A DEMOCRATIC-ENTERPRISE-BASED MARKET SOCIALISM*

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July 1992

*This paper was published in Pranab Bardhan and John Roemer (eds.),

Market Socialism: The Current Debate

Oxford University Press, 1993 (pp. 120-141).
In this paper I question the widely prevailing view that societies seeking to move from an administrative-command to a market economy have no viable alternative but to adopt a conventional capitalist system of property rights. I first make a general case for a market socialist "third way" that would simultaneously meet important socialist objectives and benefit from the efficiency advantages of a market-based economic system. I then explain why I believe such a third way is particularly appropriate for the nations of Eastern Europe and the former Soviet Union as they emerge from their administrative-command systems.

I. The Rationale for Market Socialism

The idea of a third way between capitalism and administrative-command socialism has long been very appealing to democratic socialists, critical of many aspects of real-world capitalist societies but well aware of the failures of real-world socialism. The challenge has been to articulate an alternative form of socialism that could achieve long-standing socialist objectives while maintaining efficiency in the use of resources to meet desired ends.

A. Socialist Objectives

Advocates of socialism have developed distinctively socialist objectives out of a multi-faceted critique of capitalist societies:

(a) arguing that capitalism leads to a highly unequal distribution of income, wealth and power, socialists call for greater equality in the distribution of material welfare -- both as an end in itself and as a means of promoting more equal participation in democratic politics;

(b) arguing that capitalism limits opportunities for self-governance in economic affairs, socialists call for more democracy not only in the political arena but also via the extension of democratic principles from the political to the economic sphere (in particular, to the workplace);
(c) arguing that capitalism divides people from one another both in residential neighborhoods and at the workplace, socialists call for greater community -- the opportunity to belong to, and to participate on an equal basis in, stable associations of people with common interests and a shared identity.

The case for socialism has been made not only in terms of its capacity to achieve such distinctly socialist objectives, but also in terms of its capacity to be more successful than capitalism in serving the general economic interest rather than particularistic interests. Although advocates of capitalism have always hailed it as the most efficient possible economic system, socialists have argued that the invisible hand of the market and the structure of the capitalist firm fail in many respects to translate the atomistic pursuit of private gain into a general social optimum -- for example, with respect to the treatment of the earth's environment and the social relations of the firm. Thus we can identify a fourth socialist objective associated with comprehensive efficiency:

(d) greater social rationality -- both at the macro level (to promote optimal allocation of resources where markets are inherently imperfect and "externalities" abound) and at the micro level (to promote optimal use of resources via cooperative solutions to enterprise coordination problems).¹

Socialists have traditionally assumed that attainment of the above four basic socialist objectives would require substantial diminution of the role of markets in the economic system and their replacement by mechanisms of (democratic) economic planning, as well as substantial diminution of the scope of private property rights and their replacement by social property rights. Advocates of market socialism as a third way accept the many theoretical and empirical arguments that have been raised over the years -- and especially in recent times -- against primary reliance on planning rather than markets.² They seek therefore to change capitalist institutions primarily by embedding within a competitive market structure a system of enterprise ownership characterized by some form of social property rights. The objective of market socialism is thus to combine the recognized advantages of markets with respect to efficiency with a
system of social property rights which would contribute to the achievement of the four goals prominently associated with socialism.\textsuperscript{3}

B. Toward Social Forms of Enterprise Ownership

The property rights at issue involve the way in which various kinds of ownership rights to the productive assets of an economic enterprise are held. It will be useful here to distinguish two kinds of enterprise ownership rights:

(a) control rights over enterprise management, which involve the right to determine how enterprise assets will be acquired and used and the right to allocate enterprise net revenues among alternative uses; and

(b) income rights to enterprise assets, which involve the right to receive income from the use of productive assets, and the right to receive the proceeds from the sale of such assets.

Capitalist forms of enterprise ownership are characterized by (1) the bundling together of control and income rights into comprehensive ownership rights, and (2) the opportunity for private individuals to acquire such ownership rights in varying amounts -- by purchasing enterprise assets or equity shares. Market socialists have advocated that some or all of the ownership rights over enterprise assets should be held by members of a suitable community of people sharing equally in the relevant rights. Different kinds of social property rights can be distinguished according to: (i) the nature of the community in whom enterprise ownership rights are to be vested -- in particular, whether the community is a political constituency (local, regional or national) or an economic constituency (those who work in an enterprise); and (ii) which enterprise ownership rights -- control and/or income -- are to be held on an equal basis by members of the relevant community, and which (if any) are still to be available for acquisition in varying amounts by private individuals.
Advocates of market socialism have tended to support one or the other of two quite different models, each of which calls for the full ownership rights associated with capitalism to be held socially by communities:

(a) **public market socialism**, in which politically-constituted citizen communities hold both control and income rights in enterprises; enterprises are run by managers accountable to government agencies (at the local, regional or national level), which in turn are accountable to their citizen constituents; and the net operating surplus of the enterprise belongs to the whole citizen constituency and is allocated according to its collective desire;

(b) **self-managed market socialism**, in which the workers of an enterprise hold both control and income rights; enterprises are run by managers accountable to their workers (directly or through workers' councils); and the net revenue generated by the enterprise (after payment for inputs other than labor) belongs to the whole workforce and is allocated according to its collective desire.

Advocates of these two "pure" types of market socialism point to their ability to contribute to a somewhat differing subset of the socialist objectives listed above. **Public market socialism** has been advocated mainly as a way of contributing to the socialist objectives of: (a) greater equality in the distribution of material welfare (by treating the income generated by productive assets as a "social dividend" to be distributed more or less equally to all citizens); (b) greater democracy in the political arena (by virtue of greater equality in income and wealth); and (d) greater social rationality at the macro level (by enabling many externalities to be internalized). **Self-managed market socialism** has been advocated mainly as a way of contributing to the socialist objectives of: (b) greater democracy, by virtue of the extension of democratic self-governance to the workplace; (c) greater community at the workplace, by encouraging workers to participate in the management of enterprises;\(^4\) and (d) greater social rationality at the micro level (by encouraging labor-management cooperation within enterprises).

