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A POLITICAL AND ECONOMIC CASE FOR THE DEMOCRATIC ENTERPRISE

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1. INTRODUCTION

We consider two reasons why firms should be owned and run democratically by their workers. The first concerns *accountability*: Because the employment relationship involves the exercise of power, its governance should on democratic grounds be accountable to those most directly affected. The second concerns *efficiency*: The democratic firm uses a lower level of inputs per unit of output than the analogous capitalist firm.[1]

These claims are not obvious. If labor is transferred to an employer through a voluntary exchange in a competitive market, how can the employment relationship exhibit a well-defined power relationship? If the democratic firm is more efficient, what prevents the capitalist from replicating it and reaping the profits? And if capitalist firms cannot capture the efficiencies of democratic firms, why have democratic firms not simply outcompeted capitalist firms?

The existing theoretical literature on the democratic firm has strongly argued against its viability. Ward (1958), Domar (1966), and Vanek (1970) modeled the worker-controlled firm as maximizing net revenue per worker rather than profits, and proved that such firms would hire too few workers and, furthermore, would respond perversely to price changes, decreasing output when prices increase and vice versa. Meade (1972) showed that different, but equally inefficient results follow if the

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1. See Elster and Moene (1989) for a broader set of criteria.

democratic firm is prohibited from adjusting its employment in response to economic conditions. Furubotn and Pejovich (1974), and later Jensen and Meckling (1979), showed that the absence of competitive capital markets would lead democratic firms to allocate investment resources inefficiently. In particular, if workers have no ownership rights to the capital stock when they leave the democratic firm, such firms will systematically underinvest, favoring the full distribution of potential investment funds to worker-members.

These studies have suffered from serious methodological biases, however, treating the capitalist firm as embedded in an environment free from market failure, and the democratic firm as embedded in an environment of contrived restrictions leading to systematic inefficiencies. Each of the above perversities of the democratic firm arises from some restriction placed on the democratic firm limiting its ability to achieve optimal allocations, but not entailed by any general prerequisites of democratic governance. Dow (1986, 1992), Dreze (1976, 1989), and others have pointed out that where market failures are absent and both forms are equally unrestricted, the two institutional forms are indistinguishable in their behavior. Indeed, this is the gist of Paul Samuelson's (1957) provocative remark that in "a perfectly competitive model it really does not matter who hires whom," since an economy of workers renting machines is indistinguishable from an economy of capitalists owning machines and hiring workers.

A more even-handed treatment of the capitalist versus the democratic firm identifies the market failures that *both* types of firms face and then analyzes their comparative performance in handling these market failures.[2] We here follow such a strategy, identifying failures in labor and capital markets inherent in all market economies, to which capitalist and democratic firms can be expected to respond in systematically different ways.

Our approach differs from the existing literature on the democratic firm primarily in that we address problems of motivation, incentives, discipline, malfeasance, and opportunism. Surprisingly, these issues are absent in most theoretical treatments by economists, yet many consider these concerns central to the evaluation of governance structures and property rights. More technically, our approach focusses on agency problems. An agency problem exists when a principal *A* cannot costlessly control the behavior of an agent *B*, but would like *B* to take some action that *B* would otherwise not undertake. The market failures that differentiate the performance of the democratic and capitalist firm arise because of agency problems in labor and capital markets.

2. We say a "market failure" occurs when uncoordinated market interactions lead to results that are inferior by comparison to some other technically feasible outcome.

In addition to realism, our focus on agency problems enjoys two advantages unavailable to approaches that abstract from these issues. First, our focus on the agency problems associated with the regulation of labor intensity, the so-called labor discipline problem, permits a precise definition of the concept of the "power" of employers over workers in a competitive capitalist economy. This concept of power in turn motivates our claim that on democratic grounds firms ought to be governed by their workers.

Our concept of power is as follows: agent *A* has power over agent *B* if, by imposing or threatening to impose sanctions on *B*, *A* is capable of affecting *B*'s actions in ways that further *A*'s interests, while *B* lacks this capacity with respect to *A*. Thus, the advantageous and asymmetric exercise of sanctions is a sufficient condition for the existence of a power relationship.

We use this concept to advance specifically democratic criteria for the evaluation of the organization of the firm and to demonstrate the superior efficiency characteristics of the democratic firm. Neither the political nor the efficiency argument can be sustained in a framework, such as the standard neoclassical model, that ignores agency problems. Indeed, the elimination of agency problems by assumption, typical of much of the literature on worker self-management, reduces the case for the democratic firm to the curious claim that it would mimic the capitalist firm. But if, as this view implies, the political structure of the enterprise is politically noncoercive and economically irrelevant, the reasons for preferring democratic firms over their capitalist counterparts must be sought elsewhere. Neither democratic nor efficiency arguments would be germane.

Second, by providing a unified treatment of agency problems arising in labor and capital markets, we can assess the strengths and weaknesses of the democratic firm more adequately than when labor and capital markets are treated in isolation or when general equilibrium approaches that abstract from agency problems are adopted. In particular, we can offer a coherent explanation of the failure of the democratic firm to outcompete its capitalist counterparts despite its efficiency advantages, and we can analyze what we believe to be the major weakness of the democratic firm: its tendency to engage in insufficient levels of risk-taking and innovation.

The efficiency gains associated with the democratic firm arise from three sources, all related to market failures arising from the employment relationship and the problem of labor discipline: (1) a correct social, rather than private, accounting of the costs of regulating the intensity of labor and, consequently, an optimal mix of monitoring costs and wage incentives; (2) an increased effectiveness of monitoring of the labor process due to the incentive for workers to report private information on the activities of their fellow workers; and (3) improved incentive compatibility concerning the intensity of labor. The effectiveness of all three mechanisms derives from the residual claimancy status of workers. The first two operate irrespective of the size of the work team, while the third diminishes in importance as the work team becomes larger. The resulting efficiency gains may be expressed either as Pareto improvements or as increases in output per unit of input.

If agency problems in the labor market confer an efficiency advantage on the democratic firm, agency problems in capital markets place the democratic firm at a competitive disadvantage in a capitalist economy. Capitalist owners, being asset-rich, are better able to address capital market failures than are worker owners, who are generally asset-poor: Even in perfectly competitive credit markets, asset-poor workers cannot borrow funds on terms equivalent to those available to asset-rich borrowers. The result is both a competitive disadvantage for the worker-owned firm and a tendency toward a conservative response to risk. In light of the tendency of the democratic firm to undertake a suboptimal level of innovation and risk, the preferred ownership structure of the democratic firm takes account of the tendency of external ownership to promote innovation and risk-taking and of worker ownership to promote labor effort. It consequently involves a balance of internal and external residual claimancy and control.

