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Why Aren't There More?

Assessing Barriers to ESOP Creation

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Executive Summary

A significant and growing body of research shows that employee stock ownership plans (ESOPs) at privately held companies provide U.S. workers with retirement security through employee ownership, job stability, increased workplace productivity and other key benefits that derive from the alignment of worker and owner incentives. ESOPs also provide retiring business owners with an exit strategy that allows for controlling the succession of the business, while rewarding the valued workforce with an ownership stake.

Given these benefits — together with previous research showing that ESOPs help address wealth and wage inequality — this study looks at why there are not more ESOPs and considers how to address potential barriers to entry. To understand the barriers better, this study considers the results of a survey of 250 non-ESOP business owners and leaders, as well as a series of interviews with business owners whose companies did transition from traditional private ownership to an S corporation ESOP model, and other leaders of employee-owned companies.

From that analysis, education and awareness about private ESOP structures, both for owners and their professional advisors, are the most frequent hurdles to ESOP creation. Other hurdles include opportunity costs of owners who are looking to sell quickly and do not want to invest the time and resources to set up an ESOP. To help overcome these hurdles, this study recommends private and governmental approaches that can help more retiring business owners access the resources and information they need to fully consider an ESOP for their company as part of their own retirement pathway. Given the adequacy of existing tax incentives to create ESOPs, this analysis does not support the need for further tax benefits to private companies that become ESOP-owned.

Finding new approaches to help smaller and midsize private companies that oftentimes do not have the funding or the professional advisor bench to consider and conduct an ESOP transaction holds important promise for aligning incentives within firms, improving the quality of jobs, and increasing workers' wealth while generating important new benefits in productivity for their companies.

Introduction

The study explores a simple question: why are there not more Employee Stock Ownership Plans, or ESOPs?

Before discussing the motivation for this question and how I go about trying to answer it, a brief explanation of ESOPs, along with their benefits and costs, is warranted for the uninitiated (as you will see, lack of basic information about ESOPs is one answer to the question). As their name implies, ESOPs are a form of employee ownership where the workers own stock in the company that employs them. This arrangement, which barely existed before the mid-1970s, serves various purposes. ESOPs provide retirement savings similar to other defined contribution plans, but unlike standard versions of such plans where, for example, employers match worker contributions, the contributions to ESOPs are shares of stock in the employee's company. Importantly, these shares are predominantly provided by employers who sell portions of their ownership stake to the ESOP.

Another purpose of an ESOP is to align the value of the company with the work of its employees. ESOPs are a form of (deferred) profit sharing and as such, as I argued in an earlier paper, they help to solve a classical economics problem known as the "principal-agent problem," the idea that the objectives of workers and owners are not clearly aligned. Though this problem, as taught in microeconomic classes, is theoretical, it invariably came up in discussions with business owners who set up ESOPs, as reported below, who often cited it as part of their motivation. ESOPs give a firm's workforce more skin in the game in terms of the firm's success.

Considerable research finds that under certain conditions, of which the most important is workers' input into the production process, this alignment often has its intended effect. ESOP companies, and those with employee ownership (EO) in general, have been shown to be more robust to the business cycle, with steadier output and employment than comparable firms without employee owners. EO firms have been found to have lower rates of bankruptcy and liquidation in periods of economic shocks, in part due to their lower loan-default rates. They've also been found to outperform on sales, job growth, and productivity.

ESOPs give a firm's workforce more skin in the game in terms of the firm's success.

ESOPs also provide a way for retiring owners of closely held businesses, including family businesses, to control the succession of their business and provide a valued workforce with an ownership stake. They provide an opportunity for "preserving the legacy of the company and rewarding management and employees with ownership." Owners who are stepping back can sell a portion or the whole of the business to the trust that holds the company's stock. Moreover, these transactions in setting up and maintaining ESOPs provide considerable and far reaching tax advantages as discussed below (see interview with Ken Baker).

There are also costs to ESOPs, and from the perspective of this analysis, perhaps the biggest is the opportunity cost to the retiring owner of setting up the ESOP trust versus selling their company on the open market. Even with the tax breaks, depending on the nature of demand for the type of firm, owners could often earn a higher premium from a traditional sale. Setting up and running ESOPs also invokes both fixed and ongoing costs, though the latter must be compared to those of any other retirement plan. In this regard, another finding from this study, one that comes out in the interviews featured below, is that it takes a certain type of owner to go through the work and pay the opportunity costs of selling to her employees.

