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Employee Ownership: Economic Miracle or ESOPs Fable? [\[In Brief\]](#)

Worker ownership is a growing phenomenon, but experts are divided as to its inherent rewards

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Here's a riddle for you: If you melded Adam Smith with Karl Marx, what would you get? Aside from a person constantly arguing with himself, you might also get something similar to an economic model that is slowly taking root in the U.S. economy: employee ownership.

Employee ownership and its newly coined cousin "shared capitalism" might sound like concepts straight out of the *Communist Manifesto*, but they've built a largely unnoticed niche in the U.S. economy. An estimated 20 percent, and possibly more, of the private workforce holds some form of direct ownership in the company it works for, up from almost zilch little more than three decades ago. An even larger percentage of workers receives add-on compensation based on company earnings—a quasi-ownership claim to profit from a firm's good performance.

Arguments on behalf of employee ownership sometimes revolve around a squishy desire for economic fairness, "distributing the fruits of economic success more widely and equitably," as one source put it, and creating "a form of economic democracy that complements our political democracy." But research to date suggests that employee ownership holds a much more convincing economic argument: Firms that offer some form of ownership or other worker-reward system have demonstrated impressive performance, possibly better than those that don't.

Employee ownership combines the capitalist motives of profit and private ownership with a populist desire for workers to share in the wealth they help create. Though it seems like the start of a bad joke ("so Karl Marx and Adam Smith walk into this business..."), employee ownership has demonstrated a unique chemistry with the U.S. economy. Those familiar with employee ownership consider it something of a secret—not the kind you keep to yourself on purpose, but more of an idea that's had trouble gaining much visibility despite its growth.

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The lack of visibility traces back to a research base that is rather narrow and shallow. Recently, though, researchers have been wielding a bigger shovel, and they have just completed a major study that gives a better idea of the incidence and depth of employee ownership. Even so, this research offers but a prologue to the effects of employee ownership and shared capitalism on workers, firms and the broader U.S. economy.

Taking stock

Various models of employee ownership are in place today (see [sidebar](#)). The most differentiated form is the employee stock ownership plan (ESOP) which, among other things, offers workers the opportunity to gain majority ownership and control of a business.

Technically, an ESOP is a retirement plan trust. Created as part of the landmark Employee Retirement Income Security Act of 1974 (ERISA), it is designed to help employees buy out an existing owner, sometimes partially at first. Without going into the financial and operations minutiae, as a trust, an ESOP can go into debt on behalf of workers to buy out existing owners.

From a worker's viewpoint, the ability to finance debt is an ESOP's central advantage over a cooperative, where workers must invest personal capital upfront to own a company. (It's one reason there are over 9,000 ESOPs in the United States, compared to only an estimated 300 or so worker co-ops.) An ESOP gives employees "a no-money-down freebie" on company ownership, says Don Israel, president of Benefit Concepts Systems, a benefit consulting firm in New York City that specializes in ESOPs. "It's the best kept secret there is."

Once the ESOP is established, the firm makes contributions to it that gradually pay off the transaction debt, thereby creating equity that is distributed as company shares to employees, based on a prearranged formula. The total value of the company (and its individual shares) is determined periodically by independent valuation consultants.

All of this takes place with considerable tax advantages. For example, if a sale to an ESOP entails 30 percent or more of the company, the owner can defer capital gains taxes on the sale, and sometimes avoid them altogether. "The attractions are so compelling, it's hard to turn them down," said Martin Staubus, director of consulting at the Beyster Institute at the University of California, San Diego. Though ESOPs have a steep learning curve, "a very high percentage of [owners] are going to want to do it."

Tax benefits also accrue to the sponsoring company and its worker-owners. Because ESOPs are a qualified retirement plan for employees, a company's contributions to the ESOP are made with pretax dollars. This enlarges the ESOP contribution a company can afford to make, which in turn allows the ESOP to retire its transaction debt and build shareholder equity more quickly. ESOPs are also eligible to become so-called S corporations, which place the income tax burden on shareholders rather than on the firm. As trusts, S-corp ESOPs are exempt from taxes on any income they receive as shareholders.

Year	Number of Plans	Number of Employees (thousands)
2005	9,225	10,150
2004	9,115	10,030
2003	8,875	9,600
2002	8,450	9,300
2001	8,050	8,885
2000	7,700	8,500
1999	7,600	8,000
1993	9,225	7,500
1990	8,080	5,000
1980	4,000	3,100
1975	1,600	250

Source: National Center for Employee Ownership

A fuzzy snapshot

All these advantages might give you the impression that ESOPs must be growing like gangbusters. Wrong impression.

