock in a corporation) which are owned by persons. In contrast, membership in the other three organizations mentioned above is not obtained through ownership of a piece of property but by personally fulfilling a certain functional role. If an organization is thought of as a molecule made of certain atoms, then the two different organizations have quite different atoms. For the

capitalist corporation and the condominium, the atoms are the property shares (which are owned by people), while for a democratic organization (like the three considered above), the atoms are the people themselves.

We will therefore say that an organization is *people-based* if the membership rights are personal rights (i.e. the atomic building blocks are the people themselves), and that an organization is *property-based* if the membership rights are attached to property shares owned by people.



Two Basic Different Types of Organizations

This useful distinction shows up in ordinary language. In a democracy, the people vote, whereas in a corporation the shares vote, and in a condominium the units vote. In either case, it is people who ultimately cast votes but a citizen casts his or her vote while shareholders cast the votes on their shares and unit-owners cast the votes assigned to their units. The distinction also ties in with the inheritability test. In an association of persons, the death of the person forfeits that membership, but in an association of property shares, the property survives. Thus when a person dies, the heirs do not inherit the person's political vote but they would inherit any corporate stock or condominium units owned by the deceased.

Another important distinction between a people-based and a property-based organization is in the distribution of ultimate voting rights. In a property-based organization, the most basic "constitutional" voting (say, to adopt the fundamental charter of a corporation) is according to shares. In a people-based organization, the most basic constitutional level of agreement must be based on one-person/one-vote. Moreover since no one can be committed without their consent, the vote must be unanimous. The unanimity requirement is not as restrictive as it seems at first since it may work to determine which people may join an organization. The set of possible members is not necessarily "given" ahead of time. Late joiners need to agree to the basic rules as a condition of joining.

The agreed-upon constitution needs to specify how subsequent decisions will be made. Some later decisions might be delegated to representatives who are selected by some agreed-upon procedure. Other decisions might be put to a vote of the members. In such a second-stage and post-constitutional level of voting, there seems to be no theoretical reason why the voting should be one-person/one-vote—so long as the procedure was agreed to at the constitutional level. Much ink has been spilt on the question of one-person/one-vote in the American worker ownership movement (including by the author). But no convincing basic argument has emerged as to why post-constitutional decision-making in a democratic organization has to be based on the one-person/one-vote rule, or has to be put to a vote at all (as opposed to being a delegated decision). This is not to say that one voting rule is as good as another, but only that fundamental principles do not force the one-person/one-vote rule.

People might belong to many different democratic organizations. Some people might have a very incidental connection to an organization while others might have a central involvement. When the members have agreed on a specific goal, then the members might have very different responsibility for achieving that goal. The members might agree that post-constitutional voting should be based on some measure of a person's contribution or responsibility towards the goal of the organization. For instance in a democratic firm, a person's salary (i.e., share of salary in total salaries) might be taken as a measure of the person's importance to the firm and might be a basis for post-constitutional voting. There might be some psychological resistance to this unequal voting, but, then again, there is also some psychological resistance to unequal salaries in the first place. In the American political system, there is roughly equal voting for candidates to the lower house (the House of Representatives), but there is rather unequal representation in the upper house (the Senate). Each state elects two senators regardless of the size of the state. In a similar manner, one might have different groups in a democratic firm electing representatives to the board of directors. Each person might have the same vote within the group but with different sized groups, there would be unequal representation on the board.

Clearly once an organization gets away from a thorough-going equality rule, then there is room for abuse. One type of abuse would be voting rules that push the organization back towards a property-based organization. For instance, salary is based on the functional role of working in the firm, but the ownership of shares is not. If votes are based on the number of shares owned (e.g., due to using the legal form of a joint stock company) and if shares are freely transferable, then the organization has been converted back into a property-based firm. However, if the number of shares owned is proportional to salary and the shares are not transferable (e.g., are held in a trust), then share-based voting would be compatible with a people-based democratic firm.

Democracy Denied by the Employment Contract, not Private Property

The Employment Contract

We saw in the previous chapter that capitalist production, i.e. production based on the employment contract denies workers the right to the (positive and negative) fruits of their labor. Yet people's right to the fruits of their labor has always been the natural basis for private property appropriation. Thus capitalist production, far from being founded on private property, in fact denies the natural basis for private property appropriation. In contrast, the system of economic democracy based on democratic worker-owned firms restores people's right to the fruits of their labor. Thus democratic firms, far from violating private property, restore the just basis for private property appropriation.

Thus to switch from capitalist firms to democratic firms is a way to transform and perfect the private property system by restoring the labor basis of appropriation. It is not private property that needs to be abolished—but the employment contract. In the switch-over from capitalist firms to democratic firms, the employment relation would be replaced with the membership relation.

A similar picture emerges when the firm is analyzed from the viewpoint of governance rather than property appropriation; the employment contract is the culprit, not private property. The employment contract is the rental relation applied to persons. It is now illegal to sell oneself; workers rent or hire themselves out.

> Since slavery was abolished, human earning power is forbidden by law to be capitalized. A man is not even free to sell himself: he must *rent* himself at a wage. (Samuelson, 1976, p. 52 [his italics])

When an entity, a person or a thing, is rented out, then a certain portion of the entity's services are sold. When a car is rented out for a day, a car-day of services are sold. When an apartment is rented out for a month, an apartment-month of services are sold. When a man is rented out for eight hours, eight man-hours of services are sold. The party renting the entity has the ownership of those services which gives that party the direct control rights over the use of the rented entity within the limits of the contract. Thus tenants are free to make their own decisions about using a rented apartment—but only within the constraints set by the rental contract.

It is the same when people are rented. The buyer of the services, the renter of the workers, is the employer. The employer has the direct control rights over the use of those services within the scope of the employment contract. The archaic name for the employer–employee relation is

the "master–servant relation" (language still used in Agency Law). That authority relation is not now and never was a democratic relationship. The employer is not the representative of the employees; the employer does not act in the name of the employees. The right to govern the employees is transferred or alienated to the employer who then acts in his own name; it is not a delegation of authority.

There is the contrasting democratic authority relationship wherein authority is delegated to those who govern from the governed. Those who govern do so in the name of and on behalf of those who are governed. This is the relationship between the managers or governors in a democratic organization (political or economic) and those who are managed or governed.

Democratic and Undemocratic Constitutions

Both authority relations are based on "the consent of the governed." There are two diametrically opposite types of voluntary contracts or constitutions that can form the basis of constitutional governance:

— the Hobbesian constitution or *pactum subjectionis* wherein the rights of governance are alienated and transferred to the ruler, or

— the democratic constitution wherein the inalienable rights of governance are merely delegated or entrusted to the governors to use on behalf of the governed.

The distinction between these two opposite consent-based authority relations is basic to democratic theory. Sophisticated liberal defenders of undemocratic governments from the Middle Ages onward have argued that government was based on an implicit or explicit social contract of subjugation which transferred the right of governance to the ruler [see Ellerman, 1992 for that intellectual history]. Early proponents of democracy tried to reinterpret the mandate of the ruler as a delegation rather than a transfer.

> This dispute also reaches far back into the Middle Ages. It first took a strictly juristic form in the dispute ... as to the legal nature of the ancient "translatio imperii" from the Roman people to the Princeps. One school explained this as a definitive and irrevocable alienation of power, the other as a mere concession of its use and exercise. ... On the one hand from the people's abdication the most absolute sovereignty of the prince might be deduced, ... On the other hand the assumption of a mere "concessio imperii" led to the doctrine of popular sovereignty. [Gierke, 1966, pp. 93–4]

"Translatio" or "concessio," transfer or delegation; that is the question.

That question is still with us. As noted previously, the employer is not the delegate or representative of the employees. The employment contract is a *transfer* of the management rights, not a delegation. Thus the employment contract is a limited workplace version of the Hobbesian constitution. The democratic firm is based on the opposite type of constitution, the democratic constitution. The board of directors is the parliament elected by those who are governed. The board selects the top manager (like the prime minister) who in turn assembles the management team. Management governs in the name of and on behalf of the governed.

Are Democracy and Private Property in Conflict?

Economic democracy requires the abolition of the employment relation, not the abolition of private property. But doesn't it require the abolition of the conventional property-based corporation? Isn't that type of corporation undemocratic? Here we must be very careful; the analysis must be much more fine-grained than the crude Marxist slogans about the "private ownership of the means of production."

The capitalist corporation combines two different functions that must be peeled apart:

(1) the corporation as a holding company for owning certain assets and liabilities, and
(2) the corporation as the residual claimant in a production process.

A number of people can pool their assets together and clothe them in a corporate shell by setting up a corporation and putting in their capital assets as equity. That only creates a company in the first sense above. The company is only a holding company for these assets; the company is as yet "uninhabited." If the corporate assets were just leased out to other parties, that transaction could be handled by the shareholders or their attorneys all without anyone working in the company. The company would remain an asset-holding shell. There is no governance of people, only the administration of things. There is private property, but no employment contract.

It is only when the company wants to undertake some productive activity to produce a product or deliver a service that it would need to hire in employees, buy other inputs, undertake the productive operation, and then sell the resulting product or service. Then the company would be the residual claimant for that operation, bearing the costs and receiving the revenues. It is only in that second role that the corporation becomes an organization for the governance or management of people, the corporate employees. And it acquires that role precisely because of the employment contract. The employment contract is the Archimedean point that moves the capitalist world. From the conceptual viewpoint, the *capitalist* corporation is a "wholly owned subsidiary" of the employment contract.

We have differentiated the roles of private property and the employment contract in the capitalist corporation. Without the employment contract, the corporation as an asset-holding shell is comparable to a condominium. The tenants in a condominium unit (whether a unit-owner or a renter) are not under the authority of the condominium association. The tenant has the direct control rights over the use of the apartment-unit within the constraints specified by the condominium rules (and the rental contract if the apartment is rented out).

In a similar fashion, an uninhabited asset-owning company might lease its assets out to other parties. The company would not have an authority relation (i.e. direct control rights) over the lessees. The lessees could use the leased assets within the constraints of the lease contract.

Is a capitalist corporation undemocratic? In which role? In its role as a depopulated asset-holding shell, it does not have an authority relation over any people at all. It would not then be an organization for the governing of people, only for the management of property. It thus would be neither democratic nor undemocratic since no people were governed. When a farmer manages his farmland property, we do not ask if he does so democratically or undemocratically since the management of his property does not involve an authority relationship over other people. In the same fashion, we may say that a conventional corporation that is without any employment contract and that operates solely as an asset-holding shell is neither democratic nor undemocratic. Yet it is a privately owned property-based organization. Thus there is no inherent conflict between "the private ownership of the means of production" and democratic rights in the workplace.

A conventional corporation only takes on an authority relation over people when it hires them as employees (managers or blue-collar workers). And, as we have seen, there *is* a conflict between democratic rights and the employment contract. Thus democratic rights require not the abolition of the private ownership of the means of production but of the employment contract. They require that conventional corporations not be abolished but only "depopulated" as a result of the abolition of the employment relation. To be employed productively, the assets would have to be leased to a democratic firm.

The reversal of the contract between capital and labor (so that labor hires capital) could also take place by internally restructuring a capitalist corporation as a democratic firm with the old shareholders' securities being restructured as participating debt securities.

Democracy can be married with private property in the workplace; the result of the union is the democratic worker-owned firm.

The *De Facto* Theory of Inalienable Rights

The analysis of capitalist production based on the labor theory of property (see previous chapter) culminated in an argument that the employment contract was a juridically invalid contract. It pretends to alienate that which is *de facto* inalienable, namely a person's *de facto* responsibility for the positive and negative results of his or her actions. This *de facto* inalienability of responsibility was illustrated using the example of the employee who commits a crime at the command of the employer. Then the legal authorities intervene, set aside the employment contract, and recognize the fact that the employee and employer cooperated together to commit the crime. They are jointly *de facto* responsible for it, and the law accordingly holds them legally responsible for it.

When the joint venture being carried out by employer and employees is not criminal, the employees do not suddenly become *de facto* instruments. However, the law then does not intervene. It accepts the employees' same *de facto* responsible cooperation with the employer as "fulfilling" the contract. The employer then has the legal role of having borne the costs of all the used-up inputs including the labor costs, so the employer has the undivided legal claim on the produced outputs. Thus the employer legally appropriates the whole product (i.e. the input-liabilities and the output-assets).

The critique does not assert that the employment contract is involuntary or socially coercive. The critique asserts that what the employees do voluntarily (i.e. voluntarily co-operate with the employer) does not fulfill the employment contract. Labor, in the sense of responsible human action, is *de facto* non-transferable, so the contract to buy and sell labor services is inherently invalid. The rights to the positive and negative fruits of one's labor are thus inalienable rights.

This argument is not new; it was originally developed by radical abolitionists as a critique of the voluntary self-sale contract and it was the basis for the antislavery doctrine of inalienable rights developed during the Enlightenment. The employment contract is the self-rental contract, the contract to sell a limited portion of one's labor—as opposed to selling all of one's labor, "rump and stump" [Marx, 1906, p. 186] as in the self-sale contract. But *de facto* responsibility does not suddenly become factually transferable when it is "sold" by the hour or day rather than by the lifetime. Thus economic democrats are the modern abolitionists who apply the same inalienable rights critique to the employment contract that their predecessors applied to the self-sale contract.

This *de facto* theory of inalienable rights was also developed as a part of democratic theory. There it was directed not against the individual self-enslavement contract but against the collective version of the contract, the Hobbesian *pactum subjectionis*. In questions of

governance (as opposed to production), the emphasis is on decision-making (as opposed to responsibility). But the basic facts are the same. Decision-making capacity is *de facto* inalienable. A person cannot in fact alienate his or her decision-making capacity just as he or she cannot alienate *de facto* responsibility. “Deciding to do as one is told” is only another way of deciding what to do.

Here again it is useful to contrast what one can do with oneself with what one can do with a thing such as a widget-making machine. When the machine is leased out to another individual, the machine can in fact be turned over to be employed by that ”employer.” The employer can then use the machine without any personal involvement of the machine-owner. The employer is solely *de facto* responsible for the results of said use. Furthermore, the employer has the direct control rights over the use of the machine. The employer decides to use the machine to do X rather then Y (within the scope of the lease contract), and the machine-owner is not involved in that decision making. Thus decision-making about the particular use of the machine and the responsibility for the results of the machine’s services are *de facto* alienable from the machine-owner to the machine-employer.

The employment contract applies the same legal superstructure to the very different case when the worker takes the place of the machine. Then the decision-making and the responsibility for the results of the services is not *de facto* transferable from the worker to the employer.

People cannot in fact alienate or transfer decision-making capability—but persons can delegate the authority to make a decision to other persons acting as their representatives or agents. The first persons, the principals, then accept and ratify the decisions indicated by their delegates, representatives, or agents.

The Hobbesian *pactum subjectionis* is the political constitution wherein a people legally alienate and transfer their decision-making rights over their own affairs to a Sovereign (see Philmore, 1982 reprinted in Ellerman, 1995, Chapter 3 for an intellectual history of the *liberal* contractarian defense of slavery and autocracy). Since human decision-making capability is *de facto* inalienable, Enlightenment democratic theory argued that the Hobbesian contract was inherently invalid.

> There is, at least, *one* right that cannot be ceded or abandoned: the right to personality. Arguing upon this principle the most influential writers on politics in the seventeenth century rejected the conclusions drawn by Hobbes. They charged the great logician with a contradiction in terms. If a man could give up his

> personality he would cease being a moral being... This fundamental right, the right to personality, includes in a sense all the others. To maintain and to develop his personality is a universal right. It ... cannot, therefore, be transferred from one individual to another... There is no *pactum subjectionis*, no act of submission by which man can give up the state of a free agent and enslave himself. (Cassirer 1963, p. 175)

The employment contract can be viewed both as a limited individual version of the rump-and-stump labor contract (the self-sale contract) and as a limited economic version of the Hobbesian collective contract. The employees legally alienate and transfer to the employer their decision-making rights over the use of their labor within the scope of their employment. Thus the other branch of inalienable rights theory, the critique of the Hobbesian contract, can also be applied against the employment contract.

The critique of the employment contract based on the *de facto* inalienability of responsibility and decision-making thus descends to modern times from the abolitionism and democratic theory of the Enlightenment which applied the critique to the self-sale contract and the *pactum subjectionis*.

Chapter 3: *The Democratic Firm*

Theoretical Basis for the Democratic Firm

The Democratic Principle and the Labor Theory

We now start the descent from first principles—the labor theory of property and democratic theory—down to the structure of the democratic worker-owned company.

In the world today, the main form of enterprise is based on renting human beings (privately or publicly). Our task is to construct the alternative. In the alternative type of firm, employment by the firm is replaced with membership in the firm. How can the corporation be taken apart and reconstructed without the employment relation? How can the labor principle at the basis of private property appropriation be built into corporate structure? How can the democratic principle of self-governance be built into corporate structure?

In a capitalist corporation, the shareholders own, as property rights, the conventional ownership bundle of rights.

The Conventional Ownership Bundle (partitioned into two parts)

Residual claimant or membership rights (#1 & #2) =	1. Voting rights (e.g., to elect the Board of Directors), 2. Net income rights to the residual, and
Net asset rights (#3) =	3. Net asset rights to the net value of the current corporate assets and liabilities.

