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Economic Democracy in USA

Introduction

Since 1974, more and more U. S. companies have begun to experiment with partial or full employee ownership. The current employee ownership movement reflects Americans' belief in the merits of bringing capitalist opportunities within the reach of common workers (McElrath, 1992), but it is primarily the result of a number of more immediate and concrete forces, such as: changes in the economy, social change in the workplace, and perhaps most important, federal legislation encouraging employee ownership.

In the 1970s and early 1980s U. S. firms faced new worldwide competition, tougher economic conditions at home, and an end to the seemingly automatic productivity gains of the 1950s and 1960s. At the same time an increasingly educated American workforce demanded new opportunities for participation in work (Lawler, 1986). These pressures necessitated new and more effective ways to motivate workers and increase productivity. The conjuction of these events, the insight and persistence of Louis Kelso (an attorney who devised and ardently supported one now common model of employee ownership), and the powerful backing of Senator Russell Long led to the passage of a series of laws to encourage firms to share ownership with employees. Starting in 1974 these laws provided tax incentives for companies to set up employee ownership plans. Proponents of the legislation argued that employee ownership would use the free enterprise system to create a more equitable distribution of wealth. This logic was particularly appealing to a federal government facing increasing constraints on public funding for social programs aimed at income distribution. Proponents also believed that employees, as owners, would be more motivated and satisfied in their work, leading to productivity gains for their firms and the economy as a whole. Finally, though the legislation was designed to encourage profitable firms to try employee ownership, the laws could be used to facilitate employee buyouts of companies that might otherwise close.

How Employee Stock Ownership Plans (ESOPs) Work

U. S. employee ownership companies vary widely in the form of worker ownership, the amount of stock owned by employees, and the extent of worker control. Even though there are many variations, the most popular employee ownership types are employee stock ownership plans[1] *(ESOPs)* and worker co-operatives. This paper focuses on ESOPs only.

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[1] ESOPs are viewed as *"employee financial participation plans"* in some cases, although they are primarily used as employee retirement benefit plans.

The Basic ESOP Structure

ESOPs are the most common form of employee ownership and the most likely to be found in a wide range of companies. In an ESOP the firm sets up an employee stock ownership trust *(ESOT)* and makes tax-deductible contributions to it of company stock or cash to buy stock. An ESOP can own any percentage of company stock, from a token amount to full ownership of the company. Only very rarely do employees buy the stock themselves. Rather, the company gives its employee stock as an employee benefit.

The ESOP stock is held in trust, where it is allocated to accounts of individual employees. Generally, all full-time workers over 21 years of age participate in the plan. ESOP stock is allocated to employees based on salary or other unique formula. The stock remains in trust tax-free until the employee retires or otherwise leaves the company. Since 1976, ESOPs have had the right to pay out dividends on stock held in ESOP accounts directly to individual employees, but the United States General Accounting Office (US GAO, 1986b:36-48) found in 1985 that only about 5% of ESOPs had actually done so.

The employee does not necessarily receive all the stock in his (her) account when he (she) leaves the company, however. In order to encourage employees to stay with the company, stock allocations are subject to vesting[2] Unvested stock is returned to the trust and reallocated to the accounts of the remaining employees.

The stock that employees received upon leaving the company may be sold back to the company at its current fair market value *(FMV)* or sold on a stock exchange if the company's stock is publicly traded. In privately traded ESOP firms, company stock must be valued by an independent stock appraisor each year in order to determine FMV. Employee gain on the stock is only lightly taxed.

In publicly traded companies, employees must be able to vote their allocated ESOP shares. In privately traded firms, employees are allowed to vote on a limited number of major issues only (e. g. liquidation), although firms may pass through full voting rights.

Reasons for Forming an ESOP

ESOPs have a variety of uses and can be found in almost any kind and size of business, except those with less than ten employees.

Using ESOPs as Employee Benefit Plans

The most common use of an ESOP is in an ongoing, profitable company as a means to provide retirement benefits for employees (US GAO, 1986b:20).

Unlike conventional pension plans, ESOPs do not commit employers to paying retiring employees at a level of benefits that is specified in advance, but instead commits them only to disbursing to retiring employees whatever amount of assets has been accumulated in their individal accounts (Russell, 1985).

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[2] Vesting refers to a process by which employee acquire a gradually increasing right to their allocations, usually zero percent for the first one to three years, then increasing regularly to one hundred percent vesting by ten years.

Using ESOPs for the Tax Advantages

As noted in the TABLE 1, the second most popular reason for forming an ESOP is the best-known attraction of the ESOPs, namely, their tax benefits (US GAO, 1986b:20). Within limits, contributions to ESOPs are tax deductible, and loans funneled through an ESOP are repaid in pretax dollars.

The number of ESOPs has been increased by virtually every federal tax change since 1974. The Employee Retirement Income Security Act of 1974 *(ERISA)*, the Tax Reduction Act of 1975 and the Deficit Reduction Act of 1984 drew increased attention to the tax benefits to firms of setting up ESOPs.