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Bottom line, ESOPs have both benefits and costs. Some of these could be quantified, such as the sale price in the open market vs. to the ESOP trust, or the value of solving the principal-agent problem. But others, such as the value the seller places on "preserving legacy" or rewarding a loyal workforce resist quantifying. Therefore, when asking the question of why we don't see more ESOPs, I am not suggesting that I have in mind an optimal number well above that of the current number (about 7,000 ESOPs exist, covering 28 million worker participants).

But, to come clean from the start, my research, my concerns about the elevated extent of wealth inequality in America, and my experience interacting with business owners who started ESOPs, lead me to believe that there should be more of them. One motivation comes from my own work and that of many others on the rise of economic inequality, i.e., the increased dispersion in incomes, wages, and wealth. Recent Federal Reserve data show that in 2019Q4, over half the value of corporate stock (including mutual fund shares) was held by the wealthiest 1 percent of households, and almost 90 percent was held by the top 10 percent. The bottom half held less than 1 percent of the value of corporate equities. Because ESOPs provide equity to working-class people who increasingly lack such assets, I've argued that they are a potentially useful tool in pushing back on our historically high levels of wealth concentration. I also argue below (see Nestegard interview), that ESOP firms tend to eschew the "short-termism" and quarterly profit maximization that can undermine longer-term planning with more lastingly positive results for the economy and the workforce. ESOP capital appears to be more patient capital.

These insights and findings provide the motivation for the question that frames this paper. I attempt to answer the question with two tools. After a brief detour into how ESOPs are set up, I review the results of a survey fielded for this paper by the polling firm John Zogby Strategies (JZS). The poll samples persons in a position to decide whether an ESOP might make sense for their firm and asks a detailed battery of questions as to their views on the issue. It is the first such poll of this type that I know of, and its findings were revealing. Second, I report on a number of discussions with ESOP owners about some of the barriers to entry that surfaced in the poll, along with some of their own views as to why more companies haven't set up ESOPs. The paper concludes with a synthesis of what I believe we know about the answer to the question and some ideas for policies that might incentivize more ESOPs.

A summary of the findings of the study suggest the following factors explain why there are not more ESOPs. The most prominent barrier is awareness. If more selling owners knew about the option, some would likely take it up. However, another barrier is the lack of expertise among necessary service providers — lawyers, accountants, government officials, outside estimators of a company's worth — necessary to set up the plans. A third barrier is the opportunity cost one mentioned above. Both the survey and the interviews suggest that concerns around legacy, job quality, employee sense of ownership, and other such intangibles play a significant role in the motivation to sell into an ESOP. Finally, one barrier I expected to find received mixed evidence from this analysis: reluctance to incur the debt often required in the process of setting up an ESOP (owners often lend the ESOP trust the resources needed to buy, partially or wholly, them out). Perhaps because the cost of capital has been so low for so long, in tandem with ESOPs' tax advantages, this concern was downplayed in the interviews with owners who set up ESOPs. Survey responses, however, provided evidence of some concern that the costs of setting up an ESOP outweighed its benefits.

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How *do* ESOPs get started?

For those less familiar with ESOPs, a brief look at how they are set up provides useful context for the forthcoming analysis. The broad outline is that setting up an ESOP involves transferring some portion of an asset, in this case, the ownership of a company, from the current owner to the employee owners, who will hold their ownership in a trust whose returns will pay them retirement benefits. Key set-up issues include making sure the process follows the rules for ESOPs set out in the ERISA legislation, and how the transfer of the asset is financed.

One of the first rules in the set-up process is that purchase cost of the ESOP must not exceed the company's fair market value. This step is easier with public companies as they already have a market valuation. According to the National Center for Employee Ownership, private valuations, done by an outside estimator, consider "cash flow, profits, market conditions, assets, comparable company values, goodwill, and overall economic factors" such as demand for the product or service the company provides.