Restructuring the corporation to create a democratic firm does not mean just finding a new set of owners (such as the "employees") for that bundle of rights. It means taking the bundle apart and restructuring the rights so that the whole nature of "corporate ownership" is changed.

The democratic firm is based on two fundamental principles:

Democratic principle of self-government: people's inalienable right to self-govern all of their human activities (political or economic), and

Labor theory of property: people's inalienable right to appropriate the (positive and negative) fruits of their labor.

These two principles are correlated respectively with the first two rights in the conventional ownership bundle:

— the voting rights and
— the residual or net income rights

which are attached to the pure (current) residual claimant's role and which will be called the *membership rights*. We will see that:

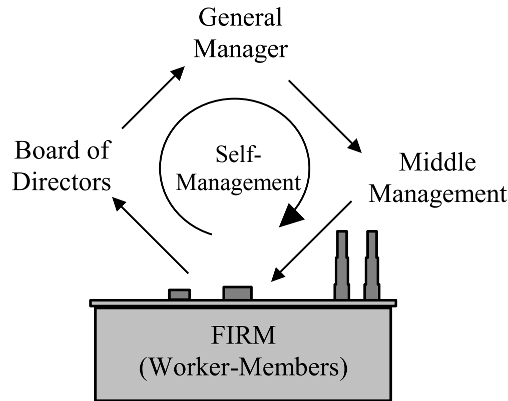
the democratic principle implies that the voting rights should be assigned to the workers, and the labor theory of property implies that the residual rights should be assigned to the workers.

Implementing the Democratic Principle in an Organization

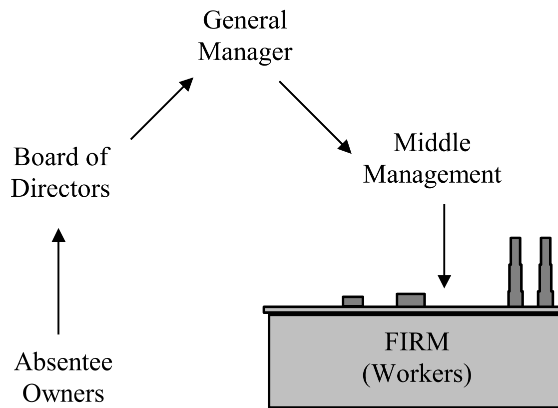
How are the two fundamental principles realized in the design of organizations?

> The principle of democratic self-government or self-management is built into the structure of an institution by assigning the right to elect the governors to the functional role of being governed.

The only people who are under the authority of the management (i.e. who take orders from the managers) of an economic enterprise are the people who work in the enterprise. Therefore the democratic principle is implemented in a firm by assigning to the people who work in the firm the voting rights to elect those managers (or to elect the board that selects the managers).



Governance of Democratic Firm



Governance of Non-Democratic Firm

In contrast, the ultimate control rights in a non-democratic firm are not held by those who are governed.

Note that the democratic principle assigns the right to elect those who govern to those who are *governed*. There are a number of outside groups whose rightful interests (i.e. property or personal interests protected by rights) are only *affected* by company activities such as the consumers, shareholders, suppliers, and the local residents. By what we called the "affected interests principle," those outside interests should be protected by a voluntary interface between the enterprise and the affected parties. By the market relationship (where more choice between firms is preferred to less), customers and suppliers can largely protect their interests. For externalities such as pollution, governments can establish emission restrictions, pollution taxes, or subsidies for pollution control equipment.

The democratic principle assigns the direct control right giving the ultimate authority for governance decisions to the governed. Since the external parties do not fall under the authority

of the management of the firm (that is, do not take orders from the managers), the democratic principle does not assign the external parties a direct control right to elect that management.

In summary,
Affected Interests Principle: the veto to those only affected,
Democratic Principle: the vote to those who are governed.

Implementing the Labor Theory in an Organization

The "*labor theory* " has always had two quite different interpretations:

(A) as a *theory of value* holding that price or value is determined by labor, and
(B) as a *theory of property* holding that workers should get the fruits (both positive and negative) of their labor.

Neo-classical economics has focused on the labor theory of value as a theory of price, but it is "the labor theory" as a theory of property, that is, the *labor theory of property*, that determines the structure of property rights in a democratic firm.

The positive fruits of the labor of the people working in an enterprise (workers including managers) are the new assets produced as outputs which could be represented as Q. The negative fruits of their labor are the liabilities for the inputs used up in the production process. The used-up inputs could be represented by K (all non-labor inputs such as capital services and the services of land).

The firm as a corporate entity legally owns those assets Q and holds those liabilities for the used-up K. Therefore the people who work in a firm will jointly appropriate the positive and negative fruits of their joint labor when *they* are the legal members of the firm.

> The labor theory of property is implemented in the legal structure of a company by assigning the residual rights to the functional role of working in the company.

If P is the unit price of the outputs Q and R is the unit rental rate for the input services K, then the residual PQ–RK is the revenue minus the non-labor costs. In a democratic firm, that residual would be the labor income accruing to the workers as wages and salaries paid out during the year and as surplus or profits determined at the end of the fiscal year. Thus both "wages" and "profits" are labor income; there is only a timing difference between them.

The Democratic Labor-based Firm

Definition of the Legal Structure

In a capitalist corporation, the membership rights (voting and profit rights) are part of the property rights attached to the shares which are transferable on the stock market or in private transactions. In a democratic firm, the membership rights are not property rights at all; they are personal rights assigned to the functional role of working in the firm, i.e. assigned to the workers as workers (not as capital suppliers).

In particular, the democratic principle states that the right to elect those who govern or manage (for example, the municipal government) should be assigned to the functional role of being governed or managed (e.g. living in the municipality). Hence the democratic principle assigns the voting rights to elect the board of directors to the workers as their personal rights (because they have the functional role of being managed). After an initial probationary period, it is "up or out"; a worker is either accepted into membership or let go so that all long-term workers in the firm are members. Upon retiring or otherwise leaving the firm, the member gives up the membership rights so that the votes always go to those being governed.

In a similar manner, the labor theory of property states that the rights to the produced outputs (Q) and the liabilities for the used-up inputs (K) should be assigned to the functional role of producing those outputs and liabilities. Hence the labor theory assigns the residual rights to the workers as their personal rights (because they have the functional role of producing those outputs and using up those inputs). If a worker left enterprise A and joined firm B, then he or she would forfeit any share in the future residual of A (since he or she ceased to produce that residual) and would gain a residual share in firm B.

The democratic principle and the labor theory of property are thus legally institutionalized in a corporation by assigning the two membership rights, the voting rights and the residual claimant rights, to the functional role of working in the firm. When membership rights are thus assigned to the role of labor, then the rights are said to be *labor-based*. When membership rights are owned as property or capital, the membership rights are to be *capital-based* or *capital-ist* even when those rights are owned by the employees. In the democratic labor-based firm, the workers are the masters of their enterprise—and they are the masters *as workers*, not as "small capital-ists."

The third set of rights in the conventional ownership bundle, the net asset rights (i.e., the rights to the net value of the current assets and liabilities), are quite different. They represent the value of the original endowment plus the value of the past fruits of the labor of the firm's current

and past members reinvested in the firm. The rights due to the members' past labor should be respected as property rights eventually recoupable by the current and past members.

The job of restructuring the conventional ownership bundle to create the legal structure of a *democratic firm* (also "democratic labor-based firm" or "democratic worker-owned firm") can now be precisely specified.

Restructured Ownership Bundle in a Democratic Firm

Membership rights (#1 & #2) assigned as personal rights to worker's role.	1. Voting rights (e.g., to elect the Board of Directors), 2. Net income rights to the residual, and
Net asset rights (#3) are property rights recorded in internal capital accounts.	3. Net asset rights to the net value of the current corporate assets and liabilities.

The first two rights, the voting and residual rights, i.e. the membership rights, should be assigned as personal rights to the functional role of working in the firm. The third right to the value of the net assets should remain a property right recoupable in part by the current and past members who invested and reinvested their property to build up those net assets (see the later discussion of internal capital accounts).

The Social Aspects of Democratic Labor-based Firms

The democratic labor-based firm does not just supply a new set of owners for the conventional ownership bundle of rights. It completely changes the nature of the rights and thus the nature of the corporation.

Who "owns" a democratic labor-based firm? The question is not well-posed—like the question of who "owns" a freedman. The conventional ownership bundle has been cut apart and restructured in a democratic firm. The membership rights were completely transformed from property or ownership rights into personal rights held by the workers. Thus the workers do hold the "ownership rights" but not *as ownership rights*; those membership rights are held *as personal rights*. Thus it may be more appropriate to call the workers in a democratic firm "members" rather than "owners." Nevertheless, they are the "owners" in the sense they do hold the "ownership rights" (as personal rights), and it is in that sense that we can call a democratic labor-based firm a "worker-owned firm."

The change in the nature of the membership rights from property rights to personal rights implies a corresponding change in the nature of the corporation itself. No longer is it "owned" by anyone. The "ownership" or membership rights are indeed held by the current workers (so

they will self-manage their work and reap the full fruits of their labor) but they do not own these rights as their property which they need to buy or can sell. The workers qualify for the membership rights by working in the firm (beyond a certain probationary period) and they forfeit those rights upon leaving.

Since those membership rights are not property which could be bought or sold, the democratic labor-based corporation is not a piece of property. It is a *democratic social institution.*

It is useful to contrast the democratic labor-based corporation with a democratic city, town, or community. It is sometimes thought that, say, a municipal government is "social" because it represents "everyone" while a particular set of workers in an enterprise is "private" because that grouping is not all-inclusive. But no grouping is really "all-inclusive"; each city excludes the neighboring cities, each province excludes the other provinces, and each country excludes the other countries. Only "humanity" is all-inclusive—yet no government represents all of humanity.

Governments are "all-inclusive" in that they represent everyone who legally resides in a certain *geographical* area, the jurisdiction of the local, state, or national government. But the management of a democratic firm is *also* "all-inclusive" in that it represents everyone who works in the enterprise. It is a community of those who *work* together, just as a city or town is a community of those who *live* together in a certain area. Why shouldn't a grouping of people together by common labor be just as "social" as the grouping of people together by a common area of residence?

The genuinely "social" aspect of a democratically governed community is that the community itself is not a piece of property. The right to elect those who govern the community is a personal right attached to the functional role of being governed, that is, to legally residing within the jurisdiction of that government. Citizens cannot buy those rights and may not sell those rights—they are personal rights rather than property rights.

In contrast, consider a town, village, or protective association (see Nozick, 1974) that was "owned" by a prince or warlord as his property, a property that could be bought and sold. That would be a "government" of a sort, but it would not be a *res publica*; that "government" would not be a social or public institution.

The democratic corporation is a social community, a community of work rather than a community of residence. It is a republic or *res publica* of the workplace. The ultimate governance rights are assigned as personal rights to those who are governed by the management, that is, to the people who work in the firm. And in accordance with the property rights version

of the "labor theory of value," the rights to the residual claimant's role are assigned as personal rights to the people who produce the outputs by using up the inputs of the firm, that is, to the workers of the firm. This analysis shows how a firm can be socialized and yet remain "private" in the sense of not being government-owned.

Capital Rights in Democratic Firms

What About the Net Asset Value of a Corporation?

We have so far focused most of our attention on the membership rights (the first two rights in the ownership bundle) in our treatment of the democratic firm. Now we turn to the third right, the right to the net asset value. That is the hard one. One of the most important and most difficult aspects of enterprise reform is again in the treatment of those property rights.

The value of that third right is the net asset value, the value of the assets (depreciated by use but perhaps with adjustments for inflation) minus the value of the enterprise's liabilities. The net asset value may or may not be approximated by the net *book* value depending on the bookkeeping procedures in use [see Ellerman, 1982 for a treatment of such accounting questions]. Of more importance, the net asset value is not the same as the so-called "value of a [capitalist] corporation" even if all the assets have their true market values. The "value of a corporation" is the net asset value *plus* the net value of the fruits of all the future workers in the enterprise [see Ellerman 1982 or 1986 for a formal model]. In a democratic firm, the net value of the fruits of the future workers' labor should accrue to those future workers, not the present workers. Hence our discussion of the capital rights of the current workers quite purposely focuses on the net asset value, not the "value of the corporation."

The net asset value arises from the original endowment or paid-in capital of the enterprise plus (minus) the retained profits (losses) from each year's operations. Thus it is not necessarily even the fruits of the labor of the current workers; the endowment may have come from other parties and the *past* workers who made the past profits and losses. Hence the third right, the right to the net asset value, should *not* be treated as a personal right attached to the functional role of working in the firm.

There is considerable controversy about how the net asset value should be treated. One widespread socialist belief is that the net asset value must be collectively owned as in the English common-ownership firms or the former Yugoslav self-managed firms; otherwise there would be "private ownership of the means of production." To analyze this view, it must first be recalled that the control (voting) and profit rights have been partitioned away from the rights to the net asset value. The phrase "private ownership of the means of production" usually does include

specifically the rights to control and reap the profits from the means of production. But those rights have been restructured as personal rights assigned to labor in the democratic firm. Hence the remaining right to the net asset value does *not* include the control and profit rights traditionally associated with "equity capital" or with the "ownership of the means of production."

Let us suppose that it is still argued that any private claim (for example, by past workers) on the net asset value of a democratic firm would be "appropriating social capital to private uses." This argument has much merit for that portion of the net asset value that comes from some original social endowment. But what about that portion of the net asset value that comes from retained earnings in the past?

In a democratic firm, the past workers could, in theory, have used their control and profit rights to pay out all the net earnings instead of retaining any in the firm. Suppose they retained some earnings to finance a machine. Why should those workers lose their claim on that value—except as they use up the machine? Why should the fruits of their labor suddenly become "social property" simply because they choose to reinvest it in their company?

Consider the following thought-experiment. Instead of retaining the earnings to finance a machine, suppose the workers paid out the earnings as bonuses, deposited them all in one savings bank, and then took out a loan from the bank to finance the machine using the deposits as collateral. Then the workers would not lose the value of those earnings since that value is represented in the balance in their savings accounts in the bank. And the enterprise still gets to finance the machine. Since the finance was raised by a loan, there was no private claim on the social equity capital of the enterprise and thus no violation of "socialist principles." The loan capital is capital hired by labor; it gets only interest with no votes and no share of the profits.

Now we come to the point of the thought-experiment. How is it different in principle if we simply leave the bank out and move the workers' savings accounts into the firm itself? Instead of going through the whole circuitous loop of paying out the earnings, depositing them in the bank's savings accounts, and then borrowing the money back—suppose the firm directly retains the earnings, credits the workers' savings accounts in the firm, and buys the machine. The capital balance represented in the savings accounts is essentially *loan* capital. It is hired by labor, it receives interest, and it has no votes or profit shares. Such accounts have been developed in the Mondragon worker cooperatives, and they are called *internal capital accounts*.

One lesson of this thought-experiment is that once the control and profit rights have been separated off from the net asset value, any remaining claim on that value is essentially a debt claim receiving interest but no votes or profits. "Equity capital" (in the traditional sense) *does not exist* in the democratic firm; *labor* has taken on the residual claimant's role.

Capital Accounts as Flexible Internal Debt Capital

Internal capital accounts for the worker-members in a democratic corporation are a form of debt capital. Labor is hiring capital, and some of the hired capital is provided by the workers themselves and is recorded in the internal capital accounts. These internal capital accounts represent *internal debt capital* owed to members, as opposed to *external* debt owed to outsiders. Instead of debt and equity as in a conventional corporation, a democratic firm with internal capital accounts has external and internal debt.

How does internal debt differ from external debt, and how does an internal capital account differ from a savings account? Any organization, to survive, must have a way to meet its deficits. There seem to be two widely used methods: (1) tax, and (2) lien. Governments use the power to tax citizens, and unions similarly use the power to assess or tax members to cover their deficits. Other organizations place a lien on certain assets so that deficits can be taken out of the value of those assets. For instance, it is a common practice to require damage deposits from people renting apartments. Damages are assessed against the deposit before the remainder is returned to a departing tenant.

A free-standing democratic firm must similarly find a way to ultimately cover its deficits. Assuming members could always quit and could not then be assessed for possible losses accumulating in the current year, the more likely method is to place a lien against any money owed to the member by the firm. Each member's share of the losses incurred while the worker was a member of the firm would be subtracted from the firm's internal debt or internal capital account balance for the member. This procedure would be agreed to in the constitution or ground rules of the democratic firm. Losses, of course, may not be subtracted from the external debts owed to outsiders. Hence internal debt in a democratic firm would have the unique characteristic of being downward flexible or "soft" in comparison with external "hard" debt. It is thus also different from a savings account in a bank which would not be debited for a part of the bank's losses.

In the comparison between a democratic firm and a democratic political government, the firm's liabilities are analogous to the country's national debt. The internal capital accounts, as internal debt capital, are analogous to the domestic portion of the national debt owed to the country's own citizens. The differences arise because of the two different methods of covering deficits. The firm uses the lien method while political governments rely on the power to tax.

The firm's lien against a member's internal capital account also motivates the common practice of requiring a fixed initial membership fee to be paid in from payroll or out of pocket.

