

# Exit or Voice

## Wage Earner or Employee Owner?

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## **Exit or voice – wage earner or employee owner ?**

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# **Exit or voice – wage earner or employee owner ?**

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## **Abstract**

The paper investigates the determinants behind the choice between a wage earner position versus employee ownership. These determinants can be found both at the *individual* level: desire for self-governance, risk aversion, human capital, wealth, mobility; *company level*: size, complexity, heterogeneity of labor, capital intensity, human capital; and *society level*: labor market dynamics, social security, role of unions and specific institutional rules for employee ownership. The choice is determined by the possibility for wage-earners to adjust working conditions by exit versus the possibilities and costs for employee to use voice as owners of their company. It is predicted that employee ownership will be found in organizations which are small, homogenous, simple in structure, and with high emphasis on specific human capital. The opportunities of globalization with complex organizations crossing borders/cultures will be more difficult to implement in employee owned companies. Specific external institutions (tax incentives, company laws, privatization opportunities) and innovative internal institutions may change the balance in favor of employee ownership. The predictions are not tested, but illustrated by examples especially from recent evidence from Eastern Europe.

**Keywords:** Employee ownership, wage-earner position, exit and voice,

## 1. Introduction

To be or not to be owner has been the question for many employees in several enterprises in Eastern Europe in the last decade. In many transitional countries the privatization process resulted in a high number of companies majority owned by a broad group of the employees. However, in the period after privatization most of these employee owned companies have been transformed to ownership by other stakeholders like managers or concentrated outside owners (Jones and Mygind 2006, Mygind et al 2006).

In Western industrialized countries employee ownership is not widespread although there are some exceptions like the Mondragon cooperatives in Spain, the worker cooperatives connected to the Lega in Northern Italy, or ESOPs in US. It is surprising that employee owned enterprises are so rare in the Scandinavian welfare states shaped by strong unions and Social Democratic parties. The agenda from the 1970s on a systematic development of economic democracy has not evolved into employee ownership. Instead pension funds like in all developed economies play an increasing role as owners of enterprises.

The rarity of employee ownership is not because of inferior incentives. On the contrary most studies show that employee owned enterprises mean higher motivation and productivity (Blinder 1990). However, they have often problems in relation to attracting capital and the functioning of a market for individual employee shares. Dow (2003) finds the basic difference in comparison with the dominant capitalist firm in relation to the inalienability of labor in contrast to the situation for capital. Employee owned firms have a *commitment problem* in relation to external capital inputs, a *composition problem* in relation to the collective decision making by the employee owners and a *commodification problem* in relation to trading employee shares. Dow's analysis gives a comprehensive and well founded explanation for the rarity of employee owned companies. However, the aspect of the motivation of the individual worker as well as the entry and exit of employee owners versus the mobility as pure wage earners without ownership deserves some more emphasis as will be done in this paper.

An individual employee will have to ask herself will I invest a considerable amount in my own company? How much effort will I use to go into the control process. Will I take active part in the decision process or should I let the other do the task. If not satisfied with the given conditions de-

terminated by the persons in control the employee could try to change these conditions in the individual job-contract and/or by voice try to change the decision at a higher level in the company. Alternatively the employee could find some other job – exit the company. This choice between exit and voice may in quite many cases lead the employee not to be owner, but instead she will only take a wage-earner position and adjust the working conditions by exit and look for another job.

In this first section I will sketch out some of the most important elements influencing the choice between ownership versus wage-earner contract. These elements can be found both at the individual level, the company level and at the level including the surrounding society. These three levels are closely interrelated. I will not discuss the choice between ownership by different stakeholders, but focus on employee ownership in contrast to other types of non-employee owners. I assume that the stakeholder group that gets the highest net-benefits of ownership will be the owners (Mygind 2004). There may be some net-benefits for employees being the dominant owner-group seen in relation to only being wage-earners. However the owner-benefits may be even higher for a traditional capitalist investor and ownership will go to the highest bidder.

A special section will be devoted to the problem of voice versus exit – the entry and exit of employee owners seen in relation to a wage earner's mobility between different jobs. A basic assumption is that the ownership entry and exit involves more barriers, higher transaction costs, compared to entry and exit as a wage-earner. The entry and exit of individual employee owners are closely related to the entry/exit of employee owned companies also to be analyzed in this section.

