Guest editorial

The State of ESOPs: what's past is Prologue[1]

The major version of majority to 100 percent employee ownership in the US is the Employee Stock Ownership Plans (ESOP). Briefly, ESOPs are retirement plans under the Employee Retirement Income Security Act of 1974. These plans allow companies to set up employee trusts that can use credit to borrow money to buy the company's stock on behalf of the workers, typically without the workers paying for the shares themselves from wages or savings. To be clear, the employees who build the company and create its profit do earn the employee share ownership that they receive. However, the unique feature of ESOPs is that the company pays back the loan out of its revenues and the company itself is collateral for the loan, while the workers are typically granted their stock and do not pay for it with savings, wages or pension concessions. Think of it like this: real estate investors often borrow lots of capital to buy or build large apartment buildings with the promise to pay back those loans with the rents generated by these buildings. This approach of using leverage or credit to acquire assets with the income on those assets retiring the loan is common in American business. The ESOP simply extends the idea of self-liquidating credit to acquire assets to regular workers using the ESOP trust idea which was, by the way, invented by law professor and investment banker, Louis O. Kelso in the 50s.

There are over 6,000 ESOPs with assets of nearly 1.5 trillion dollars and over 10m active participants in the USA, and those numbers are increasing (NCEO 2019). At the same time, there are some significant differences and divergences among ESOPs. A fine-tuned analysis of the most recent Department of Labor Research File on ESOPs (Kruse and Blasi, 2019) indicates that 5,740 ESOPs are in closely held companies with 2.1m workers, $307bn in total assets, and an average employee ownership estate of $142,245 per employee participant. In contrast, 503 stock market companies haves 8.5m ESOP workers with $1,070bn in value and an average employee ownership estate of about $107,000 per employee participant. These stock market ESOPs are typically holding from 1 percent to 5 percent of a company's stock. This means that most of the workers in ESOPs and most of the value in ESOPs is in publicly traded stock market companies. Among the 5,740 closely held ESOPs, there are several thousand where the ESOP owns the majority or 100 percent of the company, often with larger average employee stakes than in the large public companies. It is the closely held ESOPs that are the focus on this volume, not those in stock market companies.

ESOPs can be found across a broad range of industries, though, according to the National Center for Employee Ownership (NCEO) data they are most common in manufacturing, professional, finance/insurance/real estate and science and technical services. Among the closely held ESOPs with majority and 100 percent employee share ownership the industry concentration is similar, according to the Rutgers data. Manufacturing, professional, science and technical services, finance/insurance/real estate and construction account for 68.5 percent of all closely held ESOP companies and 58.9 percent of all workers in closely held ESOPs.

What about the overall growth of ESOPs? A recent analysis of ESOP growth trends indicates that, while the number of employee owners and quantity of their assets in ESOPs have been improving, they are doing so rather slowly. Over the six years between 2010 and 2016 as tracked by the NCEO, the number of ESOP participants has gone up by around 3 percent (i.e. less than 1 percent annually) while assets have grown by around 45 percent (i.e. around 6.5 percent annually). The latter result likely reflects economic growth during that time, as well as the success and growth of many ESOPs (through, internal growth and

Journal of Participation and
Employee Ownership
Vol. 2 No. 3, 2019
pp. 177-182
© Emerald Publishing Limited
2514-7641
DOI 10.1108/JPEO-12-2019-026

mergers and acquisitions of other companies), rather than any significant increase in ESOP contributions and foundations. According to the Rutgers data, there are only 200 new closely held ESOPs a year. Thus, internal growth rather than new ESOP companies explains the large expansion of ESOP assets in the US on the one hand, this has built a durable employee share ownership sector in the American economy that is serving as a magnet for both research and policy. On the other hand, any large growth spurt by ESOPs will depend on some changes and evolution.