Then there is an initial balance in each member's account to cover a member's share of losses during his or her first year of work.

Profits or year-end surpluses, like losses or year-end deficits, would be allocated among the members in accordance with their labor, not their capital, since labor is hiring capital and is thus the residual claimant. The labor of each member is commonly measured by their wage or salary, or, in some cases, by the hours regardless of the pay rate. In worker cooperatives, that measure of each member's labor is called "patronage" and net earnings are allocated in accordance with labor patronage.

When the net earnings are negative, the losses are allocated between the capital accounts in accordance with labor. Thus the system of internal capital accounts provides a risk-absorbing mechanism with a labor-based allocation of losses.

The Internal Capital Accounts Rollover

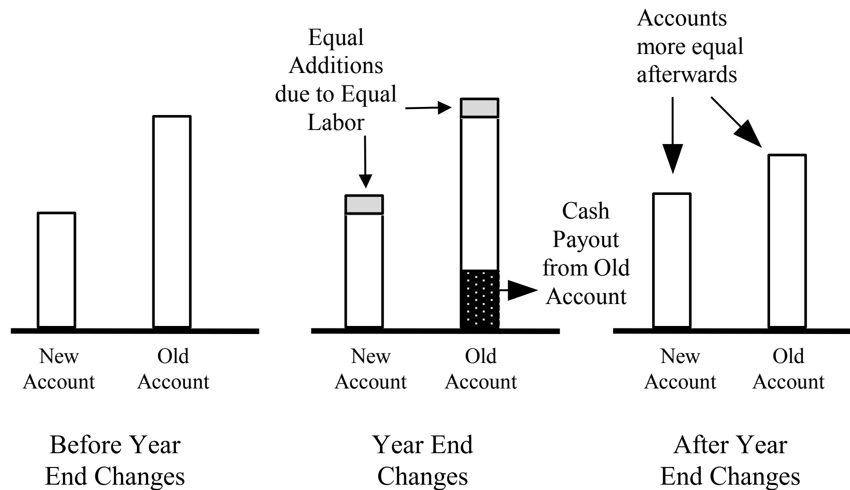
"Allocation" is not the same thing as cash distribution. There are good practical arguments for *not* paying out current profits as current labor dividends. The immediate payout of current profits promotes a "hand-to-mouth" mentality and fails to tie the workers' interests to the long term interests of the enterprise. By retaining the profits and crediting that value to the capital accounts, the workers need to insure that the enterprise prospers so their value can eventually be recovered.

When should the accounts be paid out? One idea is to leave the account until the worker retires or otherwise terminates work in the enterprise, and then to pay out the account over a period of years. There are several reasons why that termination payout scheme is not a good idea.

By waiting until termination or retirement for the account payout, the accounts of the older workers would be much larger than those of the younger workers and thus the older workers would be bearing a grossly unequal portion of the risk. Risk-bearing should be more equally shared between the older and younger workers. Moreover, it would create an incentive for the older and better trained workers to quit in order to cash out their account and reduce their risks. For young workers, retirement is too distant a time horizon. Current profits would be an almost meaningless incentive for them if the profits could not be recovered until retirement. And finally cash flow planning would be difficult if the cash demands of account payouts were a function of unpredictable terminations.

These problems with the termination payout scheme are alleviated by an "account rollover scheme" wherein the account entries are paid out after a fixed time period. The allocations to the

accounts are dated. Cash payouts should be used to reduce the older entries in the capital accounts. If an account entry has survived the risk of being debited to cover losses for, say, five years, then the entry should be paid out. That is sometimes called a "rollover" (as in rolling over or turning over an inventory on a first-in-first-out or FIFO basis) and it tends to equalize the balances in the capital accounts and thus equalize the risks borne by the different members.



Internal Capital Account Rollover

Current retained labor patronage allocation adds to all members' accounts (equal additions assumed in the above illustration), and then the cash payouts reduce the balance in the larger and older accounts—thereby tending to equalize all the accounts. The incentive to terminate is relieved since the account entries are paid out after the fixed time period whether the member terminates or not. And cash flow planning is eased since the firm knows the payout requirements, say, five years ahead of time.

Instead of receiving wages and current profit dividends, workers would receive wages and the five-year-lagged rollover payments. New workers would not receive the rollover payments during their first five years. They would be, as it were, paying off the "mortgage" held by the older workers—without being senior enough to start receiving the "mortgage payments" themselves.

A Collective Internal Capital Account

In a socialist country, some of a democratic firm's net asset value might be endowed from a governmental unit, and there is no reason why that value should ultimately accrue to the workers of

the enterprise. Hence there should be a *collective account* to contain the value of the collective endowment not attributable to the members.

Assets	Liabilities
Cash	External Debts
Inventory	Internal Capital Accounts
Equipment	(internal debts)
Real Estate	Collective Account

Balance Sheet with Internal Capital Accounts

The net asset value (defined as the value of the assets minus the value of the external debts) equals the sum of the balances in the individual capital accounts and the collective account. Two other accounts, a temporary collective account called a "suspense account" and a "loan balance account," will be introduced in the later model of a hybrid democratic firm in order to accommodate ESOP-type transactions.

There is another reason for a collective account, namely, self-insurance against the risks involved in paying out the members' capital accounts. After retirement, the enterprise must pay out to a member the remaining balance in the worker's capital account. In an uncertain world, it would be foolish to think that an enterprise could always eventually pay out 100 per cent of its retained earnings. Any scheme to finance that payout would have to pay the price of bearing the risk of default. One option is always self-insurance. Instead of promising to ultimately pay back 100 per cent of retained earnings to the members, the firm should only promise, say, a 70 per cent or a 50 per cent payback. That is, 30 per cent to 50 per cent of the retained earnings could always be credited as a "self-insurance allocation" to the collective account, and that would serve to insure that the other 70 per cent to 50 per cent could ultimately be paid back to the members.

The self-insurance allocation should also be applied to losses. That is, when retained earnings are negative, 30 per cent to 50 per cent should be debited to the collective account with the remaining losses distributed among the members' individual capital accounts in accordance with labor patronage. Thus the self-insurance allocation would dampen both the up-swings and down-swings in net income.

The current members of a democratic firm with a large collective account should not be allowed to appropriate the collective account by voluntary dissolution (after paying out their

individual accounts). Any net value left after liquidating the assets and paying out the external and internal debts should accrue to charitable organizations or to *all* past members.

Financing Internal Capital Account Payouts

In an economy where all firms were organized as democratic labor-based firms, there would be no equity capital markets since membership rights would not be property rights at all. However, there could and should be a vigorous market in debt capital instruments such as bonds, debentures, and even variable interest or "participating" debt securities.

How can democratic firms finance the payouts of their internal capital accounts? For a debt instrument with a finite maturity date, a company must eventually pay out the principal amount of the loan. However, a capitalist firm does not have to ever pay out the issued value of an equity share. A democratic firm could obtain the same effect by issuing perpetual debt instruments which pay interest but have no maturity date. Such a debt security is called a *perpetuity* or a *perpetual annuity* [see Brealey and Myers, 1984]. If the firm ever wants to pay off the principal value of a perpetuity, it simply buys it back.

A democratic firm could use perpetuities to pay out the rollover or the closing balance in an internal capital account. To increase the perpetuity's resale value on debt markets, many firms could pool the risks by issuing the perpetuities through a government, quasi-public, or cooperative financial institution or bank.

The pooling bank would pay a lower interest rate on the face value of the perpetuity than the firms pay to it; the difference between the interest rates would cover the risks of default and the transactions costs. The allocation to the collective account for the purpose of self-insurance would not then be necessary since the cost of risk would be borne by the firm in the form of the interest differential. Since the perpetuities would be guaranteed by the pooling institution (not the firm), workers could resell them without significant penalty.

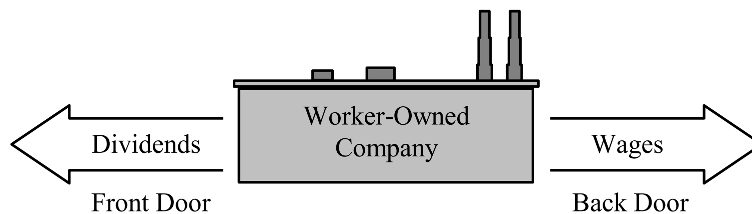
The balance in a worker's internal capital account is a property right, not a personal right. For instance, if a worker-member dies, his or her vote and right to a residual share are extinguished but the right to the balance in the account passes to the heirs. Since the balance in the account is a property right, why can't the worker sell it? The only reason is the lien the enterprise has against the account to cover the worker's share of future losses (while the worker is a member). But if the balance is large enough (in spite of the rollover) or the worker is near enough to retirement, then part of the account *could* be paid out in salable perpetuities (in addition to the rollover payouts). Internal capital accounts could also be paid out using *variable income* or "participating" securities.

Participating Securities

Since democratic organizations can only issue debt instruments, greater creativity should be applied to the design of new forms of corporate debt. Some risks could be shared with creditors by a reverse form of profit-sharing where the interest rate was geared to some objective measure of enterprise performance.

In a worker-owned firm, conventional preferred stock would not work well since it is geared to common stock. Ordinarily, common stockholders can only get value out of the corporation by declaring dividends on the common stock. Preferred stock has value because it is "piggy-backed" onto the common stock dividends. Dividends up to a certain percentage of face value must be paid on preferred stock before any common stock dividends can be paid. Preferred stockholders do not need control rights since they can assume the common stockholders will follow their own interests.

The preferred stockholders are like tax collectors that charge their tax on any value the common stockholders take out the front door. But that theory breaks down if the common stockholders have a *back door*—a way to extract value from the company without paying the tax to the preferred stockholders.



The Back Door Problem

That is the situation in a worker-owned company where the employees own the bulk of the common stock. They can always take their value out the "back door" of wages, bonuses, and benefits without paying the "tax" to the preferred stockholders. Hence the valuation mechanism for preferred stock breaks down in worker-owned companies. For similar reasons, absentee ownership of a minority of common stock would not make much sense in a worker-owned company; the workers would have little incentive to pay common dividends out the front door to absentee minority shareholders when the back door is open. *Discretionary* payments won't be made out the front door when the back door is open.

There are two ways to repair this problem in worker-owned companies:

— charge the preferred stock "tax" at all doors (front and back), or

— make the payout to preferred stockholders more mandatory and thus independent of what goes out the doors.

The first option leads to a form of non-voting preferred stock that would be workable for worker-owned companies where the preferred "dividend" is required and is geared to some other measure of the total value accruing to the worker-owners.

The second option pushes in the direction of a debt instrument—perhaps with a variable income feature. The interest could be variable but mandatory, geared to the company's "value-added" (revenue minus non-labor costs) to establish a form of profit-sharing in reverse (labor sharing profits with capital).

The two resulting conceptions are about the same: a non-voting preferred stock with a required "dividend" geared to some measure of the workers' total payout, and a perpetual bond with a variable return geared to value-added. Debt-equity hybrids are sometimes called "dequity." This general sort of non-voting, variable income, perpetual security could be called a *participating dequity security* since outside capital suppliers participate in the variability of the value-added. Jaroslav Vanek [1977, Chapter 11] describes a similar "variable income debenture" and Roger McCain [1977, pp. 358-9] likewise considers a "risk participation bond."

A debt instrument where interest is only payable if the company has a certain level of net income is called an "income bond" [see Brealey and Myers, 1984, p. 519]. Dividends on preferred and common stock is paid at the discretion of the board of directors whereas the interest on an income bond *must* be paid if the company has a pre-specified level of accounting net income.

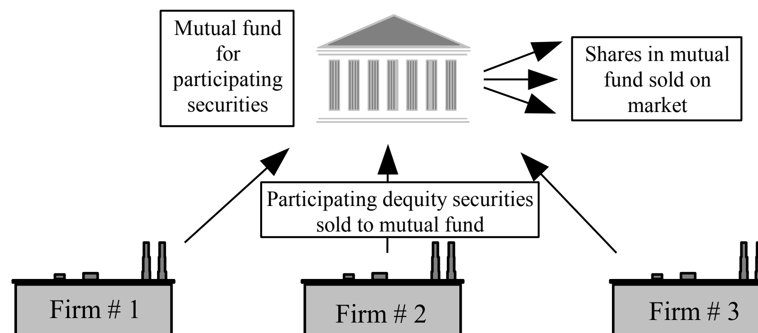
There is also a special type of income bond with two levels of interest; some interest is fixed, and then an additional interest or "dividend" is only payable if the company has sufficient income. These partly fixed-interest and partly variable-interest bonds are called "participating bonds" or "profit-sharing bonds" [Donaldson and Pfahl, 1963, p. 192]. A participating perpetuity would be a perpetual security with the participation feature.

Could large public markets be developed for such participating securities? Yes, such securities would closely approximate the dispersed equity shares in the large public stock markets in the United States and Europe. With the separation of ownership and control in the large quoted corporations, the vote is of little use to small shareholders. The notion that a publicly-quoted company can "miss a dividend" means that the dividend is sliding along the scale from being totally discretionary towards being more expected or required. Thus dispersed equity shares in large quoted corporations already function much like non-voting, variable

income, perpetual securities, i.e. as participating dequity securities. Thus public markets in participating dequity securities not only can exist but in effect already do exist.

Mutual Funds for Participating Securities

It was previously noted that the market value of fixed-income securities would be enhanced if they were issued by a financial intermediary which could pool together the securities of a number of enterprises.



Pooling Participating Securities in a Mutual Fund

That application of the "insurance principle" would reduce the riskiness of the mixed-interest participating securities. There could be a "mutual fund" or "unit trust" that pools together the participating securities of enterprises it felt had good profit potential. Risk-taking individuals could buy securities directly from companies, while more risk-adverse individuals could buy shares of mutual funds that pooled together participating securities from many companies.

Workers receiving participating securities from their company could sell them directly for cash, hold them and receive interest, or could swap them for shares in the mutual fund carrying that company's participating securities which could then be held or sold.

The participating securities also reduce risk for the company. The variable interest portion automatically reduces the interest charges when the company takes a downturn. The security-holder then gets less so the security-holder has shared the risk. The interest charges go up when the firm does well—but not beyond the maximum variable-interest cap. Thus the participating securities work to reduce the variance or variability of the net income for the company as a whole. Participating dequity securities allow democratic firms to utilize the risk allocative efficiency of public capital markets without putting the membership rights up for sale.

Aside from diversifying risk, the other major use of participating securities is to pay out the internal capital accounts of workers due to receive a "rollover" payment or who have retired or

otherwise terminated work in the company. A public capital market in participating securities allows workers to capitalize the value of their internal capital accounts without the company itself having to "provide the market."

Chapter 4: *Worker Cooperatives*

Introduction: Worker Ownership in America

In the second half of the nineteenth century, the first American trade unions of national scope, the National Trade Union and the Knights of Labor, saw their ultimate goal as a Cooperative Commonwealth where the wage system would be replaced by people working for themselves in worker cooperatives. Around the turn of the century, these reform unions were replaced by the business unions which accepted the wage system and sought to increase wages and benefits within that system through collective bargaining. During the Depression, there was an upsurge of self-help cooperatives, and after World War II there was a burst of worker cooperative development in the plywood industry of the Pacific Northwest. The plywood cooperatives used a traditional stock cooperative structure which mitigated against their long term survival as cooperatives.

In recent decades there have been two trends in American worker ownership, one minor and one major. The minor trend was the development of worker cooperatives that grew out of the civil rights and antiwar movements of the 1960s. The worker cooperative or collective was the form of business that suited the alternatives movement of the 1970s and 1980s. Many of the worker cooperatives looked more to the Mondragon cooperatives in the Basque country in Spain than to the American past for their inspiration. We will analyze the Mondragon-type worker cooperative in this chapter, not because it has been numerically important in the American economy, but because it represents a relatively pure form of democratic worker ownership.

The major trend in American worker ownership has been the development of the employee stock ownership plans or ESOPs. The ESOP movement offers many lessons about worker ownership, both positive and negative. It is a very interesting case study in the rise of significant worker ownership in the midst of a capitalist economy. Of particular interest are the divergences between the public ideology of the ESOP movement and the reality of the ESOP structure. ESOPs are discussed in the next two chapters.

Worker Cooperatives in General

Existing worker-owned companies will be analyzed by considering the restructuring (or lack of it) for the conventional ownership bundle of rights: (1) the voting rights, (2) the profit or residual rights, and (3) the net asset rights.

All cooperatives have two broad characteristics:

(1) voting on a one-person/one-vote basis, and
(2) allocation of the net savings or residual to the members on the basis of their patronage.

Patronage is defined differently in different types of cooperatives. For example, in a marketing cooperative patronage is based on the dollar volume bought or sold by the member through the cooperative. A worker cooperative is a cooperative where the members are the people working in the company, and where patronage is based on their labor as measured by hours or by pay. Thus a *worker cooperative* is a company where the membership rights (the voting rights and the profit rights) are assigned to the people working in the company—with the voting always on a one-person/one-vote basis and the profit allocation on the basis of labor patronage.