Since their inception more than three decades ago, ESOPs have seen both growth and stagnation, reaching 9,000 plans in the early 1990s, falling to 7,700 plans in 2000 and climbing again to 9,225 plans in 2005, according to the National Center for Employee Ownership (NCEO), a nonprofit industry association. ESOPs come in different sizes and shapes. The number of firms that are majority-owned by their ESOP is estimated to be about 2,500. Roughly a thousand firms are believed to be 100 percent ESOP-owned.

Depending on how you look at it, ESOPs are both undersized and oversized. The total number of ESOP firms represents a tiny rounding error among the nation's 6 million firms with employees, but they employ a disproportionately large number of workers who, as a group, have grown steadily over time. Today, about 10 million participate in an ESOP, or about one of every 11 workers in the private sector.

Most ESOPs—and virtually all ESOPs with majority ownership—are privately held companies. But the biggest ESOP firms in terms of employees and revenues tend to be large, publicly traded companies whose ESOP share of company stock is typically less than 30 percent. Total assets in ESOP plans have skyrocketed, from \$133 billion in 1990 to more than \$620 billion by 2003.

Oddly, that's the rough extent of our knowledge of ESOPs as a macroeconomic phenomenon. What little we do know has been cobbled together by the NCEO from a patchwork of sources. "It's nasty to try and figure out these numbers," says Corey Rosen, NCEO executive director and co-founder.

Probably the most fundamental reason for the lack of firm and other ESOP-related data stems from this being largely a private-company phenomenon, particularly of late, and likely going forward. Changes made in federal law in the 1980s made ESOPs less attractive for public companies, so their numbers have slowly been declining and now represent a sliver of all ESOPs. As ESOPs become concentrated with

private firms, they are harder to study because private firms aren't legally required to divulge company information as fully as public companies.

About the only regularly reported information on ESOPs offers a glimpse at the research challenge. Firms with ESOPs have to file IRS form 5500 relating to qualified retirement plans. The Department of Labor publishes an infrequent report on 5500 filings; the most recent iteration came out late last year. But the 2006 report profiles 2003 filings and counts only 7,600 ESOPs because plans with fewer than 100 participants are not required to file. Rosen said it's not uncommon for ESOP firms to not show up in the 5500 data for a variety of other reasons. "So there are a lot of data inaccuracies," he says.

Which way now?

With unreliable data at the most basic levels, it's difficult to know exactly what's happening with ESOPs.

We might think that ESOPs are on the cusp of significant growth, given strong financial incentives for owners and employees, coupled with a bubble of baby boomer business owners thinking about exit strategies and retirement. But that doesn't appear to be the case, at least in terms of total ESOP plans, and the reasons appear to be plentiful. For example, ESOP start-up costs can be prohibitive for a smaller firm; owners often are interested in maximizing their firm's sale value, and ESOPs can't pay more than fair market price as determined by an independent consultant. Many owners have adversarial relationships with their employees, and selling the company to them is tantamount to "letting the inmates run the asylum. ... But [owners] can't say that because [they'd] sound like jerks," says Michael Keeling, president of the ESOP Association.

ESOPs are also complicated, technical and prone to information bottlenecks, according to numerous industry sources. When it comes to succession planning, owners rely on their accountants and lawyers for direction, and because there is little formal training available on how to establish ESOPs, these advisers tend to learn by doing. As a result, "you still have a lot of lawyers and accountants who are not familiar with ESOPs," and they have little incentive to learn, according to Keeling. Nor are they likely to bring in an ESOP specialist and risk losing a client.

Even ESOP advocates acknowledge that this model doesn't fit every firm. "The number of companies that could [transition to an ESOP] is not as large as you might think," Rosen says. A ballpark figure of sufficiently profitable, private companies with at least 15 employees (generally considered the threshold for an ESOP) probably numbers around 150,000, he says. The NCEO has roughly estimated the equilibrium number for ESOPs at around 15,000 to 20,000.

Yet despite very modest growth of late in the number of ESOP plans, industry sources described a situation of evolving growth for ESOPs. For example, there appears to be more churn—births and deaths—among ESOPs.

