

## **Voting for Your Boss:**

### **An Economic Argument for Workplace Democracy**

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**Abstract**

Should there be a multi-stakeholder voting system to elect corporate leadership, as opposed to a voting system in which only shareholders participate? A system of workplace democracy in which employees as well as equity participate can be defended as more consistent with the basic values of a democratic society than a system of shareholder voting only. Any such advocacy, though, must deal with the concern that multi-stakeholder voting would be economically inefficient. In this paper, we offer an original efficiency-based economic argument for multi-stakeholder voting. We argue that, although some models of multi-stakeholder voting arrangements result in inefficient group-based conflict and exploitation, the efficiency problems are not inherent in all multi-stakeholder voting systems. We model systems of multi-stakeholder voting in which the contending sides split their support among the major interest groups of employees, managers, and investors. We go on to argue that in such “group-splitting” systems the outcomes are as good or better from an efficiency perspective as those under shareholder voting only.

## VOTING FOR YOUR BOSS:

### AN ECONOMIC ARGUMENT FOR WORKPLACE DEMOCRACY

#### I. INTRODUCTION

Social reformers such as John Stuart Mill and John Dewey have long expressed concern about a tension between democratic principles and organizational practices that appear undemocratic.<sup>1</sup> More recently, a substantial body of academic literature advocating changes in organizations to make them more democratic has arisen.<sup>2</sup> Change has been advocated on a variety of normative grounds; in a noteworthy recent contribution to the genre, political scientist Ian Shapiro argues that justice rightly understood is inseparable from democracy, and argues that management should be required to justify the business necessity of hierarchical, undemocratic practices, much as it is currently required to demonstrate the business necessity of practices with a racially disparate impact.<sup>3</sup>

Over the last few decades, during the period in which advocates of more democratic organizations have been making their case, a counter-movement has also been active. That movement is centered in economics, and has used economic arguments to contend that the current Anglo-American structure of corporate democracy, with the franchise limited to shareholders, is more efficient than employee ownership and voting,

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<sup>1</sup> See, e.g., John Stuart Mill, *Principles of Political Economy* (1909); John Dewey, *Democracy and Education* (1966).

<sup>2</sup> Notable examples include Carole Pateman, *Participation and Democratic Theory* (1970), Robert A. Dahl, *A Preface to Economic Democracy* (1985), and Ian Shapiro, *Democratic Justice* (1999). More popular works in the same vein are David Ewing, *Freedom Inside the Organization* (1977) and David Ellerman, *The Worker-Owned Firm* (1990).

<sup>3</sup> Shapiro, *ibid.*, at 166-195.

except under limited circumstances when the employees have homogeneous interests.<sup>4</sup>

Although the economic case against changing the current standard corporate voting structure has not gone unanswered,<sup>5</sup> the argument against employee voting when employees have hierarchical interests that conflict with those of other employees or those of investors forms a formidable counterweight to advocacy of greater organizational democracy.<sup>6</sup>

One response to the claim that employee voting for board members would be inefficient is to define democracy in such a fashion that no such voting is entailed.<sup>7</sup>

Democracy is a broad and complex concept, and the question of what greater democracy in workplaces would entail is correspondingly broad and complex.<sup>8</sup> We do not believe

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<sup>4</sup> Major contributions to the literature upholding shareholder voting are Henry Hansmann, *The Ownership of Enterprise* (1996) and Oliver Williamson, *The Economic Institutions of Capitalism* (1985). See also Oliver Williamson, *The Mechanisms of Corporate Governance* (1996), Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy*, 99 *Yale L. J.* 1749 (1990).

<sup>5</sup> For efforts to suggest that employee ownership would or could be efficient, see R. David Kershaw, "Manufacturing Survival: The Uncertain Case for the Inefficiency of Worker Ownership" (unpublished manuscript available from the authors), Alan Hyde, *In Defense of Employee Ownership*, 67 *Chicago-Kent L. Rev.* 159 (1982).

<sup>6</sup> Of course, underlying the debate over shareholder voting is the classic Berle-Dodd debate over whether the corporation should be managed exclusively for the benefit of shareholders. A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 *Harv. L. Rev.* 1049 (1931); A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 *Harv. L. Rev.* 1365 (1932); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 *Harv. L. Rev.* 1145 (1932). For more recent discussions of the debate, see A. A. Sommer, Jr. *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 *Del. J. Corp. L.* 33 (1991); William W. Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 *Cornell L. Rev.* 407 (1989); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 *Wash. & Lee L. Rev.* 1373 (1993); David Millon, *Theories of the Corporation*, 1990 *Duke L.J.* 210. See also Thomas W. Dunfee, *Corporate Governance in a Market With Morality*, 62 *Law & Contemp. Probs.* 129 (Summer 1999). The classic economic case for managing a corporation solely in the interests of shareholders is Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, *N.Y. Times*, September 13, 1970 (Magazine), at 32.