Based on the assumptions of elements influencing the choice of employee ownership versus wage-earner position some predictions about the spread of employee ownership in relation to the conditions at the individual, company and society levels will be discussed and shortly confronted with some evidence including recent experience from Eastern Europe where employee ownership has had a strong, but rather short-lived occurrence. Finally, some implication for the possible behavior of employee owned firms will be sketched out. The basic assumption is that if employee owners want to sustain the specific type of ownership they will tend to avoid adjustments which make this ownership type less viable. This may mean that employee owned enterprises will be reluctant to growth in the labor-force, to capital intensive investments and to global expansion which may de-

mand complex ownership structures across borders. To overcome these barriers it will be necessary with innovative changes in the institutional framework for employee owned enterprises.

## **2. Elements influencing the choice of ownership versus a wage-earner market contract**

### *Benefits and costs of ownership*

An employee has the possibility of choice in relation to different job-opportunities and often also different degrees of employee ownership. The rationality of choice between different possibilities can be assumed to be maximum utility based on: income, job-security, working condition, self-governance, security etc. and the choice depends on: individual preferences, company conditions, and conditions at the level of society.

The utility is calculated as the sum of a broad specter of benefits minus a broad specter of costs including transaction cost of the given choice of job and ownership. Not only the direct benefits of income and wealth are weighted, the employees consider the whole package including, jobsecurity, risk of losing capital, benefits of participation in relation to self-governance, adjustment of working conditions, transaction costs of getting and monitoring employee shares, etc.

The value of ownership for the employees is reflected in the price the employees are willing to pay for ownership. As a condition for employee ownership this price must be positive, but it must also be assumed that other stakeholder groups like the managers or an outside investor are not willing to pay an even higher price for the benefits they can get as owners. I will not go into detail with the owner benefits for the specter of other possible owners (Mygind 2004). In the current analysis the pure external shareholder ownership are seen as the relevant alternative to employee ownership.

Where most studies focus on specific company conditions and conditions at the society level I will here stress the individual level: personal preferences, skills, wealth etc. I also emphasize the transaction costs related to entry and exit of the different types of contracts. An important point is that entry/exit of ordinary wage contracts is an alternative way of adjusting the working conditions to the actual preferences of the individual employees.

Figure 1 gives an overview over the most important elements influencing the wage-earner/owner choice. These elements can be divided into the individual, the company and the society levels. The

different elements are related to each other across these three levels: Personal preferences are determined by the development at the level of society. Culture and socialization shape these preferences and generates systematic variations between countries. The situation on the labor market interacts with the individual preferences for self-governance. Defensive employee takeovers are more frequent in macroeconomic downturns than in periods of economic booms.

There are systematic variations between different countries. The frequency of employee owned enterprises is not just determined by existence of specific institutions favoring or hindering employee ownership, but also culture, technology level, macroeconomic development etc. I will illustrate the different elements with examples from different countries with most focus on the transitional countries in Eastern Europe, where privatization in many countries led to the start of quite many majority employee owned enterprises. Also examples from the successful Mondragon cooperatives, the US ESOPs and the Italian Lega-cooperatives will be mentioned.

It is important to stress that the different levels are interdependent. The possibilities for Self-governance plays together with the company condition on size. Wealth with the condition on capital intensity and again with the development of the financial market on the institutional level. The need for job-security interacts with specificity of human capital and with the situation on the labor market. In this way the elements plays together both in relation to where to find employee ownership and the specific behavior of these companies, see the following sections.