Two limitations of our argument should be highlighted at the outset. First, we confine ourselves to a comparison of the capitalist firm and the democratic firm, thereby considering only in passing other institutional forms that might also foster greater accountability, efficiency, equality, and the formation of a democratic culture. We do not address the issue, for example, of whether a system of collective bargaining both at the firm and economy-wide level, perhaps embedded in a social democratic institutional framework, would in some respects outperform an economy with a widespread network of democratic enterprises.

Second, our capitalist and democratic firms may be considered somewhat abstract. For instance, we forgo a number of arguments in favor of the democratic firm. These include the lesser propensity of the democratic firm to engage in dangerous and environmentally destructive practices due to the fact that workers are often the most adversely impacted by these practices. The argument clearly applies to local environmental effects, but not to such global problems as greenhouse gas emissions. Further, because democratic firms are less likely to lay off workers during business cycle downturns, their effect is to stabilize the macroeconomy by dampening the successive rounds of layoffs and reductions in expenditure that generally result from any autonomous reduction in aggregate demand.[3] Democratic firms thus would be a private

3. Karl Moene, "Strong Unions or Worker Control?" in Elster and Moene (1989).

macroeconomic equivalent of government-funded unemployment insurance or any of the other built-in stabilizers.

Conversely, we abstract from a number of problems likely to confront the democratic firm. For instance, while we take account of the work monitoring costs in both types of firms, we abstract from the costs of democratic decisionmaking, expressed both in the time spent by participants and in the possible drawbacks of cyclicity in voting, unresponsiveness, and susceptibility to manipulation.[4]

2. THE EMPLOYMENT RELATIONSHIP AND CONTESTED EXCHANGE

The classical theory of contract used in most of neoclassical economics holds that the enforcement of claims is performed by the judicial system at negligible cost to the exchanging parties. We refer to this third-party enforcement assumption as *exogenous enforcement*. Where, by contrast, third-party enforcement of claims arising from an exchange is infeasible or excessively costly, the exchanging agents must themselves seek to enforce their claims. In the presence of *endogenous enforcement*, exchange is a strategic, nonanonymous relationship, in the sense that the terms of exchange depend on the power of the exchanging parties to enforce favorable outcomes and are continually subject to *de facto* respecification (Bowles and Gintis, forthcoming).

Consider agent A, who purchases a good or service from agent B. We call the exchange *contested* when B's offering possesses an attribute that is valuable to A, is costly for B to provide, yet is not adequately specified in an exogenously enforceable contract. Exogenous enforcement is absent under a variety of quite common conditions: when there is no relevant third-party (as when A and B are sovereign states), when the contested attribute can be measured only imperfectly and at considerable cost (work effort, for example, or the degree of risk assumed by a firm's management), when the relevant evidence is not admissible in a court of law (such as an agent's eyewitness but unsubstantiated experience), when there is no possible means of redress (for example, when the liable party is bankrupt), or when the nature of the contingencies concerning future states of the world relevant to the exchange precludes writing a fully specified contract. In such cases, the *ex post* terms of exchange are determined by the structure of the interaction between A and B, in particular on the strategies A is able to adopt to induce B to provide the desired level of the contested attribute and the

4. It is difficult to evaluate the importance of these omitted costs of collective decisionmaking. Hansmann (1990) contends that they are substantial in all except very simple settings, while Wittman (1989) offers a strong argument that democratic collective decisionmaking is relatively efficient.

counter strategies available to *B*. As endogenous enforcement is ubiquitous in labor markets, credit markets, and even some goods markets, we consider it to be a fundamental aspect of the capitalist economy.

Strategies typically adopted by the principal include monitoring *B*'s activities or *B*'s output, securing a bond from *B* that will be forfeited if *A* is not satisfied with *B*'s contribution, granting to *B* a profit share in *A*'s business or some other claim on the benefits or costs associated with *B*'s performance, or insisting on becoming part of the governance structure of *B*'s organization. The principal, *A*, might seek a change in technology or product design to render the contested attribute more easily monitored. In contested exchanges involving work organizations, *A*, the employer, may engage in attempts to alter the workers' attitudes toward the organization itself, toward work or authority, or their degree of solidarity with other workers, so as to minimize resistance to *A*'s desired level of work intensity.

We shall here analyze only one, but an extremely important, endogenous enforcement mechanism: *contingent renewal*. Contingent renewal obtains when *A* elicits performance from *B* by promising to renew the contract in future periods if satisfied and to terminate the contract if not.[5] For instance, a manager may promise an employee reemployment contingent upon satisfactory performance, or a lender may offer a borrower a short-term loan with the promise of rolling over the loan contingent upon the borrower's prudent business behavior. The labor market is a case in point.

An employment relationship is established when, in return for a wage, the worker agrees to submit to the authority of the employer. The worker's promise to bestow an adequate level of effort and care upon the tasks assigned, even if offered, is for the most part legally unenforceable. At the level of effort expected by management, work is subjectively costly for the worker to provide, valuable to the employer, and difficult to measure. The manager-worker relationship is thus a contested exchange in the sense just defined. The endogenous enforcement mechanisms of the enterprise, not the state, are thus directly responsible for ensuring the delivery of any particular level of labor services per hour of labor time supplied.[6]

5. Our analysis is limited to the case where enforcement problems are present on only *one side* of the exchange. By addressing cases in which one side of the exchange provides a monetary payment (the costs of monitoring of which are assumed to be zero), we set aside the more general problem of "bilateral endogenous enforcement," in which both parties to exchange exercise strategic power.
6. The analysis presented in this section is developed in Gintis (1976), Bowles (1985), and Gintis and Ishikawa (1987). Related models have been developed by Calvo (1979) and Shapiro and Stiglitz (1984). The reader will recognize its affinities with Marx's analysis of the extraction of labor from labor power.

We assume effort is costly for the worker (*B* in the above scenario) to provide above some minimal level. The employer, *A*, knows that *B* (one of a team of employees) will choose a level of effort in response to both the cost of supplying effort and the penalty that *A* imposes if dissatisfied with *B*'s performance. In particular, unless threatened with penalties, *B* will not supply more than the minimum level of effort. For simplicity we assume the sanction *A* will impose is the nonrenewal of the employment relationship; that is, dismissing the worker.