Each of the pure types of market socialism sketched above is vulnerable to criticism on the grounds that it suffers from serious efficiency problems. Critics of pure public market socialism have focused particular attention on capital allocational inefficiencies associated with collective public capital ownership, agency problems
associated with soft budget constraints, the difficulty of disciplining managers in the absence of a market for corporate control, and the disincentive to risk-taking and innovation resulting from limited material rewards for risk-takers and innovators.\textsuperscript{5} Critics of pure self-managed market socialism have faulted it especially for inefficient capital formation and a bias toward consumption over investment, labor allocational inefficiencies due to the lack of a conventional labor market, sluggish (if not perverse) supply responses to demand changes, and risk aversion (because workers' assets are highly concentrated in their own enterprise).\textsuperscript{6}

In response to such criticism advocates of both the public enterprise and worker self-management variants of market socialism have developed constructive and ingenious proposals to improve their efficiency characteristics. For example, Roemer's model of a "coupon economy" and Bardhan's proposal for a bank-centric financial structure establish strong incentives for good managerial performance in the context of public capital ownership.\textsuperscript{7} And among many ideas for improving the efficiency characteristics of labor-managed enterprises, Vanek's proposals for capital leasing, Ellerman's internal capital accounts and cross-enterprise income pooling, and Sertel's markets in membership rights go a long way to meet the efficiency challenges raised by critics.\textsuperscript{8}

This is not to say that such modifications in models of market socialism can or will succeed completely in meeting the conventional efficiency criteria associated with a pure capitalist model. Since the modified models invariably retain more restrictions on voluntary contracting by individuals than do capitalist alternatives, they cannot be expected to do so. Instead, their advantage must lie in their ability to meet the kind of non-efficiency goals articulated in the first section and/or to achieve a larger social rationality than is encompassed by the individual-rationality-oriented conventional efficiency criteria.\textsuperscript{9}
C. Why Not Just Reform Capitalism?

Modifications of market socialist models designed to ameliorate their efficiency characteristics tend to bring those models into closer conformity with capitalism. In so doing, they tend to open up greater opportunities for the development of income inequalities and/or to reduce the scope of worker self-management. Why not then start with a conventional capitalist model and modify it via reforms to promote socialist objectives rather than insist on the fundamental changes in property rights associated with market socialism?

Greater equality might be achieved through continuous income redistribution via government taxes and transfers on income and/or wealth; or it might be achieved by a more radical program of property redistribution designed to achieve an initial desired egalitarian distribution of wealth. A serious problem with seeking to assure greater equality via continuous government income redistribution, however, is that such redistribution is not politically stable: taxes and transfers are a matter for legislation and, as such, can be altered every time the political winds shift. A once-and-for-all program of radical property redistribution to equalize wealth holdings would not suffer from the same problem, but it would allow wealth inequalities to re-emerge and grow over time with changes in asset values and asset ownership patterns. To assure that income and wealth does not become increasingly unequally distributed over time, there appears to be a need for institutionalized limits on wealth concentration.

More democracy in the political arena might be promoted via the kind of government redistributive measures suggested above, which would reduce inequalities in political power as well as in material welfare. But a permanent levelling of the political playing field requires stable institutional safeguards against growing economic inequalities. Democracy at the workplace might be fostered by having representatives of
workers as well as shareholders sit on boards of directors of capitalist corporations (as under German "co-determination"). But such schemes hardly serve to redress the balance of power in favor of shareholders in capitalist firms. Truly democratic self-governance at the workplace requires management to be formally accountable on a one-person-one-vote basis to those who work in the enterprise, for only in this way is enterprise governance rooted in a community of the governed.

Greater community among neighborhood residents might be promoted by the strengthening of local government institutions. In this case it is not clear that there is a superior institutional alternative. Greater community among workers might be achieved by facilitating the formation and increasing the power of labor unions. Unions in capitalist firms, however, may not be sufficiently conducive to community at the workplace for several reasons: many workers in capitalist societies are not represented by unions; union influence is typically confined to a limited range of issues; and unions often involve workers in an adversarial dynamic with managers and owners.

Greater social rationality at the macro level might be served by government taxes, subsidies, and/or regulations (along the lines of Japanese or French industrial policy) to steer private actors in a social direction and thus overcome market failures. The case for some form of public ownership in order to accomplish these ends is strong in certain activities — such as natural monopolies — but this is recognized by advocates of capitalism as well. At the micro level, enterprise organizational restructuring designed to encourage worker participation and long-term employment relations (along Swedish or Japanese lines) might foster greater cooperation at the workplace and deal with coordination problems within a capitalist context. But when worker participation in enterprise management is institutionally grounded in worker democratic decision-making rights it is arguably more stable politically and more effective economically.
The arguments for fundamental change in property rights are thus most convincing when it comes to (i) assuring institutionally that the distribution of holdings of income-generating productive property does not become highly unequal, so as to promote material equality and political democracy, and (ii) building in institutionally the opportunity for workers to participate in and influence enterprise decision-making, so as to promote workplace democracy and community as well as micro-level social rationality.

II. A Reconceptualization of Market Socialism

The analysis of the preceding section suggests that to achieve socialist goals it is necessary to institutionalize a levelling of the distribution of capital income and to institutionalize economic democracy at workplaces. These are precisely the basic objectives of the two models of market socialism which I have discussed to this point; yet each is clearly deficient with respect to the basic objective of the other.

