Turning employees into owners
An analysis of policy initiatives for rebuilding the American Dream

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Abstract
Purpose – The purpose of this paper is to review and analyze policies where employee share ownership might be relevant to the inequality debate in the USA.

Design/methodology/approach – Description and analysis of policy alternatives designed to increase the prevalence of employee ownership in the USA economy.

Findings – Since 1974, Congress has passed many provisions to encourage employee ownership, all with widespread bipartisan support. Additional policies would have an even greater impact. Congress could "level the playing field" for corporate divestitures and sales of companies by private equity firms; create Employee Ownership Investment Corporations, modeled after Small Business Investment Corporations, to provide capital for sales to employees; and create an Employee Equity Loan Program to guarantee loans for employee-ownership transactions. Such measures would have no budgetary impact. It could also create tax incentives to encourage corporate and private-equity sales to employees and establish regulations to ensure that employee-owned companies are eligible for the full benefit of recent opportunity zone legislation. Legislation could also encourage publicly traded companies to offer stock to employees at a discount and require companies that receive various forms of special treatment from the government to establish employee stock-ownership programs.

Originality/value – The academic journal literature has virtually no policy analyses on employee share ownership.

Keywords ESOP, Legislation, Policy analysis, Employee ownership, Employee stock ownership plan, Opportunity zones

Paper type Conceptual paper

Americans believe that theirs is the land of opportunity. Citizens celebrate business pioneers, from Thomas Edison to Steve Jobs. They admire men and women who rise from poverty through enterprise and diligence. Over the years, this has made America the preferred destination for millions of immigrants whose ambition and talents find their fullest expression here. The nation’s relatively high rates of entrepreneurship reflect this dynamism.

Today, however, this engine of opportunity is sputtering. New-business formations are flat or declining. For many, the US economy is not delivering the income growth, job security and middle-class standard of living that were once the reward for a lifetime of hard work. The American dream once promised that children would do better than their parents. But despite the current booming stock market and low unemployment, the USA is moving from a fluid land of opportunity into a stratified society characterized by growing disparities of wealth and income.

A variety of statistics support this contention:

1. A lack of good jobs: about two-thirds of Americans still do not have a college degree (Wilson, 2017). With the decline in manufacturing jobs, people without college educations or special skills have difficulty finding rewarding employment. Even in
today’s low-unemployment economy, millions of jobs pay less than $15 an hour, provide few benefits and offer little or no security. Walmart, the country’s biggest private employer, raised its starting wage in 2018 to just $11 (Thomas and Reagan, 2018) and now pays its hourly employees an average of $13.79, or not quite $29,000 a year for full-time work (Kline, 2018).

(2) Little or no economic cushion: the median wealth of American families in 2016 was about $78,000 (Marcellus, 2019). But wealth ownership is highly concentrated. The top 0.1 percent of households own as many assets as the bottom 90 percent (Marcellus, 2019). The top tenth own 84 percent of all US-owned stock, including shares held in 401(k) accounts and pension funds (Cohen, 2018). About half of Americans own no stock. A Federal Reserve survey in 2018 found that four in ten US adults would have trouble coming up with $400 in an emergency (Board of Governors of the Federal Reserve System, 2018). About half of Americans 55 and older have no retirement savings (US Government Accountability Office, 2015). Among those who do, the median amount is enough to generate only about $400 a month. Bureau of Labor Statistics data show that just over half of full-time workers participate in any kind of retirement plan; the proportion decreases as you go down the wage scale[1].

(3) Stagnant incomes: between 1979 and 2015, the US economy grew nearly 160 percent in real terms[2], and GDP per capita was up about 80 percent (Amadeo, 2019). According to the Congressional Budget Office’s conservative figures, people at the very top of the income scale – the famous one percent – increased their pretax income 233 percent. Meanwhile the lower four-fifths of the income distribution gained 32 percent (Congressional Budget Office, 2018). In short, the incomes of most American households rose less than half as much as GDP per capita.

(4) High returns to capital, low returns to labor: another set of figures illustrates a similar discrepancy: from 1973 to 2018, inflation-adjusted wages for nonsupervisory workers were essentially flat (Desilver, 2018). Meanwhile, a dollar’s worth of stock grew (in real terms) to $14.09[3]. So those working for a living have seen their incomes stagnate, while those with significant income from capital ownership have done very well. This is a recipe for widespread discontent and frustration.