Traditional Worker Stock Cooperatives

The most controversial feature of cooperative structure is the treatment of the third set of rights, the net asset rights. How do the members recoup the value of retained earnings that adds to the net asset value? Some cooperatives treat the net asset value as "social property" that cannot be recouped by the members (see the section below on common-ownership firms). Other cooperatives used a stock mechanism for the members to recoup their capital. In the United States, the best known examples of these worker stock cooperatives are the plywood cooperatives in Oregon and Washington [see Berman, 1967 and Bellas, 1972].

The plywood cooperatives use one legal instrument, the membership share, to carry both the membership rights (voting and net income rights) *and* the member's capital rights. A worker must buy a membership share in order to be a member, but the worker only gets one vote even if he or she owns several shares. Moreover, the dividends go only to the members but are based on their labor patronage. In a successful plywood co-op, the value of a membership share could rise considerably. For example, in a recent plywood co-op "offer sheet," membership shares were offered for $95,000 with a $20,000 down payment. New workers often do not have the resources or credit to buy a membership share so they are hired as non-member employees, which recreates the employer–employee relationship between the member and non-member workers.

When the original cohort of founding workers cannot sell their shares upon retirement, the whole cooperative might be sold to a capitalist firm to finance the founders' retirement. Thus the worker stock cooperatives tend to revert to capitalist firms either slowly (hiring more non-members) or quickly (by sale of the company). Jaroslav Vanek has called them "mule firms" since they tend not to reproduce themselves for another generation.

In a democratic labor-based firm, the membership rights (voting and profit rights) are partitioned away from the net asset or capital rights, and the membership rights become personal rights attached to the workers as workers. A new social invention, the Mondragon-type internal capital accounts, is used to carry the capital rights of the members. The mistake in the stock cooperatives is that they use *one* instrument, the membership share, to carry *both* the membership and capital rights. The new workers who qualify for membership based on their labor nevertheless cannot just be "given" a membership share (carrying the membership rights) since that share *also* carries essentially the capital value accruing to any retiring member.

With the system of internal capital accounts, a new worker can be given membership (after a probationary period such as six months) but his or her account starts off at zero until the standard membership fee is paid in (for example, more like one or two thousand dollars than $95,000). The firm itself pays out the balances in the capital accounts either in cash or in negotiable debt instruments such as perpetuities or participating debt securities.

Since the workers do not acquire membership based on their labor in these traditional worker stock cooperatives, they are not labor-based democratic firms. They represent a confused combination of capitalist features (membership based on share ownership) and cooperative attributes (one vote per member).

Common-Ownership Firms in England

A labor-based democratic firm is a firm that assigns the membership rights (the voting and residual rights) to the functional role of working in the firm. But there are two different ways to treat the third rights, the right to the net asset value. Some democratic firms treat the net asset value completely as social or common property, while other democratic firms treat it as partially individualized property.

The common-ownership firms in the UK or the former Yugoslavian self-managed firms are examples of worker-managed firms which treat the net asset value as common or social property. These firms do assign the membership rights to the functional role of working in the firm, but deny any individual recoupable claim on the fruits of past labor reinvested in the firm. Most of the worker cooperatives in the United Kingdom today are organized as common-ownership cooperatives.

There are a number of problems with the social property or common-ownership equity structure which can be resolved using the Mondragon-type individual capital accounts. We consider here some of the problems in Western firms with this social property equity structure. The related difficulties in the Yugoslav self-managed firms will be considered later.

The "common-ownership" equity structure has some rather curious ideological support in the United Kingdom. Having a recoupable claim on the net asset value of the company is considered as illicit in some circles. The reason is far from clear. Perhaps the antipathy is to a capital-ist equity structure where the membership rights are treated as "capital." But then the antipathy should not extend (as it often does) to the Mondragon-type cooperative structure where the membership rights are personal rights attached to the functional role of working in the company.

Perhaps there is a lack of understanding that the only capital-based appreciation on the capital accounts is interest which has always been allowed in cooperatives. The only other allocations to the capital accounts are the labor-based patronage allocations, but those allocations are analogous to depositing a wage bonus in a savings account. A deposited wage bonus increases the balance in the savings account but it is not a return to the capital in the account. An internal capital account is a form of internal debt capital. Apparently there is no general antipathy in common-ownership companies to workers having explicit debt claims on retained cash flows. The largest common-ownership company, the John Lewis Partnership, has "paid out" bonuses in debt notes to be redeemed in the future. The total of the outstanding debt notes for each member would be a simple form of an internal capital account.

The social property equity structure is best suited to small, labor-intensive, service-oriented cooperatives. None of the complications involved in setting up, maintaining, and paying out internal capital accounts arise since there are no such accounts. Since there is no recoupable claim on retained earnings, the incentive is to distribute all net earnings as pay or bonuses, and to finance all investment with external debt. But any lender, no matter how sympathetic otherwise, would be reluctant to lend to a small firm which had no incentive to build up its own equity and whose members had no direct financial stake in the company.

Firms which have converted to a common-ownership structure after becoming well-established (e.g. Scott Bader Commonwealth or the John Lewis Partnership in England) can obtain loans based on their proven earning power, but small startups lack that option. Thus the use of the common property equity structure in small co-ops will unfortunately perpetuate the image of worker cooperatives as "dwarfish," labor-intensive, under-financed, low-pay marginal firms.

The system of internal capital accounts in Mondragon-type cooperatives is not a panacea for the problems of the worker cooperatives. But it does represent an important lesson in how worker cooperatives can learn from their past experiences to surmount their problems, self-inflicted and otherwise.

Mondragon-type Worker Cooperatives

The Mondragon Group of Cooperatives

The Mondragon worker cooperatives in the Basque region of Northern Spain provide one of the best examples of worker cooperatives in the world today. The first industrial cooperative of the movement was established in 1956 in the town of Mondragon. Today, it is a complex of around 100 industrial cooperatives with more than 20,000 members which includes the largest producers of consumer durables (stoves, refrigerators, and washing machines) in Spain and a broad of array of cooperatives producing computerized machine tools, electronic components, and other high technology products. The cooperatives grew out of a technical school started by a Basque priest, Father Jose Arizmendi. Today, the school is a Polytechnical College which awards engineering degrees.

The financial center of the Mondragon movement is the Caja Laboral Popular (CLP), the Bank of the People's Labor. It is a cooperative bank with 180 branch offices in the Basque region of Spain. The worker cooperatives, instead of the individual depositors, are the members of the Caja Laboral Popular. The bank built up a unique Entrepreneurial Division with several hundred professionally trained members. This division has in effect "socialized" the entrepreneurial process so that it works with workers to systematically set up new cooperatives (see Ellerman, 1984a). The division is now split off as a separate cooperative, *Lan Kide Suztaketa* or LKS.

The CLP is one of a number of second-degree or superstructural cooperatives which support the activities of the Mondragon group. There is also:

— *Arizmendi Eskola Politeknikoa*, a technical engineering college which was the outgrowth of the technical school originally set up by Father Arizmendi;
— *Ikerlan*, an advanced applied research institute that develops applications of new technologies for the cooperatives (for example CAD/CAM, robotics, computerized manufacturing process control, and artificial intelligence);
— *Lagun-Aro*, a social service and medical support cooperative serving all the cooperators and their families in the Mondragon group; and
— *Ikasbide*, a postgraduate and professional management training institute.

The whole Mondragon cooperative complex has developed in a little over 30 years. It has pioneered many innovations, including the system of internal capital accounts. A worker's account starts off with the paid-in membership fee, it accrues interest (usually paid out currently), and it receives the labor-based allocation of retained profits and losses. Upon

termination, the balance in a worker's account is paid out over several years. There is also a collective account which receives a portion of retained profits or losses. The collective account is not paid out; it is part of the patrimony received by each generation of workers and passed on to the next generation [for more analysis, see Oakeshott, 1978; Thomas and Logan, 1982; Ellerman, 1984a; Wiener and Oakeshott, 1987; or Whyte and Whyte, 1988].

Implementing the Mondragon-type Co-op in America

A *Mondragon-type worker cooperative* is a labor-based worker cooperative with a system of internal capital accounts. There are several ways to implement this legal structure in the United States. A firm can incorporate under standard business corporation law and then internally restructure as a Mondragon-type worker cooperative using a special set of by-laws [e.g. ICA, 1984].

The key to the by-law restructuring of a standard business corporation as a Mondragon-type worker cooperative is to partition the conventional bundle of ownership rights attached to the shares so that the membership rights can be transformed into personal rights assigned to the workers. Since the net asset rights need to be partitioned off from the membership rights, two instruments are required (unlike the one membership share in the traditional stock cooperatives). Thus either the net asset rights or the membership rights must be removed from the equity shares in the restructured business corporation. The net asset rights are separated off from the shares, and kept track of using another mechanism than share ownership, namely, the internal capital accounts.

After a probationary period (typically six months), an employee must be accepted into membership or let go (the "up or out rule"). If accepted, the worker is issued one and only one share, the "membership share." Membership has obligations as well as rights. Just as a citizen pays taxes, so a member is required to pay in a standard membership fee usually out of payroll deductions. This forms the initial balance in the member's internal capital account. When the member retires or otherwise terminates work in the company, the membership share is forfeited back to the firm. The person's internal account is closed as of the end of that fiscal year, and the closing balance is paid out over a period of years.

The by-laws require that the membership share is not transferable to anyone else. The company issues it upon acceptance into membership, and the company takes it back upon termination. Since the share is not marketable, it has no market value. It functions simply as a value-less *membership certificate*. Having two membership shares would give one no more rights than having two ID cards or two identical passports. One would just be a copy of the other. In this manner, the allocation of the shares is transformed from a property rights

allocation mechanism (whoever buys the shares) to a personal rights allocation mechanism (assigned to the functional role of working in the firm beyond the probationary period).

Since the value has been stripped away from the share-as-membership-certificate, the internal capital accounts are created to take over that function of recording the value to be ultimately paid back to the member. That value balance remains a property right representing the value of the members' paid-in membership fees, the reinvested value of the fruits of their labor, and the accumulated interest. If a member dies, the membership rights (as personal rights) revert to the firm while the balance in the person's capital account would be paid out to the person's estate and heirs.

In America, corporations are chartered by state law, not federal law, so there are fifty state corporate statutes. The cooperative by-laws could be used in a business corporation in any of the states. However, some states have now passed special statutes for Mondragon-type cooperatives using internal capital accounts. The first worker cooperative statute in America explicitly authorizing the Mondragon-type system of internal capital accounts was codrafted by ICA attorney Peter Pitegoff and the author, and was passed in Massachusetts in 1982 [see Ellerman and Pitegoff, 1983]. Since then, mirror statutes have been passed in a number of other states (such as Maine, Connecticut, Vermont, New York, Oregon, and Washington). Similar legislation is being prepared for other states. A British version of the statute has been accepted in Parliament as Table G of the Companies Act.

Risk Diversification and Labor Mobility

There are two conventional arguments against worker ownership that need to be considered in light of the Mondragon experience. One argument is that worker ownership impedes the birth and death of firms by cutting down on labor mobility. The other argument is that worker ownership forces the workers to bear too much risk since they cannot diversify their capital in a large number of enterprises.

Both arguments tend to assume that the approach to these problems in a capitalist economy is the only approach. For instance, labor mobility—by contracting or closing some firms and starting or expanding others—is not the only mechanism of industrial change. In Mondragon, management planning takes the membership in the firm as a given short-run fixed factor not under the discretionary control of the management [see Ellerman, 1984b]. When a business is failing in its current product line, the response is not to contract the firm by firing workers. The response is to convert the business in a deliberate manner to a more profitable line. The crucial element in the conversion is the socialization of entrepreneurship through the CLP's Empresarial Division-LKS. The Empresarial Division-LKS uses its broad knowledge of alternative product

lines to work with the managers on the conversion. Thus the social function of allowing old product lines to die and promoting new products is carried out in a manner that does not presuppose labor mobility.

The other argument is that, under worker ownership, the workers cannot reduce their risk by diversifying their equity capital holdings. Since a worker typically works in only one job, attaching equity rights to labor allegedly does not allow diversification of risk. All the worker's eggs are in one basket. But there are other ways to address the risk reduction problem, namely the *horizontal association* or grouping of enterprises to pool their business risks. The cooperatives are associated together in a number of regional groups that pool their profits in varying degrees. Instead of a worker diversifying his or her capital in six companies, six companies partially pool their profits in a group or federation and accomplish the same risk-reduction purpose without transferable equity capital.

Suppose that with some form of transferable equity claims a worker in co-op 1 could diversify his or her equity to get (say) 50 per cent of firm 1's average income per worker and then 10 per cent each from firms 2 through 6 to make up his or her annual pay. The alternative is risk-pooling in federations of cooperatives. The six cooperatives group together so that a member gets 40 per cent of average income per worker from his or her firm plus 60 per cent of the average of all the six firms. A co-op 1 worker would receive the same diversified income package as the previous annual pay obtained with transferable equity claims. Thus transferable equity capital is not necessary to obtain risk diversification in the flow of annual worker income.

Chapter 5: *Employee Stock Ownership Plans*

ESOPs: An American Phenomenon

After a century of unionism in America, only about 15 per cent of the nonagricultural workforce is unionized and that percentage is declining. In only a decade and a half, ESOPs have spread to cover about 10 per cent of the workforce and that percentage is climbing. Clearly something significant is happening.

Employee ownership has so far not become a partisan issue in America or the United Kingdom. Publications favorable to ESOPs in the UK have been recently promoted by the conservative Adam Smith Institute [Taylor, 1988] and by the Fabian Research Unit [McDonald, 1989]. In America, ESOPs draw support from across the relatively narrow political spectrum. While there is strong conservative support for ESOPs, the right wing in America has not been a strong supporter of worker empowerment. That suggests most ESOPs have not been a form of worker empowerment. What then does drive the current ESOP movement in the minds of conservatives and moderates?

One motive cited by conservatives and moderates is the maldistribution of wealth and income. For instance, over half of the personally-held corporate stock is held by the top one per cent of households [with similar statistics holding in the UK, see McDonald 1989, p. 10]. Conventional capitalism is characterized as a "closed-loop financing system"—in other words, the rich get richer and the poor get poorer. New wealth accrues primarily to equity ownership, so until workers get in on equity ownership, they will remain permanently outside the loop. Thus the idea is "Capitalism—Heal Thyself." ESOPs are the prescription.

The developer of the leveraged ESOP idea, Louis O. Kelso, ESOPs as *democratic* capitalism [see Kelso and Kelso, 1986]. There is much pressure to use the word "democratic" in America. The adjective "democratic" is sometimes used to mean anything that can be spread amongst the common people without discrimination—like the common cold. The wealth redistributive purpose of ESOPs is to give the common people a "piece of the action" and thus to make capitalism more "democratic" in *that* sense.

But other motives seem to have hitched a ride on the redistributive bandwagon. By investing workers with ownership, workers may be weaned away from unions. In fact many of the ESOPs designed as the opposite of workplace democracy would leave workers without any form of collective decision-making and action.

Many ESOPs are set up in small to medium-sized family-owned firms which are seldom a hot-bed of unionism. The founder, or his family, want to cash out at least over a period of years. The traditional route has been to sell to a large firm—which left the loyal employees with an uncertain fate. The alternative of getting tax breaks by selling to the workers through an ESOP is thus motivated by a tax-sweetened paternalism. ESOP consultants sometimes use the pitch, "Here is how you can sell your company and still keep control of it."

When hostile takeovers are a possibility (as in the USA in the 80's), large firms turn to ESOPs for rather different reasons. With an ESOP, a sizable block of shares is in friendly hands so a hostile takeover is that much more difficult.

The takeovers seem driven less by real efficiency gains than by the short-term profits obtained by redrafting in the company's favor all the implicit contracts with the employees, the (non-junk) bondholders, and the local communities. The long-terms effects are anti-investment; they work against company investment in employee training or in new product development, against the investment of non-junk long-term capital, and against state and local government investment in infrastructure development for (now outside-controlled) companies.

Some unions have embraced ESOPs, but only after a shotgun marriage. The long-term decline of the unionized steel industry has forced workers to take their fate more and more into their own hands. The success of Weirton Steel, a 100 per cent ESOP buyout from National Steel, has been one of the brightest spots in employee ownership during the 1980's.

Unions have found common cause with management on using ESOPs as an anti-takeover device. If the company is going to become heavily leveraged to prevent a takeover (e.g. to buy back shares), then the employees might as well be earning shares for themselves as they tighten their belts to pay off the company debt. Recently the unions led the ESOP buyout of United Airlines, one of the largest airlines in the world.

Employee ownership offers American liberals an almost unique opportunity to be pro-worker without being anti-business. We are witnessing the drawing to a close of the era of America's economic prominence based on the vitality of its market economy and its endowment of unexploited natural resources in the New World. In the finely-tuned competitive environment of today's international marketplace, American industry can ill-afford the inherent "X-inefficiency" of the firm organized on the basis of the us-vs.-them mentality of the employer–employee relationship [see Leibenstein 1987]. A new cooperative and participative model of the enterprise is needed where the workers are seen as long-term "members" rather than as "employees." Many forward-looking American liberals and progressives see worker ownership as the natural legal framework for that new model of the enterprise.

There have thus been many reasons for the ESOP phenomenon and for the widespread political support. To further analyze the ESOP contribution, we must turn to a closer description of ESOPs.