**Figure 1 The choice of employee ownership vs. wage earner contract**

<b>Determining elements</b>	<b>Where to find empl.ownership</b>	<b>Behavior of employee owned</b>
<p><b><u>Individual level</u></b></p> <p><b>Preferences:</b> self-governance/wage-earner individual vs. collective, risk-aversion.</p> <p><b>Human capital:</b> Education, skills for governance access to information, ability participate in democracy specific human capital.</p> <p><b>Wealth &amp; liquidity constraints</b> job-dependency,</p> <p><b>Mobility:</b> desire for traveling, collecting experience vs. strong ties to local area, family etc.</p>	<p>Cultures with collective entrepreneurship</p> <p>not too risk-averse</p> <p>groups with high education, skills, human capital, ability to participate in democracy</p> <p>high wealth</p> <p>high dependency on the job</p> <p>low mobility</p>	<p>Lower growth</p> <p>High weight on participation</p> <p>High R &amp; D</p>
<p><b><u>Company level</u></b></p> <p><b>Collective decision problem:</b> number of employees, heterogeneity of labor, complexity of organization, information flows within firm.</p> <p><b>Capital intensity</b> – finance</p> <p><b>Human capital dependency,</b> optimal effort of employees.</p> <p><b>Participation level</b> without formal ownership rights</p>	<p>Small companies</p> <p>Homogenous employee groups</p> <p>Low complexity</p> <p>Low capital intensity</p> <p>High human capital dependency</p>	<p>Lower growth</p> <p>Globalization: outsourcing not outplacng, networks not acquisitions</p> <p>low investment</p> <p>high labor productivity</p>
<p><b><u>Society level</u></b></p> <p><b>Labor market:</b> employment possibilities, employment security systems, unemployment benefit,</p> <p><b>Union role,</b> density, strength.</p> <p><b>Institutions</b> for ownership (legislation, tax, company law rules for participation in control, profit-sharing etc.), finance</p>	<p>Limited alternative job opportunities, low unemployment benefits</p> <p>Depend on policy</p> <p>Special institutions can solve commitment and commodification problem</p>	<p>start ups during recessions</p> <p>defensive takeovers</p> <p>specific institutions can overcome barriers and change behavior of EO – higher size, investment etc.</p>

*Individual level*

The individual preferences for being owners vary both between individuals and between different cultures, e.g. as indicated by high variations in *individualism* (Hofstede 1980). It can be assumed



that a higher degree of collective attitudes would make it simpler for the employees to overcome the composition problem of a heterogeneous labor-force and the resulting collective decision making would be easier. Also the desire for self-determination for self-management may vary. Hofstede's *powerdistance* could be an indicator – suggesting that low powerdistance means high desire for self-governance. The leaders feel close to their subordinates and the subordinates are not willing to be driven around by their bosses. However, there may be a contradiction in the sense that individualism means that you want to make the decisions yourself, self-governance. At the same time you need to make the decisions collectively with the other employees. High individualism may thus lead to high entrepreneurship, leading to management ownership, but not to employee ownership.

It is not enough with an individual desire for being part of decision making. The employees must have the necessary skills, the education and the ability to go into this process. They must also be willing to offer the effort and time for going into the decision processes, which in a democratic employee owned company may be quite demanding. Employee owners can thus be expected to be found, especially among the higher educated and more experienced employees. In knowledge based companies the highly educated employees often have better access to the necessary information to monitor the managers than it is the case for external capital investors.

Personal wealth of the employees will play an important role when it is necessary to pay a considerable down-payment for ownership. Wealthy employees can afford this contribution without concentrating a high proportion of their wealth in the same venture where they have also invested their human capital. This concentration of risk must be seen in combination with the individual preferences, the degree of risk-aversion, and the capital problem discussed below in relation to the company level elements. Risking both the job and a high proportion of personal wealth is like putting all the eggs in one basket as pointed out by Meade (1972) and Putterman (1993). The risk connected to losing the job including some specific human capital is an important element determining the value of employee ownership (Blair, 1995). The costs of lost specific human capital will be included with extra weight in the decision process in the employee owned firm compared to the situation in the traditional capitalist firm.

In cases where the employees have low wealth and the real income flows are reduced like it was the case in the first years of transition in Eastern Europe such a liquidity constraint can be an important

reason for relatively fast sale of the individual employee shares after privatization. Furthermore, these shares were mostly sold at undervalued prices because the employees had no information about the real value and because the managers who often were the buyers controlled the process of buying and selling shares (Mygind and Kalmi, 2006).

The cost of losing the job also depends on the individual mobility. The cost is very high for a well established employee with family, house etc. who could not move to another location without considerable costs. This can be contrasted to young mobile employees who frequently shift between different enterprises to collect experience and who are not bonded by family obligations and high investments in the local area. Therefore, macro variables such as alternative local employment possibilities play an important role for the weight an employee puts on the mobility factor. This includes also the level of unemployment benefits and the social safety net in general, see below.