Public market socialism inadequately promotes more democracy (because it does not extend democratic self-governance to the workplace), and it does nothing to promote greater community at the workplace (because it does not enable workers to participate collectively in enterprise management). Self-managed market socialism fails in an important respect to promote greater equality (because it does not prevent the development of significant inequalities between enterprises), and it fails in the same respect to promote more democracy in the political arena. These shortcomings suggest that a truly adequate market socialism should seek to combine the strengths of each of the above-mentioned models -- while at the same time maintaining a reasonable degree of efficiency and social rationality at both the macro and the micro level.
To achieve these objectives I propose a market socialist system based upon three key elements: (i) democratic control of enterprises, (ii) broadly distributed claims to enterprise capital income, and (iii) active government economic policy at the local, regional and national levels. My proposal unbundles the control and income rights associated with capitalist enterprise ownership. It represents a hybrid form of market socialism, applying ideas drawn from self-managed market socialists (Vanek, Ellerman, et al.) to the assignment of control rights and applying ideas drawn from public market socialists (Roemer, Bardhan et al.) to the assignment of income rights.  

A. Democratic Self-Management.

I propose that democratic self-management be required for all enterprises with more than a minimum number of people involved (say 5); otherwise, conventional private ownership of small businesses -- by individuals, families or partners, would be permitted. Capitalist ownership generally confers control over enterprises on a group of private owners or shareholders with unequal membership rights, little social contact, few ties to the area in which the enterprise is located, and no enduring common identity. Democratic self-management confers control equally on those people most directly affected by enterprise governance, bringing an important set of economic decisions into an egalitarian community decision-making arena.

Under democratic self-management all the members of an enterprise community elect enterprise councils on a one-person, one-vote basis, and managers are hired by and responsible to the councils. Managers have decision-making responsibility with respect to the employment and disposition of enterprise workers, the use of enterprise productive assets, and the allocation of the net revenue of the enterprise (after all obligations -- including payments to external capital suppliers -- have been met). Workers are free to join democratically self-managed enterprises on any terms offered by enterprise
management; the only inviolable condition is that they gain the right to vote (at least after a short probationary period). And workers are also free to leave an enterprise, giving up their right to vote and cashing in any insider equity stake they have acquired (more on this below). Any system of pay is admissible -- whether it involves the sharing of net revenues or pre-set wages, income equality or wage differentials, incentives geared to performance or to seniority; what is required is simply that management be accountable for its pay policy (and all other policies) to every enterprise member on a democratic basis.

I propose that democratically self-managed enterprises acquire productive assets in any of the following several ways:

(a) by leasing assets from other enterprises or small businesses at agreed-upon rental rates (in this case, the enterprise manages the assets for the duration of the lease agreements, but outside lessors receive fixed payments and retain the right to sell the assets and to receive the proceeds from such sales, after meeting obligations specified in the lease agreements);

(b) by borrowing from independent and democratically self-managed banks or other financial intermediaries to purchase assets (here financial institutions receive fixed payments, while the enterprise gets the right to manage and to sell the assets and to receive the proceeds from any such sales);

(c) by selling non-voting tradable equity shares to independent mutual funds (to be described further below) or to foreign investors, and using the proceeds to purchase assets which they have the right to manage and to sell (external holders of these equity shares acquire no formal control rights but only the right to receive capital income in the form of dividends and the right to realize capital gains or losses by selling shares; the amount of the dividends and possible capital gains/losses is of course dependent on enterprise performance);

(d) by reinvesting some of their net operating surplus in the purchase of assets which they have the right to manage and to sell (in this case all members of the enterprise community receive -- in proportion to the rate at which they earn income in the enterprise -- individual non-voting non-tradable equity shares, which generate dividends and capital gains or losses in exactly the same way as any tradable shares held by outsiders, according to the performance of the firm; the capital gains or losses can be realized, however, only as and when the insiders leave the firm and cash in their equity -- by selling positive equity claims back to the enterprise, or making good on negative equity claims resulting from poor enterprise performance).
This system of capital financing for self-managed enterprises effectively divides up the claims to residual enterprise income among several different groups -- in proportions that depend on how particular enterprises choose to acquire their capital and compensate their managers. External equity holders -- mutual funds and foreign investors -- share in the residual to the extent of their tradable equity holdings, since their dividends and the value of their shares vary with the performance of the firm. Internal equity holders -- the voting members of the enterprise, including managers as well as workers -- share in the residual to the extent of their non-tradable equity holdings, since the dividends they receive and the value of their shares varies with the performance of the firm. Managers may well share additionally in the residual to the extent that their compensation is specifically linked to firm performance (according to terms ultimately under the control of all enterprise members).

Under democratic self-management equity-holding capital suppliers do not hold any direct control rights (as they do under capitalism); they would, however, have indirect influence via their ability to influence the terms on which they supply capital to enterprises and to withhold future infusions of capital (much as debt-holders are able indirectly to influence management in conventional capitalist firms). Capital suppliers may even negotiate with enterprise managers to retain certain kinds of control over the capital they supply: the point is not to deny them the opportunity for any control rights, but to provide such rights not as an inherent prerogative of capital ownership but as a matter to be negotiated with managers who are democratically accountable to workers rather than shareholders. Thus, democratic self-management of enterprises can be viewed as a good way to redress the preponderance of influence held by capital-suppliers in favor of labor-suppliers, establishing a more balanced distribution of influence among stakeholders in enterprise decisions.16
B. Socialization of Capital Income.

I propose to generate a broad distribution of claims to enterprise capital income by establishing a restricted two-tier stock market system along lines proposed by Roemer\textsuperscript{17} -- except that equity shares confer no formal control rights. First of all, I envisage a market in non-voting enterprise shares (already described above) in which independent mutual funds as well as foreign investors could participate. Second, I envisage a market in mutual fund shares, in which all adult citizens of the society would participate. Shares in mutual funds would entitle their owners to a corresponding proportion of the net revenues of the funds, which themselves would be organized as democratically self-managed enterprises or as small private businesses according to the guidelines set out in the previous section.

To assure a reasonably equitable distribution of capital income claims, I propose to begin the establishment of the market socialist economy with an equal \textit{per capita} claim by all adult citizens to the productive assets of all the enterprises large enough to be democratically self-managed.\textsuperscript{18} This could be achieved by distributing to everyone initially an equal amount of shares in a large number of mutual funds, each of which initially holds (income) claims to an equal proportion of the productive assets of every democratically self-managed enterprise.