The worker seeks to avoid the sanction because the loss of the job is costly to her, in the following sense. We define the *value of employment* as the present value of the worker's expected net benefits from the job, taking account of the associated income, working conditions, and intensity of labor all summed over the expected duration of the job. The worker's fallback position, correspondingly, is the analogous present value of net benefits if she loses her job, perhaps a stream of unemployment insurance as well as the nonpecuniary benefits and cost associated with both the leisure and social stigma of joblessness, followed by the stream of net benefits of another job. We call the difference between the value of employment and the fallback position the *enforcement rent*, or the *cost of job loss*. The key observation is that *A*'s threat of dismissal is costly to the worker only if the cost of job loss to *B* is positive.

The necessity of a positive cost of job loss can be recast in terms of the wage rate, as follows: Let us define the *reservation wage* as the wage the employer would have to pay the worker to reduce the cost of job loss to zero; that is, to render the worker indifferent between holding and losing the job. A positive cost of job loss then implies that the wage exceeds the reservation wage.

Two important results follow from the fact that the employer offers a wage yielding a positive cost of job loss. First, in the resulting equilibrium, *B* provides a level of effort greater than would have been the case in the absence of the cost of job loss, so *A*'s enforcement strategy is effective (otherwise *A* would be unwilling to pay the excess of the wage over the reservation wage). Second, since the wage exceeds the reservation wage, the labor market does not clear in competitive equilibrium: Excess supply, or unemployment, exists. Thus, workers holding jobs are not indifferent to losing them, and there are workers identical to *B* either involuntarily unemployed, or employed in less desirable jobs.

As this argument hinges on the fact that the employer will choose a wage rate yielding a positive cost of job loss, and indeed such a wage will also be the competitive equilibrium wage, we should explore whether this might not be the case. In making a wage offer, the employer balances two effects working in opposite directions: An increase in the wage will enhance worker effort, raising output and firm revenues; but at the same time a wage increase is costly. The rule allowing the employer to find the wage that maximizes the firms profits is as follows: "Start with the reservation wage and then increase the wage as long as the gains from increased effort are greater than the cost of the wage increase itself." As long as the gains to a wage increase exceed the direct costs of the increase when the employer is offering the reservation wage, a higher wage rate will be offered, and the cost of job loss will be positive, sustaining our argument.

If, counter to our argument, the employer were to offer the reservation wage, the worker would do exactly as she pleases at work, putting in what we call the "whistle-while-you-work" level of effort (or on-the-job leisure, as the case may be). Under what conditions could this be optimal for the employer? Two suggest themselves. First, the worker could be *income-satiated*, so that increases or losses in income have little or no effect on her behavior; in this case the cost of job loss would be ineffective as a sanction. Second, the worker could be *unalienated*, wishing voluntarily to work at such a high pace that little increase in the intensity of labor could be induced, even by powerful incentives.

While these two conditions leading to a zero cost of job loss and hence a clearing labor market are imaginable, they are not plausible as a general rule, and in any case, the suggestion that the labor market clears is empirically contradicted not only by data on the unemployed but by evidence that the cost of job loss is indeed substantial for most workers. Further, less direct confirmation is suggested by the fact that employers regularly hire supervisors to monitor the labor process; yet this expenditure would be irrational if the employer had already conceded that there existed no means of affecting the behavior of the employee, as would be the case for either the income-satiated or unalienated worker.

3. SHORT-SIDE POWER AND DEMOCRATIC ACCOUNTABILITY

The analysis of the labor market as a contested exchange motivates our claim that in a capitalist economy the employment relationship gives the employer power over the worker, that on democratic grounds this power should be democratically accountable, and that a workplace democracy is a means toward securing this democratic accountability.

We begin by asking: Does the employer indeed have power over the worker? In a neoclassical competitive equilibrium, no sanctions may be imposed through the private actions of noncolluding agents, and hence there is no power in our sense of the term, accountable or otherwise. Prices in this model implement each agent's constrained optimum and simultaneously eliminate excess supply or demand in all markets, thus resulting in clearing markets. In competitive equilibrium, if agents *A* and *B* exchange, *B*'s gain exactly equals the gain from her next best alternative. For if this were not the case – if, for example, *B*'s gain exceeded her next-best alternative – there would be some third agent C who currently received the same (lower) value as *B*'s next best alternative and who would benefit from occupying *B*'s current position. Agent C could thus have offered *A* a contract superior to that offered by *B*, blocking *B*'s exchange with *A*. Since this did not occur, no such C exists, and *B*'s next best alternative must be at least as valuable as the exchange with *A*. On the other hand, *B*'s next best alternative cannot have greater value, or *B* would not have entered into the current contract with *A*. We conclude that *B*'s gain from trading with *A* exactly equals the gain from *B*'s next best alternative, so *A*'s threat of nonrenewal of contract with *B*, forcing *B* to her next best alternative, imposes no costs on *B*, and hence gives *A* no power over *B*.

In the neoclassical model, it follows, the locus of sovereignty within the enterprise, its political structure, has no effect in competitive equilibrium and hence is irrelevant to the study of power. But if this were so, the conversion of a firm from capitalist to democratic rule would be without consequence. The neoclassical model, however, is based on the dubious assumption that claims are enforceable at zero cost to the exchanging parties. In contested exchanges characterized by endogenous enforcement, by contrast, equilibria are characterized by a well-defined distribution of power.

Consider our model of the employment relationship: Does *A* (the employer) have power over *B* (the worker)? First, there is a range of wage rates from which *A* can choose, any of which would be acceptable to *B*, but the choice of which affects *B*'s well-being (as measured by the value of employment). Additionally, *A* may dismiss *B*, reducing *B*'s welfare to the reservation position. Hence, *A* can apply sanctions to *B*. Second, *A* can use sanctions to elicit a preferred level of effort from *B* and thus to further *A*'s interests. Finally, while *B* may be capable of applying sanctions to *A* (for instance, *B* may be capable of burning down *A*'s factory), *B* cannot use this capacity to induce *A* to choose a different wage or to refrain from dismissing *B* should *A* desire to do so. Should *B* make *A* a take-it-or-leave-it offer to work at a higher than equilibrium wage, or should *B* threaten to apply sanctions unless *A* offers a higher wage, *A* would simply reject the offer and hire another worker. For, as we have seen in the previous section, in equilibrium there will exist unemployed workers identical to *B* who would prefer to be employed.[7]

The point is not that a worker cannot impose a cost or otherwise harm the employer. This she clearly can do, especially if she has acquired

7. Readers familiar with noncooperative game theory might wonder, if the cost to the employer of replacing a dismissed worker is positive, whether the threat to dismiss is credible, in the sense that it is in the employer's interest to carry out this threat when actually faced by a shirking worker. If the employer's disciplinary actions are observable by other (present and future) workers, then a "reputation effect" argument shows that this is the case. See Bowles and Gintis (1990) for details.

skills on the job at the employer's expense. The worker can simply quit. Our point, rather, is that it is not generally in the interest of the worker to impose these costs on the employer because in order to do so the worker's own welfare will be reduced. Hence any threat to do so is not credible and will be ignored by the employer, thus having no effect on outcome of their exchange. Because *A*'s threats are thus credible and *B*'s are not, *A* has power over *B*.[8]

This power is based on *A*'s favorable location in a nonclearing market. We say that the employer *A*, who can purchase any desired amount of labor and hence is not quantity constrained, is on the *short side* of the market. Where excess supply exists, as in the labor market, the demand side is the short side, and conversely.[9] Suppliers of labor are on the *long side* of the market; some of them cannot sell all the labor time they would like to at the going wage (or perhaps not at all).