#### *Company level*

The problem of collective decision making and the free rider problem increase with bigger size, with increasing heterogeneity of the labor force and in general with higher complexity of the employee-owned organization. This is what Dow (2003) calls the *composition* problem of the controlling owner group. He compares with the capitalist firm where the group of owners often is smaller and the owners have more parallel interests. Hansmann (1988 and 1996) emphasizes the problem of decision making in a heterogeneous group of employees where e.g. unskilled workers may have conflicting interests with the group of highly skilled professional workers. This type of conflict was found in a case study at the Danish employee owned newspaper Information (Westenholz and Mygind, 1986). The conflict between printing workers and journalists was a main reason for the demise of employee ownership in this company.

The complexity issue can be illustrated by the operation of a multinational company exploiting synergies of different production and sales units spread all over the globe. To exploit these synergies a centralized organization is necessary. If this company should be employee managed still with some scope for decision making at the decentralized levels a quite complex group structure would be necessary. Such a group structure has been developed in Mondragon, but even here the globalization process has been difficult since one of the binding elements in the group is the connection to the

Basque identity. The solution has been to keep the control within the Basque country, so employees in other countries are only to a limited degree included in the ownership and control structure.

The finance problem connected to high capital intensity is a classical problem in the literature on employee owned firms (Vanek, 1971; Meade, 1972; Putterman, 1988). High capital intensity, high assets per worker, means that the capital cost per employee is very high and in most cases beyond the possibilities of the average employee. At the same time there is a commitment problem (Dow, 2003) for attracting external capital both as bank loans and as non-controlling equity because there may be conflict of goals between the employee owners and the external capital. Therefore, employee owned companies will have lower debt leverage than the capitalist owned enterprise.

On the other hand a company may have a high dependency on human capital. This is especially the case in knowledge based companies e.g. in IT and professional companies. Some of this human capital may be specific in relation to the company and could not be used in another company. Therefore, the employees need extra incentives to invest time for training and developing these specific skills. They run the risk of losing this human capital if they have to change to another company. In this way there is mutual dependence between the employees and the company – a dependency which makes employee ownership an obvious solution. However, in a heterogeneous group with varying human capital between the employees only some of them may become owners.

Teamwork, empowerment of employees, modern HRM-techniques etc. are ways to involve the employees for higher effort and investing specific human capital into the firm. It may involve part of the package of employee ownership in the form of different forms of financial participation, profit sharing, stock options etc, or in the form of participation in some decisions (Kaarsemaker and Poutsma, 2006). It could be an advantageous strategy for the capital owners to introduce some elements of employee participation and ripping some of the benefits of employee ownership without giving up the ultimate control. According to Dow (2003), however, without full employee ownership there would be a commitment problem now in disfavor of capital ownership. Still, it could be assumed that a management style with a high degree of employee participation like in the typical Scandinavian company may decrease the pressure for real employee ownership.

*Society level*

The individual choice of employee ownership depends as earlier mentioned on the possibilities for finding satisfactory working conditions on the labor market. These conditions are determined by the economic development in the given country, legislation and the role and strength of the unions.

In economic downturns with high unemployment the job alternatives are few and unsatisfactory giving pressure for more employee ownership including defensive takeovers of companies about to close down. Therefore, the start of employee owned firms is expected to be countercyclical (reference? Bonin et.al. 1993 \*\*, Uvalic+Bartlett).

Labor market legislation determines to a high degree the conditions for the traditional wage-earner situation. There is a substitution effect between favorable market conditions for labor with good employment possibilities and a security system in case of unemployment on one side and the need of employee ownership on the other side as an alternative if the labor market shows high uncertainty and few opportunities for employees. Therefore, strong unions and a high support level for employees can limit the need for employee ownership. Codetermination with obligatory seats for employee in the boards of stock companies and in general a participatory management style can have the same effect – the employees have influence, so why bother with direct ownership?

Special legislation supporting employee ownership can shift the balance vs. traditional wage-earner relations. The US ESOP legislation with strong tax-incentives is an important example, but also the cooperative legislation and different rules for participation in countries such as Italy, Spain and France goes in this direction. Such legislative frameworks can open up for innovative institutional solutions at the company level like it happened in the Mondragon cooperatives (Thomas and Logan, 1982, Whyte and Whyte, 1991). In this way employee ownership oriented institutions can develop both on the company level and on the society level. Such rules can both secure the entry of new employee owners, the exit without selling to outsiders, and the supply of capital to the company. In this way both the earlier mentioned commodification and the commitment problem can be solved. The rules can include a certain element of individual ownership with possibility for capital gain when an individual leave the enterprise (Mygind, 1992). By easing the transfer of employee shares the transaction costs of entry and exit of employee members fall considerably and here is an important reason for the success of workers cooperatives in Southern Europe.