(5) Declining opportunities: migration from lower-income groups toward higher-income groups is becoming increasingly difficult, even for talented young people. Rates of social mobility, which regularly increased until around 1980, are now flat or declining (Davis and Mazumder, 2017). More of the children of the poor are staying poor, while more of the offspring of the well-to-do are remaining well-to-do. Again, this is a recipe for discontent.

(6) Distant and disconnected ownership: many companies – notably those controlled by financial owners such as private equity firms – are regarded more as pawns on a financial chessboard than as pillars of local communities. They are acquired, divested, and moved from one absentee owner to another. They may be shut down even when profitable – if, for example, relocating their assets or brands to offshore production promises more profit. These are the companies that should be the economic bedrock of communities and the source of employment for millions of Americans, especially in rural and small-town America.

(7) Declining innovation: in 2018, the USA dropped out of Bloomberg’s list of the world’s ten most innovative economies (Jamrisko and Lu, 2018). Increasing market dominance by supersized companies, especially in technology, has led to a broad slowdown in spending on innovation throughout the economy.
These are familiar indictments, and there is no lack of proposed solutions from both true-blue liberals and bright-red conservatives. But the US political system seems to be in perpetual stalemate; both federal and state public policy measures have had little effect. Existing elements of the social safety net – including food stamps, subsidized housing and Medicaid – help many low-income people, but by themselves are wholly inadequate to take care of the estimated 80 percent of the population who live from paycheck to paycheck.

We are convinced from our research and experience that employee ownership is an enterprise-friendly, nongovernmental solution to many of these ills, and that Congress could easily expand it at little cost to the taxpayer.

Revitalizing the middle class
At the moment, close to 7,000 US companies have an employee stock ownership plan, or ESOP, that owns anywhere from a small minority to 100 percent of the firm's shares (National Center for Employee Ownership, 2019a). An estimated 2,000 of these companies are wholly owned by their employees. The ESOP world includes giants such as Publix Super Markets (190,000 employees), midsize companies such as W.L. Gore and Associates (9,500 employees), and smaller firms such as King Arthur Flour (375 employees). Many other companies do not have an ESOP but provide their employees with significant numbers of shares through stock or option awards. A few hundred enterprises are wholly owned by their workers through a co-op structure.

Researchers have studied the effects of ESOP ownership over many years, and their findings are remarkably consistent. Employee ownership companies outperform similar companies with conventional ownership. They put more money in the hands of their workers. The findings include:

- Better corporate performance: adjusting for changes in overall industry growth, ESOP companies grow about 2.5 percentage points per year faster in sales, employment and productivity after they set up an ESOP than would have been expected if they had not set up an ESOP. Other studies have found productivity increases of up to 4–5 percent, on average, in the year an ESOP is adopted (National Center for Employee Ownership, 2019b).

- Higher survival rates: a study tracking the entire population of ESOP companies over ten years found that privately held ESOP companies were only half as likely as non-ESOP firms to go bankrupt or close, and three-fifths as likely to disappear for any reason (Park et al., 2004).

- Fewer layoffs: nationally representative surveys consistently show employee-owners less likely to report being laid off in the previous year. In 2014, the layoff figure was 9.5 percent for all working adults compared to 1.3 percent for employee-owners (Rosen, 2015).

- Better employee compensation and benefits: one study found employee-owners earning between 5 and 12 percent more in median wages compared to employees in matching non-ESOP companies. The same study found that ESOP participants have 2.5 times as much in retirement plans and 20 percent more financial assets overall than employees of the comparison group of non-ESOP companies. Higher compensation and retirement benefits mean fewer demands on public social services (National Center for Employee Ownership, 2019b).

- Greater opportunity for young workers: a recent survey, which looked at workers’ economic circumstances over time, compared people age 28 to 34 with employee ownership to their peers without. The study found that those with employee
ownership enjoyed 92 percent higher median household wealth, 33 percent higher
income from wages and 53 percent longer median job tenure (National Center for
Employee Ownership, 2017).

- Higher levels of innovation: companies with broad-based employee-ownership
programs are more likely than others to introduce high-engagement, team-based
management practices. These practices create more opportunities for idea generation
and internal entrepreneurship than conventional top-down management (Garrett, 2010).

Since the first ESOP legislation in 1974, employee ownership has grown steadily to include
9 percent of the private sector workforce. If the proportion were to grow to 20, 30 percent or
more, the result would likely be an uptick in US productivity, an increase in incomes and
wealth for many workers, and correspondingly stronger communities.