It is this context into which the paper, "Promoting employee ownership: a look at the States," by Corey Rosen, Nancy Wiefek and Timothy Garbinsky wades. While ESOP participants represent about 8 percent of all private-sector employees, the total number of ESOP firms is dwarfed by the 2.7m businesses that are owned by baby boomers aged 55 or older – businesses that will either change owners or disappear in the near future. This so-called "silver tsunami" that is beginning to affect business owners offers a window of opportunity for employee ownership that will not be seen again for many decades. Here the numbers of potential ESOP-able companies – through employee buyouts of retiring business owners – is enormous, potentially reaching trillions of dollars, tens of millions of workers and thousands of firms. While states struggle to maintain or improve employment in the face of larger economic headwinds, there are typically many thousands of businesses in each state that are approaching a business transition where a retiring business owner does not have a daughter or son or extended family member who wishes to continue managing the business. Many small towns, neighborhoods in cities and rural areas are very dependent on just a few small- to medium-sized small businesses for employment and growth and economic stability. Converting companies to ESOPs or worker coops in these areas might be of wide interest to economic development policy makers and researchers. Shutting down a business or selling it to outside investors with their own interests can be detrimental to local employment prospects; in contrast, selling the business to an ESOP is much more likely to result in jobs being preserved locally by the newly minted, and local, employee owners. For this reason, the policies of individual states regarding employee ownership are now of historic importance, given the potential for dramatic growth in such firms, sparked by local economic development efforts and incentives.

The state of worker cooperatives: a changing future

The report by the Democracy at Work Institute's Director of Research, Tim Palmer, "The state of the sector: US worker cooperatives in 2017," allows some comparisons of the worker cooperative world with the ESOP world. Worker cooperatives are owned by their workers, who vote their share of ownership on a one-person one-vote basis, and either elect management directly or elect a board-level body that selects management. Typically, they have been founded using the savings of workers, modest loans or philanthropic support as in cases such as the Evergreen Cooperatives in Cleveland, Ohio. As of 2017, 323 unique worker cooperatives with 6,033 workers and a typical size of 9 workers per company have been identified. A realistic estimate by the editors of this volume is that there are about 400 worker cooperatives with about 7,000 employees nationally. The majority of worker cooperatives are in retail, professional and technical services, manufacturing, administration/waste management and food services. Clearly, worker cooperatives and ESOPs overlap in terms of industry groups, although worker coops are more common in service industries that have lower capital intensity and thus a lower barrier to entry for individuals who have to fund their own worker start-ups. There is no exaggerating the importance of Palmer's work and the Democracy at Work Institute's effort to finally and systematically document the state of worker coops nationally over the last few years. This effort opens up a wealth of new systematic information for objective research. The Democracy at Work Institute recently sponsored a detailed social scientific

employee survey of the workers in these coops and we expect scientific papers on these dates to start appearing soon.

We hope that the data in this volume will spur researchers to analyze the differing growth patterns of worker cooperatives and ESOPs. We really know very little about why these patterns have developed. A lot is conjecture. On one hand, the small number of worker cooperatives may be due to a historic focus on riskier start-ups than conversion of existing businesses, a lack of credit to buy very expensive companies, the dependency on worker savings to start-up, the fact that transactions for worker cooperatives (unlike for ESOPs) have traditionally not been done by major investment banks and law firms and business advisors, and, perhaps, inexperience among many workers with the direct democracy management model of worker cooperatives. This last component may or may not be a factor since no one really knows the answer to this question. ESOPs have a more conventional form of management (no election of executives or board members by workers, and voting by a trust except on major corporate transactions that are voted directly by the employees themselves) yet their growth has definitely slowed, so it is hard to argue that a less democratic governance structure is a spur to growth. When employee ownership is used in a business transition, the more conventional governance form of the ESOP is likely to be more appealing to retiring business owners as they sell the firm to the workers and managers in 10, 20 and 30 percent chunks until a full 100 percent is sold.

Because it is very likely that the more conventional form of governance of ESOPs makes them more acceptable to retiring business owners who often sell the business to the workers in stages, this is one objective factor worth studying. It is hard to imagine the local family-owned plumbing business having workers on the board after the owner sells only 30–50 percent to the employees. On the other hand, with a median worker coop size of 9–11, it is hard to argue that the pure worker coop democratic governance model can be adapted to firms that would be the size of most ESOPs. Researchers will need to examine a range of governance models between the current ESOP model at one end and the direct democracy worker coop model at the other end of the governance spectrum. Indeed, even workers in the Mondragon conglomerate of worker coops in the Basque region of Spain do not directly elect managers, but elect representatives who elect managers. It is possible that, on one hand, a more representative vs direct democracy form of governance might spur the development of larger worker coops and that, on the other hand, the phenomenon of workers electing board members might become a regular feature of ESOPs. What we do not know or understand is the interest and tolerance of contemporary employees for direct democraty models, representative models of governance, or the more conventional model of ESOP governance. We do not understand how these factors into the growth horizon of both forms except to say that retiring business owners are understandably more conservative about governance until they are totally bought out. This governance issue lays underneath all of the discussions on growth trends and future prospects.