In the specific Mondragon structure the finance problem has been solved by the bank, Caja Laboral Popular, functioning as a key-unit in the whole Mondragon system. The bank channels savings from a big part of the Basque population into investments in the cooperatives giving them a possibility for debt leverage on a level similar to capitalist firms. Combined with the accumulating individual employee-accounts this had made it possible for the Mondragon cooperatives to expand in sectors with quite high capital intensity (Thomas and Logan, 1982; Whyte and Whyte, 1991).

### **3. Voice and exit – employee owner or wage-earner – entry/exit of employee owned companies**

The exit and voice theory (Hirschman, 1970; Stryjan, 1989) can be used to contrast the employee owner situation with the conditions as pure wage-earner. An employee owner can adjust the working conditions by directly influencing decision making - by voice. In the ideal situation with a homogenous group of employees all being owners the package of choices of technology, employment, work-intensity, safety etc. can be optimally adjusted to the preferences of the workers. However, problems of collective decision making because of size, heterogeneous workforce, free rider problems, lack of transparency etc. mean that the voice option may be troublesome and still not lead to a fully satisfactory result for many of the employees.

This situation should be compared to the wage-earner situation where the workers have the possibility for exit and finding a job where the combination of effort, compensation level, safety etc. better fit their preferences. In an ideal situation with full mobility and transparency of the different job-opportunities this type of adjustment could lead to a high fit between workers preferences and their actual job-situation. However, in the real world with unemployment, lack of information etc. this exit option may not work so well. Still, in the choice between employee owner's voice and wage earner's exit most employees may prefer the exit option and this could explain the rarity of employee ownership.

There may often be a split in the workforce where key employees with the highest educations, the highest degree of information about the company, with most specific human capital etc. will include ownership as an important instrument for influence while other employees with limited resources, information, etc. may chose the exit option. However, special institutional rules e.g. for worker cooperatives can avoid this unequal distribution of ownership if it limits the possibility for such individual adjustment by demanding one vote per employee and all workers being owners.

Exit is also a possibility for the employee owner, but this entry may include quite high transaction costs because of the dual change in employment and in ownership. This combined contract on employment and ownership also makes the entry more complicated. There is a link between entry/exit problems at the individual level and change in ownership structure at the company level. I will first look closer at the individual level and then entry/exit for employee owned companies.

The entry/exit conditions are determined by the specific form of employee ownership - the specific rules for the connection between employment and membership/ownership. In most worker cooperatives entering workers need to be members and they must pay a certain ownership fee. However, in these organizations some kind of loan for part of the capital stake makes the down-payment affordable for most entering employees. Still, it means that the members have a certain and often increasing amount bonded to their company. This increases their risk-exposure and may make their possible exit less smooth.

In most cases in Eastern Europe ownership of the company was established through individual share ownership. There was no direct link between the employment contract and the ownership of the company. The employees got individual shares through the privatization process often as a sort of gift or at discounted prices. However, for new workers entering the firm at later stages there were no automatic offerings of cheap shares. Likewise, for leaving employees there was no obligation to sell. Therefore, changes in the workforce meant strong tendencies in the direction of diluting the proportion of owners among the employees (Kalmi 2002).

Often managers bought employees-shares at the nominal price or a similar price much below the real value of the shares. There were a serious commodification problem (Dow, 2003) with no well-functioning market for employee shares and no mechanism for a fair valuation at exit, and thus the exit was quite costly for the selling employees. This burdened the exit by high transaction cost both in relation to the uncertainty of the price and the difficulties in making the transaction.

The individual entry/exit is closely related to the entry/exit of the company as a majority employee owned enterprise. In Eastern Europe the transaction costs in relation to the commodification problem were not reduced by specific institutional arrangements like in the different types of Western

worker cooperatives. New workers entered the company without being owners so that the proportion of owning workers fell. At the same time leaving employees kept their shares or they sold to outsiders or to managers or other key employees who in this way concentrated ownership (Mygind and Kalmi 2006). At a certain point ownership was concentrated on a small group of top level employees/managers and it changed to management ownership. Thus, entry/exit problems at the individual level meant exit of employee ownership at the company level.