<sup>7</sup> Examples of advocacy of organizational democracy that focus on matters such as due process or participative consensus rather than employee voting, at least of an adversarial sort, include Jane Mansbridge, *Beyond Adversary Democracy* (1983), Jane Mansbridge, "Fear of Conflict in Face to Face Democracies," in *Workplace Democracy and Social Change*, (Frank Lindenfield & Joyce Witt, eds., (1982), and Nien-he Hsieh, "Justice and the Ownership and Governance of Firms" (unpublished manuscript available from authors).

<sup>8</sup> For an argument in favor of "value diversity" in corporate decision-making that does not specify how such value diversity might be incorporated into corporate governance procedures, see Wayne Eastman & Michael A. Santoro, *The Importance of Value Diversity in Moral Free Space* (forthcoming, *Bus. Ethics Q.*).

that employee voting for corporate board members is the only or even necessarily the central criterion for organizational democracy. We do believe, though, that a fundamental democratic principle is the ability of a citizen to participate in the selection of leaders. That principle stands in troubling tension with the inability of employees to vote for corporate leaders. At the same time, we believe that to make a case for employee voting plausible, it must be ready to speak in terms of economics rather than to elide economics in favor of other normative perspectives. Although we strongly believe that an economic perspective based on efficiency and rational choice is not the only relevant normative perspective for determining the merits of a proposal for organizational democracy, such an economic perspective is a valid, central component of the debate over economic democracy, and it is the perspective we employ here.

We begin our argument by demonstrating how inefficiency arises in the context of group-based conflict and exploitation under a system in which managers and employees as well as investors vote for corporate leadership. We then go on to show, however, that such efficiency problems are not inherent in all forms of multi-stakeholder voting. Indeed, we argue that in certain sorts of “group-splitting” systems with employee voting that we shall outline the outcomes are as good or better from an efficiency perspective as those under shareholder voting only.

## **II. GROUP INTERESTS AND INEFFICIENCY**

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For a broader theory that defines moral free space in the context of a contractarian approach to business ethics, see Thomas Donaldson & Thomas W. Dunfee, *Ties that Bind: A Social Contracts Approach to Business Ethics* (1999). Both the Eastman and Santoro and the Donaldson and Dunfee approaches are, in our view, favorable toward enhanced corporate democracy, though neither directly addresses the voting issue that is central to this paper.

Our argument relies heavily on the concepts of group-based interests and of efficient as opposed to inefficient corporate policies. Accordingly, it is important to define what we mean by these concepts.

First, as to group-based interests: Corporations are characterized by the presence of stakeholders with cooperative but also often conflicting interests. These stakeholders fall into groups, such as managers, investors, and employees. Collective interests derive from group affiliations. Although not every manager has the same interests, it is meaningful to speak of managerial group interests relative to those of other groups, such as non-managerial employees or investors.

For present purposes, we leave open the significant question, much discussed in the ethics literature,<sup>9</sup> of whether a given group affected by corporate actions, such as the community in which a corporation operates, should be understood as a stakeholder whose interests should in some fashion be taken into account in corporate policy-making. Instead, this paper deals with three significant groups at the center rather than at the periphery as stakeholders: equity investors, managers, and non-managerial employees.

Our characterization of a corporation as an aggregation of groups and their associated interests implies a definition of efficiency: The efficient policy from the perspective of the corporation—as distinct from the perspective of society as a whole—is the policy that maximizes the total welfare of the various groups that make up the corporation. On the face of it, this multi-group definition of efficiency might appear to be in conflict with the financial economist’s conception of efficient firm policy as the

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<sup>9</sup> R. Edward Freeman’s classic discussion of stakeholder theory can be found in *Strategic Management: A Stakeholder Approach* (1984). A thoughtful collection of critical essays about stakeholder theory appears in *Business Ethics Quarterly*, 4(4), Oct. 1994. See also John Jordan, “The Multi-Stakeholder Concept of Organization,” in *Partners in Enterprise* (Jack Quarter and George Melnyk eds., Black Rose Press, 1989).

policy that maximizes the net present value of the firm as reflected in the value of the firm's equity.<sup>10</sup> But if we assume contractual relations between groups—a reasonable assumption for relations among managers, employees, and investors, though not necessarily for all other groups affected by a firm—rather than relations characterized by externalities and an absence of bargaining, the two definitions of efficiency are compatible. For example, it would not be efficient in terms of either our multi-group definition or of net present value to adopt a policy that increased the welfare of investors by 1 while decreasing the welfare of employees by 3. Under our multi-group definition, such a policy is clearly inefficient. It is also inefficient under the net present value view, because imposing an additional cost of 3 on employees will lead them to require investors to compensate them accordingly and thereby diminish shareholder value.