When contingent renewal is operative, the principle of *short side power* holds: Agents on the short side of the market have power over agents on the long side with whom they transact. Long-side agents are of two types: those such as *B*, who succeed in finding an employer and receive a rent that constrains them to accept the employer's authority, and those such as *C*, who fail to make a transaction and hence are rationed out of the market.[10]

Two objections to our interpretation may be raised. First, it might appear that *A* has expressed a preference for power and has simply traded away some income, the enforcement rent, to gain power. But this is false: *A* is assumed to be indifferent to the nature of the authority relationship *per se* and is simply maximizing profits.

Second, it may be argued that *B* has power over *A*, if not in our formal sense, then in the sense that *B* has the capacity to induce *A* to offer an enforcement rent over and above the amount needed to induce *B* to enter into the transaction. But the fact that *B* receives a rent, while certainly conferring a distributional advantage to *B* as compared to a no-rent alternative, does not involve "power" in the sense of a capacity that can be strategically deployed toward furthering one's interests; it is therefore not relevant to the issue of democratic accountability. To see this, note that *A*'s power to dismiss *B* is a credible threat, while *B* can issue no credible threat. Rather than attributing the fact that *B* receives a wage in excess of the reservation wage to "*B*'s power over *A*," we

8. Of course, where workers can collectively threaten to impose costs it may be in their interests to carry out threats, but this is not the case under investigation.

9. More generally: the short side of an exchange is located where the total amount of desired transactions is least; the demand side, if there is excess supply; and the supply side, if there is excess demand (Benassy 1982).

10. A more extended treatment would take account of agents who attain some level of transactions, but less than they would have chosen at the prevailing price or wage.

might better say that the enforcement rent derives from *B*'s autonomy, that is, from the inability of *A* costlessly to dictate *B*'s level of effort.

The conclusion that the employer *A* does indeed have power over the worker *B* is the basis of our claim that *A* should be democratically accountable to *B* and the other members of the team of workers. It is far from obvious, however, that the appropriate remedy for the concentration of short-side power in the hands of the employer is to give democratic voice to the employed long-siders through workplace democracy. A menu of alternative remedies suggests itself. The most obvious remedy, however, is not feasible technically: The abolition of employment relationship itself and its replacement by self-employment is prohibitively costly, except in those lines of work not characterized by economies of large-scale production.

A second remedy might be to redesign the nature of work and to alter the process of human development to make working more intrinsically rewarding, so that the work intensity freely chosen by the worker would be sufficiently high as to make labor disciplining strategies unnecessary, or possibly counterproductive. As we have seen, these conditions would support a labor market clearing equilibrium, thereby eliminating the short side of the market and with it, of course, short-side power.[11] If the previous remedy, abolishing team production, could be termed the *yeoman's utopia,* this approach is *utopian socialist* in flavor. We do not doubt that changing property rights and altering the structure of control over labor could render the process of work considerably less unpleasant; but we doubt that any feasible program of disalienation of labor can eliminate the problem of work discipline, except in a minority of jobs.

A more promising remedy would seem to be the elimination of the short-side power through the assurance of costless exit to employees. This could be accomplished either through the pursuit of macroeconomic policies to eliminate all but frictional unemployment or by granting of unemployment benefits at or near the level of the going wage. Compelling objections, however, may be raised against the strategy of assuring costless exit: It is neither feasible nor desirable.

The elimination of employment rents entailed by the free-exit strategy is impossible, because independently of the level of unemployment benefits or the macroeconomic environment, it will generally be cost minimizing for the employer to offer a wage such that employment is preferable to the worker's next best alternative. Attempts to eliminate the employment rent will redistribute income from capital to labor and possibly foster inflation, but cannot eliminate the employment rent, unless firms are prohibited from raising wages.

11. Unalienated workers, who willingly exert themselves on the job, would still need to be paid a wage to induce them to give up their time from other pursuits.

The elimination of employment rents is also undesirable, for the only wage at which exit could become costless is the worker's reservation wage, which, if offered, would elicit the worker's reservation level of work effort (the effort that is preferred by the worker independently of the effect on output or reward). The result would be a reduction in the level of output per hour of work. But a work-incentive scheme that places no value on output per hour of work is clearly irrational.

Economies of scale in production and the resulting team nature of production, the infeasibility of basing labor exclusively on intrinsic reward, and the efficacy of contingent renewal strategies of endogenous enforcement thus all strongly disfavor the strategy of addressing the problem of concentrated short-side power either by abolishing the employment relationship or by eliminating the coercive element in work or by ensuring costless exit from employment. Lacking attractive strategies for obviating the problem of short-side power, we propose that on democratic grounds short-side power ought to be accountable to work-team members. In support of this claim, we offer four arguments, each based on standard and widely accepted arguments in political philosophy for a democratic state.

Keep in mind that our claim for democratic accountability does not refer to the *administrative*, but rather to the *political* structure of the enterprise. The former refers roughly to its organizational chart, while the latter refers to the locus of final accountability. We might envisage, for example, a bureaucratic administrative structure combined with a democratic political structure, all members of the firm electing the chief executive officer who then enjoys broad organizational authority.[12] This system is democratic by comparison to an organization with the same administrative structure and a political structure according to which the chief executive officer was accountable to no one. Democratic accountability logically entails neither participatory decisionmaking nor nonhierarchical administrative structures, though accountability may in some circumstances be enhanced functionally speaking by those participatory and nonhierarchical attributes often mistakenly considered to *define* the democratic firm.