The challenge and the opportunities
Employee ownership, in short, is a market-tested concept that is capable of significantly
reshaping the American economy. Political leaders who espouse it have a range of options.
To build political support, they can visit and celebrate employee-owned companies and the
employee-owners who work there. They can use their bully pulpit to educate voters about
the ways in which the US economy fails many of its citizens, and about how employee
ownership could help remedy these failings. Where policy is concerned, they have several
choices: new regulations, new agencies, new investment institutions and new tax incentives,
all designed to foster and support this form of ownership. In what follows, we will look at
how companies currently become employee owned, how many more could become so, and
the obstacles that get in the way of these transitions. We will also propose some specific
legal structures and incentives that could overcome these obstacles and thereby lead to a
substantial increase in the number and influence of employee-owned firms.

Sale of a company to an ESOP
In the USA, ESOPs are by far the most common form of employee ownership. Legally, they
are government-regulated retirement plans, and they have enjoyed broad bipartisan support
in Congress. Thanks to previous legislation, individual company owners who sell their
businesses to the employees through an ESOP gain certain tax advantages on the proceeds.
An S corporation that is partly or wholly owned by an ESOP pays no current federal income
tax on the corresponding portion of its earnings.

Most existing ESOPs were established when individual owners decided to sell part or all
of their businesses to employees through this mechanism. Contrary to a common belief,
employees almost always pay nothing for the stock they receive in their ESOP account. The
transactions are typically funded by company cash or bank loans; often, the seller takes
back a note for part of the selling price. If there are loans or notes, the debt is paid off from
the future earnings of the company, as in an ordinary leveraged buyout. ESOPs without
leverage are funded by annual contributions from the company.

As baby-boom entrepreneurs begin to retire in large numbers, more individually owned
companies will come up for sale. According to estimates, at least 150,000 of these companies
are candidates for ESOPs. But not all companies that are offered for sale are owned by
individuals. Two other categories of sellers account for a large number of transactions and a
great deal of economic value:

- Corporate divestitures: in 2016, public companies in the USA divested more than
$75bn worth of subsidiary divisions, most of that total bought by domestic acquirers
(Deloitte, 2017). As far as we know, none of these companies were sold to employees.
This should not be surprising: corporate divestiture teams are unlikely to be familiar
with ESOPs, and there are no specific incentives that might induce them to consider this option.

- Private equity sales: US private equity firms today actively manage more than $3 trillion in corporate assets (Comtois, 2018). The usual goal of such firms is to turn over 100 percent of their assets every five to seven years through the sale of portfolio companies to new owners. Few of these sales have resulted in employee ownership.

These numbers are a reminder: every business that does not close its doors will eventually be sold. It will be sold to public investors, to an investment firm, to another company, to a group of individuals such as a management team, or to its employees. The numbers are also a reminder that employee ownership could be scaled up quickly if the right institutions and incentives were in place.

The obstacles, and how to overcome them

However, there is a significant disparity between a prospective ESOP buyer and other buyers, such as private equity funds and corporate acquirers. For example:

- Corporate and other buyers typically have ready cash available for the purchase – an appealing factor for sellers. ESOPs, by contrast, must usually borrow much of the necessary capital from a bank. Because it is difficult to finance 100 percent of a deal, ESOPs typically must find other sources of capital, such as seller financing, or they must buy out an owner over time. Neither of these approaches is attractive to a corporate seller.

- Corporate and other buyers may have synergies that allow them to pay a relatively high price; ESOPs face legal constraints that may make it impossible for them to pay the same amount.

- Corporate and other buyers may be able to provide the management and functional resources that enable the new company to operate independently; ESOPs spinning off from a corporate parent may find that task more difficult.

New institutions, along with new tax and regulatory policies, could level this playing field. There are several possibilities.

Employee ownership investment corporations (EOICs)

Like existing Small Business Investment Corporations, or SBICs, EOICs would be privately funded. They would be designed to address the gaps in capital required for employee ownership transactions, especially those involving corporate divestitures. EOICs would provide subordinated “first dollars in” to a deal – funds that serve the same function as equity in the eyes of other lenders. Where the resulting ESOP owns at least 30 percent of the company’s stock, such financing would be eligible for federal guarantees, strengthening the EOIC’s borrowing capacity to finance the remainder of the deal.