Worker Capitalist Corporations

A *worker-capitalist corporation* is a company where the conventional ownership bundle remains as a bundle of property rights, that is, as capital (not partially restructured as personal rights) and those property rights are owned by the employees of the corporation. Instead of directly working for themselves, the workers own the capital that employs them.

In a worker-capitalist firm, the employee might own the shares directly or only own them indirectly through a trust such as an Employee Stock Ownership Plan or ESOP. Before considering these two forms, it should be noted how worker-capitalist firms violate the democratic rule of one vote per person and do not allocate the net income in accordance with labor.

Votes are conventionally attached to shares, and different employees will usually own widely differing numbers of shares (different longevity, pay rates, and so forth). The votes will be as unequal as the share distribution. The voting rights are part of the property rights attached to the shares so it is the shares that vote, not the people. The shareholders don't vote themselves; they vote their shares.

In any capitalist firm, worker-owned or absentee-owned, the net income ultimately accrues to the shareholders either in the form of share dividends or capital gains (increased share value). Both dividends and capital gains are per share so they are proportional to the shareholding of the employees, not their labor during the fiscal year.

Before the development of ESOPs, there were sporadic examples of worker buyouts that established worker capitalist firms where the workers directly owned all or a majority of the shares. When the shares are *directly* owned by some or all of the employees, the employee ownership tends to be a very temporary characteristic of the company—at least in a full-blown market society. If the company succeeds, the share value rises so the workers and their shares are soon parted. The Vermont Asbestos Group and the Mohawk Valley Community Corporation were examples of pre-ESOP worker buyouts in the 1970s. Within three to five years, managers or outsiders had purchased majority control in both companies.

Employee-owned corporations are more stable if the shares are *indirectly* owned through a trust as in the employee stock ownership plans (ESOPs). In an ESOP, each employee has an account which keeps track of the employee's capital. The shares represented in the accounts are

held in the trust so the employees cannot sell them. The employees only receive the shares upon leaving the company or retirement, and even then the company usually buys back the shares to maintain the employee-owned nature of the company.

In a conventional ESOP, the voting and profit rights are distributed to workers—not according to their labor—but according to their capital. The voting is on one per share basis, and workers and managers can own widely differing numbers of shares depending on their pay scale and longevity with the company. The profits accrue to the employee-shareholders either as dividends or as capital gains (realized increase in share price) and both are proportional to the number of shares held, not the labor performed by the worker.

Origin of ESOPs

The original architect of the ESOP was a corporate and investment banking lawyer, Louis Kelso, who has co-authored books entitled *The Capitalist Manifesto*, *How to Turn Eighty Million Workers Into Capitalists on Borrowed Money*, and *Two-Factor Theory*. The conservative but populist aspects of the Kelso plan appealed to Senator Russell Long (son of spread-the-wealth Southern populist, Huey Long), who pushed the original ESOP legislation through Congress and continued to spearhead the ESOP legislation (e.g. the *Tax Reform Act of 1984*) until his retirement from the Senate.

An ESOP is a special type of benefit plan authorized by the Employee Retirement Income Security Act (ERISA) of 1974. As in any employee benefit plan, the employer contributions to an ESOP trust are deductible from taxable corporate income. But, unlike an ordinary pension trust, an ESOP invests most or all of its assets in the employer's stock. This makes an ESOP into a new vehicle for worker ownership but it is not a substitute for a diversified pension plan.

ESOPs have received strong tax preferences so for that reason, if for no other, their growth has been significant. From the beginning in 1974, 10,000 ESOPs sprung up in the United States covering about 10 per cent of the workforce (in comparison, about 15 per cent of the workforce is unionized). There are perhaps 1000 ESOPs holding a majority of the shares in the company. However, only 50–100 of the ESOPs have the democratic and cooperative attributes such as one-person/one-vote as opposed to one-share/one-vote. The overwhelming majority of ESOPs are designed by managers to be controlled by management and the lenders (at least for the duration of the ESOP loan).

The main tax advantage to the company is the ability to deduct the value of shares issued to an ESOP from the taxable corporate income. The *Tax Reform Act of 1984* has increased the tax-favored status of ESOPs for companies, owners, and banks. The taxable income to a bank is the

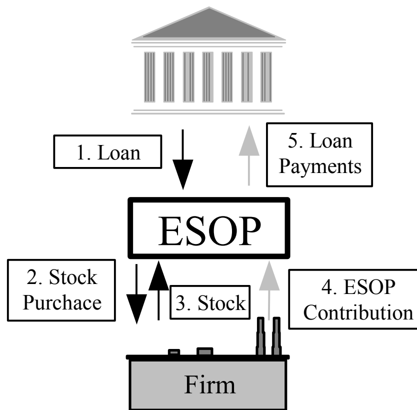
interest paid on a bank loan. On a loan to a leveraged ESOP, 50 per cent of the interest is now tax-free to the bank. Dividends paid out on stock held in an ESOP are deductible from corporate income (similar to an existing tax benefit of cooperatives) whereas dividends in conventional corporations come out of after-tax corporate income. If an owner sells a business to an ESOP (or a worker-owned cooperative) and reinvests the proceeds in the securities of another business within a year, then the tax on the capital gains is deferred until the new securities are sold. These tax breaks have made the ESOP into a highly favored financial instrument.

Due to the strong tax preferences to the firms as well as to lenders, most large-sized worker-owned companies in the United States are organized as ESOPs. However, the transaction costs involved in setting up and administering an ESOP are large, so the cooperative form is often used for smaller worker-owned enterprises. The ESOP structure allows for partial employee ownership—whereas a cooperative tends to be an all-or-nothing affair. Indeed, most ESOPs are hybrid companies which combine employee with absentee ownership. The average ESOP company has less than 20 per cent employee ownership [for a review of the ESOP literature and research, see Blasi, 1988].

Structure of ESOP Transactions

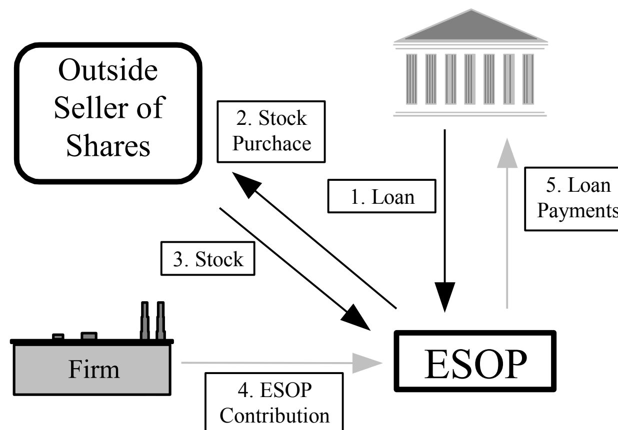
In the leveraged ESOP transaction, the corporate employer adopts an employee stock ownership plan (ESOP) which includes a trust as a separate legal entity formed to hold employer stock. The ESOP borrows money from a bank or other lender (step 1 in diagram below), and uses that money to purchase some or all of the employer stock at fair market value (steps 2 and 3). The loan proceeds thus pass through the trust to the employer, and the stock is held in the trust. Ordinarily, the company guarantees repayment of the loan by the ESOP and the stock in the trust is pledged to guarantee the loan.

Over time, the employer makes contributions of cash to the ESOP in amounts needed to repay the principal and interest of the bank loan (step 4) and the trust passes the payments through to the bank (step 5). Thus, the employer pays off the loan gradually by repayments to the lender through the ESOP—payments that are deductible from taxable income as deferred labor compensation. This deduction of both interest and principal payments represents a significant tax advantage since the employer ordinarily can deduct only the interest payments. The implicit cost of the tax break to the original shareholders is the dilution of their shares represented by the employee shares in the ESOP.



A Standard Leveraged ESOP

An ESOP can also be used to partially or wholly buy out a company from a private or public owner. This is called the "leveraged *buyout* transaction." Taking the previous owner as the government, the ESOP borrows money (step 1 in diagram below) and the loan payments are guaranteed by the firm with the purchased shares as collateral. The shares are then purchased from the outside owner, such as the government, with the loan proceeds (steps 2 and 3)—instead of buying newly issued shares from the company.



Leveraged Worker Buy-Out from Outside Seller

Again the firm makes ESOP contributions which are passed through to pay off the loan (steps 4 and 5). A variation on this plan is for the seller to supply all or some of the credit. By combining the functions of the bank and government in the above diagram, we have the "pure credit" leveraged buyout transaction.

Two Examples of ESOPs

One of the best-known world-wide companies that is employee-owned through an ESOP is the Avis car rental company. After going through five different corporate owners in eleven years, Avis was sold to an ESOP in 1987 for a little less than $2 billion dollars. Avis has added involvement to the bare bones of ownership with its employee participation group system. Before the buyout, Avis used the advertising slogan "We try harder"; after the buyout the slogan was "Owners try harder." After the buyout, profits increased from $16 million to $79 in the first year and to $93 million in the following year.

Today the biggest ESOP in America is also a well-known world-wide company, United Airlines. In 1993, two out of the three unions and the non-union employees agreed to a plan to reduce wages and benefits in the amount of about $5 billion dollars over the next five to six years. In exchange, an ESOP would received at least 55% of the shares with the remainder being still publicly traded. The workers' 55% of the shares were purchased with money from a package of loans to be paid off over the next six years. United, like Avis, uses employee ownership as a force in its advertising program. In American, the low morale of employees in conventional companies is sometimes expressed in the phrase "We just work here." United started its pride of ownership campaign with pictures of employee-owners saying "We don't just work here."

Chapter 6: *Model of a Hybrid Democratic Firm*

Introduction: A Model for Transplanting

ESOPs and worker cooperatives have evolved in idiosyncratic ways in the United States and elsewhere. How can the "core" of these legal structures be introduced in rather different legal environments elsewhere in the West—not to mention in the transitional economies? For instance, worker cooperatives have always been limited because they are all-or-nothing affairs. There is no intermediate stage that allows a company to ramp up to 100 per cent worker ownership over a period of years. This chapter presents a hybrid form of the Mondragon-type worker cooperative.

ESOPs do allow for that partial or hybrid intermediate structure. But the American ESOPs require an external trust in addition to the corporation. How can the ESOP structure be applied in non-Anglo-Saxon countries which have little or no trust law? This chapter presents the idea of an "internal ESOP" which captures the basic ideas of the leveraged ESOP transaction with *no* external trust.

The resulting models of a hybridized Mondragon-type worker cooperative and an internalized democratic ESOP turn out to be essentially the same—so *that* is the model of the *hybrid democratic firm* presented here.

A Hybrid Mondragon-type Worker Cooperative

The worker-owned cooperative has historically been an all-or-nothing creature. It tends to assume a workforce that already understands and appreciates the rights and responsibilities of democratic worker ownership. A more practical compromise is a hybrid structure that can initially accommodate less than 100 per cent or even minority worker ownership—but where that portion of worker ownership is organized on a democratic cooperative basis.

A *hybridized* Mondragon-type worker cooperative is a corporation where a certain percentage of the ownership rights is organized as a Mondragon-type worker cooperative, that is, with voting by an agreed-upon rule (e.g., equal or according to salary) to determine total vote of workers' shares and with workers' residual allocated among them according to labor (as measured, for instance, by salary).

An Internalized Democratic ESOP

The democratic ESOP is already a hybrid structure for democratic worker ownership. Any percentage of the ownership could be in the ESOP, and that portion can be organized on a cooperative basis. However, the ESOP has evolved in an idiosyncratic way depending on the peculiarities of American law and the political process. In designing a new institutional form, it is best to think through the real function served by all the ESOP trust apparatus and then implement a streamlined version accomplishing the desired ends.

In particular, an external trust is a somewhat peculiar mechanism for *worker* ownership. The workers are, in fact, inside the firm. But an external ESOP trust is set up with the workers as beneficiaries. Then the firm issues external shares to be held by the trust. By this circuitous route, the workers have the ownership rights in their enterprise.

The external ESOP trust evolved in American law from a pension trust designed to hold shares in *other* companies. There is little need for the trust to be external if its primary purpose is to register ownership in the company itself. Corporate law could be modified or new corporate law drafted to, in effect, move the ESOP inside the corporation itself. The whole circuitous loop of worker ownership through an external democratic ESOP could be simplified and streamlined by moving the ESOP inside the corporation.

In America, starting and administering an ESOP requires an army of lawyers, financial analysts, valuation experts, and accountants all resulting in sizable transaction costs. Indeed, a whole industry has developed for the "care and feeding" of ESOPs. Less of this would be necessary if the ESOP structure was internal to the structure of the corporation.

An *internalized* democratic ESOP is a corporation where a certain percentage of the ownership rights is organized as a "democratic ESOP" within the company.

The Hybrid Democratic Firm

The interesting result is that a hybridized Mondragon-type worker cooperative is essentially the *same* as an internalized democratic ESOP—and *that* is the structure we are proposing as a hybrid partial worker-owned democratic firm—which, for short, will be called a *hybrid democratic firm*.

Many useful ideas can be suggested by using the two ways of conceptually deriving the structure of a hybridized democratic firm (as a hybridized co-op or an internalized ESOP). However, we will initially describe the structure in general terms.

The equity of the hybrid firm is divided into two parts:

(1) the *workers' portion of the equity* which is the "inside ownership" and

(2) the *external portion of the equity* owned by outside parties such as organs of government, intermediate institutions, or private parties.

In a transitional economy, the external ownership might be public, that is, by the state, city, county, township, or village government.

There are two limiting cases: 0 per cent and 100 per cent inside ownership. With 0 per cent inside ownership, the firm would be a conventional corporation owned by public or private parties. With 100 per cent internal ownership, the firm would be a (non-hybridized) Mondragon-type worker cooperative which could also be seen as a 100 per cent democratic ESOP (i.e. an ESOP with 100 per cent of the ownership) internalized to the company.

In an American corporation, there is a difference between shares that are *authorized* and shares that have been issued to become *outstanding*. A certain number of shares (assume all common voting shares) are authorized in the original corporate charter. Some of these shares are then issued to shareholders in return for their paid-in capital so those shares are then outstanding. If a company bought back or redeemed any shares, those shares would not be outstanding and would be retired to the company treasury until re-issued. Only the shares that are issued and outstanding can vote or receive dividends. The authorized but unissued or redeemed shares can neither vote, receive dividends, nor reflect any net worth.

In what follows, we assume the hybrid firm is organized as a corporation with common voting shares—although a simpler structure might also be used to implement the ideas. In a hybrid democratic corporation with shares, the inside ownership is *a new category of issued and outstanding shares*; it is not unissued or treasury stock. The workers' stock is issued and outstanding but held in the firm for the inside owners, the workers. Each worker does not own a certain number of shares since the workers' portion of the company is to be organized in a labor-based democratic fashion. The worker *shares* are held collectively and are unmarketable. The workers vote on an agreed-upon basis as to how the collectivity of the worker shares will be voted. The workers would elect a number of representatives to the board of directors proportional to the workers' portion of the equity (e.g. one third of the directors for one third of the equity). The worker representatives on the board would form a natural subcommittee to control the shares in the workers' portion of the equity in analogy with an ESOP governing committee in the American external ESOP.

Some shares have a par or face value that is the value for which the shares were originally issued, but that value has no significance later on. Often shares are no-par shares with no par or face value; they simply have some original issued value. After a company has been in operation,

the shares will have a book value (net book value divided by the number of common shares). If the shares are marketable, they will also have a market value. The book and market values are in general different from the face or issued values of the shares. The relevant valuation of the worker shares in a democratic firm is their net asset value or "economic book value".

Assets	Liabilities
Cash	External Debt
Inventory	External Equity
Equipment	Internal ESOP:
Real Estate	Individual Capital Accounts
	Suspense Account
	Collective Account
	minus Loan Balance Account

Hybrid Democratic Firm's Balance Sheet

The total book value of the worker shares is divided between several types of internal capital accounts in the internal ESOP:

(1) each worker has a value-denominated *individual capital account* which would contain a certain amount of value (not a certain number of shares);

(2) there is a *suspense account* which serves as a temporary collective account or "holding pen" for value to be eventually allocated to individual accounts;

(3) a permanent *collective account*, and

(4) there would also be a (debit-balance) *loan balance account* which could be treated as a contra-account to the collective account.

Company law could be redrafted so that the *workers' portion* of the equity was a *normal part of any corporation*. A company typically runs several accounts such as total year-to-date wages or accrued vacation time. A worker's internal capital account would be another account maintained for each person in the company.

Each worker could have a membership certificate, but it would be quite different from a share certificate. The number of shares in the total workers' portion might grow over time, but each worker only needs one membership certificate to signify membership. Each year, the workers would receive Capital Account Statements showing the transactions in their accounts due to the year's operations and the resulting ending balances.

Some details can be best illustrated by considering a concrete example. Consider a hybrid democratic firm where one-third of the ownership is inside or workers' ownership. There could be, say, 960 shares issued and outstanding with 33 per cent or 320 shares held in the firm as worker shares. In a corporate election of (say) board members, there are 960 share-votes, 320 of which are controlled by the workers. The workers vote on a democratic basis as to how their 320 share votes should be cast.

A new worker might pay in a standard membership fee through payroll deductions. Shares with book value equal to the membership fee would be issued by the company to the total workers' portion of the equity, and that value would be credited to the new worker's individual capital account.