Our four arguments for democratic accountability of the employer follow. First, where one group has the capacity to tyrannize another – as, for example, a state elite might tyrannize a citizenry – democratic institutions have been advocated as a protection against despotism. Indeed, this is the traditional argument for democratic governance of the state. Does it apply to the firm? Our deliberate use of the terms *tyrannize* and *despotism* may suggest not, but this impression is false. While the

12. Louis Putterman (1984) makes just this point.

power of employers over workers arises in our model as a rational strategy in the interests of profit-maximizing by owners, the uses of power by managers may include assaults on the dignity of workers bearing no relationship whatsoever to the relatively benign objective of regulating labor effort. Sexual harassment comes to mind. Because owners necessarily exercise less than perfect control over the various levels of management, these and other uses of power that are arbitrary from the standpoint of the regulation of effort have substantial latitude.[13] Thus, the power of employers need not take the benign forms illuminated by our approach: the short-side power of the employer is both arbitrary and unaccountable in the same sense that might be said of a despotic state.

Indeed, we may strengthen our claim somewhat, drawing on Robert Dahl's recent treatment of democratic and property rights in firms: Any compelling argument for democratic governance of the state entails democratic governance of firms as well; and arguments that deny the legitimacy of democratic governance of firms equally oppose democratic governance of the state.

A modern restatement of the classical argument for democracy as a defense against tyranny is this: when decisions of major importance (perhaps including matters of life and death) are binding on parties not directly involved in the decisionmaking, the decisionmakers should be accountable to those directly affected. There can be little doubt that employers make important (even life and death) decisions affecting workers. But, are the decisions binding? If the cost of job loss is high, with financial distress, loss of medical insurance, disruption of one's family, having to relocate and the like as consequences of leaving one's job, the firm's decisions must be taken as binding on the worker in the same sense that government decisions are binding. Of course, citizens may leave their nations and workers may leave their work. But, Robert Dahl asks:

> [i]s not "exit" (or exile) often so costly, in every sense, that membership is for all practical purposes compulsory – whether it requires one to leave a country, a municipality, or a firm? If so, then the government of a firm looks rather more like the government of a state than we are habitually inclined to believe: because exit is costly, membership in a firm is not significantly more voluntary

13. Assaulting the dignity of workers is not likely to be a profit-maximizing strategy (among other things, because it lowers the value of employment and hence the cost of job loss), but the power created by the short-side location of the employer, along with the owners' inability to perfectly solve their own principal agent problem vis-à vis-management provides ample opportunity for managers to cater to their own personal objectives.

> or less compulsory than citizenship in a municipality or perhaps even in a country. (Dahl, 1985, p. 115)

Some might agree that membership in the firm is perhaps more compulsory than membership in a municipality but balk at applying the analogy to the nation. But in view of the fact that democratic governance of localities is widely advocated, does not even this limited view support the claim for democratic governance of firms?

The fact that power may be wielded in benign ways does not alter the case for its accountability. It is of course true that workers are better off employed than not employed and better off employed in the face of a cost of job loss threat than without the threat. But to offer this as an argument against accountability of power is analogous to defending slavery on the grounds that slave living standards were higher than that of free agricultural labor. Moreover, this objection confuses the administrative structure of the firm with its political structure: Hierarchy may well be efficient as an administrative structure, and contingent renewal may well be an effective means of disciplining labor. This, however, in no way justifies a lack of democratic accountability in the selection of those at the top of the hierarchy or in determining procedures for terminating workers. It is, of course, conceivable that workers running a democratic firm might choose to erect a hierarchical administrative structure making use of penalties for less than adequate work. Indeed, the democratic firm we have modeled does just this.

Standard neoclassical economic arguments, such as those offered by Oliver Williamson (1984) and Armen Alchian and Harold Demsetz (1972), support the notion of sanctions and hierarchy. But they in no way justify a lack of democratic accountability. Alchian and Demsetz, in fact, go to some lengths to convince their readers that a team of equal workers might have freely chosen to appoint one of their number to monitor them. They provide no reason, however, why the monitor might not be subject to periodic re-election.

A second argument for democratic governance is that it produces better decisions by exploiting both the superior information structures and motivational environments made possible by involving those directly affected in making decisions. Our argument concerning mutual monitoring is an example of such reasoning. While supporting workplace democracy, this argument gives us reason to reject the position of those who concede that employers exercise power over workers but insist that their power should be made accountable through the democratic election of states with regulatory powers over employers.

A third argument (originally suggested by John Stuart Mill) is that democratic governance is a school for the formation of democratic citizens capable of collective self-rule. This human development argument for the democratic firm begins with the observation, often overlooked in economic theory, that *the economy produces people,* their experiences as economic actors strongly affecting their personal capacities, their attitudes, and the character of their interpersonal relations. Democratic social relationships foster forms of social development both desirable in their own right and supplying the skills allowing individuals to control their political and community lives. The undemocratic structure of the capitalist enterprise, by virtue of the everyday experiences it fosters and the cultural forces mobilized in its defense, thus thwarts the development of a fully democratic culture (Pateman, 1970; Kohn, 1969; Almond and Verba, 1963). Indeed, we have suggested that the sharp contrast between the democratic character of political life and the authoritarian character of primary and secondary education in contemporary liberal democratic societies, flows from the requirement of the educational system to prepare youth for their future positions in an authoritarian workplace (Bowles and Gintis, 1976). A greater diversity in the political organization of firms would, according to this logic, allow the educational system to foster more participatory social relations without undermining the dominant culture of the workplace.

A final argument (proposed by R. H. Tawney, T. H. Marshall, and others) is that democratic accountability of the state is essential to assuring the equal dignity of citizens. This argument holds that unaccountable relationships of power establish master-servant relationships inimical to self-respect and mutual recognition among citizens. If our first argument concerning the compulsory nature of membership in the firm, stemming from our analysis of the power of the employer, is accepted, this fourth argument clearly applies to the governance of the firm, though we would want to stop short of prohibiting capitalist employment relationships as contrary to democratic citizenship.

As this last remark suggests, we do not think that the above case requires that in any real economy all employment relationships be made democratically accountable. Some employment relationships may exhibit such ease of exit that the tyranny argument does not apply, for example. In others the costs of democratic governance might be exceedingly high, suggesting a compromise of democratic governance in favor of economic efficiency. And one might on libertarian grounds wish not to restrict unduly the freedom to contract for the sale or purchase of labor time.

The argument for democratic governance, not surprisingly, is thus one among possibly competing arguments. Among the competing claims often advanced is the proposition that democratic governance of firms would lead to economic inefficiency. We will see that while such a conflict might obtain in special cases, democratic firms are likely to be more efficient, at least in the static sense of maximizing output per unit of inputs.