The worker cooperative report in this volume indicates that worker cooperatives are evolving. Recent figures indicate that about 20 percent of new worker cooperatives are arising from business transitions, which are also the key driver of ESOP growth. There is increasing evidence that credit to buy entire companies is becoming more available to spur this growth. Therefore, we observe a coalescence of factors explaining the development of both worker coops and ESOPs. Palmer's report presents far more data on the demographic make-up of workers in worker cooperatives than has been available for ESOPs, including a lot of detail about their history, racial and gender make-up. Similar information on demographics within ESOPs is lagging because we know precious little of the gender and racial make-up of ESOPs. This is one of the first research volumes that presents the ESOP and worker coop data in parallel and we hope it leads to much more comparative research.

The business transition challenge

The article entitled "Turning employees into owners: analysis of policy initiatives for rebuilding the American dream" by ESOP company executive Michael Quarrey – who authored one of the formative studies on ESOPs and economic performance decades ago – and journalist John Case makes a very clear statement about this future: it will be determined by the response of the employee ownership community to the huge retiring business owner transition that Baby Boomer founders of businesses will drive. They see explaining the evolution of employee ownership not so much as a debate about individual organizational formats (ESOPs vs worker coops), but rather as having more to do with how federal and state policies and availability of credit allow regular workers to have the opportunity to participate in the purchase and sale of small businesses. The article on state policy is also relevant to this question.

The challenge is making business owners aware of this possibility. Quarrey and Case review the benefits of ESOPs for workers as well as for firms (e.g. Kruse *et al.*, 2010; Blasi *et al.*, 2013) and proceed with the central theme of spreading information about those outcomes. Their suggestions for how to reach out to business owners and inform them of the benefits of ESOPs can inform efforts to make a difference in this area.

The snowball effect or a snowball's chance in hell?

One version of the ESOP – S corporations – loom large in the context of employee ownership. An S corporation under US law is contrasted to a C corporation, which is the typical joint stock company form under which corporations pay Federal income taxes on their profits at the end of every year. S corporations, in contrast, pass through their profits to their individual shareholders who pay taxes at that level, while the S corporation does not pay Federal corporate taxes. The emergence of S corporation ESOPs on the US employee ownership scene is a phenomenon that most academic researchers have ignored. Here, we have an employee ownership format that pays no Federal taxes, although taxes on that wealth is paid at the individual level. About half of all ESOPs are in S corporations, making them an important part of ESOP research.

What is the effect of the S corporation status on the evolution of employee ownership? How do the tax advantages of S corporations and worker cooperatives compare? In their article, "S corporation ESOPs and retirement security," Nancy Wiefek and Nathan Nicholson provide one of the first in-depth looks at the many benefits of ESOPs to the individual employees in S corporations, in particular regarding wealth and retirement, compared to the rest of the economy. For the first time, using the Palmer study and the Wiefek/Nicholson study, researchers can begin to compare the nascent worker cooperative sector's wages and benefits to the S corporation ESOP sector. This S corporation ESOP study represents a state-of-the-art look at the wealth impacts on workers from this important and growing segment of employee ownership firms.

While around 50 percent of all ESOPs are in S corporations, less than 10 percent of all ESOP members or assets are in S corporations, underscoring the comparatively small size of these firms. If S corporations are small at less than three hundred employees per firm, then worker cooperatives are even smaller at an average of less than 50 employees per firm or a typical size of 9 or 10. Worker cooperatives are also likely to be relatively new or newly converted, though there are examples of large and long-lasting businesses. Harking back to the business transition theme, will both these corporate forms snowball in numbers and size thanks to the silver tsunami, or will they continue to remain limited in scope, perhaps even shrinking relative to their counterparts in the non-employee-owned sectors of the economy? Quarrey and Case's answer to this question is that it has to do with future Federal policy choices, while the authors of the state policy piece see more potential impact for growth at the state level.