The workers' portion of the ownership would be exercised in not only a democratic but a labor-based manner. Workers would receive wages and salaries as usual, and then 33 per cent of the profits would be allocated among the workers according to their labor—after interest is paid on the capital accounts.

Profits will accrue to the workers in two ways. A firm-wide decision might be made for some of the profits to be paid out in dividends on the shares. Then, in the example, 33 per cent of the dividends would go to the workers collectively to be divided between them according to their labor (measured by salary or by hours). The dividends could be paid out in cash, or they could be added to the capital accounts and then used to pay out the oldest account entries according to the rollover plan. The remainder of the profits (not declared as dividends) would be retained so they would increase the net book value per share. The shares in the workers' portion are valued at book value. Hence 33 per cent of the retained profit (= increase in net book value) would accrue to the workers' individual accounts.

The allocation formula between worker accounts depends on whether the individual capital accounts bear interest or not. Accounting is simpler if interest is ignored, but interest is the only compensation proportional to the larger risk borne by large account holders (older workers). The interest comes out of the workers' retained profit. The interest should be added to each account with the remainder of the workers' retained profit (their one-third)—which could now be negative—allocated between the accounts according to labor. If there are little or no profits, the interest is still added to the workers' accounts and the correspondingly more negative retained profits (i.e. greater losses) are allocated between the accounts according to labor.

It should be remembered that the workers do not have any individual ownership of shares; only the book value is represented in their individual capital accounts. In the hybrid firm, the shares still package together the three main rights in the ownership bundle (voting, profit, and net

asset rights). But the workers' portion of the ownership is organized in a labor-based democratic manner so the voting and profit rights (carried by the shares in the workers' portion) are split off and assigned as personal rights to the workers' role, while the book value of the worker shares is allocated between the capital accounts (individual, suspense, and collective accounts).

A worker's account would be paid out in the regular rollover payouts (assuming the rollover plan is used) with the remainder paid out after termination or retirement. There are several ways to consider the payouts on the capital accounts when the firm is a hybrid instead of 100 per cent worker-owned. If a cash payout, in accordance with the rollover plan or upon termination, is from general funds of the company (and there is no proportional payout to the external shareholders), then worker shares with book value equal to the payout should be retired to the company treasury. Alternatively, if there was a cash dividend on all shares, then the worker portion of the dividend could be credited to the accounts according to current labor and then used to rollover the oldest account entries or to pay out terminated accounts. In that case, there would be no need to retire an equal amount of shares since the external shareholders received their proportional part of the dividend payout.

The ESOP Transactions with an Internal ESOP

The "Leveraged ESOP" Transaction

Consider a hybrid firm that starts off entirely or almost entirely government owned. Then a loan is channeled through the workers' portion of the equity as an "internal ESOP" in order to increase the workers' share of the company.

Let us suppose $300,000 is borrowed by the firm from a bank. There were previously 660 shares, 640 held by the government, 20 held by the workers, and the share book value was $1,000 each. With the loan channeled through the workers' portion of the equity, 300 (= 300,000/1,000) new shares are issued to the workers' portion of the ownership so the workers then have 320/960 or 33 per cent of the ownership. However, the share value is allocated to the suspense account.

Each loan payment is divided into a principal and interest portion. In many countries such as the United States, the interest portion is already an expense deductible from taxable corporate income. The principal portion is to be treated as a labor expense so that it would also be deductible as an expense from taxable corporate income. This procedure would need to be approved by the relevant tax authorities—as it has been approved in the United States.

A value amount equal to the principal payment is allocated from the suspense account to the individual accounts to be divided between them in accordance with labor. It is *as if* each

principal payment is paid out to the workers as a bonus and then immediately reinvested in worker equity, and the money is then paid to the bank as the principal payment. In this manner, the hybrid firm internally mimics the leveraged ESOP transaction.

It should be remembered that changes in the worker accounts resulting from retained profits or losses are also taking place at the end of the fiscal year in addition to the credits relating to the principal payments. Those year-end profits or losses of the firm are computed with the principal payments treated as a labor expense.

When the loan is paid off, the principal amount of the loan will have been allocated between the individual accounts. The financial reward to the whole company for channeling the loan through the "internal ESOP," the workers' portion of ownership, is that the principal payments on the loan were deducted from taxable income. The increased worker ownership should also reap other rewards through the greater motivation and productivity of the workers.

The "Leveraged ESOP" Buyout Transaction

In the previously described leveraged internal ESOP transactions, the loan money went to the company, and the worker shares were newly issued and valued at book value. An alternative leveraged transaction is to use the loan proceeds to buy externally held shares for the workers' portion of the ownership.

The bank or financial institution loans money to the company. The cash is passed through the company and used to buy back externally held shares from the government authority or other party holding the shares. However, instead of interpreting this as a share redemption (which would retire the shares to the corporate treasury), it is viewed as the workers collectively buying the shares from the external owners. Hence those shares enter the workers' portion of the ownership instead of the corporate treasury, and the workers would determine how those share votes are to be cast.

The Simplified Internal ESOP

It is also possible to have a simplified internal ESOP which removes some of the complications in favor of a minimal structure. The simplified internal ESOP is more appropriate for companies with all or substantially all of the ownership in the ESOP so that there is little point to differentiate between a loan channeled through the ESOP and a direct loan to the company. That allows considerable simplification in the ESOP structure. The suspense account, the loan-balance account, and the notion of special ESOP contribution (as opposed to an ordinary loan payment) can be eliminated.

What is left? With no special tax breaks (the typical situation when an "ESOP" is implemented on a firm-by-firm basis in a country with joint stock company law) and no special notion of an ESOP loan, what is left of the original ESOP idea? The basic idea of a manager/employee leveraged buyout is still there; indeed the insiders have substantially all the ownership. The trust aspect is also still there. The employee shares may not be freely sold, and the company will supply the market for repurchasing the shares. Thus the ownership is controlled as in a shareholders' agreement in a closely-held company. In particular, it is controlled in order to maintain the correlation between ownership and working in the company.

Since there is no distribution of shares from the suspense account into the individual share accounts (there being no suspense account), all the more emphasis is put on the employees' initial purchase of shares. The ESOP would impose a maximum number of shares that could be purchased by each employee where the maximum was proportional to salary (that is, a certain number of shares for each $100 of monthly salary). The ESOP might also impose a minimum purchase specified as so many month's salaries. Employees who would not make the minimum purchase (even when offered installment payments out of salary) could either be terminated (hard version) or left unprotected when layoffs have to be made (soft version). Some distinction is usually necessary between existing employees at the time of buyout and new hires. The existing employees might be "grandfathered" into the ESOP while the minimum purchase of shares is made a condition of employment for new employees.

In the full featured internal ESOP, the periodic repurchase or rollover plan is designed to smooth out the liability to repurchase older worker shares instead of allowing it to build up and be triggered by termination or retirement. When the shares are repurchased with ESOP contributions in the periodic repurchase plan, the shares are redistributed to the current employees. But in the simplified ESOP, employees only get shares by purchasing them. There is no automatic redistribution of repurchased shares.

In the simplified ESOP, the functional equivalent of the periodic repurchase plan can be obtained by an appropriate dividend policy. There is little or no leakage of dividends to non-employees since we have assumed that all or substantially all the ownership is in the ESOP. Shares will only be repurchased upon termination or retirement but the dividends will keep share value down. The equivalent of the (say) five year wait for shares to be repurchased under the periodic repurchase plan could be obtained by declaring dividends in five year notes.

Implementation Questions

How can the hybrid democratic firm be implemented? There are questions involving both corporate structure and tax benefits. The corporate structure of the hybrid democratic firm

should at best be implemented by additions to existing corporate statutes authorizing the creation of the "workers' portion" of the equity of a company. Legislation should be preceded by experimentation. The structure could be experimentally implemented (without legislation) in an enterprise by appropriately drafting the charter and by-laws of the enterprise and obtaining the agreement of the present owners and the Workers' Assembly. These could be developed as simple amendments to existing charters and by-laws to add the workers' portion of equity onto an existing joint stock company. After the development of a model seasoned by experience in a particular country, appropriate legislation can be drafted and passed.

The tax benefits of the "internal ESOP" transactions would require authorization from the tax authorities. This requires both allowing the principal payments on loans channeled through the workers' portion of equity to be deducted as labor expenses and deferring any personal income tax incidence for the workers until the capital accounts are paid out.

There are reasonable arguments for both tax benefits as well as the strong American precedent. It is as if the principal payment was paid out as a deductible labor bonus and then immediately rolled over into equity shares in the company (the equity injection then being used to pay off the loan). Or one could think of the company as making the principal payment directly to the bank and simultaneously issuing an equal (book value) amount of shares to the workers' portion of the equity as a deductible stock bonus. In either case, it should be a deductible labor expense to the firm. The workers have no increase in their disposable income so it is reasonable to defer personal taxation until the capital accounts are paid out.

ESOPs use American trust law. Trust law tends to be quite different, idiosyncratic, or non-existent in other countries. Rather than have the costly and bulky apparatus of the external ESOP trust as in current American law, the internal or workers' portion of the equity should be a *normal part of every company*—with the workers' percentage of ownership varying from the beginning of 0 percent up to 100 percent. Alternatively, a country could draft laws to create the machinery of trusts and then the machinery for the external ESOP trust.

Whether or not an external trust is used, it is key that the ESOP hold the shares in trust so that the workers cannot individually sell the shares. Each worker would like to have the benefits of working in a democratic firm and also have the cash from selling his or her shares (assuming everyone else does not do the same). But if everyone did likewise, the firm would no longer be a democratic firm. Hence there needs to be a collective decision to structure a firm in a democratic fashion, and thereafter individuals cannot sell their shares and remain in the company—anymore than citizens can sell their voting rights.

Management and Governance Structures

We turn now to some structural aspects of management (top-down use of delegated authority) and governance (bottom-up delegation of authority) in a democratic firm (hybrid or 100 per cent).

The usual governance structure in a corporation is for the shareholders to elect the board of directors, and then for the board to appoint the general manager and possibly other members of the top management team. Top management then appoints the middle managers who, in turn, select the low-level managers or foremen at the shop floor level. In a hybrid democratic firm, the workers should elect a portion of the board at least equal to their portion of the ownership.

Even in a majority or 100 per cent worker-owned company, it is not appropriate for workers to directly elect shopfloor managers. Those managers would then be in an intolerable position between middle management and the workers. They would have to "serve two masters"—to carry out the orders and management plans from above while at the same time being answerable to the workers who elect them.

Worker-owners also should not have the right to countermand management orders at the shopfloor level (except in the case of direct physical endangerment). There must be channels for workers to use to register their complaints. These could take two forms: (1) *disagreements* over policy questions or (2) *grievances* against managers or other workers for allegedly breaking enterprise rules.

For the workers to intelligently use their ultimate control rights (e.g. votes to elect representatives to the board or to vote on other issues put to the shareholders), they must have a flow of *information* about the company operations. In particular, worker representatives need timely information in order to have an input in management decisions. There should be a number of forums where information can be communicated, questions can be asked of management, and disagreements can be expressed.

There is the *annual meeting* of the Workers' Assembly but that can only deal with the larger issues of overall policy. There should be frequent *shop meetings* (weekly, bi-weekly, or at least monthly). It is important that at least part of each meeting is not chaired by the shop foreman or any other representative of management. There should be another non-managerial elected shop or office representative such as a "shop steward." In part of the shop meetings, the shop steward should preside, disagreements should be voiced in a respectful manner (perhaps by the steward) without fear of recriminations, and the shop managers should have to explain actions and decisions which are called into question.

Another forum for communication and discussions could be the *company newsletter* or newspaper. Ordinarily, this would be controlled by management. But there should be a column given over to the shop stewards who collectively want to bring an issue before the company as a whole. There could also be letters to the editor, questions to managers with their answers, and brief interviews with randomly selected workers on the topics of current interest.

There should also be a *grievance procedure* for workers who feel they have been wronged by managers in terms of the company rules, regulations, and policies. The shop steward would function as the spokesperson for the worker with the grievance (who may otherwise be intimidated by the whole procedure). The political doctrine of "separation of powers" argues that abuses of power are best held in check if there is some separation of powers and authority between the different branches of government such as the legislative, executive, and judicial branches. The board of directors is the legislative branch and the management team is the executive branch in a company. A separate judicial branch would be an elected grievance committee that would function as the court of last appeal in the grievance procedure. However, since the grievance committee would be elected by the shareholders, the board of directors could also play that role as the court of last appeal. That would involve some loss in the separation of powers, but it is hard to imagine a grievance committee having much autonomy if the board and management are already in agreement on an issue. If the workers were convinced that major injustices or abuses had occurred with the concurrence of their board representatives and if the workers could not wait until the annual meeting of the Workers' Assembly, then they should use a recall procedure to change their representatives on the board of directors.

One general principle in any democratic organization is that those who are not in direct positions of power should have the organizational ability to voice and discuss their concerns. This is the idea of the "*loyal opposition*" (see Ellerman, 1988b discussing the inside role of a union as the loyal opposition in a democratic firm). "Opposition" is not always the right word since the idea is not to always oppose current management but to have enough *independence* so that opposition could be voiced whenever deemed necessary. That, for example, is why there should be some worker-elected representatives, herein called "shop stewards," who are not part of management's line of command, and that is why the shop stewards should chair at least part of the shop meetings. The need for some such loyal oppositional structure is obvious when workers only have a minority ownership position in a hybrid firm, but it is also needed when workers have majority or 100 per cent of the ownership. Periodic election of directors is often insufficient to keep management accountable so the watchdog role of the oppositional structure is still needed in the majority worker-owned company.

The American ESOP is a separate external trust with its own governing committee. It sometimes has its own decisions to make—independent of company decisions. For example, the ESOP might accumulate contributed funds and use them to buy back the shares of departing workers. In the simplified hybrid structure recommended here, the ESOP is internalized as part of the company so there is no separate trust with its governing committee. Nevertheless, there will be some "ESOP decisions" that are decisions of the collectivity of workers, not decisions of the board or management of the hybrid firm. The suggested structure is that the worker representatives on the board form the subcommittee to function as the "*internal ESOP" governing committee*. They would decide, for example, whether dividends would be passed through to current workers, or whether the accounts would be credited and the cash paid out to rollover the oldest account entries.

An important program in a hybrid democratic firm is the *internal education program* [see Adams and Hansen, 1987]. The whole idea of being part of a democratic decision-making organization might be new to the workers. The workers might be accustomed to taking orders from an authority figure. The workers have stepped out of their subordinate "employee" role to become worker-owners in a horizontally interdependent organization. They have a whole new set of rights, responsibilities, and concerns. They need to develop skills for discussion and participation in meetings, to learn something about the business side of the enterprise, and to read simplified financial statements and capital account summaries.

Responsibility should be pushed down to the lowest feasible level through worker *participation and quality-of-working-life (QWL) programs*. Worker ownership creates the possibility of substantial increases in motivation and productivity, but it is not automatic. Ownership must be realized at the shopfloor level through worker participation in order to deliver the maximum effect on productivity.

Chapter 7: *Self-Management in Former Yugoslavia*

Introduction

The Western press and many Western scholars look at the world in bipolar terms: capitalism or (state) socialism. State ownership and central planning have failed to deliver a modern economy so "socialism" is being abandoned in favor of capitalism. But the reality is more complicated. There are many "socialisms" and there are many "capitalisms." If "capitalism" means a decentralized economy of independent firms with definite property rights and interrelated by input and output markets, then that also fits certain types of "socialism."

There are two broad traditions of socialism: *state socialism* and *self-management socialism*. State socialism is based on government ownership of major industry, while self-management socialism envisions the decentralized firms being worker self-managed and not owned or managed by the government [see Horvat *et al.*, 1975].

It is a thesis of this book that an economic democracy, a market economy of democratic firms, represents a common ground for the East and West. There are forces of convergence towards that common ground from both sides. An economic democracy could be seen as the humanization and democratization of a market economy where the renting of workers is universally replaced by democratic membership in the firm. An economic democracy can also be represented as the result of decentralizing and democratizing a state socialist economy in favor of a market economy of self-managing firms.

Yugoslavian Self-Management: Pitfalls of a Pioneer

The current economic reforms in the transitional economies actually began with Yugoslavia (see Sacks, 1983; Estrin, 1983; or Prasnikar and Prasnikar, 1986) which from the 1950s moved from the state socialist model towards a model of self-management socialism.

> The only genuinely new model—i.e. different from the various versions of the basic Soviet-type model—already in existence, is the Yugoslav model. [Nuti, 1988, p. 357]

Being a pioneer is not all glory; the pioneer may stumble many times like one who walks at night holding the lantern behind him—of no help to himself but illuminating the path for those who follow.

In the former Yugoslavia, there was no centralized command planning over production. The enterprises were embedded in factor and output markets. The workers in each enterprise elected the workers' council which, in turn, through a committee structure selected the enterprise director. Legally, the director is responsible to the workers' council and the collectivity of workers, but there were strong indirect influences from the League of Communists (the party) and/or the various levels of government. The assets of the enterprise were considered to be "social property." Even though the assets may have been built up by retained earnings (that could have been paid out as pay bonuses), the enterprise only had use rights over the assets and the workers have no individualized claim against the company for the value of those assets.