Our definition of firm efficiency, though compatible with the net present value definition—at least as related to employees, managers, and investors—does not in any way assume that stock prices, especially short-term changes in stock prices, in fact act as a signal of efficient policy for a firm. In our view, investors, and all other groups, operate in an environment often characterized by deep ambiguity over which policy will enhance the aggregate value of all contracting groups making up the firm. Given a lack of reliable information over which policy is in fact efficient, all groups have an incentive to support policies that favor that group relative to others in slicing up the corporate pie. As we will discuss further in modeling firm voting procedures, investors do in some respects have better incentives to avoid sub-optimal decisions than employees. But given a lack of credible information on payoffs, which we assume in our model to be the case, investors will choose an inefficient policy that boosts their immediate return by 1 while lowering

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<sup>10</sup> See, e.g., Richard A. Brealey & Steward C. Myers, *Principles of Corporate Finance* (2000).

that of employees by 3, just as employees for their part would choose a policy raising their welfare by 1 and lowering that of investors by 3.

The example just given and the basic definition of efficiency in terms of maximizing the aggregate welfare of the groups making up the firm further imply a definition of inefficient policy-making in a firm. As we define it, an inefficient policy is one in which a group with power to make policy adheres to its interest in a situation in which it either disregards or lacks credible information as to the greater interest of the other side. Such a policy may also be termed exploitative, and we refer to group-based exploitation (or opportunism) at later points in the paper.<sup>11</sup>

### **III. THE BASIC MODEL OF EMPLOYEE VOTING**

Our key argument in this section is that having employees vote along with other stakeholders--multi-stakeholder voting—is more efficient outcomes if investors, managers, and workers are split internally rather than united against the other groups. Multi-stakeholder voting in which the contending sides or “parties” take positions conducive to major groups being internally split we will call “group-splitting,” and voting in which the contending sides take positions conducive to those groups being unified internally we will call “group-based.” Our basic story goes as follows: The existence of group-splitting parties weeds out proposals for inefficient actions that, even though they are advantageous to one key group in the corporation, are unappealing to some of the

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<sup>11</sup> Note that exploitation (or opportunism; we use the terms interchangeably) as defined here does not require that the group making the decision consciously disregard the interests of others. Lack of information as to all relevant payoffs is at least as likely a basis for exploitative decisions, especially among equity investors, who have an incentive to maximize the residual value of the firm. Our focus on opportunism is indebted to Williamson’s interpretation of corporate governance as a way to reduce the

swing voters who will decide the election. Group-based parties, on the other hand, lack an incentive to weed out such exploitation. We do not rely on any assumption that group-splitting voting leads to different, more altruistic preferences, and hence better outcomes because of a reduced level of selfishness. On the contrary, we assume, in concordance with the most fundamental assumptions of the neoclassical economic model of individual motivation, that group-splitting voting does not modify preferences in the slightest, and, moreover, that preferences differ sharply and primarily (or even exclusively) according to group membership rather than according to other values. Even given such conditions, we argue that organizing workplace voting along group-splitting rather than group-based lines results in the reduction of exploitative policies that prevail under group-based politics.<sup>12</sup>

A model helps illustrate our claim. Suppose that a firm is evenly divided in voting strength between two classes, bosses and workers. (For simplicity, this initial model of politics and hierarchy ignores investors; our second model takes them into account.) Further suppose that the bosses and workers have to decide between various policies for firm work arrangements. These policies, we will assume, involve two dimensions, “egalitarianism” versus “inegalitarianism” and “vanguardism” versus “traditionalism.” That is, the policies make work arrangements more or less egalitarian

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costs of opportunism by individuals and groups. See Oliver E. Williamson, *The Economic Institutions of Capitalism* (1987).