The exit of employee owned companies may also happen simply by closure of the company. This is often the case where employees have made a defensive takeover to defend their work-places. They may succeed for a certain period beyond what traditional capitalist owners would do because the employees include the costs of unemployment and loss of specific human capital in their calculations, but still the structural changes of the market may make the closure inevitable.

Another exit route for an employee owned company could be related to the lack of sources for external capital. Because of the reluctance of banks and external minority investors the company may not get the necessary funds for investments. Instead an external investor will simply take over the majority of shares and take control with the company. Such a takeover may also happen in successful employee owned companies where the employee owners because of the high value of the company may get an offer to good to decline. There are several cases of such takeovers from our research in the Baltic countries (Mygind and Kalmi, 2006).

Exit of companies is frequent in a dynamic economy. The problem for employee ownership, especially, in the transitional economies of Eastern Europe, was that there were nearly no newly established employee owned enterprises. The development of the number of employee owned companies can be characterized by a ratchet effect with a lot of majority employee owned companies started in relation to privatization, but when they over time closed down or were taken over by other owner-groups there were no or very few new-coming employee owned companies to fill the holes.

New employee owned companies could come in the form of defensive employee takeovers, but in most cases these firms would have a very short expected lifetime. In the West, we have also seen examples of takeovers as a way to continue a company when the founding owner want to retire and the family is not ready to continue the company. In this case the group of employees could be a

logic choice for the new owner-group. This is in some countries facilitated by tax-benefits e.g. in US in the form of a takeover by an ESOP. Without such institutional rules demanding that all employees are offered the possibility to join, the takeover may be done by only the leading group of employees resulting in management ownership. This is often the case in spin-offs from existing companies. It is also the case when a group of employee-owners start up a company from scratch. If the common ownership is not part of the founding idea, but only an instrument to realize a certain business opportunity, the successful growth of the company means that the ownership stay concentrated in the hands of the founders and does not include the new-coming employees.

Only in the case where such new companies are institutionally bonded to employee ownership like in the ESOP case or in the case where the employee owned company are started up within a worker cooperative institutional structure, like the Italian Lega or the Mondragon group, it can be expected that the company will have a sustainable structure of employee ownership.

#### **4. Predictions about where to find employee ownership**

From the analysis on elements supporting or hindering employee ownership we can make some predictions about where to find employee owned enterprises. I will not test these predictions, but give some examples supporting the predictions. Again the analysis is structured on the individual, company and society levels:

At the *individual level* it can be predicted which type of employees will be most likely to go for employee ownership. Companies with a high proportion of this type of employees will have a higher frequency of employee ownership.

- If the employees have a collective attitude combined with a desire for self-governance there will be more employee ownership. It is not enough to have a collective culture because it may be dominated by a collective wage-earner attitude accepting that control resides at the capitalist owner.
- There will be frequent occurrence of employee ownership in knowledge based companies with a big proportion of highly educated employees and a strong specific investment in human capital.
- There will be more employee ownership in societies with a high level of personal wealth ready to invest in companies. Then employees can afford some risky investments. This tendency can be weakened by a high degree of risk aversion among the employees. If the savings for pensions



are done collectively this part of the wealth will not be the basis for employee ownership unless there are special possibilities for investing pension savings in their own companies as it is the case for the US ESOP legislation.

- Tough liquidity constraint as experienced in the first part of transition in Eastern Europe may make the employees sell their shares in exchange for relatively small short run gains. This tendency was observed in several countries in Eastern Europe where employees had got shares at preferential terms in the first rounds of privatization, (Jones and Mygind, 2006; Mygind et. al., 2006).
- The individual need of protection of job and human capital may lead to defensive employee takeovers as an alternative to closure. This tendency must be understood in close connection to the situation at the labor market.
- Highly mobile workers prefer wage-earner positions to employee ownership. This means that employee-owners will be found especially among established employees with children, house etc. while the youngest group of employees will neither have the wealth nor the desire for being owners.