In the Yugoslav self-managed firm, the two membership rights, the control rights and the net income rights, were at least partially assigned as personal rights to the workers in the firm. The assignment of the control rights to the working collectivity of the firm was attenuated by the hegemony of the League of Communists in the surrounding social structure, e.g. in the local government. The assignment of the net income to the workers was also attenuated since the income that accrued to the workers was a function of the disposition of the income. If the income was paid out in wages and bonuses then it accrued to the workers. If, however, the income was retained in the firm, then it reverted to "social property" and the workers lost any re-coupable claim on it.

The weakness in the net income rights can be traced to the treatment of the third right in the traditional ownership bundle, the rights to the value of the net assets of the firm. That right was treated as disembodied "social property." The problems in the former Yugoslav economy, of course, could not be traced to any one source. But surely one of the most important sources of malfunction was this social property equity structure which had broad ramifications for efficiency and motivation throughout the economy.

If retained earnings become social or common property, the workers had less of a long-term interest in the company. Reinvestment of earnings to buy a machine might not penalize younger or middle-aged workers who would be around to depreciate the machine. But an older worker near retirement or a worker thinking about leaving the firm would be simply losing what could otherwise be a pay bonus. Since the different responses are due to different time horizons with the firm, the original property rights deficiency is called the "*horizon problem*" of the Yugoslav firms [see Furubotn and Pejovich 1970, 1974; Ellerman, 1986b; or Bonin and Putterman, 1987].

It might be noted parenthetically that there is a whole academic literature on what is called the "Illyrian firm" [see Ward 1967; or Vanek, 1970] named after the Roman province that became part of Yugoslavia. The main peculiarity of this model is that it assumes the firm would expel members when that would increase the net income of the surviving members. The resulting short-run perversities have endeared the model to capitalist economists. Yet the Illyrian model has been an academic toy in the grand tradition of much of modern economics. The predicted short-run behavior had not been observed in Yugoslavia or elsewhere, and worker-managed firms such as the Mondragon cooperatives take membership as a short-run fixed factor [see Ellerman, 1984b]. Moreover, in spite of intensive academic cultivation in the Illyrian field for almost two decades, not a single practical recommendation has emerged for the structure of real world labor-managed firms—other than "Don't start acting like the Illyrian model." Hence we will continue to treat the Illyrian model with its much-deserved neglect.

The valuable analysis of the property rights deficiencies in the "social property" structure of many labor-managed firms is often packaged together with the perversities of the Illyrian model in academic literature. Yet the two are quite independent. Property rights problems arise with labor taken as a fixed factor and for a wide range of firm objectives. Unlike the Illyrian model, the academic analysis of the property rights problem in labor-managed firms is an important contribution to the theory and practice of workers' self-management.

With social property, the incentive is to distribute all net earnings as pay (wages and bonuses) and to finance all investment with external debt. The resulting consumer demand and the upward push on money supply to satisfy the demand for loans will both fuel inflation—which had become a serious problem in the former Yugoslavia.

The social property structure also creates an unnecessary bias against bringing in new workers. Economic necessity as well as government regulation in the case of Yugoslavia would lead social property firms to retain some earnings to finance investment in firm assets (in spite of the pressure to finance all investment by borrowing). One way the workers could try to recoup "their investment" was through higher wages—which, in part, were an implicit rent on the new assets. Any new workers would receive the same "wage" for the same work but would not have contributed to that investment. Allowing new workers in would be forcing the old workers to share the rent on their implicit equity. Thus the social property structure led to a bias against new workers—who often had to find jobs as "guest workers" in Northern Europe. With the system of internal capital accounts, the old workers receive the rent or interest on their explicit account balance, that rent is not shared with new workers, and thus that forced-rent-sharing bias against new workers is removed. The problems with social property equity structure can be solved using the Mondragon-type individual capital accounts.

A Decentralizing Model for Restructuring Large Firms

The restructuring of ownership should be accompanied by splitting up and decentralizing the huge firms so as to reduce socialist gigantism at one end of the scale and to fill the need for small and medium-sized firm at the other end at the other end of the scale. The resulting worker-owned firms should be medium-sized or small businesses that are human-scaled, more competitive, and perhaps even entrepreneurial. They will be joined together as in a keiretsu or as in Mondragon in a federation to keep some of the benefits of acting together.

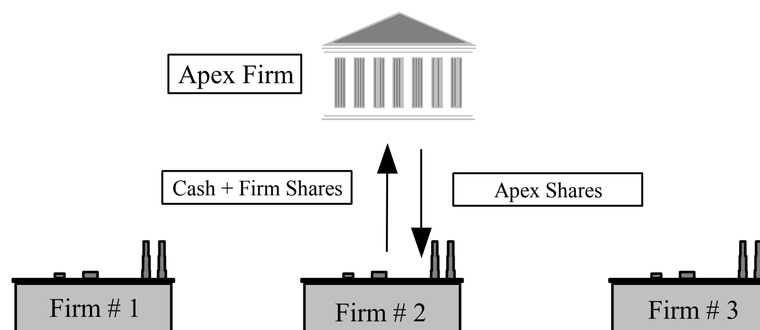
We will sketch a restructuring model might be used in transitional countries. The details might change with implementation since the actual legal constraints on restructuring will only be discovered as the restructuring takes place.

The restructuring can be divided into steps:

(1) The workers and managers in the original socialist firm are divided into divisions perhaps with some remaining in a central unit.

(2) The people in each division, as independent citizens, set up joint stock companies with each person making a small but mandatory contribution of cash.

(3) The same people in the Workers' Assembly of the original socialist firm then vote to convert the firm into a joint stock "apex" company and to issue its stock to the various companies set up by the divisional members in return for some of their cash. The value of the original assets is balanced by the collective equity account, so the value of the original assets would not determine the issuing value of the new stock. The stock could be issued—as with a new company—for an arbitrarily set cash price. Each of the smaller divisional firms might own a part of the new apex company in proportion to the number of workers in the divisional firm. Some of the shares in the apex firm might be retained as worker shares for the people who remain in the original firm.



Separate Worker-owned Divisional Firms

(4) The separate divisional firms and the remaining parent firm join together in a federation with the parent firm as the apex organization performing appropriate functions such as strategic planning, marketing for the group, import-export for the group, and settling conflicts between the divisional firms. The money paid back to the apex firm would allow it to also act as a development bank for the group.

(5) Then each of the divisional firms buys in an ESOP-type credit transaction the assets it needs for its operations from the apex firm. The apex firm might also obtain some of the preferred (profit-sharing) or common shares in the divisional firms in exchange for the assets.

(6) The operations of the divisions is switched over to the separate democratic worker-owned companies.

Chapter 8: *Employee Sovereignty in the Japanese Model*

The Hegemony of the American Model

Almost all the discussion of economic reform in the transitional economies has been dominated by the American (or Anglo-American) model. The Anglo-American corporate structure is presented by Western advisors and multilateral organizations as if it was the only model. It is presented as "the" joint-stock company; anything else is viewed as an immature example that will eventually evolve into the "modern" and "fully developed" model.

One problem with this exclusive focus on "the American model" is that there is a major divergence between the reality in the large American corporations and the model. The greatest and most significant divergence is the separation of ownership and control analyzed by Adolf Berle and Gardner Means in the first third of the 20th century [1932, 1967]. The large corporations with publicly traded shares (sometimes called "public corporations" where the "public" refers to publicly traded shares instead of public or state ownership) have such widely dispersed shares that the shareholders are not able to organize together to act as a coherent decision-making unit. If dissatisfied with decisions made by the firm, each small shareholder would have to incur great costs to organize other shareholders and would stand to gain only a minuscule amount. Thus the shareholders apply the "Wall Street rule" of "voting with their feet", i.e., selling their shares.

The voting rights attached to the common equity shares fall into disuse, and the *de facto* control rights over the company fall into the hands of the managers (who typically own an insignificant amount of shares). These management-dominated companies are sometimes called "managerist" companies, and they have evolved a philosophy of "managerialism" [Enteman 1993]. According to this view, the corporate managers are endowed with a "social responsibility" to balance and promote the interests of all the "stakeholders" which include the shareholders, employees, creditors, suppliers, customers, local residents, and government. By being "responsible" to everyone, the managers are in fact accountable to no one but themselves (as one can judge by considering the levels of executive compensation and benefits in the large American companies).

The American model is held up to the world as the example of an economy operating according to clearly defined property rights. Yet, we have seen the reality is quite different. One of the crucial parts of "property rights" are the control rights, and the control rights over the major corporations in America are *de facto* held by people based on their functional role (as the corporation's managers), not based on their property.

Conventional economics offers no explanation of how the American economy could function so well in spite of diverging at such a crucial juncture from "the American model." Instead conventional economics downplays the "separation of ownership and control" into the "agency problem of corporate governance" where—as in any agency situation—there might be some divergence between the desires of the principals and the decisions of the agents. And then attention is focused on how the managerial labor market and the takeover market (or market for corporate control) might function to lessen the agency problem. With such soothing discussions, one can easily forget about the fundamental divergence between "the American model" of a property-rights-based economy and the reality of the managerist corporation.

The Japanese Model

When any consideration is given to alternative non-Anglo-American models, the German model (with employee representation on the co-determination boards) or the Japanese model are usually mentioned. Since it now appears that early 21st century world economy will have the Asian economies of Japan and China as a major if not dominant part, we will focus on the Japanese model. It is fundamentally different from the Anglo-American model.

> The fundamental principle underlying the Japanese model of mixed economy is anthropocentricism, or what Keisuke Itami refers to as "peoplism." Peoplism is given concrete expression in the form of employee sovereignty with the corporation, and an emphasis on the independent, land-owning farmer within agriculture. This principle is clearly different from the ideological foundations of Western capitalism, and it would be incorrect to assume that the Japanese system belongs to the same regime just because it uses market mechanisms extensively and exists side by side with a democratic political system. [Sakakibara 1993, p. 4]

Post-war Japan was the original East Asian "miracle" economy, and, in spite of the hegemony of the American model in most discussions, the Japanese model may well exert a strong direct or indirect influence on the evolution of the large enterprises in China.

Many treatments of the Japanese economy focus on the role of the state and industrial policy. However, the state does not produce the products that have so successfully blanketed the world. The Japanese firm has been the main actor in this success story. Two sides of the Japanese firm need to be considered: the external connections to other business-related firms and the internal system of corporate governance.

Much of the productive power of modern Japan is contained in the financial-industrial groupings called "keiretsu" [see Gerlach 1989]. There are vertical keiretsu dominated by one firm such as Toyota and horizontal keiretsu such as Mitsui or Mitsubishi where a large variety of industries are represented within the group. Each group has a main bank that plays the leading financial role.

In the "standard American model" of a company, the insiders (managers and workers) are agents who are supposed to answer to the "owners", the shareholders. We have noted how the large American companies have, aided by the stock market, gained "separation" from the shareholders and a degree of managerial autonomy through a strategy of atomizing shareholdings. The insiders in large Japanese firms have gained their autonomy from the shareholders through the strategy of cross-ownership. Shares are, in effect, exchanged with business partners so that most of the shareholding will be in friendly hands. The firms are thus tied together both by business and by shareholding.

> A high proportion of the holders of Japanese equity have more to gain from the other business they do with the company whose shares they hold than from profits or capital gains on the shares themselves. They are 'committed' in interest terms because they have a stake in the actual long-term growth of the company. They are committed in practical institutional terms in that they hold the shares by arrangement with the issuing company and it is hardly thinkable that they could dispose of the holding without consulting with the company's managers. [Dore 1987, p. 113]

As long as a firm is performing satisfactorily, the cross-shareholders will defer to the managers of the firm. When a firm is in distress, the main bank typically steps in with the blessings of the cross-shareholders to orchestrate the restructuring of the firm. Thus the cross-holding creates a system of contingent self-governance—insider or employee sovereignty contingent on the company staying out of financial or business distress.

When company A owns shares in company B, and company A gets into distress, then it may ask B for permission to sell the B shares to raise some needed capital. This is considered something of a disgrace and is usually accompanied by promises to buy back the shares from the market when profitability returns. If a typically unrelated shareholder would not normally ask the permission of management to sell shares in the company, then those shares are called "floating shares". Ordinarily, only about 20-30% of the shares in the large companies are floating shares on the stock market. The remaining 70-80% of the shares are locked into the cross-holding pattern.

With over a majority of the shares stabilized in friendly hands, there is virtually no takeover market or market for corporate control in modern Japan. The very idea of a takeover is held in disrepute in Japan.

> The reason Japanese think this way is not because the Japanese spiritual make-up is particularly special, but because Japanese corporations are organized as aggregate bodies of corporate employees, and in effect the buying and selling of a company takes on a semblance of buying and selling a group of human beings. [Matsumoto 1991, p. 45]

Since the War, there have been only a handful of hostile takeovers in Japan and those were in small to medium-sized companies [see Kester 1991].

In the standard Western model of a market economy, market relationships between buyers and sellers are thought of as spot or auction market transactions. If the same commodity can be purchased from another seller at a lower price, then demand switches to the lower-cost supplier. In the Japanese economy, there is the rather different notion of relational contracting [see Goldberg 1980]. It is a long-term high-trust relationship with extensive communication along many other dimensions than just price and quantity. Relational contracting extends well outside the specific keiretsu groupings. Contractual partners might even exchange shares as a symbol of the long-term relationship.

In the Western model, shareholding is by itself a relationship; it makes the shareholder an "owner" of the company. If the shareholder has some other business relationship with the company, that is considered a "conflict of interest." The unrelated shareholder would be interested only in the pure profit of the firm (in the form of dividends or capital gains). A related shareholder would have a "divided loyalty"—some other economic interest in the firm aside from profit (e.g., salaries or the price paid for the products)—so the shareholder would not be a pure representative of the firm. Representatives of related shareholders on the board would not

be “independent” directors. Related parties, such as workers, managers, suppliers, or customers, are external to the firm. The shareholders are thought of as the “members” of the firm whose interests (profit) define the goal or objective of the firm to be maximized.

In the Japanese firm, the shareholders are not sovereign. The returns on the shares have more of the characteristics of debt or preferred stock [see also Gerlach 1989, p. 157; Matsumoto 1991, p. 6; Dore 1987, p. 114].

> Against this pattern as it has developed in the West, the common stock shareholder of the Japanese company is more in the position of a preferred shareholder in a Western company. Having made an investment that is at risk, the shareholder is entitled to a return on that investment. Therefore dividends are paid, but not as a percent of earnings but as a percent of the par value of shares in the company. [Abegglen and Stalk 1985, p. 184]

In the Japanese model, shareholding is usually symbolic of some other business relationship.

> Unlike Western institutional shareholders, which invest largely for dividends and capital appreciation, Japanese institutional shareholders tend to be the company's business partners and associates; shareholding is the mere expression of their relationship, not the relationship itself. [Clark 1979, p. 86]

The board of directors would typically be made up of representatives of the related parties—firstly the managers and other long-term employees and then the banking and insurance partners, the main customers, and the suppliers.

The basic difference between shareholding as the relationship, and shareholding as being only symbolic of a relationship can be explained using the distinction between property rights and rights that are attached to a functional role (which are sometimes called “personal rights”). In the standard Western corporation, the control and current income rights attached to the common voting shares are considered to be property rights that may be bought and sold freely between legal parties. In the model democratic firm, the control and current income rights are personal rights attached to the functional role of working in the firm (so that the insiders would be self-governing in their work and would reap the positive and negative fruits of their labor). Board members should be representative of those who have this functional role. When a business entity is in a web of relational contracts, then the exact boundaries of the firm become

vague. Thus the presence of a few representatives of relational partners on the board is broadly within the bounds of the notion of a democratic firm. The insiders are represented on the board through the presence of the senior and retired managers (although there is no formal machinery for these board members to be elected by, or held accountable to, the insiders).

> Although there is some danger of oversimplification in making such a statement, the most direct description of this situation is that Japanese corporations 'are controlled by, and exist for, their employees'. Japanese corporations are thus united bodies of corporate employees. [Matsumoto 1991, p. 27]

> On the basis of analyses made on control structures within Japanese corporations, Takanori Nishiyama claims that the Japanese economic system has already been transformed into a system that might called 'laborism', where corporations are under the control of workers, or, perhaps, supervisory workers. [Matsumoto 1991, p. 20]

The connection between board membership and representation of those having the functional role of being "in the firm as a community" realizes part of the basic structure of the democratic firm [see Dore 1987 for the model of the Japanese firm as a community].

If the legal shell of the joint stock company is used to package a democratic firm, then the ownership of the shares must be attached to the functional role of working in the firm. Share ownership by insiders, however, has not been an important feature in the Japanese model (or the German model where employees are represented by law on the supervisory boards independent of share ownership). While major relational partners may own corporate shares and be represented on the board, the insiders in the large Japanese firms have usually not been major shareholders. If the insider or employee sovereignty of the Japanese model is to be institutionalized in a formal corporate structure, then insider share ownership using something like the Employee Stock Ownership Plan or ESOP may well be a possibility.