<sup>12</sup> Though the models that follow are original ones, the methodology employed has been derived from three major sources: 1) Anthony Downs’s model of competition between parties; Anthony Downs, *An Economic Theory of Democracy* (1957); see also, John E. Roemer, *Political Competition* (2001); 2) political science literature on the value of cross-cutting cleavages in mitigating group conflict; see, e.g., Arend Lijphart, *Democracy in Plural Societies* (1976); Donald L. Horowitz, *Ethnic Groups in Conflict* (1985); Seymour Martin Lipset, *Political Man* (1960); and 3) the game-theoretic literature on strategic interaction, especially under circumstances involving imperfect information; see, e.g., Thomas C. Schelling, *The Strategy of Conflict* (1960); Douglas G. Baird, Robert H. Gertner, and Randal C. Picker, *Game Theory and the Law* (1994); Herbert Gintis, *Game Theory Evolving* (2000).

in terms of economic and status disparities between higher-ranking groups and lower-ranking groups. The policies also make work arrangements more or less “vanguardist” by making them more in keeping with contemporary, up to the minute managerial thought, or alternatively more in keeping with traditional work roles and privileges. Some egalitarian and vanguardist policies are efficient, while others are exploitative; the same applies to inegalitarian and traditionalist policies. Efficient proposals increase the firm’s welfare (assumed here to be the sum of the welfare of bosses and workers), while exploitative proposals reduce it. Initially, we will assume that policy preferences divide solely along group lines, with no other component to them. We will further assume that workers favor egalitarian and traditionalist policies and oppose inegalitarian and vanguardist ones, while bosses favor inegalitarian and vanguardist policies and oppose egalitarian and traditionalist ones.

Now assume there are two egalitarian proposals and two inegalitarian proposals, along with two vanguardist and two traditionalist proposals. One of each of the four types of proposals is efficient, while the other is exploitative. We shall assume that the efficient egalitarian proposal has a considerable positive value for workers and a lesser negative value for bosses, while the exploitative one has a fairly small positive value for workers and a large negative value for bosses. The efficient inegalitarian proposal has a small negative value for workers and a large positive value for bosses, and the exploitative one has a large negative value for workers and a smaller positive value for bosses. The efficient vanguardist proposal has a small negative value for workers and a larger positive value for bosses, while the opportunistic one has a large negative value for workers and a smaller positive one for bosses. The efficient traditionalist proposal has a

fair sized positive value for workers and a smaller negative one for bosses, while the exploitative one has a small positive value for workers and a large negative one for bosses.

Now we reach the crucial point, which involves comparing the policies that will be adopted by the firm under two different political systems. In the first system, a “boss party” and a “worker party” compete for control. In this system, victory will depend simply on which party is more diligent or luckier in turning out its group base, given an initial assumption of an equal numerical division of strength between the two groups. The boss party has no incentive to weed out the exploitative inegalitarian and vanguardist proposals from its platform, and the worker party equally has no incentive to weed out the exploitative egalitarian and traditionalist proposals from its agenda. If the boss party wins, it will carry out two efficient and two exploitative proposals; if the worker party wins, it will also carry out two efficient and two exploitative proposals. (In an actual firm, investor interests may modify the incentives of boss or worker parties to exploit, as we will discuss later; for now, the point is to see the difference between how group-based and ideological politics work for managers and employees, leaving investors aside.)

In the second system, a “liberal” party that favors egalitarianism and vanguardism competes against a “conservative” party that favors inegalitarianism and traditionalism for control of the firm. Given the numbers above, two of the egalitarian and vanguard proposals favored by the liberal party are efficient and two are inefficient. The same is true for the conservative party, whose platform of two inegalitarian and two traditionalist proposals is likewise split between efficient and inefficient items.

Unlike the worker and boss parties, who simply stick with proposals favoring their side, the liberal and conservative parties do not rely on support from a group, but compete for votes among both workers and bosses. To gain boss votes, the liberal party has an incentive to jettison the inefficient egalitarian proposal from its agenda, which makes its platform have a greater value to bosses. For the same reason, the conservative party has an incentive to jettison the inefficient traditionalist proposal from its agenda, which makes its platform also worth more for bosses. Also, to gain worker votes, the liberals have an incentive to jettison their inefficient vanguardist proposal, while the conservatives have an incentive to jettison their inefficient inegalitarian one. The outcome of this competition for votes is the jettisoning of the four inefficient proposals, which results in a two-plank liberal platform and a two-plank conservative platform from which the inefficient proposals have been purged.<sup>13</sup>