Making it happen

In addition to reviewing the business transition challenge, the paper by Quarrey and Case also reviews more broadly the benefits and challenges of implementing employee ownership, and offers a broad set of far-reaching policy options that the author assert could vastly expand its use. The authors' suggestions cover new institutions as well as tax and regulatory policies: Employee Ownership Investment Corporations could provide the capital for selling to an ESOP; divestiture and private equity incentives in the form of exemptions on taxable gains; ESOP tax benefits in Opportunity Zones; and regulations covering employee ownership in publicly traded companies as well as in companies enjoying government-funded privileges. This report also covers a number of companies and non-profit organizations involved in employee ownership initiatives. "Turning employees into owners" is a thorough review of how employee ownership could potentially matter in the economic inequality debate, how to go about expanding it and who might be involved in making it happen. Taken as a whole, it takes the academic study of employee ownership and contextualizes it in terms of broad social and economic developments (inequality, business transitions), the credit infrastructure of the country for buying and selling assets, major domestic policies and non-profit and for-profit actors.

One of the innovations of this Special Issue is finally bringing the very insightful white papers, research reports and deep dives into contemporary empirical data generated by non-profits, such as the NCEO and the Democracy at Work Institute, to the attention of the research community. Given the rigors of collecting data and getting articles reviewed, refereed academic articles can sometimes have several years between their appearance and the reality on the ground that they study. Non-profits studying phenomena are often closer to the ground and have faster access to data. We hope to continue to bring high-quality work from the non-profit sector to the attention of academic researchers in the future.

And being efficient about it

Rounding out this selection of reports on employee ownership is an empirical paper by Dan Weltmann that investigates a major cross-cutting theme in the profit sharing and employee share ownership literature that has not received sufficient attention by researchers: efficiency wage theory. It examines the effects of employee stock ownership on attitudes and behaviors, with comparisons to the effects of profit sharing and wages. The study "The efficiency of wages, profit sharing, and stock" was conducted within the framework of efficiency wage theory, extending this staple of economics theory to the field of employee share ownership.

This study examined which forms of compensation are more efficient at affecting employee attitudes, thus extending efficiency wage theory from wage-based compensation to profit sharing and stock-based compensation. Despite the fact that efficiency wage theory is one of the main theories of economists that is relevant to granting shares to workers, the empirical work on exploring its connection to equity shares had never taken place. In this paper, three models of efficiency wage theory were tested: shirking, turnover and gift exchange. The effects of those three modes of compensation (wages, profit sharing and stock), were contrasted for the three models of efficiency wage theory. This study returns to the National Bureau of Economic Research Shared Capitalism Project data set collected in the 1990s and early 2000s, and reanalyzes this large data set to study this question.

The findings are that raising wages is the most efficient form of compensation for lowering turnover and shirking, while in the gift exchange model profit sharing and stock-based compensation may function like efficiency wages in improving employee loyalty. To the extent that improved attitudes and behaviors can lead to greater individual productivity and improved firm performance, these findings support the idea of a flexible set of compensation tools for influencing employees, depending on the

desired outcomes. While many studies of employee ownership have been informed by agency theory and other incentive theories, this is the first to delve into distinguishing these theories empirically.

Conclusion

The articles in this issue are particularly well suited for updating our knowledge of the employee ownership landscape because, with one exception, they are very recent reports on policy and on-the-ground developments that can deeply inform research quite quickly. “S corporation ESOPs and retirement security” and “State of the sector: US worker cooperatives in 2017” provide a thorough analysis of that status of S corporations and worker cooperatives. While there is slow but steady growth in ESOPs (NCEO 2019), the growth could potentially expand dramatically given the millions of aging business owners looking to exit their businesses who may sell to their employees (cite: Promoting Employee Ownership). Quarrey and Case offer a range of institutions as well as tax and regulatory policies that can bring about this transition more effectively and on a much larger scale. It is our hope that this special issue of the *JPEO* will shed light on the prospects, problems and mechanisms of the employee share ownership sector in American society.

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Note

1. Shakespeare, W 1610-1611, *The Tempest.*

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