This proposal is budget-neutral to the federal government, and the idea stands on its own without further incentives. To accelerate the growth of employee ownership, however, Congress could also provide EOIC investors with a 50 percent reduction in taxable interest income from such investments. This incentive is analogous to that provided in prior legislation, repealed in 1992, that gave banks a 50 percent exclusion of interest income from loans to ESOPs. That provision dramatically raised the profile of ESOP lending in the banking community. The current proposal, however, focuses specifically on subordinated debt, thereby addressing a key obstacle to establishing ESOPs in divestitures and private equity transactions.
The employee equity loan act

A new Employee Equity Loan Program (EELP), housed within an appropriate branch of the federal government such as the Economic Development Administration of the Commerce Department, could also provide such guarantees, again at no net cost to the federal government. Qualifying loans supported by this program would be sized and priced to compete with private equity buyout funds.

EELP loans could be sourced through the existing network of financial institutions that have staffs trained in administering government loan guarantee programs. Unlike existing programs, however, these loans would specifically target middle-market businesses ($50m to $500m in revenue). They would also require that the proceeds be used to purchase stock either from the selling owner or from the company making the loan application. The purchased stock would have to be contributed to a legal trust, such as an ESOP, formed for the benefit of the company’s management and employees[4].

Tax policy has also been widely used to achieve certain social objectives, including existing support for ESOP transactions and ESOP-owned companies. Additional tax incentives could have a significant effect on the behavior of corporations and private equity firms that are selling operating businesses. The impact of trillions of dollars in employee-owner equity after a decade or more of corporations and private equity firms selling to ESOPs would be substantial. For example, Congress could offer:

Divestiture incentives
Legislation could grant an exemption in taxable gains, up to responsible fiscal limits per transaction, for corporations that divest operating units into employee ownership. To prevent abuse, it should include provisions to ensure that employees receive a meaningful share of ownership in the ESOP, and regulations to prevent governance and financial abuse by market manipulators. It should also add a minimum holding period for the sold shares or assets and a clawback of avoided gains by the seller if the acquiring firm fails to retain a significant percentage of employee ownership over a meaningful period. Such measures would help compensate the seller for potentially lower sale prices. The welfare of employees is often a consideration in corporate divestitures, and many large companies might divest to ESOPs if appropriate incentives were in place.

Private equity incentives
Congress could also grant an exemption in taxable gains, up to responsible fiscal limits per transaction, for private equity and investment companies that sell portfolio companies to ESOPs. Again, the legislation should include measures to ensure that employees receive a meaningful share of ownership in the ESOP and to prevent governance and financial abuse. It should add a minimum holding period for the sold shares or assets and a clawback of avoided gains by the seller if the new firm fails to retain a significant percentage of employee ownership over a meaningful period. It could also include a clawback provision if initial performance under the ESOP falters.

ESOPs in opportunity zones
Opportunity zones are a new policy designed to promote economic growth in distressed communities through tax incentives. Provisions implementing the idea were included in the Tax Cuts and Jobs Act of 2017. A conventional opportunity-zone investment involves acquiring equity in a business or building located in such a zone; an investor who holds the property for at least ten years and then sells it enjoys significant tax relief on the proceeds. Private equity firms and other investors specializing in ESOPs have designed transactions where an employee stock ownership trust purchases a company in conjunction with private
equity capital, typically reorganizing the company into a 100 percent ESOP-owned S corporation and structuring the investor’s interest as (for example) subordinated debt or warrants. We believe that opportunity zone regulations should make clear that such investments qualify for the full benefits of the legislation.

**Employee ownership in publicly traded companies**

The case of publicly traded companies is different. Some smaller ones could be sold to their employees through a buyout. But most will continue to be publicly traded, and many of these have already created a variety of methods to get shares into the hands of their employees. Procter and Gamble’s employees own an estimated 15 percent of their company’s shares. Southwest Airlines’ employees own a significant chunk of theirs. Many high-tech companies, including Google and Microsoft, distribute shares, stock options or both to a broad base of employees. Simple changes to the tax laws could encourage more companies to spread the wealth in this manner.

For example, many public companies currently offer stock to employees at significantly discounted rates. Employees specify a payroll deduction over an offering period of three months to two years, at which point they can use that money to buy shares at a discount (normally 10 percent but sometimes considerably more). Because of the programs’ structure, employees have an opportunity to build significant equity stakes in addition to their pension or 401(k) benefits. Yet only about a third of eligible employees participate. Some may live paycheck to paycheck. Many may not understand the program. If companies seeded the first two years of participation in the fund by giving everyone a $1,000 grant to buy shares, employees would likely see the “guaranteed win” nature of the offering and participate at much higher rates. To encourage this, the government could provide a tax deduction for these grants.