To prevent the accumulation of concentrated capital holdings by individual citizens, I propose to isolate the stock market in mutual fund shares by barring the exchange of such shares for anything but other mutual fund shares. In other words, citizens may neither increase their mutual fund share holdings by purchasing more shares with cash or other assets, nor may they liquidate their portfolios for cash or other assets. This restriction assures that every citizen will continue to hold some claim to the economy's capital income (and can assure her/himself the average claim by maintaining
a completely balanced portfolio), while allowing individual citizens to seek to increase the value of their claims (and risk decreasing its value) through trades of shares in different mutual funds.

In general, of course, citizens' personal wealth portfolios would not be limited to mutual fund shares. The available forms of income-generating wealth include also assets directly purchased and used in one's own small business, and fixed-return savings deposits in financial institutions. Thus, in spite of the proposed capital market restrictions, individuals would retain a substantial amount of freedom of choice with respect to the allocation of their wealth. Moreover, the opportunity to borrow on the collateral of one's mutual fund share holdings would be available to individuals whose immediate liquidity needs exceeded the value of their other assets.

C. **Active Government Economic Policy.**

I propose active government economic policy at the national, regional and local levels in order to meet the objectives of social rationality at the economy-wide and neighborhood community levels. The case for government influence on enterprise decisions affecting the overall rate and pattern of capital formation and economic growth (and especially their effect on the earth's environment) rests on well-known limitations of completely free markets in areas beset with externalities and coordination problems. The case for government involvement in these areas can also be made in terms of democracy: people should have equal rights as citizens to determine the overall direction of the society in which they live, which is strongly affected by rate and pattern of capital formation. Even in capitalist societies it is taken for granted that there is a role for national and regional government policy to bring the actions of individuals and enterprises more closely into line with the general social interest in these areas than could be expected from the unfettered pursuit of self-interest by uncoordinated agents.19 Furthermore, it is well recognized that there is a role for economy-wide government
policy in insuring citizens against risks due to factors over which they have no control -- such as macroeconomic fluctuations in aggregate demand and employment. Finally, there is just as strong a case for local government policy to bring to bear the interests of local communities on the decision-making of local enterprises -- since many enterprise decisions affect local interests and concerns in ways that cannot be reflected in the prices faced by enterprise decision-makers.

The proposals I am making here are neither controversial nor unique to a market socialist model; they are relevant to all market economies, whatever the structure of their property rights. It is arguable that some of the problems that an activist government policy is designed to address could be solved more efficaciously by a re-assignment of property rights than by discretionary policy intervention. For example, the establishment of local community property rights in clean air, clean water and other environmental amenities could conceivably ensure market-based solutions to environmental externality problems. Such an approach would be particularly congenial to a market socialist approach based on the socialization of certain key property rights; but it surely could not fully substitute for government policies designed to bring to bear the public interest on enterprise decision-making.

D. Potential Efficiency Problems.

The democratic-enterprise-based market socialism I am advocating combines elements drawn from modified versions of the public and the self-managed market socialist models, thereby sharing some of the efficiency advantages of such modified models as compared with the pure types I first described in section I. Indeed, there are some features of my proposal that render it less restrictive than many other versions of market socialism -- for example, the variety of capital financing options available to enterprises. Yet because my model does still rule out certain types of enterprise
ownership rights, and because it does still impose certain restrictions on the operation of both capital and labor markets, it can and will be subject to criticism on efficiency grounds. Some of the most likely points of criticism -- and responses thereto -- are set out below.

1. Lack of management discipline. One of the primary virtues of capitalist property rights is considered to be the way in which discipline is enforced on enterprise managers: If a firm is being poorly managed, the value of its shares on the stock market will fall and the firm will become an increasingly appealing target for a hostile takeover by new investors who have reason to believe that the installation of new management will improve firm performance. The stock market thus provides information about the quality of current management performance, incentives to current managers to perform better, and a mechanism for the replacement of current managers if they fail to do so.

There is an enormous literature on the effectiveness of conventional stock markets in eliciting good management performance. It is fair to say, at the very least, that there is no consensus on this issue. Strong arguments have been advanced to the effect that alternative mechanisms relying more on voice and less on exit -- such as bank-centric monitoring systems -- are considerably more effective in eliciting good management performance.20

The model of market socialism that I am proposing seeks to take advantage of the information-conveying function of stock markets while minimizing the tendency of such markets to concentrate wealth and power. Thus it does provide for equity markets in which share values will be responsive to enterprise performance, but it does not permit hostile takeovers. Instead, it enables those with a strong stake in enterprise performance -- in particular enterprise workers, but potentially also mutual funds with substantial share holdings and/or banks that have extended substantial credit -- to put
pressure on management to function well. These affected stakeholders have
information, strong incentives and considerable means to influence management
(democratic voting power, the threat not to supply capital in the future). Finally,
management compensation can be tied directly to measures of enterprise performance;
and product market competition remains a strong force for good decision-making..

The issue of management discipline arises in my market socialist model with
respect to mutual fund managers as well as to enterprise managers. Here again there is
an equity market to provide information about performance, and there are insiders (the
personnel of small private funds, or the workers of large democratically self-managed
funds) with the incentives and the means to influence management. Although outsiders
(the individual citizens holding fund shares) will typically not have stakes in fund
performance -- or means to influence fund management -- comparable with those of
enterprise capital-suppliers, management salaries can here too be tied to measures of
fund performance, and competition among mutual funds will help to enforce
management discipline.

2. Inadequate supply of capital. In my market socialist model the full range of
capitalist financial instruments are not available for the supply of capital to democratic
self-managed enterprises; in particular, there are no equity shares conferring control
rights. It is therefore arguable that potential external investors will be less inclined to
finance enterprise capital formation than in a capitalist economy.