TABLE 1: Why Firms Set Up ESOPs

Reason Given:	%
To provide a benefit for employees	91
For the tax advantages	74
For anticipated effects on labor force:	
Improve productivity	70
Decrease turnover	36
Decrease absenteeism	14
Avoid Unionization	8
Exchange for wage concessions	3
For financial reasons:	
Buy stock of a major owners	38
Transfer majority ownership to employees	32
Raise capital for investment	24
Less vulnerable to hostile takeovers	5
Save company from going out of business	4
Turn company private	1

Beyond their tax advantages, the ESOPs have a variety of more specific uses and attractions that have already been explored in a number of previous works (e. g. Rothschild & Whitt, 1983; Klein & Rosen, 1986; Rosen et al., 1986). The major contribution of the GAO data in this aspect is in giving us our first credible estimates of how common each of these previously identified uses actually is. As noted in Russel (1984), these additional uses of ESOPs can be sorted into two major groups. First, many companies are attracted to the ESOPs by the effects they hope the ESOPs will have on their labor force. These firms see the ESOPs specifically as a means either to raise the quality or quantity of their employees' labor or to lower its cost. Secondly, companies are attracted to the ESOPs by a number of financial uses of the ESOPs, such as those that are listed at the bottom of TABLE 1.

Using ESOPs for Anticipated Effects on Employees

In so far as companies do turn to ESOPs for their potential effects on their employees, the GAO data indicate that the most common expectation is that employees' new financial stakes in the success of their companies will inspire them to become more productive (70%). Smaller but still substantial numbers of companies expect the ESOPs to make their workers less likely to seek jobs in other firms (36%) or to be absent from work (14%). A still smaller but not insignificant 8% of firms with ESOPs acknowledge that they set up their ESOPs at least partly in the expectation that owning stock would make workers less likely to want to join a union in the future. In only 3% of ESOPs, however, were the employer's ESOP contributions explicitly granted in exchange for wage concessions from workers. This is a mechanism that has received a good deal of publicity for its use in many steel-making, airline, and road transport firms (Hochner et al., 1988).

Using ESOPs for Financial Reasons

Finally, the GAO data document the frequency of several financial uses of ESOPs that were not expected in the initial ESOP legislation,[3] but that have risen to prominence in the years since. Most importantly, it has become increasingly apparent that an ESOP is a very attractive way to divest a firm. The sale of a firm to an ESOP provides a retiring owner with a mechanism for divesting himself (herself) of the business at a low rate of tax in a way that ensures the continuity of the firm and allows the owner to depart from the firm at a time and on terms of his (her) own choosing. The power of these inducements is evident from the high frequency with which ESOPs are established to buy the stock of a major owner (38%) and to transfer majority ownership to employees (32%). It is important to note that these companies being sold to their employees are generally healthy companies, not declining firms being bought by their workers in a last-ditch effort to save the firm. ESOPs have occasionally been used for this purpose, some of the most prominent instances having been described in a book called The International Yearbook of Organizational Democracy (e.g. Blasi et al., 1983:641–642, & 1984:309; Rothschild & Whitt, 1983:393–396; Klein & Rosen, 1986: 392). While these worker buyouts of failing firms have captured the largest share of the headlines about the ESOPs and have also appeared prominently in the ESOP's politics (Hochner, 1988), the GAO data indicate that they account for only 4% of the ESOP population as a whole.

The GAO data also reveal the frequency of a number of other salient financial uses of the ESOPs. Both of the ESOP's intellectual father Louis Kelso and their chief legislative sponsor Russell Long have often expressed the hope that ESOPs would become important mechanisms for raising capital for their firms (McElrath et al., 1992) *(See FOOTNOTE #3)*. Based on the GAO data, 24% of companies do view their plans in this way. Another unanticipated and quite controversial finanicial use of ESOPs is to make a firm less vulnerable to hostile takeover attempts (5%). This is a very high number when one considers that only 25% of ESOPs are in publicly traded companies (US GAO, 1986a:16). Note that public traded companies are most likely to become targets of attempts of this type. In only 1% of firms, however, has an ESOP been used to turn a publicly traded company into a privately traded one.

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[3] In the initial ESOP legislation, ESOPs were established as an important tool for raising additional capital for American companies.

The number and size of the ESOPs

By 1983, ESOPs had been established in more than 4,000 U. S. firms, and had made stockholders of more than 7 million employees (US GAO, 1986a:9 & 23). By 1986, the GAO estimates that the number of ESOPs had grown to nearly 5,000 plans, and that more than 2,000 additional comporations were maintaining stock bonus plans for their workers that were like the ESOPs in all but name (US GAO, 1986b:63).

In addition to estimating the number of ESOPs, the GAO has also provided data on the size of the plans. Through the end of 1983, the GAO calculates that the total population of ESOPs had accumulated $ 18.66 billion in assets in the names of more than 7 million employees. Because these figures are strongly influenced by a small number of very large plans the GAO notes that the median ESOP had 54 participating employees and held an everage of $ 5,226's worth of stock in each employee's account (US GAO, 1986a:23).

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