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Why in a democratic society are so few firms structured along democratic principles? A good part of the answer relates to differential access to credit and capital markets and the divergent interests of workers and outside stockholders with respect to risk. (Mathematical proofs of these propositions are appended to the original paper.)

FINANCIAL MARKETS AND FIRM STRUCTURE

Most economic activity takes place in firms in which management is accountable to outside creditors and stockholders, not to those engaged in the firm's day-to-day activities (the firm's employees, called "members" here to emphasize the potential for democratic governance). Conventional wisdom holds that the hierarchical division of labor in most firms is not compatible with participatory decision-making, and that democratic firms cannot control opportunistic behavior. However, this confuses the organization of the firm, which incorporates efficiency goals, with its political structure, which addresses accountability. Even in a firm in which authority resides with the members, those members can delegate authority to management in the interests of efficient operation; conversely, since factor markets are imperfect, conventional firms are as likely to misallocate resources as democratic ones.

Worker-*owned* firms tend to be scarce because of the unique problems of obtaining adequate financing. Capital markets diversify risk, whereas financing through members' equity concentrates risk: both their jobs and their savings become dependent on the same enterprise. Workers are not generally wealthy and find it difficult to raise sufficient equity by themselves; furthermore, when they go to borrow, their lack of equity means they are turned down for loans or must pay relatively higher interest rates for borrowed funds. However, full worker ownership is not necessarily the only path to economic democracy. Even a firm that is financed through external equity and credit markets can be run in a democratic fashion, that is, "accountable to its members according to some reasonable notion of political representation"[311], and should, in theory, be able to attract capital in financial markets if it is operated in a competitive fashion.

In reality, even with an efficient management structure, a democratic firm will lack access to equity markets on a par with conventional firms. Potential stockholders, who can diversify risks through equity markets, usually prefer relatively high levels of risk at any one firm in hopes of large returns. Employees, on the other hand, who are more concerned with keeping their jobs, would be less willing to make risky decisions if the decisions were in their hands. Since risk behavior is difficult to observe and enforce, stockholders would have to offer costly incentives to induce levels of risk acceptable to them. In a firm with a democratic decision-making structure, these inducements would have to be offered to the majority of members, but in a managerially controlled firm inducements can be limited to only a few managers.

If an economy that can foster rapid innovation – thereby engendering more risk – is dynamically superior to more conservative regimes, then the challenge is to devise mechanisms that can preserve competitive financial markets without reinforcing anti-democratic biases.

MODELING RISK BEHAVIOR

To focus on the availability of equity, certain assumptions are made: namely that debt levels, product and factor prices, and production possibilities are the same for all firms. Members remain employed unless the firm fails. If the firm fails, wages will be paid up to date but workers will be unemployed thereafter; creditors will receive the liquidation value of the firm. In the case of success, stockholders are the net benefactors. In this model, the only choice variable is the level of risk, with the implication that higher risks yield higher returns to investors. For workers, employment has a present value and job loss has a cost. These can be evaluated for various levels of risk. Even if workers have assets, unemployment insurance, or alternative employment, job loss has a positive cost. Several propositions follow from these assumptions.

> (1) If members prefer to minimize the risk of bankruptcy, but stockholders prefer higher levels of risk, outside stockholders will be better off if members also own stock.
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> (2) The level of risk chosen rises with the degree of member ownership; a decline in the cost of job loss means that workers can tolerate higher risk and outside stockholders can tolerate more democracy in the firm.
>
> (3) Under some circumstances it is in the stockholders' interest to give stock to firm members, in order to make them share the stockholders' attitudes toward risk. The higher the cost of job loss, the greater the stock transfer that is required to achieve any given change in firm members' preferred risk levels. This explains one reason why owners prefer hierarchical management: it is obviously cheaper to give stock to a few top managers, rather than to a majority of employees: in the hierarchical firm, the top managers are the only firm members whose risk preferences matter.

CONCLUSION

"Our analysis may strike the reader as a mere gloss on the venerable argument that the democratic firm allocates risk inefficiently because it does not maximize profits, and is shunned by competitive financial markets because it is inefficient."[317] However, equity markets are imperfect even with respect to traditional firms. This analysis suggests that firm members and owners have different interests in the choice of risk and that owners can induce desired risk behavior more effectively through incentives to a few managers than through a wide distribution of incentives to members.

A democratic society presumably wants to expand democratic participation in the economy if that does not conflict with standards of liberty, efficiency, innovation, and growth. However, simply guaranteeing financing to circumvent competition and increase performance is not being advocated here. Indeed, policy-makers are no better at assessing a firm's risk behavior than stockholders. A strategy of taxes, subsidies, and regulation that offset the advantage of traditional firms also reduce overall risk-taking in the productive sectors of the economy. This may result in suboptimal levels of innovation, even more so for democratic firms. Thus the most successful policies may be those that repair failures in labor and capital markets.

In the labor market, work intensity and quality cannot be contractually enforced. This leads to unemployed labor and excessive job loss even in equilibrium, making democratic firms even more conservative toward risk. The market fails to provide insurance against job loss if workers' performance can not be controlled or if job loss is not a threat. This leaves insurers to face a moral hazard, since less-employable workers are more likely to seek insurance. Public policy can act in favor of tight labor markets, unemployment compensation, and retraining in a way that would render the democratic enterprise competitive and socially efficient.

In capital markets, the risk behavior of financial resource managers cannot be contractually specified, so both capital and credit are rationed according to access to equity. This is a vicious cycle since it is difficult for many individuals with insufficient equity to advance without borrowing first. Since ownership sharing improves the position of firm members relative to passive investors and creditors and also raises the firms' optimal risk level, public policy should provide a source of credit to members of democratic firms.