The salience of this concern, however, is diminished by the fact that much of the
capital supplied to conventional capitalist corporations is supplied by people (or
institutions) who do not acquire any effective control over the corporation. Moreover, in
situations where a potential capital-supplier wished to purchase enough equity so as to
gain a controlling interest in a conventional corporation (and where other sources of
sufficient capital were not available), that capital-supplier would be in a position to
negotiate with worker-accountable management over the terms on which the capital is to be supplied in such a way as to gain *de facto* certain control rights that are *de jure* in capitalist economies.\textsuperscript{21}

3. **Inefficient allocation of capital.** The restrictions on capital markets embedded in my market socialist model might arguably interfere not only with the overall supply of capital funds but also with the optimal allocation of capital across competing uses and enterprises. This can hardly be denied if one is confident that unfettered capital markets do indeed lead to the optimal allocation of capital; but (like the argument for the effectiveness of stock market discipline of management), the argument that capital is efficiently allocated by unrestricted capital markets is at best highly controversial. The most convincing critiques of socialist models of capital allocation target bureaucratic public sector agencies. The system I am proposing, however, is very decentralized, multi-faceted and competitive; thus it avoids all the well-known problems associated with centralized and/or bureaucratic methods of capital allocation.

4. **Lack of worker discipline.** The fact that workers in democratically self-managed enterprises have more power over managers than they do in conventional capitalist firms may lead to fears that they would use this power to sacrifice enterprise productive efficiency for their own immediate benefit -- e.g., by making it possible to exert less effort on the job, to improve working conditions without improving work performance, to resist labor-saving technology, or more generally to ensure employment stability at the expense of productive efficiency. There are several levels at which such concerns can be addressed.

First of all, these concerns reflect a profound distrust of the democratic process. Note that the same kinds of arguments could be raised against the principle of one-person one-vote for citizens in the political arena. Won't people vote only in their own
immediate self-interest, rather than in the interest of society as a whole? Won’t they seek short-term gain at the expense of long-term loss? Such questions ignore the fact that the democratic process itself can help to educate voters as to the real alternatives they face, and to engage their cooperation rather than their resistance to needed measures. It is easy to be cynical about democracy in the contemporary political era; yet surely the best approach is not to abandon democracy but to seek to make it more effective -- by increasing participation, levelling the playing field, and promoting a more educated and better informed electorate.

Second, precisely the same kinds of concerns have been raised in objection to labor unions in capitalist economies. And, indeed, there are instances in which unions have served mainly to promote featherbedding and have hampered enterprise performance. But there are just as many instances where unions have contributed to increased productivity and better enterprise performance.22 Whatever one’s evaluation of such matters, it is clear that what is crucial is not the presence or absence of unions per se, but the nature of the unions and the context in which they operate: the biggest problems are associated with lack of democratic union structures and lack of competitive firm product markets. The market socialist model I am proposing builds democracy into the structure of worker influence, and it promotes product market competition.

Third, in a democratically self-managed enterprise workers as a group have at least as strong an interest in assuring good job performance by individual workers as have shareholder owners as a group in a capitalist firm. Management responsible to workers could establish the same kind of work incentives -- e.g., close links between individual worker performance and individual worker material gain -- as could management responsible to shareholders. A real difference arises only when a capitalist firm has a small number of shareholders with effective control, and the gains or losses to each of these (few) particular shareholders are much more sensitive to the performance
of the firm than the gains or losses to each of the (many) individual workers in a
democratic enterprise. Weighing against this apparent advantage of a tightly focused
capitalist ownership group over worker control is the fact that losses due to poor firm
performance are likely to have a greater impact on the standard of living of the typical
worker than on the standard of living of the typical controlling shareholder-owner.

5. Bias against investment. This is really a special -- but important -- case of
the more general potential problem of worker indiscipline. Many critics of worker self-
management have argued that it would lead enterprises to favor the distribution of net
revenue in forms generating current worker consumption rather than the retention of
net revenues for investment, because the time horizon within which workers can benefit
from enterprise revenues is limited to their period of work at the enterprise.

First of all, this concern is vastly over-rated: most current workers expect to be in
their particular enterprise for a long time, and, even if their claim to enterprise net
revenues were based solely on current distributions while they were still on the payroll,
they would have a considerable interest in the future revenue-generating capacity of the
enterprise. Second, this kind of concern is greatly mitigated in the model of democratic
self-managed enterprises I am proposing here by the system of internal equity that
provides workers with individual claims on capital income to the extent that enterprise
net revenue is reinvested. Moreover, enterprise reinvestment of some of its own net
revenue is likely to be a condition for obtaining external finance, which will also militate
against any bias toward redistribution rather than reinvestment.

6. Inefficient allocation of labor. This concern arises especially because of the
likely ability of workers in democratically self-managed enterprises to press for greater
employment stability than they would be able to achieve in a capitalist firm. In general,
enterprise workers are likely to prefer changes in their rate of pay rather than in the
number of workers employed when changing demand conditions result in changes in enterprise net revenue, whereas shareholder-owners are likely to be quicker to hire new workers or to dismiss current workers in response to demand fluctuations.

There would indeed be a tendency toward less variability in enterprise employment and less overall labor mobility in a system of democratically-self-managed enterprises than in a system of capitalist firms. Such a bias toward employment stability is likely to generate negative externalities in good economic times (by limiting the job creating potential of economic expansions), but it is likely to generate positive externalities in bad economic times (by limiting the job-destroying potential of economic contractions). Note, however, that the model I am proposing is less vulnerable to concerns about inadequate employment creation than traditional models of worker-owned enterprises in which new hires invariably gain not only voting rights but also a per-worker share of the net revenues of the enterprise.

7. Sluggish supply responses. This is a generalization of the concern about employment stability that I have just discussed above. Many models of labor-managed firms show that such firms would respond sluggishly -- if not actually perversely -- to changes in demand conditions; but such results emanate most unambiguously from simplified short-run models of "pure" worker self-management in which firms are characterized by an unreasonably restrictive set of operating rules. While the much more flexible nature and environment of democratically self-managed enterprises that I am advocating here may not completely eliminate some response sluggishness, it is far less vulnerable to this kind of criticism than simpler and more rigid models.