Most ESOPs are leveraged, meaning the trust borrows the money to buy whatever portion of the company's shares constitute the initial investment (this borrowing characteristic of ESOPs is unique among retirement plans). The lender can be a bank, but it could also be the selling owner, whose loans in this context are tax-favored (loans to ESOPs are repaid with pretax dollars). Following the initial transaction, the company acquires stock which it assigns to employee-owners based on various criteria, including tenure and compensation. That is, employee owners themselves do not typically buy shares in the company; they acquire them in a process roughly similar to a company's contribution to their workers' 401(k) retirement plans, but instead of putting compensation in a retirement account, the ESOP distributes stock. The appreciation of the stock — assuming it appreciates — accrues in the employee's account to be paid out when she retires or leaves the company (distributions can be lump sums or amortized over a specified period).

Non-leveraged ESOPs are initially funded not by a loan but by direct contributions (which are tax deductible) from the company itself of either cash, which is then used to buy company stock, or company stock itself.

This description is, to be clear, from 30,000 feet up. More granular details complicate the process, including valuation rules and differences in rules governing S-corp and C-corp ESOPs. As one business owner dryly put it to me, "there will be lawyers." That said, the evaluation of the process must be compared to a counterfactual. Setting up any type of retirement account, profit sharing, co-op, or employee ownership program involves complications that should be compared to this one.

Of course, once the ESOP is set up, it must be run by the company, a job often assigned to a sole individual wholly dedicated to managing the plan. Such tasks include tracking contributions, paying out benefits to recipients who retire or exit the firm, managing/repaying the loan in leveraged ESOPs, and adhering to tax rules which apply both to the handling of company profits and ESOP financing. As referenced in interviews below, the favorable tax treatment of earnings in ESOP companies is a strong selling point of the model.

The Survey

With that background, this section reviews the results of a nationwide, online survey of 250 companies of all sizes and from all sectors, administered by JZS conducted on April 23-24 and focused on the question of perceived barriers to setting up an ESOP.[1] The survey excluded any firms that already had an ESOP (or where the respondent wasn't sure), and, in order to collect germane information, ensured that respondents held one of these positions: Owner or key financial/ownership decision maker in company, retirement plan advisor, company division head/ general counsel, next-in-line for succession/ second generation. The margin of error for the sample of these decision makers is +/- 6.3 percentage points, and JZS applied slight weights to age, race, and educational achievement levels to reflect the broader population.

Table 1 shows various characteristics of the sample. Most firms in the sample (63 percent) had less than 50 employees, and the vast majority of respondents (82 percent) identified themselves as key decision makers in the company.[2] The sample was divided fairly evenly between family and non-family owned businesses and regions of country.

Table 1: Survey sample, top-lines

	Percent of sample		
<50 employees	63%		
Owner/Financial Decision Maker	82%		
Family Owned	52%		
		Number of employees	
Familiarity with ESOPs	Total	<50	>50
Very familiar	24%	16%	27%
Somewhat familiar	43%	41%	58%
Somewhat unfamiliar	12%	16%	7%
Not familiar at all	18%	25%	7%
Not sure	3%	3%	2%

Source: John Zogby Strategies, ESOP Survey

1 - *See survey results.*

2 - *Relative to Census data on U.S. firms by size, our sample skews towards larger firms, as about 95 percent of U.S. businesses have 50 or fewer employees.*

Respondents evinced some familiarity with ESOPs, but only 24 percent of respondents were very familiar with such plans and 43 percent were somewhat familiar. Predictably, respondents with existing retirement plans, such as pensions or 401(k)s, had higher familiarity with ESOPs: 73 percent were either very or somewhat familiar. Conversely, of the full sample, 18 percent were "not at all familiar," 12 percent were unfamiliar, and 3 percent were unsure, implying that about a third of respondents know little or nothing about ESOPs. Importantly, among firms without retirement plans, that "unfamiliar" share climbs to 46 percent.

Just under half (47 percent) thought ESOPs were a good vehicle for their company's succession/transition of ownership.