4. MARKET FAILURES ARISING FROM CONTESTED EXCHANGE

Our efficiency evaluation of the democratic and capitalist firm will focus upon the ability of each to address the market failures associated with the two agency problems arising from the noncontractible aspects of work effort and risk-taking. Ideally, economic institutions would generate a structure of incentives such that potential investments would be evaluated purely on the basis of their social rate of return, irrespective of their risk. Analogously, work intensity would be regulated such that the marginal productivity of effort would be equated to the worker's cost of supplying effort.

Feasible institutions, democratic, capitalist, or other, generally fail to achieve these optima. Where production takes place in teams, virtually any institutional arrangement will result in the level of work effort falling short of the optimum; for feasible pay schemes insufficiently reward the effort contribution of the individual member of a work team. Whether residual claimants or not, team members have an incentive to free-ride by reducing effort. The level of risk-taking, on the other hand, may exceed or fall short of the social optimum. Where authority over risk-taking decisions is assumed by borrowers who are residual claimants with limited liability, the level of risk will generally exceed the social optimum, namely, the level of risk that maximizes the average social rate of return. In this case, the decisionmaker benefits from large gains as a residual claimant but is protected from large losses by her limited liability status. Conversely, where risk-taking is assumed by agents who are not residual claimants but who must bear the costs in case of project failure (for example, managers), the level of risk will generally be suboptimal.

One's (correct) intuition is that while in coping with the effort determination problem the democratic firm has significant advantages stemming from the residual claimancy status of workers, in dealing with risk-taking the concentration of assets implied both by worker ownership and by the fact that workers are unable to diversify their labor-related assets will tend to render the democratic firm unduly conservative. By contrast, the classic equity-financed capitalist firm insulates the risk-taking decision from workers, who hold the most concentrated assets, placing it in the hands of managers who may be responsive to the more nearly risk-neutral objectives of residual claimant owners. Thus, by locating residual claimancy in capital, the easily diversified asset, risk-taking is promoted while the capitalist firm forgoes the superior work incentives available through the residual claimant status of workers in the democratic firm.

The central market failure resulting from the labor agency problem is that when the capitalist firm chooses a profit-maximizing wage, the resulting equilibrium wage and effort levels are less efficient than some combination of a higher wage and a greater level of work effort.[14] The implied improvements are infeasible, however, while the employer remains residual claimant, since the worker's promise of providing more effort for a higher wage is unenforceable.

Turning to the problem of risk-taking, we will identify two additional market failures. The first and most obvious market failure occurs when a residual claimant owner, highly diversified and hence risk-neutral, employs a manager to make decisions concerning the level of risk. The manager's assets (an income stream with the firm, a reputation) are highly concentrated in the firm and tied to its survival. The manager may thus prefer a lower level of risk-taking than the more diversified owner. To address this conflict of interest, the owner may offer the manager, in addition to a fixed salary, a share of firm profits, setting both such that the manager may expect to receive an income in excess of her next best alternative. This thus gives the owner short-side power over the manager (other means of influencing the manager may, of course, be used, but we ignore them here).

The manager will thus choose a welfare-maximizing level of risk, taking account of the income on the job and the likelihood that overly conservative risk choices will result in the loss of the job. The owner will offer a payment scheme for the manager designed to maximize expected profits, which will vary (over the relevant range) positively with the level of risk and negatively with the manager's income. At the resulting equilibrium, the owner would be willing to pay the manager more if a higher level of risk-taking could be secured (a first-order/second-order argument of the type presented in the previous footnote again shows that this is true), but there is no way to enforce such an agreement.

Our final market failure arises when a borrower is residual claimant on an income stream, the level of which depends on the borrower's choice between risky and less risky projects. An obvious conflict of interest arises because the borrower (as residual claimant) stands to gain from high return but risky projects, while the lender gains nothing from

14. This assertion can be understood using a "first-order/second-order" argument (for details, see Bowles and Gintis, 1990). Because the worker chooses effort to maximize welfare, she suffers only second-order losses from a small increase in effort in the neighborhood of the chosen level. By contrast, the employer enjoys first-order benefits, equal to the marginal product of effort. Thus, were it possible for the employer to contract with the worker for a small increase in effort, the cost to the employer of compensating the worker for this small increase in effort would be an order of magnitude less than the benefits. But as effort itself cannot be contracted for, this generally beneficial bargain cannot be struck.

the greater returns of these projects and stands to lose should the project fail.[15]

For simplicity, let us assume that collateral cannot be posted so that the lender relies solely on a contingent renewal enforcement strategy: The borrower would like to continue the relationship with the lender, who offers an enforcement rent in the form of a greater amount of credit or a lower rate of interest than the borrower can expect to enjoy elsewhere.[16] The lender may terminate the relationship, however, should the borrower engage in overly risky business practices. For any interest rate offered by the lender, the borrower thus maximizes her welfare by choosing a risk level to balance the expected gains from high-risk projects against the probability that risky strategies will be detected by the lender and the loan not be renewed in subsequent periods. The result is an inefficiency, in which the lender would like to offer a lower interest rate if he could induce the borrower to take less risky choices, but there is no way of enforcing such an arrangement (once again, a first-order/second-order argument demonstrates this point).

The market failures we have identified, concerning insufficient wages and effort, and either insufficient or excessive risk-taking, suggest a number of respects in which even under highly competitive conditions democratic firms might allocate resources differently than capitalist firms. We turn first to the advantages of the democratic firm in regulating the pace of work.

5. THE EFFICIENCY OF THE DEMOCRATIC FIRM IN REGULATING WORK

Consider two firms, one owned by its workers and governed by their elected representatives, the other owned by a nonworker and governed by the owner or an owner-designated manager. We assume that workers direct the managers of the democratic firm to select a payment scheme to maximize the workers' welfare. We assume that both firms employ identical workers, produce with identical technologies, and make use of a dismissal-based system of labor discipline. We will identify three reasons to think that the democratic firm will be more efficient than the capitalist firm in the sense that it uses less of at least one input to produce the same output.

First, the worker in the democratic firm is both the residual claimant on a share of the firm's income and a member of a sovereign body of members of the firm. It seems likely that workers thus integrated by

15. This conflict of interest has been explored by Stiglitz and Weiss (1981).
16. If collateral is allowed, a distinct market failure arises from the fact that agents capable of posting collateral need not coincide with agents having access to fruitful investment opportunities. For an analysis of this situation, see Bowles and Gintis (1990).

both property and political process into the firm will experience work as less onerous on the margin and, therefore, if faced with a given wage, will work harder than they would in a capitalist firm. Our reasoning is simply that the alienation of the worker from the capitalist firm, specifically the exclusion of the worker from managerial decisionmaking and from ownership of the products of labor, and the contrasting integration of the worker in the democratic firm (even if quite imperfect) give the democratic firm important motivational advantages. We refer to this as the *participation effect* entailing greater efficiency in the democratic firm.