Whichever ideological party wins, the outcome will be superior to that with group-based parties. The liberals will carry out a program with a positive value for the firm compared to a situation with group-based control, and so will the conservatives.<sup>14</sup>

What the superiority of group-splitting voting over group-based voting depends on in this model is somewhat counterintuitive. Group-splitting voting is better than group-based voting because we have assumed that preferences in the workplace are in fact arrayed along group lines rather than ideological ones. That makes exploitation more easily accomplished by group-based parties than by ideological parties. In a flipped

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<sup>13</sup> To make parties quickly responsive to voter demand it is useful to assume knowledge of payoffs. If one does not assume such knowledge, in keeping with our general approach, the parties would still be expected to jettison inefficient proposals over time, since a party that does not will find itself losing support relative to a party that does.

<sup>14</sup> Neither the liberal nor the conservative party will carry out all the efficient proposals. The liberals will carry out efficient egalitarian and vanguard changes, and the conservatives will carry out efficient inegalitarian and traditionalist changes, but neither will carry out the other party's reforms.

world in which the reverse is true, group-based politics would be a protection against exploitation by ideological parties. If preferences of workers and bosses in firm X were solely based on ideology, with a class of liberals favoring egalitarian and vanguardist proposals, both efficient and exploitative ones, and a class of conservatives favoring inegalitarian and traditionalist proposals, in order to make electoral competition work to weed out exploitative proposals, one would want to have parties based on some other criterion than ideology--such as support for the interests of bosses or workers! In such a hypothetical world, a bosses' party that supported inegalitarian and vanguardist proposals would engage in a desirable, efficiency-enhancing competition with a workers' party that supported egalitarian and traditionalist ones. The alternative firm is not on its face fantastic; there could in theory be such a place. We believe, though, that such a firm does not now exist. The firm in our model, in which employees see the advantages and disadvantages of various policies from the vantage point of being workers or bosses, is, we believe, much truer to life than an ideological firm X in which one's identity as a worker or boss is unrelated to one's preferences.

To demonstrate how robust the advantage of group-splitting voting over group-based voting is in weeding out inefficient policies, we will modify our original assumption that preferences as to work arrangements are determined solely by group membership and not at all by ideology. A plausible assumption regarding the preferences of individual firm members is that they are in large part a function of group affiliation, but that ideology also plays some role. Suppose, for example, that the workers and the bosses in a firm have different preferences, as described before, but that both groups can be divided into equal-sized factions of liberals, centrists, and conservatives. "Liberals" in

a group are more favorable to egalitarian and vanguardist proposals than “centrist” group members, and less favorable to inegalitarian and traditionalist proposals.

“Conservatives” differ from centrist group members by the same amount in the opposite direction, in that they are more favorable to inegalitarian and traditionalist proposals and less favorable to egalitarian and vanguardist proposals.

Given this preference structure and a worker party versus boss party system, workers of all ideologies are likely to remain loyal to the worker party, while bosses of all ideologies remain loyal to the boss party, unless ideological preferences are stronger than group-related preferences. As before, this results in whichever party wins embracing exploitative as well as efficient proposals. On the other hand, in a division between a liberal party and a conservative party in which ideology is weaker than group preference, the liberals have a base from among the most left-of-center bosses and workers, while the conservatives can count on the vote of the most right-of-center. The election is decided by the swing votes of the centrists, who have the same preferences as in the initial example. Given those preferences and the need to compete for the votes of centrist workers and bosses, both liberal and conservative parties should jettison exploitative proposals to maximize their vote. Thus, given a plausible assumption that ideology is weaker in determining preferences than group affiliation, the superiority of ideological politics over group-based politics in eliminating exploitation remains.

Without trying to prove the point formally, we would assert that the superiority of group-splitting politics to group-based voting as a means of countering exploitation is quite a robust result. That superiority is greatest in a situation in which voters have strong group-based preferences and weak or nonexistent ideological ones. But in a

scenario like the previous one, where ideology as well as group affiliation exercises a significant influence on preferences, the value of group-splitting politics in checking exploitation persists. Given some plausible assumptions about preferences, the efficiency edge of group-splitting organizational politics over group-based politics is quite clear-cut.

#### **IV. REFINING THE BASIC MODEL OF EMPLOYEE VOTING**

In considering how our model applies to real world circumstances, there is a serious issue that needs to be addressed. The fly in the ointment for group-splitting voting is whether a value-enhancing competition for votes across group lines is actually attainable, either from the existing preferences of workers and bosses or because of rules on how a workplace voting system must operate. If it is not, the efficiency advantages of group-splitting voting are hypothetical rather than real ones. Skeptics about democratizing organizations are likely to take the position that exactly such a situation obtains in firms, in that the preference structure of employees is not conducive to group-splitting politics working.