Many wrongly assume that ESOPs commonly die, or "terminate,"

because of economic struggles. That impression is the public-relations legacy of ill-fated ESOPs in the 1980s, as well as more recent implosions at Enron, WorldCom and United Airlines. But ESOP terminations are more often the result of success. A handful of sources said ESOPs become very attractive after 10 to 20 years because they have paid off their transaction debt and are accumulating cash. At the same time, ESOP trustees are required to have the fiduciary interests of worker-shareholders at heart, which makes them open-minded to bids that enrich owners. "Old adage," says one industry consultant, "bird in the hand is worth two in the bush."

Many ESOPs are also busy upping their ownership stake, looking to become 100 percent S-corps, according to Keeling and other sources. The reason is simple: As a shareholder trust, S-corp ESOPs are exempt from paying any taxes on the profit dividends received, making them a conveyor belt of tax-free cash for companies turning a profit. With a swelling balance sheet, many S-corp ESOPs are looking to diversify and have the capital to become active buyers. As recently as six or seven years ago, Rosen says, if he asked ESOP conference attendees whether they were involved in an acquisition, "it was rare for a single hand to go up. Today, it's rare for a single hand to not go up."

The Kevin Bacons of research

Underlying this growth is a simple, yet powerful message: Individual ESOPs must operate pretty well, and in some cases, very well.

Existing research suggests that ESOPs and other forms of employee ownership perform well along a number of parameters. In 2002 testimony before the U.S. House Subcommittee on Employer-Employee Relations, Douglas Kruse of Rutgers University told congressional members that "25 years of research shows that employee ownership often leads to higher-performing workplaces and better compensation and worklives for employees."

Much of what we do know comes, directly or indirectly, from Kruse and Joseph Blasi, aco-worker at Rutgers. Trace the lineage of almost any study on ESOPs or employee ownership, and you are sure to come across Kruse and Blasi—call them the Kevin Bacons of employee ownership research, minus about three degrees of separation. Says Rosen, "If it wasn't for Joseph Blasi and Douglas Kruse being interested in this idiosyncratic subject, there would hardly be any research on this."

According to a 2003 National Bureau of Economic Research (NBER) working paper authored by Blasi, Kruse and five others, research to date showed that "employee ownership firms tend to match or exceed the performance of other similar firms on average." The authors suggest that average productivity could be as much as 5 percent higher at employee-owned firms. They are careful to acknowledge that most studies "do not establish a statistically significant positive link between employee ownership and performance," but taken as a whole, research points toward a positive link overall because "there are far more positive results than would be expected if there is in fact no true relationship."

Within this body of literature, employee ownership (including ESOPs) has been linked to faster employment growth and higher survival rates among firms. In terms of workers, employee ownership has been linked to higher motivation and job satisfaction and greater employment stability. Anecdotes suggest that wages, benefits and retirement savings are at least as good, if not better, than at comparable firms not owned by employees, and research indicates that employees do not sacrifice pay or benefits in exchange for their share of ownership. Among ESOPs, company performance appears to be tied to an open culture of information sharing and employee participation in decision making.

For existing ESOPs, these positive findings are simply preaching to the choir. Almost all of them support their plans. A 2006 survey by the Employee Ownership Foundation found that 91 percent of 426 responding companies said creating their ESOP was a good business decision that helped the company; almost three-quarters also reported that their company stock outperformed three major stock indexes in 2005. A year earlier, the EOF survey found that 82 percent of respondents said the ESOP improved worker motivation and productivity.

Of course, economic theory would suggest that ESOPs, in particular, should be outperforming the competition because imbedded tax incentives give them an artificial advantage. If ESOPs require tax advantages to both start up and operate, well, that's not a strong argument for the ESOP business model. Where tax breaks are involved, better performance should be expected; if ESOPs perform only on par with non-ESOPs (which aren't subsidized), then scarce public resources have been spent (or revenues forgone) for no net gain or improvement.

Indeed, for all the cheerleading and feel-goodisms behind ESOPs, it's an open question whether there would be any ESOP-type firms today were it not for the 1974 ERISA law, which is widely lauded by advocates for kick-starting the ESOP movement. What enthusiasts call an incentive, an economist would call a subsidy, or worse in this case, a tax dodge.

Prove it to me

Still, taking the supposed performance advantage at face value, we know less about the traits and performance of ESOPs and other forms of employee ownership than the existing research might imply to the newcomer. The lack of basic ESOP data at the firm level is the proverbial tip of the iceberg of what we don't know.