The participation effect is easily confused with what might be termed the *direct residual claimancy effect*. This effect arises because the worker, as a residual claimant, will take account of the effect of working harder on total firm income, thereby reducing the incentive incompatibility in the employment relation. Though it may be an important consideration in small work teams, the direct residual claimancy effect is too small to provide a major motivational basis for increased work intensity in work teams of reasonable size. As we shall see, however, it may be sufficiently large to provide a motivation allowing for a superior monitoring system even in the largest firms.

Our second reason for the superior efficiency of the democratic firm is that the residual claimancy status of workers provides such a firm with monitoring mechanisms unavailable or prohibitively expensive for the capitalist firm. Abstracting from the participation and direct residual claimancy effects, one might think that the worker would have no less incentive to free-ride on the democratic firm than on the capitalist firm by pursuing on-the-job-leisure. But this view is mistaken. Workers frequently have virtually costless access to information concerning the work activities of fellow workers, and in the democratic firm each has an interest in the effort levels of other workers. The residual claimancy status of workers thus provides a motive for mutual monitoring.[17] The democratic firm could thus deploy a considerably more effective monitoring structure at less cost than the capitalist firm. We refer to this as the *mutual monitoring effect*.

Our third reason for the technical efficiency of the democratic firm is that the wage offered in the capitalist equilibrium is too low and monitoring expenditures too high. The reason is that the capitalist firm faces two prices in selecting its enforcement structure. One, the price of monitoring, correctly measures a social marginal cost, for the use of

17. It may be argued that mutual monitoring introduces sufficient discord within a work team to undermine the positive effect of participation on worker productivity. While we cannot point to empirical studies in this area, we believe that mutual monitoring in a democratic setting should strengthen the participation effect, in part by enhancing the perception of equal contribution among members, and hence of reducing the incentive to free-ride.

monitoring equipment or personnel entails real opportunity costs. But the other price, the wage, does not measure a real social cost. The payment of a higher wage is redistributive; it does not entail the greater use of scarce resources with alternative uses in production. Not surprisingly, then, the capitalist firm uses too little wage incentive and too much monitoring relative to an efficient alternative.[18] We refer to the potential gain to the democratic firms the *wage incentive effect*.

Converting the capitalist firm to a democratic firm would thus improve efficiency. Indeed, it would be possible to compensate the former owners at the level of their previous claim on the surplus and to pay out the reduced monitoring input costs to members of the firm. The former owners would be no worse off and the worker-members would be doubly better off: They would experience less disutility of labor and would receive a payment corresponding to the reduced monitoring expenditures.

However, this efficiency gain associated with the democratic firm is still not socially optimal because, even apart from the free-riding problem, workers in the democratic firm maximize their welfare, which takes account of the probability that they will lose their jobs. The social optimality criterion, by contrast, is indifferent to which workers hold jobs. Workers in a democratic firm thus have a job retention incentive to work hard corresponding to no social benefits.

The participation, direct residual claimancy, mutual monitoring, and wage-incentive effects work together to improve the efficiency of the democratic firm over its capitalist counterpart. Not only can the democratic firm achieve the same levels of output with fewer inputs, it may be able to accomplish this with less noxious forms of management. It will also be the case that the arbitrary use of power by management against workers is likely to be reduced, as the manager is subject to contingent renewal by the workers rather than by owners. The workers in a democratic firm are doubly harmed by such indignities as sexual harassment: They individually run the risk of being a target, and as residual claimants on the income of the firm, they all lose when other workers are treated in ways that make them value their job less. As important, workers are in a better position than owners to monitor managers' arbitrary use of power, simply because they are more likely to know about it.

18. An analogy will make this reasoning clear. Imagine a trucking company choosing between a shorter route over a toll road or a somewhat longer route without tolls. The two prices in question are the operating cost per mile and the road tolls. The trucking company would treat the two prices as equivalent, perhaps avoiding use of the shorter toll road. But the toll does not represent a real social cost, while the operating costs on the truck (fuel, wear and tear) do. The choice of the longer road, like the choice of lower wages and more intense monitoring, is cost-minimizing but socially inefficient.

6. IMPEDIMENTS TO THE SUCCESS OF THE DEMOCRATIC FIRM IN A COMPETITIVE CAPITALIST ECONOMY

Why do democratic firms, while more efficient in regulating work than their capitalist counterparts, nonetheless operate at a competitive disadvantage and hence not flourish in a capitalist economy? Furthermore, why can the efficiency gains associated with workplace democracy not be reaped by a capitalist firm?

Three general answers may be considered. First, learning to govern a firm effectively through democratic means takes time and requires a work force schooled in common deliberation and decisionmaking. Unless the efficiency gains associated with the democratic firm are considerable, the costs of learning and the lack of a pool of workers experienced in democratic management may be prohibitive. We call this the *democratic capacities constraint*. This constraint may be a particularly strong impediment to the proliferation of democratic firms to the extent that the experience of work in capitalist firms and the process of formal schooling orients human development toward capacities that are more functional in the context of hierarchical rather than reciprocal relationships and that discourage the development of cognitive capacities necessary for the governance of production (Bowles and Gintis, 1976).

Second, the conditions favoring the competitive viability of the democratic firm may be more likely to obtain in an economy with many such firms, and similarly for the capitalist firm. Thus, an economy composed primarily of capitalist firms might sustain and foster general economic conditions precluding the viability of the democratic firm, while an economy of democratic firms would also preclude the viability of the capitalist firm. We call this the *economic environment constraint*. For instance, Levine and Tyson (1990) argue that the variability of demand, the level of unemployment, and the general inequality of income differentially favor the capitalist over the democratic firm in a capitalist economy, but would change in a direction favorable to the democratic firm in an economy composed primarily of democratic firms. Thus, using the terminology of evolutionary biology, it is possible that a population of capitalist firms would be uninvadable by a small number of democratic firms and a population of democratic firms would also be uninvadable by a small number of capitalist firms. Both types would thus be evolutionarily stable, in the sense that homogeneous populations of capitalist firms or of democratic firms would both constitute stable evolutionary equilibria.