Managers at firms with less than 50 workers were less likely to be familiar with ESOPs (25 percent were "not at all familiar" with them). Thus, the survey is at least suggestive that one answer to the question of this study — why aren't there more ESOPs? — is that a substantial minority of financial decision makers simply don't know much at all about them, especially at smaller firms. One caveat here is that there are, in fact, few ESOPs in very small companies, probably because it is hard to achieve any meaningful scale efficiencies in such small operations, along with the fact that S-Corp ESOPs must have at least 11 employees. NCEO states that "As a rule of thumb, ESOPs work best for companies with over 20 employees."[3]

Interestingly, respondents from the next largest size category, with 50-100 employees, had high familiarity with ESOPs, as 85 percent answered that they were either very (27 percent) or somewhat (58 percent) familiar with them.

Just under half (47 percent) thought ESOPs were "a good vehicle for your company's succession/transition of ownership," compared to 31 percent who answered "no" with the rest "not sure." Asked about why ESOPs "could be a good vehicle for [their] company's succession/transition of ownership," the modal response (51 percent, though multiple responses were allowed) was that "ESOPs provide companies with tax savings, which help the company grow." In the next largest response, 44 percent of respondents believed the plans would "likely incentivize employees to be more productive" by dint of having more "skin in the game." In what is perhaps a larger share than some might have expected, just over 28 percent of respondents agreed that "ESOPs help reduce the wealth gap between top managers and rank-and-file employees."[3]

This "skin-in-the-game" rationale was also raised by the owners of various firms, as noted below (see, e.g., the conversations with Bill Roark and Ken Baker), and is also consistent with ESOPs as a solution to the "principle-agent" problem. Respondents were able to choose more than one answer to this question and a bit over half agreed that ESOPs tax savings were conducive to their company's growth. Other reasons for thinking ESOPs would be useful included reducing the wealth gap between management and rank-and-file workers, retirement security, and "company continuity."

3 - *Smaller companies, e.g., less than 20 employees, interested in employee ownership sometimes find worker cooperatives easier to set up and more conducive to their structure and goals than ESOPs.*

Conversely, in reflecting on why ESOPs might not be a good succession vehicle, more than a third of respondents (36 percent) thought the "costs of an ESOP transition probably outweigh its benefits." Though the sample size was very small on this crosstab, an interesting response on this cost/benefit question came from those who were "next in line for succession," as 53 percent believed the costs of setting up an ESOP outweighed its benefits. It is possible this reflects the potentially significant opportunity cost of selling into an ESOP versus the market. Men were also more likely than women — 41 percent to 28 percent — to view the costs as exceeding the benefits. Perhaps surprisingly, Democrats/liberals were more negative about the net benefits of ESOPs than Republicans/conservatives.

The second largest negative belief was that "selling to an ESOP prompts fear of losing control of the company" (28 percent). Because this question of "why not an ESOP?" was so central to our study, the survey allowed open responses to it. The most common clusters of responses were around "too costly," (18 percent); "our firm is too small," (17 percent); and "fear of losing control," (15 percent). Another, smaller cluster (about 8 percent) reflected "concerns for future performance" and "employee ownership is bad for business growth." In fact, research consistently finds that firms with ESOPs perform relatively higher on these sorts of metrics, suggesting room for information sharing by advocates of this form of employee ownership.

In sum, the survey's findings suggest that:

- Size matters: awareness of ESOPs grows with firm size, with a significant jump at 50 employees. More than a third of respondents at firms with less than 50 workers did not consider ESOPs to be a good vehicle for succession/transition of ownership. There was some indication that "losing control of the company" was a concern for respondents from these small firms.
- Financing matters: the survey revealed reasonable concerns about the costs, including opportunity costs (selling to employees versus selling to new owner in private market), of transitioning to an ESOP, and tax savings were considered an important motivator in this context.
- Even the process of going through the survey, thereby learning even a slight bit more about the net benefits of ESOPs appeared to significantly boost the interest in setting one up.

Thus, we suspect that providing those in decision-making positions at firms that employ around 50 or more workers with more, and probably a lot more, information about ESOPs would likely lead to more of them.

We now turn to information we gleaned from detailed interviews with owners who sold to an ESOP.

Word from the Street:

Interviews with entrepreneurs who started ESOPs.

Bill Roark first learned about ESOPs when he went to work for a defense contractor that had set up an ESOP shortly before he was hired by the firm. As he learned about the arrangement and explained it to employees, he became "pretty enamored by it." When he shortly thereafter started his own company, he and his cofounder told the initial employees that when the firm size hit 50, they'd set up an ESOP.