ESOPs are not the only form of employee ownership, of course. But whether you're talking about ESOPs or broad-based stock options or profit sharing, there are big knowledge gaps regarding all forms of employee ownership, despite the fact that its various forms touch tens of millions of workers.

According to recent literature reviews, there are at most 120 studies on employee ownership and its various components. That might sound like a lot, until you realize it's a field that's 30 years old, and there are limitless topics to investigate with workers, owners, firms, sectors and

the broader economy, not to mention the different ownership forms themselves.

Even Blasi and Kruse acknowledge that employee ownership remains outside the mainstream in academia, and economics specifically, as well as in business circles and the business press. By contrast, Blasi points out, there are hundreds of experts—not studies, *experts*—on executive compensation alone and considerable media and public attention paid to the topic. And Kruse, via e-mail, says, “I think it's true that it remains somewhat on the fringe of academic research, and should be the subject of broader study.”

Why employee ownership stays on the fringe—despite some evidence of potential rewards for both workers and firms—traces back to economic theory that, until recently, researchers had failed to tackle head on. The efforts of Blasi, Kruse and a handful of others notwithstanding, economic theory has long been skeptical about the efficiency and efficacy of employee ownership.

For starters, employee ownership suffers from a significant principal-agent problem—a misalignment of the interests of workers (the agents) and owners (the principals). Employee ownership sounds like perfect alignment—workers are owners, so they reap the rewards or suffer the consequences of their output, right?—but, in fact, the multiplicity of owners introduces the vexing problem of shirking.

Where group work takes place, the workload tends to be shared unevenly, with some workers not carrying their weight (free-riders). Compounding the matter is the lopsided cost-benefit of intervening with that interloper. The cost of intervention is borne solely by the whistle-blowing worker, but the rewards of that intervention are shared by all workers. As a firm gets bigger, a worker has less incentive to confront a free-rider because the worker will reap less of the reward for getting the free-rider's nose back to the grindstone.

Economists have also frowned theoretically on employee ownership because of the lack of financial diversification for worker-owners, whose immediate and retirement income become dependent on the fortunes of a single company. Blasi readily acknowledges the difficulties posed by these theoretical issues. “Unless you can resolve those two big problems,” he says, “it's not worth major effort” in other areas of research.

What's in the box?

So in 2000, Blasi and a handful of peers decided that research on employee ownership had to be taken to a higher level. Despite the cumulative body of research, “studies we had done had not measured a lot of the variables that researchers tend to think are important,” Blasi says, which meant the entire research approach in this field “had to be rewired.”

That year, Blasi and his team received almost \$1 million from the Russell Sage and Rockefeller foundations to tackle a much more in-depth study on the incidence of employee ownership and its influence on the workplace. The program was dubbed the Shared Capitalism Research Project to encompass both direct ownership (stock and stock

options) and compensation schemes (like profit sharing) that give workers some claim on company profits.

Under the auspices of the NBER, the Shared Capitalism project set out to study the incidence of employee ownership programs and related workplace traits and behaviors among a broader, more scientific sample of workers. "We basically went off the radar for six years. We said, 'Until we do it right, we're not going to say anything,'" says Blasi.

Surveys were conducted at 14 firms with different forms of shared capitalism, the majority of which were ESOPs. Over 40,000 surveys were completed at more than 320 worksites. In the researchers' words, "The survey can be viewed as a random sample of workers from a non-random sample of firms." To construct a control group, the 2002 General Social Survey (GSS) included a module on employee ownership and tallied 1,145 worker responses from a representative sample of for-profit firms.

Though some initial results filtered out several years ago, Blasi and his co-researchers released more complete results in the fall of last year in preparation for a national conference sponsored by Russell Sage and the NBER. (It is now being prepped for peer-reviewed journals.) The research supports employee ownership along a number of lines, including a direct repudiation of the supposed shirking problem.

Blasi points out that shirking is generally controlled or influenced three ways: by close supervision, through the presence of a corporate culture that actively encourages and supports hard work (called "bonding) and, finally, with financial or other incentives. The Shared Capitalism project found that employees at firms with shared capitalism programs are more likely to speak up about shirking—to the worker or manager—than at workplaces without those features.