The skeptics' reaction may well be correct, given the assumptions of the model we have laid out. Suppose parties are allowed to compete in a firm with the preference structure initially described, in which preferences are solely a function of group membership. Given these preferences, all workers will support an exploitative worker's party over an efficient liberal or conservative party, and all bosses will similarly support an exploitative bosses' party over either ideological party. Simply put, unconstrained

democracy does not work well given the postulated preference structures of workers and bosses in the original model.

The failure of democratic politics to produce a desirable outcome in this case is a function of the stark differences in preferences between workers and bosses that are assumed to exist in the firm. Because firms (and other hierarchical institutions) are organized along much starker and simpler group lines than society as a whole, in which there are many cross-cutting hierarchies (of class, gender, race, sexual orientation, liberal-conservative ideology, and so on), it is quite likely that there are indeed major differences between the preferences of managers and subordinates in most firms. That means that it is reasonable to guess that unconstrained democratic politics within a firm would produce group-based rather than group-splitting parties, and an attendant high level of inefficient exploitation. Unless this situation can be addressed, there would be no way to formulate an economically-based justification for multi-stakeholder voting. Therefore, we will now turn to the task of suggesting how to structure democratic politics within a firm so as to obtain economically efficient outcomes.

### ***A. Bringing investors into the model***

We will now modify the original model by assuming that the two great classes of firm life are not managers and workers but investors and employees (with employees including managers as well as investors). In this version, the employees' group interest will be assumed to be in maximizing the amount going to them from the firm. The investors' group interest is apparently parallel, in that investors want to maximize the amount from the firm going to them. But there is a crucial difference between the two groups' time preferences, which makes the comparison between group-based parties of

investors and employees work out very differently than the comparison did for worker and boss parties. While both worker and boss parties would be comparably inefficient, an investor party would, as proponents of shareholder voting have argued, espouse a more efficient agenda than a worker (or managerial) party.<sup>15</sup>

Employees who are not investors, even if they hope to stay with the firm permanently, are concerned with maximizing their gains from the firm over their working and retirement years. Investors, even if they plan to sell imminently, are concerned with investor profits over the indefinite future, since the expectation of future profits drives the current price of the company's shares. Given this difference in time horizon, an investor party and an employee party have different incentives. Specifically, the employees will be more prone to large-scale exploitation of the investors than the investors will be of comparable exploitation of the employees. Compared to employees, investors don't have as significant an incentive to exploit because of their residual claim on the firm's earnings. Exploitation reduces the firm's earnings, and generally the investors' payoffs. Investor strategies that may seem like exploitation within the firm itself may well not be, when the effect on the social system as a whole is taken into account. For example, consider a company in which the investors decide that earnings will be maximized by licensing the brand and laying off all the existing managers and workers. Even assuming the earnings of the employees will be reduced by more than the earnings of the investors will be increased, that is not clear evidence that exploitation has taken place. Other employees and managers, or at any rate other factors of production, and/or consumers, will benefit from the change to a licensing arrangement, and there is no reason to assume that these benefits are any less than the losses to the firms' current employees. In any

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<sup>15</sup> See citations in footnote 4.

event, firms that did not behave in such a profit-maximizing manner would, under neoclassical economic theory, constitute inefficient loci of capital allocation. In this sense, the proclivity of investors to maximize firm gains over an indefinite term is congruent with the overall capital allocation efficiency of an economy, which in turn is presumed to result in optimal economic welfare for the society.

The resistance of investors to exploitative behavior should not be overstated, though. Investor-driven restructurings that increase the proportion of the firm's profit going to investors rather than to employees can certainly be value-enhancing. But they can also be inefficient. As discussed in our section defining efficiency, a key reason why that is so is that investors, like other groups in a firm, very often lack sufficient information to determine what policies will in fact maximize firm earnings over time. Lacking such information, they will tend to support policies that cut investors a larger slice of the pie relative to managers and employees, but that may not in fact be maximizing for the firm.