8. Lack of innovation and entrepreneurship. The kind of restrictions I impose on capital market instruments -- and the consequent limitations on opportunities for capital accumulation -- might suggest that potential innovators and entrepreneurs
would have inadequate incentives to "do their thing." But I am not proposing any limit on the opportunity for individuals or small groups to invest, innovate and reap the resulting financial gains or losses -- so long as their activity remains within the upper limit on the number of people involved in a small business. Successful ventures seeking to expand employment beyond this limit would have to set up democratic enterprise structures, but individuals or small groups who felt that their innovational and/or entrepreneurial talent or opportunities were being stifled in such an environment could break away to form their own independent small firms.

9. Insufficient risk-taking. Among the most common points of criticism of worker-owned firms is that each worker's assets -- in the form of firm-specific skills as well as claims to financial and physical wealth -- would be so highly concentrated in the particular enterprise in which s/he works that there would be great aversion to risk in enterprise decision-making. This is the other side of the coin of the putative benefits in effort and productivity arising from having a high stake in one's own enterprise. And it constitutes one of the main arguments in favor of enterprise control by external shareholders, who are in a position to diversify their wealth so as to be neutral with respect to risk in any particular firm.

This concern about risk aversion is most salient in the context of "pure" models of worker self-management -- in particular, those in which workers exercise full ownership rights over the enterprise and thus have much of their productive wealth as well as their labor tied up with the enterprise itself. In my proposed model both enterprise finance and workers' portfolios can be much better diversified. Workers can and will acquire internal equity stakes in their own enterprises, but there is plenty of opportunity to spread the risk to outsiders via external equity finance.
In summary, it is possible to meet various lines of criticism in such a way as to diminish considerably the force of the argument that my model of market socialism will prove inefficient. I do not mean to suggest that it will be just as efficient (by conventional efficiency criteria) as a capitalist model. Against any remaining efficiency disadvantages of this market socialist model, however, must be set not only its contributions to the distinctly socialist goals emphasized in part I but also certain countervailing efficiency advantages.

E. Potential Efficiency Advantages.

The case for market socialist restrictions on property rights can be strengthened not only by showing that potential efficiency losses are not as great as often imagined, but also by showing how such restrictions can actually generate certain efficiency gains - along lines suggested below.

1. Dispersion of capital ownership. The unbundling of income and control rights, the mixture of insider and outsider equity holdings in enterprises, and the system of mutual funds -- all of which apply to all but the smallest enterprises in the proposed market socialist system -- have the effect of preventing the emergence of highly concentrated and powerful units of capital ownership of the kind that tend to dominate capitalist economies. The dispersion of economic power reduces opportunities for collusion between powerful private interests and public officials, thereby reducing overall efficiency losses associated with the pursuit of private gain at public expense. The dispersion of economic power also restrains the development of monopolistic power in product markets, thereby allowing product market competition to enforce good firm performance -- as it tends to do no matter what the precise nature of the firm's ownership and organizational structure.24
2. **Greater overall income distributional equality.** The socialization of capital income via non-tradable mutual fund shares in the proposed market socialist model assures a substantially greater degree of equality in the distribution of income than in a conventional capitalist market system. The less unequal the distribution of income in a society, the less of society's resources need to be expended in the protection of the well-to-do (and their property) from the less-well-to-do.\textsuperscript{25} Moreover, less income inequality is also likely to reduce conflict over the distributional consequences of government policy, easing the political problems associated with government efforts to stimulate overall growth and efficiency.

3. **Institutionalized worker self-management.** Almost all advocates of some form of self-management have argued that one of its principal virtues is its potential for stimulating enhanced effort, innovation and productivity on the part of workers. The gains may arise from greater positive motivation on the part of individual workers or from more effective monitoring and the resultant savings in supervisory expenses. Although worker participation in management, and worker sharing of residual claimancy, can be organized in a variety of ways by capitalist firms within capitalist economies, there are good grounds for believing that the associated efficiency gains can best be realized when worker participation and residual sharing are elements in a larger institutional environment characterized by the predominance of enterprises in which workers have significant power and by a reasonable degree of overall income distributional equality.\textsuperscript{26}

A related efficiency gain associated with worker self-management is the increased potential for achieving social rationality at the micro level via cooperative solutions to enterprise-level coordination problems. Democratically self-managed enterprises open up greater opportunities than capitalist firms for the alignment of worker interests with those of management, thereby replacing costly labor-management conflicts with a
climate of trust which can serve to promote more effective teamwork in dealing with organizational and technological problems confronting the enterprise.

III. The Eastern Context

Economists and policy-makers in Eastern Europe and the former Soviet Union, discouraged by the experience of market-oriented reforms in command-administrative economies, have tended to dismiss the possibility of a successful market-socialist third way involving social property rights and/or worker self-management. From the 1960s through the 1980s, when communist regimes still dominated policy-making in the East, the idea of a "third way" was popular in certain circles -- especially among market-oriented economic reformers who wished to liberalize the administrative-command system. Now that the alternative of a completely capitalist market economy appears within reach, only a few committed democratic socialists are still advocating a third way. Yet there are good reasons to think that a democratic-enterprise-based market socialism may well offer the best approach to a market economy in the East.

A. The Irrelevance of Past Experience with Market Socialism

Although the only country to embrace wholeheartedly a form of market socialism was Yugoslavia, Hungary extended substantially the scope of markets with its "New Economic Mechanism," and most of the East European countries as well as the Soviet Union experimented at certain times with some market-oriented reforms and/or some elements of worker control -- especially in the waning years of communist power. These efforts brought some successes, but they failed to resolve the fundamental economic problems besetting the administrative-command economies. Yet the unsatisfactory results of such reforms should not be used to discredit the whole idea of a market socialist alternative, because so many aspects of the reforms and their institutional
environment failed to conform to the requisites of the kind of market socialist model that I am advocating here.