When I asked Bill what motivated this commitment, he replied that it was a way he could maintain commitments to his workforce. He did not want to find himself in a position where he could not follow through on a promise because the company was sold and the new owners didn't honor past obligations. "You get to a situation where you have a lot of people you've made commitments to, they do what you ask them to do, and…then you can't honor the commitment. I don't ever want to be in that position again, and I don't ever want to put somebody in that position." For Bill and his partner, the ESOP was thus one way to avoid the company ever being forced into a sale.

As the company grew, they transferred 40-50 percent of the firm's ownership to the ESOP and then, in 2011, transferred the remaining 50 percent. To transact the deal, part of which involved buying stock back from employees who'd previously been granted options, Bill and his partner borrowed $12 million and raised a comparable amount through "sellers' notes," where stock owners take a note, basically an IOU, instead of payment for their stock.

This debt was paid off relatively quickly, in 2½ years. When I asked Bill about paying off the sellers' notes, which tend to hold a higher interest rate relative to bank loans, he reported that most of that payment was made from 401(k) savings that were transferred into the ESOP by about half of the workforce. This is not an unusual practice but it is one that can reduce the extent to which employees are diversified, a potential problem ESOPs often try to avoid.[4] In the case of Roark's firm, as the share values held by the employee-owners grew by a factor of 10, they clearly came out ahead. In fact, he reports that he "begged" employees to diversify but the large differential between the appreciation of the company's stock and the broader market made his advice a tough sell.

In one of the more revealing parts of this interview, I asked Roark what motivated the sale into an ESOP, asking whether he was tempted to take an easier, more traditional, and potentially more up-front profitable path of selling into the private market. In response, he told me about a quote he keeps on his door from Dr. Martin Luther King Jr. (though only after Roark reminded me that King was "a very eloquent speaker and I'm a southern redneck"): "The time is always right to do what is right."

4 - *In fact, the Internal Revenue Code requires ESOPs to offer diversification plans to employee owners as they near retirement.*

He went on: “People work hard. I’ve got a lot of people who would work to the wee hours of the night trying to make the company successful, and when the company succeeds, I don’t think it’s right for me to take all the proceeds and go home with them. And I see that happen all the time…we wanted to treat our people as owners.”

In this same spirit, Roark told a story that spoke to how ESOPs are a solution to the principal/agent dilemma of microeconomic theory. He talked about driving by the company’s building, which they own, late night on a weekend and noticing many lights were on. This prompted him to write a note to the employees pointing out that savings from reducing the $10,000 monthly electric bill would go right into the ESOP. “Next Saturday night I drove by, that building is pitch black.”

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Finally, I asked Roark about the effort and personnel required to run the ESOP. For a company of 1,100 workers, one full-time employee is needed to run the ESOP, along with the company’s 401(k) plan. Along with the basic accounting and management of the plan, the ESOP manager must also track workers’ hours: if employees work 500 hours, they get a contribution made to their ESOP account, but they must work at least 1,000 to get a distribution.[5]

Ken Baker runs a manufacturing firm in Pennsylvania that produces tubing, fittings, fitting systems and RFID tagging solutions. It’s a 65-year-old family business — a common story in ESOPs — started by Ken’s father. Ken bought the company from his father and brother (having taken on significant debt to do so) and, having learned about ESOPs at a seminar in the mid-1990s, he was “intrigued.” As he tells it, “I wanted a high-performance company, and I knew that if I didn’t give ownership, I wouldn’t get high performance. I think there’s just a different mindset of an owner versus just an employee.”

By the mid-2000s, Baker had sold about a third of the company to the employees as an ESOP. After that, he quite gradually sold larger shares to the ESOP, reaching 100 percent employee ownership by 2019. I asked Baker if, during this period, he had concerns or regrets about not just selling the company in the private market to maximize quicker profits relative to the slower process he undertook. His response was again one of concern for the future of the company and the community in which it resides. “If they don’t care about those things, then they’re not a candidate” for selling to an ESOP.

