THE LABOR-MANAGED FIRM

In previous work, Gregory K. Dow created a broad and accessible overview of worker-controlled firms. In his new book, *The Labor-Managed Firm: Theoretical Foundations*, Dow provides the formal models that underpinned his earlier work, while developing promising new directions for economic research. Emphasizing that capital is alienable while labor is inalienable, Dow shows how this distinction, together with market imperfections, explains the rarity of labor-managed firms. This book uses modern microeconomics, exploits up-to-date empirical research, and constructs a unified theory that accounts for many facts about the behavior, performance, and design of labor-managed firms. With a large number of entirely new chapters, comprehensive updating of earlier material, a critique of the literature, and policy recommendations, here Dow presents the capstone work of his career, encompassing more than three decades of theoretical research.

Gregory K. Dow has been Professor of Economics at Simon Fraser University since 1995 and chaired the economics department during 2001–2006. He has held previous academic positions at the University of Alberta and Yale University. His articles have appeared in the leading journals of the profession, including the *American Economic Review* and the *Journal of Political Economy*. His previous book *Governing the Firm: Workers' Control in Theory and Practice* was published by Cambridge University Press in 2003.

The Labor-Managed Firm

Theoretical Foundations

GREGORY K. DOW
Simon Fraser University, British Columbia

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom

One Liberty Plaza, 20th Floor, New York, NY 10006, USA

477 Williamstown Road, Port Melbourne, VIC 3207, Australia

314–321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre,
New Delhi – 110025, India

79 Anson Road, #06–04/06, Singapore 079906

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of
education, learning, and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: www.cambridge.org/9781107132979
DOI: 10.1017/9781316459423

First published 2018

Printed in the United States of America by Sheridan Books, Inc.

A catalogue record for this publication is available from the British Library.

Library of Congress Cataloging-in-Publication Data
Names: Dow, Gregory K., 1954– author.
Title: The labor-managed firm : theoretical foundations / Gregory K. Dow, Department
of Economics, Simon Fraser University, Burnaby, British Columbia.
Description: Cambridge ; New York : Cambridge University Press, [2017] | Includes
bibliographical references and index.
Identifiers: LCCN 2017009674 | ISBN 9781107132979 (alk. paper)
Subjects: LCSH: Industrial management – Employee participation. | Industrial
organization (Economic theory)
Classification: LCC HD5650 .D643 2017 | DDC 338.6/9–dc23
LC record available at https://lccn.loc.gov/2017009674

ISBN 978-1-107-13297-9 Hardback

For Margaret

"This model will be a simplification and an idealization, and consequently a falsification. It is to be hoped that the features retained for discussion are those of greatest importance in the present state of knowledge."

– Alan Turing, 1952 (quoted in Andrew Hodges, Alan Turing: The Enigma*, Vintage, 2014, p. 546)*

Contents

Figures

Preface

In every generation, social critics raise questions about the prevailing economic order. One recurring set of questions involves the organization of production. Why are there bosses? Why are the rewards from firms distributed so unequally? Can work be made more humane? If democracy is good for political systems, why is it not good for economic systems? Why are corporations designed to encourage the pursuit of profit, when this often conflicts with the interests of workers, consumers, and communities?

Why are firms usually controlled by capital suppliers rather than labor suppliers? I have been intrigued by this question for more than forty years. It is an easy question to ask but a hard one to answer. I will sketch my answer in Chapter 1 and elaborate on it throughout the book. Here I want to say how this book arose and thank some of the people who made it possible.

Over the past several decades I have published numerous journal articles and book chapters on labor-managed firms (LMFs). Some of these writings appeared in high-profile venues, while others did not. A reader would have trouble tracking them all down and piecing together the connections among them. My publication trail also left some major theoretical gaps that needed to be filled.

My 2003 book *Governing the Firm* (GTF) surveyed some of this territory. GTF started out as a long introduction to a planned book that was intended to focus mainly on formal models. The introduction gradually evolved into a 300-page manuscript and had to stand on its own. At the time, some friends said things like “Nice book, but where’s the math?” Eventually I decided to write a book containing the kind of formal theory a professional economist would want to see. The present book is organized around the economic logic of the subject as I understand it. This has allowed me to build from the ground up while exploiting earlier publications when they became relevant to the story. Those who read GTF either before or after reading this book will benefit from seeing both, but they are two different animals, and the present volume is self-contained.