First of all, market socialism and market-oriented reforms in the East were invariably carried out within a political context that remained bureaucratic and authoritarian; the essential element of democratic political democracy was conspicuously lacking. Second, even where centralized economic control was relaxed, a soft budget constraint remained endemic; national governments would provide financial support for otherwise failing enterprises, and they would tend to allocate investment capital with little regard to enterprise economic performance. Both state-controlled and more autonomous firms operated for the most part in highly monopolistic environments with little effective competition and very limited opportunities for entry and exit of firms. Where worker self-management was introduced (notably in Yugoslavia), property rights in capital assets remained ill-defined, enterprises had access to capital on terms bearing little relation to its scarcity value, and workers’ control was seriously limited by the continuing power of the communist party and the state agencies under its control.


The current political winds favoring a purely capitalist approach to a market economy in the East can be understood as a reaction to the obvious failures of bureaucratic administrative-command socialism and the comparative success of capitalism. Although capitalism has clearly promoted economic growth in many parts of the world -- notably in the West and the Pacific Rim -- there are nonetheless grounds for skepticism about its ability to deliver the goods in the very different environment of Eastern nations emerging from communist rule and administrative-command economies.

First of all, there is an enormous lack of institutional infrastructure needed for the efficient operation of labor and capital markets within a context of capitalist
property rights -- e.g., opportunities for labor mobility, information about investment opportunities, effective government regulation. The needed institutional infrastructure developed very slowly and over a long period of time in the countries where capitalism has been most successful in stimulating economic growth. Rapid introduction of private property forms into the chaos created by the demise of administrative-command economies threatens not to replace but simply to change the form of the monopolization, corruption and inefficiency that have plagued the nations of the East for so long.

Second, in spite of the failure of the administrative-command systems to live up to communist promises of equality, there remains among many people in the East a certain belief, if not in egalitarianism per se, then at least in the proposition that a small minority should not benefit out of all proportion to the vast majority. Perhaps even more important, the success of the erstwhile communist regimes in assuring economic stability and security -- albeit at a modest level of material welfare -- has generated expectations among the people for continuing stability and security. However successful it may be in stimulating economic growth, capitalism -- especially in the early stages of its development -- systematically generates inequality, instability and insecurity.

A third reason to be skeptical about the capitalist route to a market economy in the East is that it is bound to provoke significant political opposition from important groups -- notably workers -- who face the prospect of a very substantial loss of economic welfare and political power. Opposition from workers or other groups disadvantaged by the manifold social and economic changes implied by the introduction of capitalist property right can pose significant obstacles to the implementation of capitalist market reforms. Alternatively, such opposition may lead reformers to apply increasingly anti-democratic methods to push through the desired reforms. Either way, the prospects for a successful transition to a democratic market system are threatened.
I do not wish to imply that potential obstacles menace only capitalist routes to a market system. Any effort to transform the deteriorating economies of the Eastern nations into viable market systems is bound to give rise to a host of problems and uncertainties. Perhaps the most serious threat to the success of a market socialist transition is the historical legacy of bureaucratic ineptitude and rampant corruption on the part of public officials in the nations formerly under communist rule. This legacy threatens to undermine the integrity of the government role that is critical to a market socialist route to a market economy, and it underlines the importance of a genuinely democratic political order for the success of market socialism.

There are also potential problems associated with the empowerment of workers through democratic self-management at the enterprise level. To the extent that worker influence generates a bias toward stability, it may inhibit some of the changes that are needed to restructure the old command-administrative system. And there may well be a tendency for workers to adopt defensive positions designed to protect their short-run interests rather than serve their own (and society's) long-term interest in fundamental change. Yet there are substantial grounds for believing that such possible pitfalls will be more than outweighed by the potential advantages of a market socialist route out of administrative-command socialism.

C. The Promise of a Third Way in the East.

The case for a democratic-enterprise-based market socialism in the East rests upon a combination of political and economic considerations. First of all, it should be noted that any transition out of the currently chaotic situation, with its crumbling institutional infrastructure and ill-defined property rights, constitutes a huge and unprecedented experiment with unavoidably uncertain results. Contrary to popular myth, an attempt to make an immediate transition to a conventional capitalist economy
does not offer a tried-and-true path to prosperity any more than does an attempt to build a democratic market socialist economy.

Perhaps the strongest argument for the latter alternative rests on the general conservative case for gradualism in social and economic change. Although many economic reformers -- like revolutionaries -- would like to wipe the slate clean and build a new system from scratch, historical experience suggests that such an approach tends to be destructive of the good as well as the bad and thus to make successful change even more difficult than it has to be. In the context of the East, this suggests that the transition to a market economy should seek to take advantage of any elements in the old system potentially conducive to successful operation within a new decentralized competitive market context. In particular, one should seek to make use of the skills and the education embodied in the current work forces of the old state enterprises -- managers, engineers, technicians, as well as operatives; and their detailed knowledge about production processes might best be harnessed by a system in which management remains more accountable to insiders than to external financiers.

An approach that builds on worker self-management rather than rejecting it also provides the opportunity to recognize the growth -- albeit limited -- of workers' political and economic power at the workplace during the late reform stages of many of the command-administrative systems. To some extent worker control rights may also substitute for higher real wages, conferring greater legitimacy on policies for economic and social changes which in many other ways will lead to difficult times for workers. Far from leading to wage indiscipline, worker control in the declining sectors of transitional economies can lead to greater acceptance of real wage decreases as an alternative to higher unemployment.
Another important consideration militating in favor of a market socialist rather than a capitalist approach is the ability of the former to assure a more egalitarian distribution of claims to capital income. This important socialist principle is still of some importance in the East; even though the capital income generated by state enterprises was in fact distributed rather unevenly, the idea that the general population built the nation's capital stock and deserves to share in its fruits remains a compelling one. The market socialist proposal for mutual funds in which all citizens are guaranteed shares appears especially salient in the context of the "spontaneous" or "wild" privatizations of public assets (in which well-placed public officials or private robber barons take control of valuable assets previously under state authority) which have all too often become an element of the capitalist route to the market in the East.