**Employee ownership in companies enjoying government-funded privileges**

Every year, the US government and the governments of the nation’s 50 states take measures that affect the American economy. They pass tax laws and regulations. They provide tax credits, incentives, and subsidies of various sorts. Every one of these measures could be used to encourage employee ownership and contribute to the public goods of building a stronger, more equitable economy. Consider the 2017 corporate tax cut, for example. Suppose that the reduction in corporate taxes had been linked to the creation of an ESOP or another broad-based plan to encourage ownership. That would have provided the same boost to business investment and economic growth, while sharing the benefits beyond current shareholders to millions of employees.

As Rutgers professor Joseph Blasi and his coauthors put it in a recent paper, “A Congress or Administration that wants to support broader employee share ownership and profit sharing in economic rewards could develop a checklist on any major program or legislation that is proposed to examine its likely effects on, and capacity to increase, financial participation and capital ownership and access to income on capital of employees and citizens in our economy” (Blasi et al., 2017). Companies enjoying a variety of governmental benefits could be required to adopt employee ownership programs through ESOPs, broad-based stock grants, options, or similar mechanisms so that over time a meaningful percentage of their equity is held by their employees.

**Private sector initiatives**

Today, a wide variety of companies and nonprofit organizations have created a fertile ground for employee ownership initiatives. The National Center for Employee Ownership, the ESOP Association and Employee-Owned S Corporations of America have built
networks of employee ownership practitioners and advocates. State-level organizations in Ohio, Vermont, Pennsylvania and several other states educate local business leaders and policymakers about employee ownership opportunities. The Institute for the Study of Employee Ownership and Profit Sharing (Rutgers University) and the Beyster Institute (University of California at San Diego) lead academic research and analysis in the field. Many financial institutions specialize in ESOP-related transactions. A large group of attorneys, bankers, consultants and other experts help company owners establish and maintain successful ESOPs.

But there is much more that could be done by business leaders and philanthropists who wish to foster employee ownership. They could help establish more state centers. They could finance marketing campaigns to broaden public awareness of employee ownership. They could also act directly to increase the number of large, successful employee-owned companies. For instance, a private revolving fund to create ESOPs could buy companies from private owners, corporations, or private equity firms and then sell these companies to the employees over time using an ESOP. The fund could use the proceeds from its sales to buy more companies and sell those, too, to an ESOP, and so on. This effort requires no act of government. It might work through a charitable trust set up for this purpose, thereby providing additional incentives for the funders.

A note on risk
All stock ownership involves some risk. ESOPs are often thought to increase the risk because employees have “all their eggs in one basket.” When employees hold shares in the company where they work, the risk does not go away, but they are usually well placed to make sure that the basket is in good shape. Indeed, many rank-and-file employees at successful ESOP companies have already acquired a surprising degree of financial security, some with more than a million dollars in their retirement accounts.

To be sure, a lack of diversification in an investment portfolio does entail risk. This risk is moderated with ESOPs when, as is nearly always the case, employees are granted the shares and do not purchase them with wage cuts, savings, or retirement-plan funds. Moreover, employees in an ESOP company may actually face less overall risk than employees of a non-ESOP company. The proper comparison is between employees with ESOP accounts and employees with either a conventional retirement plan, such as a 401(k), or no plan at all (a group that includes about 60 percent of US private-sector workers). Consider the following facts from the nonprofit National Center for Employee Ownership:

• Based on Department of Labor filings, companies on average contribute 50 to 100 percent more to ESOPs annually than non-ESOP companies do to 401(k) plans.

• Most of the money in the typical 401(k) plan comes from the employee. With few exceptions, all the assets in an ESOP come from the company. The employees do not have their own money at risk.

• Research by the Department of Labor shows that ESOPs not only have higher rates of return than 401(k) plans, but are also less volatile.

• ESOP companies lay people off less frequently than non-ESOP companies.

• ESOPs cover more employees, especially younger and lower income employees, than 401(k) plans.

• ESOP companies are somewhat more likely to offer secondary retirement plans than conventional companies are to offer any plan (National Center for Employee Ownership, 2018).
To mitigate the remaining risk of ESOPs, future proposals can incorporate measures to reduce that risk without materially sacrificing the potential returns on the ESOP’s investment in employer stock. These measures could include public or private insurance, hedging arrangements, or other risk-pooling mechanisms.

In conclusion, we can imagine a new land of opportunity – an America transformed by more and more employee ownership. This would be a country where policies to promote corporate growth are automatically good for working people, because working people would own an ever-greater share of corporate stock. The solution to America’s problems is not less capitalism. It is more capitalists.

Notes

References


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