One less speculative reason for the paucity of democratic firms is that workers face serious wealth constraints: The firm's capital requirements are generally not within the means of workers nor would risk-averse workers rationally choose to concentrate their wealth in a single asset. Unable to finance the democratic firm directly and lacking even the collateral required for borrowing the necessary funds, workers may find the democratic firm an unattractive option, despite its superior efficiency. We refer to this as the *wealth inequality constraint*.

Of course, were capital markets like those depicted in the neoclassical model, wealth constraints would not exist, because workers could borrow whatever amount needed to finance the firm on terms no more costly than the wealth-holding capitalist. In fact, however, capital markets are as much arenas of contested exchange as are labor markets: The promise to repay a loan is enforceable only if the borrower is solvent at the time repayment is due and, as we have seen, the borrower's promise to remain solvent is not third-party enforceable.

Of course, the lender can devise contracts that induce more favorable performance than borrowers would spontaneously exhibit. Among the most effective is that of requiring the borrower to post collateral. Since this collateral is forfeited in case of borrower insolvency, the incentive incompatibility between borrower and lender is attenuated: A highly collateralized borrower has objectives closer to the lender's. But collateral by its nature must involve the borrower's own wealth and cannot (except through subterfuge) itself be borrowed without undermining the collateral's enforcement effect.

7. THE AGENCY PROBLEMS OF A DEMOCRATIC ECONOMY

We have argued that on democratic grounds firms ought to be worker-run and that capital market imperfections account for the competitive disadvantage of the democratic firm, despite its superior ability to deal with the labor agency problem. There is thus a *prima facie* case on both political and economic grounds for considering some form of subsidy for the democratic firm.

For a firm to be considered "democratic," and hence to enjoy such a subsidy, it might be required to conform to several conditions: (1) The firm must have a democratic constitution guaranteeing fair elections among worker-members subject to the protection of minority rights, freedom of speech, information, and political activity, plus whatever additional conditions are required to facilitate substantive democratic decisionmaking; (2) new workers must be extended equal rights of political participation within a reasonable period of their admission to the firm; (3) the firm must follow due process in hiring, dismissal, and promotion procedures. Associations not meeting these requirements, while not otherwise disadvantaged, would be obliged to forgo privileged access to credit.

Suppose, then, that credit were made available to the democratic firm on the same terms as its capitalist counterpart, thus eliminating its competitive disadvantage. How would we then assess the democratic firm's ability to handle the twin agency problems surrounding labor and risk-taking?

Concerning the labor agency problem, we expect the democratic firm to benefit from the participation, direct residual claimancy, wage incentive, and mutual monitoring effects.

Is there any reason, however, to believe that democratic firms would provide an adequate solution to the choice of risk and innovation? As we have seen, it is socially optimal that firms act in a risk-neutral manner, whereas economic agents tend to be risk-averse, and more so the larger the portion of their wealth involved in a particular project. Capitalist firms mitigate this problem in two ways: They vest control in relatively wealthy and hence less risk-averse agents, and they are financed through institutions, such as banks and stock markets, capable of inducing firms to innovate and take risks.

The capitalist solution is probably too conservative. But the internally financed democratic firm can be expected to act in an even more risk-avoiding manner on both counts: Its members are not wealthy and are not compelled by outside interests to take risks. Indeed, members of the democratic firm, even were they risk-neutral, would have an additional reason to shun high-risk, high-return projects: Since workers earn enforcement rents, they incur additional bankruptcy costs (the loss of job rents) not imposed on their capitalist counterparts (Gintis, 1989a).

From the democratic perspective, the problem of innovation raises the following dilemma: Some degree of external control of the firm by those who are not worker-members is justified by its contribution to a socially optimal level of risk-taking; but external control of the firm compromises the principle of democratic accountability.[19] The democratic argument for workers controlling their conditions of employment, however, does not extend to creditors controlling the conditions under which their assets are used, because creditors are not generally long-side agents facing short-siders who wield power over them.

8. CONCLUSION

Economic democracy has long occupied an uneasy place in the lexicon of liberal political philosophy: The term has an oxymoronic ring to it, for if the capitalist economy is a sphere of voluntary private interactions, what is there to democratize?

19. To complicate the picture, it is likely that a democratic firm would require a considerably *greater* degree of external influence to achieve the same level of risk-taking as a managerially controlled enterprise. This is because the external owners and creditors of a capitalist firm can focus their risk-enhancing incentives (for example, bonuses and stock options) on a small group of agents (the managers), while to induce a majority of workers to act in the same manner would generally require that such incentives extend to a majority of the firm members (Gintis, 1989b). Under some plausible conditions, dual worker-outsider ownership is also unstable (Ognedal, 1993).

Liberal political theory holds that the just society must ensure liberty: Individuals have certain rights that ought not be violated. Democratic political theory holds that the just society must ensure popular sovereignty: People ought to have a voice, and in some sense an equally effective voice, in the decisions that affect their lives. Modern liberal democratic theory generally supports the application of both democratic and liberal principles to the state, while supporting the application of the liberal principle alone to the economy. Thus, according to liberal democratic norms, capitalist economies in which effective claims on resources and command over labor generally reside in property owners and their representatives may represent a just form of social organization providing, of course, that markets are sufficiently competitive.[20]

Our analysis of the capitalist firm in competitive labor and product markets has demonstrated, however, that the controllers of the firm wield an unaccountable power over their employees in matters of great importance to their employees and their families. We are justified, then, in terming the capitalist economy a public sphere, by which we mean one in which some agents exercise socially consequential power over others. The arbitrary nature of liberal political philosophy stems, we believe, from the incorrect notion that the capitalist economy is a "private" sphere, one devoid of the exercise of power in our sense. This mistaken division of society into private and public spheres is itself implicitly based on the now-discredited Walrasian model of exchange with exogenous enforcement.

Liberal political theory goes on to argue that the economy, perhaps when suitably controlled by a democratic state, should remain private. This, however, is beside the point. For if our argument is correct, the capitalist economy is not now a private sphere, and the only real issue is its just organization as a public sphere.

Our case for the democratic firm thus does not claim that firms ought to be democratically run because this would enhance efficiency, but rather that on conventional ethical grounds firms ought to be democratically run, and that in a suitable institutional setting there is every reason to believe that the effects on productivity would be positive. Nor does our view entail the elimination of capitalist firms by fiat, for surely it is sufficient on democratic grounds that all workers have the opportunity to work in a democratic environment. Securing this opportunity, of course, would require that the arbitrary credit market disadvantages of the democratic firm stemming from the concentration of wealth be eliminated.

20. Classic statements of this view are Nozick (1974) and Gauthier (1986).

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