The process of transition to a market economy -- no matter what precise form it takes -- will surely require economic sacrifices on the part of many people; it is simply impossible to engineer a sequence of Pareto-improving steps from the present disorder to a new system. People are likely to be much more willing to endure such sacrifices if the gains and/or losses during the transition are seen as reasonably equitably distributed. The fact that a more equitable transition is more conducive to maintaining popular support means that it also offers more hope for keeping up the momentum for change within a context of political democracy. Democratic-enterprise-based market socialism may therefore offer the best hope for transition to democratic market societies in Eastern Europe and the former Soviet Union.


3. In most models of market socialism markets are not intended to replace planning completely; there is clearly room for planning in the form of public economic policy at various levels of government. And social property rights are not intended to displace private property rights completely; there is also room for private property rights on a small scale.

4. It is arguable that worker self-management also promotes greater community at places of residence: insofar as workers are more likely than shareholders to push for employment stability and locally-oriented investment, worker-controlled enterprises are more likely to contribute to the stability of the residential communities in which they are located.

5. For representative critiques of public market socialism, see the contributions by Stiglitz, Kornai and Putterman to this volume.

7. See the contributions by Roemer and Bardhan to this volume.


9. It is important to note in this context that the right of individuals to enter into mutually agreed-upon contracts is by no means unrestricted even in the most free-market of capitalist societies. Two salient examples are the prohibition of serfdom and the prohibition of purchase and sale of votes. Moreover, laws establishing limited liability for capitalist corporations represent a clear violation of purely private property rights; they are justifiable on grounds of their putative positive externalities in a way that does not differ qualitatively from the justification for market socialist alterations of pure private property rights.

10. Government redistributive taxes and transfers also have potentially adverse incentive effects; how serious these would be depends of course on their size. This kind of efficiency problem is arguably greater for income taxes than for wealth taxes; and a well-designed tax on inheritances is likely to have the smallest adverse incentive effect (see, for example, the ingenious inheritance tax proposed by Fleurbaey in his contribution to this volume).

11. Indeed, the Japanese have managed to incorporate effective employee power via (mostly implicit) long-term relations and contracts without actually building in a formal worker management role; see, for example, Masanori Hashimoto, "Employment and Wage Systems in Japan and Their Implications for

12. David Levine and Laura Tyson, "Participation, Productivity and the Firm's Environment," in Alan Blinder (ed.), Paying for Productivity (The Brookings Institution, 1990), argue persuasively that the most effective worker participatory arrangements involve gain sharing, long-term employment, group cohesiveness and solidarity, and strong guarantees of worker rights — all of which are likely to be most strongly fostered in a democratic self-managed enterprise.

13. The case for such a hybrid model gains strength from the argument that the evolutionary stability of democratic self-management is enhanced by a relatively egalitarian distribution of wealth; on this point see Bowles and Gintis, "An Economic and Political Case for the Democratic Firm," in John Roemer (ed.), The Idea of Democracy (forthcoming, 1992).

14. The ceiling of 5 on the number of people involved in a small private business is of course merely suggestive; it could be relaxed at least in the case of members of the same family.

15. Such internal equity shares conform to the spirit of the system of internal capital accounts recommended by Ellerman, which provides a capital stake to workers in proportion to the earnings they forego when the enterprise reinvests rather than distributes net revenue to collective consumption or individual wages and salaries; my proposal differs, however, in allowing outsider tradable shares as well as insider nontradable shares, and in having dividends — varying with firm performance — rather than a fixed rate of return paid on the insider shares.

16. The case for assigning voting rights in the firm to workers rather than to capital-owners is supported by the analysis of Bowles and Gintis, op. cit., showing how
workers lack power because they tend to be on the long side of the labor market while capital-suppliers derive power from being on the short side of the capital market.

17. See his contribution to this volume.

18. There are of course huge issues of transition to be addressed in any real-world application of this model — involving, for example, the question of compensation for previous ownership rights. My paper abstracts from such issues, except to note that the situation of the formerly administrative-command economies of the East -- with very vague property rights and a generalized public claim to society's productive assets -- invites an egalitarian initial distribution of income claims to the assets of the old state enterprises.

19. Such government policy need not generally take the form of direct controls, but can usually be administered effectively via taxes, subsidies, regulation and other such measures designed to "get the prices right."

20. See, for example, the contribution by Pranab Bardhan to this volume, and Ajit Singh, "The Stock Market and Economic Development: Should Developing Countries Encourage Stock Markets," unpublished paper, University of Cambridge, UK, October 1991.

21. As a practical matter, this kind of concern is most likely to arise with respect to potential foreign investment in democratically self-managed enterprises. If indeed the only realistic hope for successful enterprise performance is to have a foreigner investor bring in capital, and perhaps also a management team, then the potential foreigner investor would be in a very strong bargaining position vis-
a-vis enterprise workers and could surely exact various rights of management
and/or various guarantees as a condition for participation in the venture.


23. See Bonin and Putterman, *op. cit.*, Part I, section 1, for a review of the relevant
literature.

24. Yet another reason to prefer enterprise ownership structures that do not
concentrate decision-making power in a small number of hands is to reduce the
incidence of negative externalities associated with "public bads," as analyzed by
John Roemer in his contribution to this volume.

25. See Samuel Bowles, David M. Gordon, and Thomas E. Weisskopf, *Beyond the
Waste Land* (M.E. Sharpe, Inc., 1990), chapter 12, for an analysis of the waste
embodied in "guard labor" in the United States.

26. See Levine & Tyson, *op. cit.*, and other contributions to Alan Blinder (ed.), *Paying

27. This case has been articulated very persuasively by Peter Murrell in his
"Conservative Political Philosophy and the Strategy of Economic Transition,"