A few remarks on math and economic theory may be useful for potential readers. I have not made any compromises with regard to theoretical content—nothing has been watered down. But any professional economist comfortable with applied microeconomic theory will be able to follow the reasoning, as will graduate students who have taken the usual required courses in micro theory, game theory, and the economics of information. Advanced undergraduates should understand much of what is going on. Several chapters have no math at all, and the introductory and concluding sections of the technical chapters explain the economic arguments in words. Readers who prefer to skim through the math should be able to grasp the overall logic of the book by focusing on these verbal sections.

In a narrow sense, this book took eighteen months to write. In a broader sense, it took about fifteen years, the period since the completion of *Governing the Firm*. But in the largest sense, it took about thirty-five years, the length of my career as an economist. Over such periods one accumulates countless intellectual debts, and I cannot possibly thank everyone who has influenced this book. The people mentioned here are not responsible for the uses I have made of their ideas, which may differ considerably from what they had in mind. These acknowledgments are roughly in chronological order, although some important early individuals will not be thanked until near the end.

Murat Sertel shaped my thinking about membership markets for labor-managed firms in the 1980s and early 1990s. Sadly, we never met, so Sertel's influence occurred through his books and journal articles. I often felt that we were brothers in arms, battling an array of misguided theoretical notions about LMFs. Sertel's ideas feature prominently in Chapters 3–5.

Louis Putterman and I met in the early 1980s when I was at Yale and Louis was at Brown University, where he remains today. We shared interests in labor-managed firms and the theory of the firm more generally. In the 1990s we coauthored several working papers, journal articles, and book chapters surveying explanations for the rarity of LMFs. Echoes of this joint work can be heard in Chapter 8 of the present volume.

Gil Skillman and I received PhDs in economics from the University of Michigan a few years apart, but we did not meet until the mid-1980s when Gil was at Brown and I was at Yale. We found that we shared a critical view of the capitalist firm, among other things. We began to work together on the theory of the labor-managed firm in 1992, and this collaboration eventually led to the material presented in Chapter 12.

Oliver Williamson's work on transaction cost economics also shaped my thinking. Ollie might be surprised that I would say this, because we had pointed debates in print in the 1980s and 1990s. However, although I was unable to accept Ollie's overall intellectual program, I plundered his trove of economic concepts (incomplete contracts, opportunism, asset specificity, and so on). The results can be found in Chapters 14 and 15.

My first encounter with an economist who cared about the lack of democracy in capitalist firms occurred in my undergraduate years, at a public lecture given by Samuel Bowles in the early 1970s. I came to know Sam and his coauthor Herb Gintis in the late 1980s and early 1990s. Their joint research on contested exchange helped stimulate my interest in how firms could function without legally binding contracts. This notion plays a large role in Chapters 16–18. I also found their arguments about the financial problems facing labor-managed firms important and enlightening.

A less obvious influence came from Uskali Mäki, a philosopher of science I met in the early 1990s. Uskali was well read on the subject of transaction cost economics and had taken an interest in my debates with Williamson. His work, and in particular his whole-hearted commitment to philosophical realism, was a breath of fresh air in a period when realism was under heavy fire. This perspective colors my methodological approach throughout the book.

I supervised Xiao-yuan Dong's PhD work at the University of Alberta in the early 1990s. We coauthored two journal articles at that time; one appeared in the *Journal of Political Economy* and the other in the *Journal of Comparative Economics*. Both were on Chinese collective farming, and the key ideas for both papers came from Xiao-yuan. These projects helped me think about mutual monitoring among workers and the role of repeated games in firm organization.

Another friend who guided me along the path to this book was Bo Gustafsson. With Sam Bowles and Herb Gintis, Bo put together a conference on firm organization at the Swedish Collegium for Advanced Study in the Social Sciences (SCASSS) in June 1991. This led to an invitation for Gil Skillman and me to visit SCASSS in the fall of 1992. During that visit, Bo asked me to give a talk on labor-managed firms. I decided to discuss economic explanations for the rarity of LMFs. This led directly to my work with Louis Putterman in the late 1990s, my explanatory efforts in *Governing the Firm* in 2003, and eventually to the present book.

I have benefitted considerably from the work of a number of other authors. Avner Ben-Ner stands out for his empirical research, along with his theoretical insights into the dilemmas facing labor-managed firms. Bentley MacLeod influenced my thinking about LMFs and the application of game theory to labor markets. John Bonin provided advice on several of my papers, and I have learned a great deal from his writing. Other people who have influenced my views on labor-managed firms include Saul Estrin, Derek Jones, John Pencavel, Virginie Pérotin, Stephen Smith, and Jan Svejnar. I also want to mention the work of several people on "shared capitalism" and other hybrid forms of organization; these include Margaret Blair, Doug Kruse, Joseph Blasi, and Richard Freeman.