At the *company level* the predictions are quite straightforward:

- The typical employee owned company will be relatively small and have a simple structure, with quite homogenous labor-force. If the labor force is heterogenous ownership may be limited to a smaller homogenous group. This fits well to the evidence from the West with the Mondragon cooperatives as the exception. Even here, the purpose of restructuring the group in the 1980s was to limit the size of each cooperative(Whyte and Whyte, 1991). The complex group structure has been a way to limit the size of each cooperative and still benefit from economies of scale and scope on the group level. In the East European privatizations employee takeovers were stronger for small and medium sized enterprises in countries like Poland, Estonia and Latvia while strong advantages for employees also included employee takeovers of larger companies in Lithuania and Russia (EBRD 2005).
- The same story goes for capital-intensity. We expect quite low capital intensity in employee owned enterprises. This is confirmed by most western experience except for Mondragon (Dow, 2003). Mondragon is also the exception in relation to financial constraints on bank loans. Evidence both for Western and Eastern Europe shows that banks are reluctant to lend money to employee owned companies. In Eastern Europe capital intensity followed the same pattern as size.

In countries where employees took over small and medium enterprises these had also quite low capital intensity, while in Lithuania and Russia employee also took over larger and more capital intensive enterprises. Bank loans to enterprises were not developed in the initial stages except remains of old bad performing debt, but the scarce evidence shows bank loans to be most restricted for employee owned companies (Mygind 2000). The capital intensity barrier in Russia and Lithuania was broken because of vouchers and favorable prices. However, still the exit was not regulated and the result was a fast change of ownership away from employee ownership. Now, only few employee-owned enterprises are left in Eastern Europe. The remaining employee owned enterprises are relatively small and labor intensive (Hashi et al. 2006).

- We do not have evidence for the start up of employee owned enterprises in the new knowledge based sectors in Eastern Europe, but for the West we find a high frequency of partnerships where key employees are the dominant owners in sectors such as IT, consultants, lawyer companies and other professional services. However, if the partnership structure gets larger, more heterogeneous and complex there could be a tendency toward selling out like it has been seen for some large US consulting companies (Dow, 2003).

At the *level of society* the following predictions and examples of evidence shall be mentioned:

- Employee owned companies especially start up in times of economic downturns. Evidence?\*\*\*
- There is less pressure for starting up employee owned enterprises in a dynamic labor market offering good employment possibilities and a developed social security system. Participatory management styles and support for codetermination means less pressure for employee ownership. Strong unions, favorable labor market conditions seen from the point of view of employees and participatory organizational structures at the company level are probably an important reason why employee ownership never has got high prevalence in the Scandinavian countries. The situation in Denmark gives an interesting illustration of how different legislative element and a strong labor movement have improved mobility and the protection of labor so that the wage-earner situation is quite favorable. Therefore, employees have not sought the alternative as employee-owners to improve their situation. The Danish social security system with high and long lasting unemployment benefits have made redundancy less threatening. At the same time there are very few thresholds for firing workers. This high degree of flexibility combined with high social security is thus named “flexicurity”. The organization of work is characterized by a flat organizational structure with high degree of participation and empowerment of the employees.

Unions are quite strong and workers have a high union-membership rate. In this environment even in periods of relatively high unemployment as in the 1980s there was no movement for establishing employee owned companies in Denmark. By law employees have one third of the seats in the company board of joint stock companies with more than 50 employees. Except for this and some tax-advantages for minority employee shares there are no legislative supports for employee participation. You only find majority employee ownership in professional partnerships, legal firms, architects, IT-companies etc., but here it is typically only the leading and core employees who are owners.

- As a contrast much more employee ownership is found in Southern Europe and US with higher uncertainty for the employees on the labor market. The explanation for the different types of employee ownership in Southern Europe mostly in the form of worker cooperatives are also connected to the fact that there are special treatment in the legislation related to cooperatives or in US in relation to ESOPs with important tax advantages and institutional structures that helps the sustainability of these types of employee ownership. In Scandinavia such favorable institutional rules are only found in a few specific sectors such as some social services in Sweden (Pestoff, 2000).
- The labor market Eastern Europe with high uncertainty and lack of opportunities for employees especially in the early years of transition pushed the employees into some defensive takeovers related to the privatization process. However, the conditions at the individual and company levels were so negative that the general tendency was a steep fall in the frequency of employee ownership. The positive institutional setting in some East European countries was limited to the early privatization process. Later in the process the advantages for employees were abolished (Mygind 2000). In general there were no institutional rules to support the sustainability of employee ownership by facilitating entry and exit and by developing a structure for external finance for these companies (Hashi et al., 2006). The only exception was Slovenia where Authorized Workers Associations created an institutional structure making employee ownership more sustainable. The long experience with self-management in Slovenia also meant that managers could not dominate the employees and take over their shares at undervalued prices as it was the case in other countries in Eastern Europe (Mygind et al., 2006).