Another important aspect of the Japanese model is the labor system of lifetime employment. The so-called "employment relation" becomes the ultimate example of relational contracting—the identification of the worker with the firm. High trust is developed between workers and managers by managers exercising the self-restraint to not use their power to enrich themselves and to take advantage of the workers. On their side, the workers choose to be cooperative without feeling that they are exposing themselves to being opportunistically exploited by self-aggrandizing managers. That mutual cooperativeness in the high trust management-labor

relationship is the basis for the high X-efficiency of the Japanese firm [see Leibenstein's work collected in Button 1989]. That stands in sharp contrast with the American model where managers and employees are both seen as outsiders devoted to their own self-interest who must be "monitored" by the "owners"—the unrelated (and thus absentee) shareholders—to protect "the interests of the firm."

A simple cooperative action game (of the prisoners' dilemma variety) can be used to illustrate the difference between a company based on low trust with individual optimization and a company based on high trust, identification with the firm, and cooperation [see Leibenstein 1984, 1987 for the best treatment of this approach to the Japanese firm]. The players A and B could be thought of as managers and workers (or as any two groups in the firm) who need to cooperate together to increase the X-efficiency of the firm.

		Payoff to Player B	
	Payoff to Player A, B	Cooperate	Not Cooperate
Payoff to Player A	Cooperate	\$A+1, \$B+1	\$A-2, \$B+2
	Not Cooperate	\$A+2, \$B-2	\$A, \$B

Typical Cooperative Action Game

If each player chooses the individualistic not-cooperate action, then they receive the non-cooperative payoff of \$A and \$B. If they cooperate, then the total results increases by (say) 2 which we assume is evenly split to arrive at the cooperative payoffs of \$A+1 and \$B+1. But if one party opportunistically chooses the individualistic non-cooperative option when the other party acts cooperatively, then the total result remains the same (no increase without cooperation of parties) and two units are shifted to the rent-seeking party. The strategy pair (Not Cooperate, Not Cooperate) is the dominant equilibrium solution. No matter which strategy one player chooses, it will always pay the other player to take the non-cooperative action. But that non-cooperative outcome (\$A, \$B) is dominated by the cooperative outcome (\$A+1, \$B+1) which is better for both parties.

This prisoners' dilemma-type game is a generic representation of the countless cooperative action situations that occur continuously and at every level in the complex multi-person productive operation of a firm. In each given situation, effective monitoring and enforcement might be applied at a certain cost to change the payoffs and thus assure the cooperative outcome. But this "external" neo-classical solution is hardly feasible over the countless cooperative action situations that occur in a complex team operation. The Japanese company uses the alternative "internal" solution of developing a corporate culture of cooperation that leads to a virtuous circle or high level self-reinforcing equilibrium. This cooperative culture is feasible in the Japanese

company because the managers and workers are the members of the community and will reap the joint fruits of their cooperative efforts.

The following table summarizes these and many other areas of contrast between the American or Anglo-American model company and the Japanese model company [see Clark 1979, or Dore 1987 for similar tables]. It should be remembered that a comparison is made between models. As was previous noted, the large American companies function somewhat differently in practice.

Characteristic	**Anglo-American Model Company**	**Japanese Model Company**
Residual Claimants	Shareholders	Long-term member-workers
Entity	Property of shareholders	Community of members
Company board	Representatives of shareholders	Council of community elders with representatives of major related organizations (e.g., main bank)
Role of management	Agents of shareholders	Senior leaders of community
Management self-interest	Assumption of individual maximization of reputation in managerial labor market (non-cooperative strategy)	Assumption of cooperative leadership to make company prosper and maximize reputation within firm (cooperative strategy)
Monitoring of management	By board and ultimately by shareholders and market for corporate control	By management elders/peers and bank representatives on board
Role of shareholders	Owners	One of stakeholder groups along with suppliers and customers
Shareholder interest	Maximization of company profit (assumption that shareholders are normally unrelated to company)	Shareholding often symbolic of business relationship, the latter being the primary economic interest. Little attention to unrelated floating shareholders.
Transactions with related shareholders	To be controlled by independent directors or forbidden by "firewall" regulations	Normal part of relational contracting where shareholding is symbolic of business relationship
Dividends	Paid-out share of profits	Quasi-fixed like dividends on preferred stock
Role of long-term workers	Contractual employees	Members of community
Worker interest	Assumption of individual maximization (non-cooperative strategy)	Assumption of cooperative action to make company prosper (cooperative strategy)
Organized worker representation	Trade union (adversary relation based on workers versus company)—your jam or my jam	Enterprise union (oppositional relation loyal to company)—our jam today or our jam tomorrow
Source of labor efficiency	Allocative efficiency based on labor mobility	X-efficiency based on labor immobility
Labor training	Responsibility of worker as it increases value on labor market—training for specific skills	Responsibility of company since immobility allows company to benefit—training for general skills
Job definition	Extensively specified job definition to limit opportunism	Job flexibility and low monitoring based on worker commitment to company
Wage determination	Rate for job determined by market	Rate determined by seniority and assessed merit
Response to	Reduce employment and other direct costs to	Maintain employment, reduce hours, and

secular decline	maintain profits	retrain workers for new product lines
Relations to suppliers and customers	Auction market contracting based on assumption of mobility and exit leading to greater allocative efficiency	Relational contracting based on assumption of immobility and voice leading to greater X-efficiency

The Japanese company goes a long ways towards showing how a democratic firm might operate in practice. It puts to rest the idea that the Anglo-American model is the only model that can succeed in a modern economy, and it shows that a more democratic model may also be superior in terms of efficiency and competitiveness in addition to the first principles of getting the fruits of your labor and democratic self-determination.

Conclusion

Economic Democracy as a Third Way

An *economic democracy* can be roughly defined as a mixed market economy where the predominance of economic enterprises are democratic worker-owned firms (see Dahl, 1985). It differs from capitalism primarily in the abolition of the employment relation. The relationship between the worker and the firm is membership, an economic version of "citizenship," not employment. It differs from (state) socialism in that the firms are democratic worker-owned firms, not government-owned firms, and the firms are interrelated by a market economy with various degrees of macro-economic guidance furnished by the government.

Economic democracy is a genuine third way that is structurally different from classical capitalism and socialism. It can be viewed as an outcome of evolution starting either from capitalism or from socialism.

A capitalist economy within a political democracy can evolve to an economy of economic democracy by extending the principle of democratic self-determination to the workplace. It would be viewed by many as the perfection of capitalism since it replaces the demeaning employer–employee relationship with ownership and co-entrepreneurship for all the workers.

A state socialist economy can evolve into an economic democracy by restructuring itself along the lines of the self-management socialist tradition. It would be viewed by many as the perfection of socialism since the workers would finally become masters of their own destiny in firms organized as free associations of producers.

There is more to an economy and certainly more to a socio-political system than the form of economic enterprise. Yet we have intentionally focused only on the firm—not on broader economic or social questions. This has been quite feasible due to the traditional neglect of the firm in both capitalist and socialist economic theory. In neo-classical economics, the firm is seen as a technologically specified black-box or, from the institutional viewpoint, as a piece of property, a capital asset—not a community of work qualifying for democracy. Socialist theory, from Marx onwards, has been notoriously silent about the "socialist firm."

First Principles

The Labor Theory of Property

The democratic firm is grounded on first principles, the twin pillars of the labor theory of property and democratic theory.

The analysis began by setting aside what we called the "Fundamental Myth" that residual claimancy is part of the ownership of the means of production. The whole question of the ownership of the new assets and liabilities created in production (which accrue to the residual claimant) has been suppressed in capitalist economics because those assets and liabilities were taken as part of the already-existing ownership of the means of production. By simply considering the case where the physical means of production are rented or leased, we can see that the residual claimant appropriating those new produced assets and liabilities could be different from the owner of the means of production. The ownership of the capital used in production only determines to whom the residual claimant is liable for the used-up services of capital.

Having conceptually separated the residual claimant's role from the capital supplier's role, we then turned to the normative question of who ought to appropriate those new assets and liabilities created in production. We applied the standard juridical principle that legal responsibility should be assigned to the *de facto* responsible party. Regardless of the causal efficacy of the services of capital and land, only the intentional actions of persons can be *de facto* responsible for anything. Thus the people involved in a productive enterprise, the managers and workers, are *de facto* responsible for producing the outputs and for using up the inputs. By the standard juridical principle, they should therefore have the legal liability for the used-up inputs and the legal ownership of the produced outputs, i.e. they ought to be the residual claimant.

This argument is none other than the old "labor theory of property" usually associated with John Locke restated in modern terms using the language of jurisprudence. The argument also makes sense out the peculiar dual life that Locke's theory has always had; it is taken as the basis of private property as well as the basis for a radical critique of capitalist production. We found that there was no contradiction in that outcome. Labor is the natural foundation for private property appropriation, and capitalist production—far from being "founded on private property"—denies that labor basis for appropriation. In that sense, it is private property itself that calls for the abolition of capitalist production (i.e. the employment relation) so that people will always appropriate the positive and negative fruits of their labor.

This same idea occurs in a rather oblique form in the socialist tradition as the "labor theory of value." The labor theory of value has always had two rather different interpretations: labor as a measure of value, and labor as a "source" of value or, rather, of what has value. The measure version of the labor theory of value has been a complete failure—and, in any case, it had no interesting normative implications. Thus capitalist economists want to stick to the measure version of the theory (since it is a failure) and state socialists also want to stick to it (since it has no implications against state socialism). The alternative source version of the "labor theory of value" is the labor theory of property disguised in "value talk." It has direct implications against

capitalist production in favor of the democratic firm, and it has direct implications against state socialism in favor of the alternative tradition of democratic self-managed market economy.

The end result of this reformulation of the basic issues is that a new "villain" emerges, the employment relation. The villain of capitalist production is not private property or free markets (far from it), but the whole legal relationship of renting, hiring, or employing human beings. It was the employment relation that allowed some other party to hire the workers so that together with the ownership of the other inputs, that party would be the residual claimant.

An old inalienable rights argument, originally developed against the self-sale contract, was applied against the self-rental contract, the employment contract. As illustrated by the example of an employee obeying an order to commit a crime, *de facto* responsible human actions, i.e. labor services, are not factually transferable—so the legal contract to transfer labor is natural-law invalid.

Instead of abolishing the employment relation, state socialism nationalized it. Substituting state ownership of slaves for private ownership would not abolish slavery, and substituting employment of the workers in the name of the "public good" for employment in the interest of "private greed" does not abolish the employment, hiring, or renting of workers.

Only the democratic firm—where the workers are jointly self-employed—is a genuine alternative to private or public employment.

Democratic Theory

The residual claimant has the direct control rights over the production process. The application of democratic principles to work has thus been clouded by the Fundamental Myth that residual claimancy is part of the ownership of the means of production. As the leasing movement in the former Soviet Union discovered, the renting or leasing of capital separates the direct control rights over production from capital ownership.

The ownership of capital only gives the owner an indirect control right, a right to say "No, you may not use the capital," the right to make the worker into a trespasser. To acquire the direct control and authority over workers, the capital owner must also be an employer. Indeed, a "capitalist" is a capital owner who is also an employer. Without the employment relation, a capital owner is not a "capitalist" but is only a capital supplier to worker-managed firms.

The same logic holds when the capital owner is a corporation. Of course, the shareholders have the control rights over the *affairs of the corporation*. But it is the employment contract or its opposite, a capital leasing contract, that determines whether the "affairs of the corporation"

include authority over the workers in the production process (when labor is hired in) or simply the leasing out of capital to the workers or some other party undertaking the production process.

Traditional liberalism's inability to significantly raise the question of applying democratic principles to the workplace (see any standard economics text) has been fostered by the public/private distinction. Democracy governs in the "public" sphere while property supposedly governs in the private sphere. But that misinterprets the rights of property. Property only includes the indirect control right, say, to make a worker a trespasser. Authority or direct control over the worker only comes from the employment relation. Property is only relevant as giving the bargaining power to make the employment contract rather than the capital leasing contract.

Capitalist liberalism has also misrepresented the whole question of democratic or non-democratic government in the public sphere as a question of consent or coercion. That is superficial intellectual history (see Ellerman, 199219921992) which allows capitalist production to be presented as analogous to public democracy since both are based on consent. Marxists typically miss the point by questioning whether or not capitalist production is "really" voluntary. The real point is that there is a whole liberal tradition of apologizing for non-democratic government based on consent—on a voluntary social contract alienating governance rights to a sovereign, e.g. the Hobbesian *pactum subjectionis*. The employment contract is the modern limited workplace version of that Hobbesian contract.

The critique of capitalist production is a critique of the voluntary employment contract, the individual contract for the renting of people and the collective Hobbesian *pactum subjectionis* for the workplace. The critique is not new; it was developed in the Enlightenment doctrine of inalienable rights. It was applied by abolitionists against the voluntary self-enslavement contract and by political democrats against the voluntary contractarian defense of non-democratic government.

Today's economic democrats are the *new abolitionists* trying to abolish the whole institution of renting people in favor of democratic self-management in the workplace.

It might be noted that we have purposely refrained from emphasizing the efficiency arguments customarily used in favor of the democratic firm. Both capitalism and state socialism suffer from the motivational inefficiency of the employment relation. Thus efficiency provides the principal "practical" reason for the two-sided evolution in the direction of greater participation and democracy in the workplace.

But efficiency considerations always leave the structure of rights under-determined. If it is only efficiency that counts, then non-democratic structures can always be designed to try to *simulate* participative democratic structures (e.g. profit-sharing and participation programs in

capitalist firms). If a simulation fails, then there will always be other variations that might provide a better simulation.

Real social change, when it comes, is driven by ideas and principles, not simply by "efficiency considerations." Absolute government as well as slavery sagged after centuries of inefficiency, but it was their illegitimacy in the light of first principles that drove the democratic revolutions and the abolition of slavery in the eighteenth and nineteenth centuries. Thus we have focused on the basic principles that drive towards economic democracy.

The Democratic Firm

The democratic firm was defined by showing how the conventional bundle of ownership rights is restructured and reassigned so as to satisfy democratic theory and the labor theory of property.

Democratic theory is implemented in an organization by treating the ultimate direct control rights, i.e. the voting rights to elect the board, as personal rights assigned to the functional role of being governed.

The labor theory of property is implemented by assigning the rights to the produced outputs and the liabilities for the used-up inputs whose net value is the residual or net income to the functional role of working in the enterprise.

Thus the twin pillars of democratic theory and the labor theory of property imply that the two membership rights, the voting and profit rights, should be assigned as personal rights to the functional role of working in the firm. Since the membership rights become personal rights, the democratic firm becomes a democratic social institution rather than the traditional piece of property.

The remaining rights to the net value of the corporate assets and liabilities remain property rights represented in the internal capital accounts. The individual accounts represent property originally put in by the workers (e.g. membership fees) and the net value of the fruits of their labor reinvested in the firm.

Restructured Ownership Bundle in a Democratic Firm

Membership rights (#1 & #2) assigned as personal rights to worker's role.	1. Voting rights (e.g., to elect the Board of Directors), 2. Net income rights to the residual, and
Net asset rights (#3) are property rights recorded in internal capital accounts.	3. Net asset rights to the net value of the current corporate assets and liabilities.

The system of internal capital accounts is not an afterthought. It is an integral part of the structure that corrects the property rights deficiencies of "social property" involved in the self-managed firm.

Worker-owned Companies in the USA and Europe

The best examples of democratic firms in the world today are the worker cooperatives in the Mondragon group of the Basque country in Spain. One of their important social inventions is the system of internal capital accounts which they pioneered over the last quarter century.

Another major example of worker ownership in the West is the employee stock ownership plan or ESOP developed in the United States over the last 20 years and more recently in the United Kingdom. The ESOPs have been heavily promoted in America with tax advantages so that there are now about 10,000 ESOPs covering about 10 per cent of the workforce. The real innovation of the ESOP is allowing the workers to use the leverage of the company to take out a loan to buy stock, and then to have the company pay back the loan as a tax deductible expense. The ESOP also uses a trust to keep the worker shares from being individually salable and thus it provides ownership stability that is important to get the long-term commitment of the workers and managers to the firm.

The lessons of the Mondragon-type worker cooperative and of the democratic ESOP were combined in a new model, the *hybrid democratic firm,* which could be implemented in other countries of the East and West.

Employee Sovereignty in the Japanese Firm

The Japanese-model firm is quite important in the history of the development of the democratic firm because it demonstrates that a firm with employee sovereignty (although without democratic worker ownership) can not only survive but prosper in the modern economy. Instead

of being inefficient, it has set the standards in productivity and quality for the rest of the world to follow.

The Democratic Firm and East/West Convergence

In the West, democracy will not forever remain alien to “what people do all day long.” Even without explicit worker ownership, many firms in the capitalist world (including Japan) are evolving in the direction of recognizing the workforce as the primary stakeholders or “owners” of the firm. The ESOPs and other worker-owned companies are only the tip of the iceberg in this long-term trend in the direction of the democratic firm.

In the world of transitional economies, centralized state socialism is giving way to social market economies where worker ownership is a major form of ownership.

The East and West are thus showing signs of convergence towards the common ground of the democratic firm.

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[*] The findings, interpretations, and conclusions expressed in this paper are entirely those of the author and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to the members of its Board of Directors or the countries they represent.