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How does employee participation in decisionmaking affect productivity? Global competition has spurred interest in this question, especially in light of the strong performance of Japanese and other companies with participatory industrial relations. This article examines the effect of participation on productivity, concluding that the theoretical relationship is ambiguous, while the empirical literature finds a usually positive, often small, effect. It then identifies features of a firm's management and human resource systems that are needed to sustain employee participation, and discusses the effects of the external economic environment on the firm's decision to introduce such features.

THE THEORY OF PARTICIPATION

The standard economic theory of the firm suggests that owners will be opposed to employee participation. Agency theory implies that owners must provide incentives to motivate managers to act in the owners' interests. The greater the number of decisionmakers, the more expensive and inefficient such incentives become. However, if participatory arrangements motivate workers to create more ideas, to share their knowledge of the work process and to encourage productive behavior of fellow workers, the result may be an increase in efficiency, and even an increase in managerial control.

Still, the question of how to motivate workers remains unanswered. All firm members would be better off if everyone worked hard, yet there is always a temptation for an individual to reduce effort; any one worker can be a "free rider" if everyone else continues to work hard. The result can be a noncooperative solution which is individually rational for each worker, but far from optimal for the firm or workers as a group.

Participation can support a cooperative strategy where group interaction and peer pressure maintain the optimal level of work effort. In fact, it may actually change the goals of workers, bringing them closer to the goals of the firm. Such a discussion leaves conventional economic theory behind. Other social sciences have explored these topics, but unfortunately have not found definite consistent relationships between participation, morale, and productivity.

THE EMPIRICAL EVIDENCE

Participatory workplace arrangements can be grouped into three broad categories. *Consultative participation* solicits workers' opinions and suggestions, but reserves all final decision-making power to management. Quality control circles are the most common example of consultative participation in the United States. *Substantive participation* gives groups of workers, such as work teams, power to make decisions in selected areas. *Representative participation* gives workers as a whole formal representation through workers' councils, joint labor-management committees, and employee representatives on company boards of directors. In contrast to substantive participation, representative participation may encompass a broader range of issues, but give workers more diluted influence -- perhaps only an advisory or informational role -- on the issues that are discussed.

An extensive survey of the empirical literature on the link between participation and productivity reaches several general conclusions. Consultative participation is not likely to achieve lasting improvements in productivity; most studies find that the half-life of quality circles is under three years. On the other hand, substantive participation has a positive effect on productivity in most studies, though some have found only a weak or statistically insignificant effect; it can be hard to separate the effects of participation from other workplace innovations. Representative participation can improve performance when it is part of a package of participatory policies; when introduced alone it may improve labor-management relations but has little effect on productivity.

Studies of worker-owned firms and cooperatives usually find that both participation and ownership have positive effects on productivity. It is dangerous, however, to extrapolate these results to conventional firms; the analysis presented below suggests that the effects of participation are likely much smaller in conventionally owned and organized firms.

FOUR REQUIREMENTS FOR PARTICIPATION

Since the evidence suggests that participation can have positive effects on productivity, why don't we see more of it? Four characteristics are required for successful participatory systems; the external economic environment may discourage firms from adopting these characteristics.

First, some form of *profit or gain sharing* is a key element of participatory systems. There are many different ways of linking some part of worker compensation to a measure of profitability or group productivity. Profit sharing is required for a sense of fairness and commitment; without it, workers will feel it is unfair that they do not share in the benefits generated by their cost-saving ideas. Payment based on group performance gives workers incentives to maintain norms of high effort and monitor each other -- and to cooperate in the work process.

A second essential characteristic is job security and *long-term employment relations*. Workers are unlikely to help increase efficiency if they fear that doing so may jeopardize their jobs. Long-term commitments also encourage workers to develop the skills and the workplace relationships that allow more effective, productive work.

A third category, *measures to increase group cohesiveness*, includes narrowing differences in wages and status, and payment based on group rather than individual performance. Large firms with successful participatory arrangements tend to pay relatively egalitarian wages, in part to induce cohesiveness within the workforce.

Finally, participatory systems usually provide *guaranteed individual rights* to workers. For example, a just-cause dismissal policy, specifying the grounds on which a worker can be fired, helps foster a sense of fairness and trust, which are vital to participation.

PARTICIPATION AND THE EXTERNAL ENVIRONMENT

Even if participatory workplaces are potentially efficient, conditions in the product, labor, and capital markets can discourage firms from adopting an industrial relations system that allows participation. The more variable the demand for the firm's product, the more expensive it is to guarantee long-term employment; when the business cycle is pronounced, employers find it profitable to use cyclical layoffs. This sets up a feedback mechanism, since cyclical layoffs amplify business cycle fluctuations -- making it even more costly for other firms to maintain long-term employment and worker participation.

Labor market conditions affect the profitability of participation systems in several ways. When unemployment is high, the traditional approach to labor discipline, based on the threat of dismissal, is relatively cheap (as explained in "efficiency wage" theories; see Chapter 2). However, when unemployment falls, traditional labor discipline becomes more expensive, and a participatory system of motivation and incentives becomes more attractive.

Similar considerations apply to wage differentials: if wages are generally unequal, so that star performers are paid large premiums in other firms, then participatory firms that try to maintain egalitarian wage schedules will tend to lose their best workers. But if wage differentials are narrow at all firms, the participatory approach to motivation can lead to efficiency gains without the risk of losing the best or highest-skilled workers. Likewise, it is easier for a firm to maintain just-cause dismissal policies if all other employers do. If only one offers such policies, all the least-motivated workers will want to work there, creating an adverse selection problem.

Capital market conditions also influence the viability of participatory arrangements. Conventional lenders are biased against reliance on the intangible trust and motivation that are crucial to participatory firms, and may evaluate such firms' prospects in an unduly negative manner. This and other capital market problems can be minimized if participatory firms develop close relationships with their investors.

Brief case studies of participatory firms in Japan and Sweden suggest that both countries have enjoyed product, labor, and capital market conditions that favored participation. The four characteristics required for successful participatory systems are present in both cases (though in Japan, only about thirty to forty percent of the labor force is employed in the larger, participatory firms). These success stories can be contrasted with other environments in which market conditions have discouraged participation. There are several implications for public policy to promote participation. Desirable policies include: maintenance of high and steady aggregate demand; promotion of long-term employment relations and just-cause dismissal policies; measures to lengthen managers' and investors' time horizons; and more research and dissemination of information on workplace participation itself, to make the option more familiar and acceptable.