## **5. Some predictions about the behavior of employee owned enterprises**

The choice of employee ownership versus pure wage-earner position is a trade off between benefits and costs of the two alternatives. The choice is based on the conditions and expectations to the foreseeable future at the time of decision. There will be some inertia in the chosen positions because of transaction costs and relation specific investments. A drastic change in conditions may mean a change in ownership structure, but instead of changing ownership the employees may adjust differently to external shocks to protect the advantages of employee ownership. Therefore, the specific priorities/goals of employee owned firms not only help to predict where to find employee ownership, this is also the background for *predictions about their behavior*. If we assume that the employee owners want to keep this ownership structure – they are also willing to bypass some opportunities if fulfilling these would put pressure on their ownership structure. The idea in this paper is not to develop detailed models for the behavioral predictions, but just to sketch the main ideas with emphasis on the element where new elements are included compared to the existing literature in the field.

The *individual elements* influence the behavior by setting the objectives of the company. Self-governance can be expected to have a high priority and the employees may e.g. give less weight to expanding the firm if this threatens the employee participation in decision making. Protecting and developing the human capital of the employees can also be expected to be given high weight. This includes protection of jobs although in some situations employment consideration will have to be weighted against the possible income opportunities and the possible capital gains or losses. However, we expect relatively higher weight on wages, job security, human capital development etc. in employee owned companies compared to the capitalist twin.

The traditional theory of employee ownership based on the so called “Illyrian firm” (Ward, 1958) and further developed by Vanek (1970) are based on a narrow assumption of maximization of net income per worker. Here, instead we use a broader maximization function where elements such as self-governance and protecting specific human capital play important roles. It is also important to stress that the Illyrian theory is based on the assumption of the Yugoslav type of collective ownership where the employees cannot sell their shares and get a capital gain when leaving the firm. Sertel (1982) and others have shown that changing this assumption to individual ownership with market valued transferable employee shares makes the narrow income maximization model predict behavior quite similar to the traditional capitalist firm (Mygind, 1992).

The analysis based on individual characteristics must be seen in close connection to the *company level* elements:

Large size and high complexity is a problem for employee ownership. Therefore, it can be assumed that these companies having reached a certain size will tend not to grow so fast as their capitalist counterpart. The same conclusion can be reached if there is a certain element of collective ownership that is the employees cannot sell their shares individually at a well-functioning market. When this is not possible the existing labor-force will not be compensated fully by new incoming workers who then get part of the collective funds without paying the price. This may motivate the current labor-force not to expand so much and to underinvest (Vanek 1971).

It can also be assumed that employee owned enterprises will not expand through mergers and acquisitions since this means that the firms taken over may not fit to the ownership structure. Since both organic growth and acquisitions are key elements in the global expansion of multinational companies it can be hypothesized that employee owned enterprises will not be so active in internationalization as their capitalist counterparts. To sustain their employee ownership they will rather tend to outsource than to outplace - establish foreign subsidiaries which may not follow the principles of employee ownership.

There cannot be made behavioral predictions based on the *society level* elements. However, the institutional rules which e.g. in the case of Mondragon have overcome some of the problems related to the commitment problem of finance and the commodification problem of entry/exit of employee owners also mean that the tendencies of limiting growth and underinvestment will disappear as the Mondragon experience indicates. Specific external institutions (tax incentives, special company laws, special financing opportunities) and innovative internal institutions for employee ownership like in the Mondragon cooperatives may change the balance in favor of employee ownership. Whether innovative institutional changes related to employee ownership can meet the challenges of globalization is, however, still an open question.

## **6. Conclusion**

Summary

Perspectives, change in institutions, technology, higher human capital, higher EO – more voice less exits – also partial eo

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