"The research clearly confirmed what we had expected all along," Blasi says. "[E]mployees are more likely to respond under conditions of high bonding and high incentives"—conditions that previous research has shown, not coincidentally, are present at many successful employee-owned firms. "The combination of supportive corporate culture and trusting employee relationships with various shared capitalism [forms] reduced the chance of doing nothing [to shirkers] and significantly increased the chance of intervening" to change worker behavior, Blasi says. "We believe we have looked inside the black box."

And make no mistake, the financial incentives of employee ownership are tangible and lend support to earlier research that found correlations between employee ownership and enhanced productivity and firm performance. In a conference paper, Blasi, Kruse, Richard Freeman of Harvard University and Christopher Mackin of Ownership Associates (a consulting firm) looked more closely at survey results for the behavioral effect of financial incentives. "Most workers report that cash incentives, stock options, ESOP stock, and ESPP participation motivate them to work harder," the authors report. There was not much effect on absenteeism, but there were beneficial effects on turnover and loyalty, among other things.

The Shared Capitalism project is also providing insights into

retirement savings diversification. A paper for the annual conference of the Labor and Employment Relations Association by Robert Buchele of Smith College, Loren Rodgers from NCEO and Adria Sharf of the University of Washington uses data from the Shared Capitalism project to look at ESOP retirement savings. They note that “while far from adequate from the standpoint of financing retirement, the median pension wealth of ESOP participants is over four times higher than the median household pension wealth, and that company stock ownership in ESOPs, while highly concentrated, is considerably less concentrated than stock ownership” in the broader economy. Translation: ESOP retirement savings might not be perfect, but a diversification problem is much better than a no-savings problem.

There is also independent evidence that many ESOPs, as they evolve, are sponsoring other retirement savings plans, typically separate 401 (k)s. Slightly more than half of ESOPs did so as of 2003, according to IRS 5500 forms. That doesn't mean that ESOP participants are diversifying their holdings, merely that they have the opportunity to do so. Many ESOPs do not offer matching contributions to 401(k)s, and data from 5500 filings suggest total assets in these plans is comparatively tiny.

Participation in Shared Capitalism Programs, 2006

(U.S. private sector)

	Number of Employees (millions)	Percent of Employees
In profit-sharing plan	43.9	38.4
In gain-sharing plan	30.6	26.8
Own company stock	20.0	17.5
Hold stock options	10.6	9.3
Any of above	53.4	46.7
Total employees	114.3	

Profit sharing is defined as eligibility for bonuses based on overall organization performance.

Gain sharing is defined as eligibility for bonuses based on department or plant performance.

Source: Douglas Kruse, Joseph Blasi, and Richard Freeman, National Bureau of Economic Research Shared Capitalism Project, February 2007. The items were included in the 2006 General Social Survey, which was administered by the National Opinion Research Center at the University of Chicago.

Were blind, now we see

Additional results from the 2006 General Social Survey—recently tabulated and as yet unpublished, but provided by Blasi and Kruse—show that participation in some form of shared capitalism rose from 2002 to 2006, from 43 percent to almost 47 percent of respondents. Other trends are emerging: Profit sharing and gain sharing became more widespread during this period, while direct ownership of both company stock and stock options declined, which Kruse attributes in part to the recent requirement for stock option expensing on company balance sheets.

More important than the point-in-time results, these latest findings are beginning to establish a public database that will allow researchers to investigate the longitudinal trends and the benefits and shortcomings of various forms of employee ownership. The cumulative

effect “provides a substantial amount of critical mass” to the field of employee ownership research, Blasi says. “The level of objective national measures has not been acceptable. But we've made some good strides in turning that around.”

Blasi is also hoping the topic of employee ownership will be taken up by the Federal Reserve's own Survey of Consumer Finance, which is conducted every three years. Blasi believes this to be a natural extension from the GSS in understanding ownership at the household and individual level. He has not broached the topic yet with any Federal Reserve officials because he is waiting “to get two periods of GSS data under our belts” in order to establish that both the incidence and level of ownership are high, and thus a topic of relevance to people's short- and long-term finances.

Blasi and others believe that the employee ownership model has always been a robust one. But a confluence of factors-anxieties over job security, a yawning income gap between workers and executives, the shift away from traditional pensions, President Bush's “ownership society” speech in 2004 (which ironically didn't expressly mention employee ownership) and the growth of more rigorous research-has many believing that the profile of employee ownership might well be on the rise.

Says Blasi, “I think we're at a fork in the road as far as economists taking another look.”

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