Contrary to the more extreme claims sometimes made for investor control, we conclude that investors are not immune from inefficient actions, given the high level of ignorance of long-term payoffs that we believe prevails in the real world and the tendency of all groups to favor strategies enhancing their share of the pie.<sup>16</sup> But, for reasons outlined above, investor interests are aligned with the efficiency interests of the firm in a more powerful way than those of employees. An employee party's argument that a given proposal that redistributes in favor of employees away from investors improves firm efficiency may actually be correct in a given case. But the argument is not

likely one that an employee party can make credibly in the face of investor disagreement. The employee party has incentives for large-scale exploitation of investors, while the investor party has incentives to support redistribution away from investors, as long as it increases long-term investor value as reflected in current prices. Given these circumstances, along with the murkiness and contingency of determining what efficient policy actually is, an investor party's efficiency arguments are likely to have credibility that an employee party's arguments lack.

One response by advocates of workplace democracy to the advantages of investor control over employee control for firm efficiency has been to advocate changes in the composition of investors. Possible strategies vary widely, ranging from nationalization to employee ownership to distribution of shares to the populace as a whole to public-private holding companies.<sup>17</sup> Though we would not want to rule out the possibility that some of these strategies may have value for organizational democracy, we are not concerned for present purposes with making recommendations along those lines. Instead, we want to suggest a different response to the superiority of investor over employee control.

We believe that compared to the current regime of formal investor control and day-to-day managerial control, democratic competition that pits employees against investors would be deleterious rather than healthy to a firm.<sup>18</sup> But a group-splitting democratic competition between a "liberal" party that supports more egalitarian

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<sup>16</sup> Another reason for inefficient investor action exists if one assumes that investors can "beat the market" through, for example, breaking implicit contracts with employees without paying an offsetting price for that conduct in the future.

<sup>17</sup> Given that a variety of other nations, especially in the developing world, have corporate law regimes that are more in flux than that of the U.S., the contemporary scholarship tends to have an international focus. See, e.g., William H. Simon, *The Legal Structure of the Chinese "Socialist Market" Enterprises*, 21 *Iowa J. Corp. L.* 267 (1996),

distribution (and in doing so typically favors employees over investors) and also vanguard reshapings of production (and in doing so typically favors investors over employees) and a “conservative” party that takes contrary positions may well promote efficiency, compared to a regime of investor voting and managerial control.<sup>19</sup>

### ***B. An Investor-Employee Model***

Let’s see how such a competition would work in the context of an investor-employee politics with equal groups of investors and employees. Suppose, as in the example with boss-worker politics, that there are competing liberal and conservative parties. The liberal party supports egalitarian and vanguardist policies and the conservative party supports inegalitarian and traditionalist policies, as before. Recall that the policies are redistributive as well as efficient or inefficient ones, in that there are contrasting welfare implications for the investors and employees. Egalitarian and traditionalist proposals transfer value from investors to employees, we will assume, while inegalitarian and vanguardist proposals transfer value from employees to investors.

Now assume there are two proposals in each of the categories. As before, one proposal in each category is efficient and one is inefficient. Assume that the “liberal” and “conservative” ideological lines are arbitrary and that the preferences of investors and employees are in fact solely determined by group membership. The results follow as in the boss-worker model: Both liberal and conservative parties will compete to offer a

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<sup>18</sup> Even assuming that it were possible to work out a scheme for voting that allowed both shareholders and employees to participate and reconciled the “one person one vote” practice of standard elections with the “one share one vote” practice of American shareholder elections.

<sup>19</sup> Again, we are assuming away the problem of working out a voting scheme incorporating both employees and investors. We acknowledge that working out such a plan is a major analytical issue. We suspect that a two-party system in which a successful candidate must receive more than a certain proportion (e.g. 1/3) of votes from each of the categories of managers, workers, and investors, combined with a default rule that if no such candidate emerges the winner is chosen according to a traditional investor-only vote, may well be

compelling policy menu to members of both groups. Dropping inefficient proposals is a good way to do so, since such proposals hurt the party more in gaining support from the disadvantaged group than they help it in gaining support from the advantaged group. As long as both liberal and conservative parties are seeking and receiving a significant share of the votes from both investors and employees rather than becoming de facto group parties, the incentive to weed out inefficient proposals prevails, as it did in the earlier example involving workers and bosses.

By comparison with a regime of investor control, democratic competition between group-splitting parties looks quite good. Given their imperfect knowledge, investors with sole control will put into effect inefficient inegalitarian and vanguardist proposals as well as efficient ones, while party competition will eliminate these inefficient proposals, as well as inefficient egalitarian and traditionalist ones. Investors will not put efficient egalitarian and traditionalist proposals into effect. On the other hand, a “liberal” party will carry out an efficient egalitarian change and a “conservative” party will carry out an efficient traditionalist one (although these policies will not be carried out at the same time, as long as we assume that parties are ideologically committed and do not steal other parties’ platforms).