Over the past fifteen years, I have often taught a seminar course on labor-managed firms for fourth-year economics majors at Simon Fraser University. I am grateful to all of the students who took this course for their participation in the class discussions, which sharpened my thinking on many of the issues addressed in the book.

In my own student days I was fortunate to have some exceptional teachers, and I want to thank two of them. As an undergraduate, my exposure to economics was limited to a principles course and a few courses in economic history and the history of thought. These were interesting, but I did not see them as having special relevance for my career path. My initial contact with intermediate microeconomic theory came during my first semester in the Master of Public Policy program at the University of Michigan in 1975.

The instructor for this course was William J. (Jim) Adams. Through Jim's course I saw that economics provided a theoretically coherent way of thinking about interesting questions. Jim's teaching style was friendly, enthusiastic, and inspiring (this is not hype—he has university-wide teaching awards to prove it). A year later, I took Jim's course in industrial organization, which featured a long reading list of journal articles and showed me how economists think, write, and argue. More than any other person, Jim led me to pursue a PhD in economics. Thanks, Jim.

The person who bears the greatest responsibility for turning me into an economic theorist is Ted Bergstrom. I first met Ted in a graduate course that was nominally about government expenditure but really was a course on microeconomic theory where public goods and free rider problems were sometimes mentioned. My second course from Ted was called something like "Advanced Micro Theory II." Here I heard about game theory and learned that equilibria are not always Pareto efficient. Through Ted's courses, I also found that I enjoyed playing with formal models. Thanks, Ted.

My years as a graduate student in Ann Arbor were literally life changing, and not just because I discovered my career path and occasionally thought about labor-managed firms. In the fall of 1977, I met Margaret Duncan. Since then, we have shared life, the universe, and everything. Margaret strongly encouraged me to write this book. Thanks to Margaret for that, and for all the love along the way.

No author produces a book alone. I am grateful to Karen Maloney of Cambridge University Press for supporting this project at an early stage when its goals were modest and its structure was murky. I also want to extend thanks to Stephen Acerra, Kris Deusch, Sathish Rajendran, Lois Tardío, and Kaye Tengco for their assistance during the production process. Haiyun Kevin Chen, a PhD student in economics at Simon Fraser University, created the graphs.

Several people provided feedback on one or more chapters, including Ran Abramitzky, Gabriel Burdín, John Pencavel, Virginie Pérotin, Louis Putterman, Clyde Reed, and Gil Skillman. The prize goes to Gil, who read every chapter in draft and commented extensively. I deeply appreciate Gil's heroic efforts to improve my logic and exposition. I tried to respond conscientiously to the comments I received, although the limits of time and space made it impossible to do this in every case. Needless to say, I bear sole responsibility for all errors, omissions, and opinions.

At an institutional level, I want to thank the Department of Economics at Simon Fraser University, which has been my academic home since 1995, and the chairs, deans, and other administrators who provided study leaves that enabled me to think and write. The Social Sciences and Humanities Research Council of Canada has supported my research for many years. Other funders will be acknowledged in the relevant chapters.

Although much of the material in this book is published here for the first time, I am grateful for permission to use previous journal articles and book chapters. Elsevier gave permission to use "Control Rights, Competitive Markets, and the Labor Management Debate," *Journal of Comparative Economics* 10(1), March 1986, 48–61; "The Function of Authority in Transaction Cost Economics," *Journal of Economic Behavior and Organization* 8(1), March 1987, 13–38; and "On the Neutrality of Asset Ownership for Work Incentives," *Journal of Comparative Economics* 28(3), September 2000, 581–605. The American Economic Review gave permission to use "Why Capital Hires Labor: A Bargaining Perspective," *American Economic Review* 83(1), March 1993, 118–134. Springer gave

permission to use “Replicating Walrasian Equilibria Using Markets for Membership in Labor-Managed Firms,” *Economic Design* 2(2), November 1996, 147–162; and “Partnership Markets with Adverse Selection,” *Review of Economic Design* 18(2), June 2014, 105–126. John Wiley and Sons gave permission to use “Collective Choice and Control Rights in Firms” (coauthored with Gilbert L. Skillman), *Journal of Public Economic Theory* 9(1), February 2007, 107–125. The University of Toronto Press gave permission to use “Worker Participation and Adverse Selection,” chapter 10 in Gregory K. Dow, Andrew Eckert, and Douglas West, eds., *Industrial Organization, Trade, and Social Interaction: Essays in Honour of B. Curtis Eaton*, University of Toronto Press, Toronto, 2010, 203–222.

No author would accomplish much without readers, so my final thanks go out to all those who take the time to read this book. I hope you will find something of value here.