Group-splitting democracy does not dominate investor control, though. In terms of the model, investor control, unlike democratic ideological politics, insures efficient inegalitarian and vanguardist changes. It is empirically conceivable that the efficient inegalitarian and vanguardist policies that investor control insures are much more important than the efficient egalitarian and traditionalist ones that democracy with

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the most practical way to implement multi-stakeholder voting. But we leave the issue of proposing a specific voting plan for future reflection and research by ourselves and others.

employee voting would allow. It is further possible that the inefficient inegalitarian and vanguardist policies that also go along with investor control but are prevented by ideological democracy are fairly infrequent and minimally deleterious. Given these possibilities, investor control might conceivably be more efficient than ideological democracy, given the model's assumptions. But these are only possibilities; if the value of efficient egalitarian and traditionalist policies that firms miss out on under employee control is considerable, or if inefficient inegalitarian and vanguardist policies are a significant problem, ideological democracy will be a better bet for the firm than investor control.

As in our first model of worker-boss politics, a major difficulty for employee-investor democracy lies in creating the conditions for it to flourish. Unconstrained democratic politics in a two-class system in which investors have sharply different preferences from employees will lead to group-based rather than group-splitting politics, and to outcomes inferior to those obtained under a group-splitting system. Ideology must have some reality as a factor in influencing people's preferences; otherwise, voting will simply become group-based and foster suboptimal outcomes.

## **V. CONCLUSION**

A firm can benefit from multi-stakeholder voting, including employee voting, if that voting is group-splitting rather than group-based. That is the central message of our models, and it is one that we believe has significant applicability to the question of whether experiments in multi-stakeholder voting should be undertaken, and how such voting should be structured. To the extent that multi-stakeholder voting is group-based

voting, it will have inefficient outcomes. On the other hand, to the extent that the contending sides in such voting take positions that cut across the fundamental group-based interests of investors, managers, and workers, multi-stakeholder voting has promise from an efficiency perspective.

We readily acknowledge that there are potential difficulties with multi-stakeholder voting, even assuming that such voting is group-splitting rather than group-based. Among these issues are the following: 1) are workplaces more reliant on shared values than a political unit such as a town or country, and hence inappropriate venues for the value conflict of electoral politics with diverse groups?;<sup>20</sup> 2) would the benefits derived from hierarchy be undermined by voting for corporate leadership?; and 3) how would one design a workable voting system incorporating investors, managers, and workers?

Although we regard all these issues as serious, we do not see them as foreclosing the potential value of experiments in multi-stakeholder voting. We also believe that multi-stakeholder voting has the potential to realize benefits beyond those discussed in our models. In addition to comporting with democratic values and fulfilling a longtime aspiration of reformers, such voting would allow for more complex alliances than are possible under shareholder only elections plus day-to-day managerial control. Inefficient decisions will be less endemic, all else equal, if the governance structure allows all three of the firm's major groups to form alliances with another group to check inefficiency on the part of the third. Such two-group alliances may of course be used for exploitation as well to check exploitation; however, given that some such alliances are possible, efficient outcomes can be reached, if all groups are able to combine, that cannot be reached if

some are unable to ally. The current system provides strong opportunities for investors and managers to ally to counter opportunistic conduct by subordinates, which is an important virtue that needs to be retained in some form in an alternative system. There are also opportunities for managers and workers to ally against overreaching by investors under the current system. What the current governance system of investor voting and effective managerial control does not offer, however, are effective formal or informal means for investors and employees to ally against managerial inefficiency. A multi-stakeholder electoral system, much as it also serves other purposes, can be described as a way of permitting and facilitating alliances of investors and employees that would compete against the established alliances of investors with managers and managers with workers, and in so doing would enhance firm efficiency.

The question of whether employees should have a vote in determining corporate leadership is an important and complex one. We have argued that the conventional practice of allowing only shareholders to vote makes sense when voting is based on group affiliations. In such a situation, employee voting would lead to a polarized politics with a high potential for group-based exploitation. However, employee voting has promise from an efficiency perspective if the major groups within a firm are all split rather than united by contending liberal and conservative sides. In that case, employee voting can reduce suboptimal outcomes by opening the door to efficient policy alternatives that are foreclosed in a regime in which only shareholders vote.

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<sup>20</sup> This issue relates to the concerns expressed by Mansbridge, *supra* note 6, about adversarial democracy.