Interestingly, Baker argued that his very gradual sale of the company — the process took almost 15 years — was a strategic one to increase the value of the firm through a “skin-in-the-game” strategy. As workers gradually own more shares in the company, they’ll be motivated to work harder, increase profitability, add more value, and bump up the share prices. Thus, each tranche sells at a higher share price.

I asked Baker about the debt he incurred setting up the ESOP, which he took on right after he paid off the debt he was holding from buying out his father and brother. Initially, and this is not an uncommon procedure, he took out various bank loans to pay for the first few tranches of shares that went into

5 - *Contributions are ownership shares (stocks) granted to ESOP members; distributions are equivalent to dividend payouts.*

the ESOP. “I knew the company, which was very profitable, was going to be able to pay me back, so it wasn’t a big risk to me.”

The tax advantages of a subchapter S-corp ESOP are also important to Baker. “Money that was going to the IRS now goes over to the ESOP” (tax law directs the pro-rata share of employee ownership to the ESOP; 100 percent ownership means all profits flow to the ESOP; beneficiaries do, however, pay tax on distributions in retirement). The tax advantages can be amplified in a wide variety of ways, including higher pay, expansions, and acquisitions. Baker outlined a scenario where an S-corp with a 100 percent ESOP acquires another S-corp with a tax liability of $2 million. Post-acquisition, that $2 million goes not to the IRS but into the ESOP, or, probably more realistically, to service the debt incurred in the acquisition.

I asked Baker if he faced any bumps in the road in the process of setting up the ESOP. He discussed challenges finding lawyers, accountants, bankers and generally “people that know about ESOPs.” (This problem — inadequate information about ESOPs among service providers necessary to their formation — is a commonly heard one.) The experience led Baker to start the Pennsylvania Center for Employee Ownership, a non-profit which guides people through the process and provides vetted service providers familiar with the process of setting up ESOPs (Baker and others are in the process of taking this model to 20 other states).

Lack of awareness, Baker maintained, is the main reason why there are not more ESOPs. “People don’t know that they can sell to their employees — don’t know the tax benefits — productivity benefits.” Baker believes that if more owner-sellers knew of and understand the business model, “there’s probably 60 percent or more of the selling shareholders who do believe in their legacy and want to preserve it, who want to protect their long-term employees, who care about the communities and they hate what private equity has done to these companies, loading them up with debt and fees.”

Like others of whom I have asked this question, Baker agreed that managing an ESOP takes more work than managing traditional retirement plans. The extra burden stems from the regulatory requirement that qualified plans, such as ESOPs, are required to have the stock held by the plan valued at least annually by an independent appraisal (this applies only to privately held companies).

Joey Nestegard is the Chief Financial Officer at Schweitzer Engineering Laboratories (SEL) in Washington state, a global engineering firm that invents, designs and manufactures protection and control solutions for the electric power industry. The company employs about 5,300 workers, with about 3,000 in the U.S. It was founded in 1984 and set up an ESOP in 1994, becoming 100% employee-owned in 2009. Nestegard joined the company in 2002. So, in this case, we have an executive who did not participate in initial decisions to start the ESOP but has played a key role in expanding and running it. The company was 30 percent owned by the ESOP when he took over and our interview focused on some of the “complexities” invoked by getting to 100 percent employee ownership by 2009. Nestegard was instrumental in the sale of the remaining shares of the company to its employee owners.

SEL’s ESOP got started because the company’s founder, Ed Schweitzer, was looking for a way to share “a slice of the success” with the workforce and learned about ESOPs from his father. Much of the growth of the ESOP was seller financed (the seller becomes the lender), which is not an unusual form of ESOP financing, though in order to maintain needed cash flow within the company, bank loans were also used in the process.

This mix yielded an important problem described by Nestegard. The bank credit SEL needed "was a very small part of the transaction. But the thing that nearly held up the timeline of the deal was the bank component: banks really don't understand ESOPs" and related financing. The bank's "underwriters and their credit people, they didn't understand… the whole mechanics of how an ESOP works. And so I spent a lot of time throughout the process, trying to teach them how the whole thing worked…for them to underwrite and evaluate the credit."

Like the others to whom I spoke, Nestegard spoke highly of the "skin-in-the-game" benefits of employee ownership, pointing out that SEL is the first company he worked for "where I think everybody in the company could tell you the mission and the vision and it actually means something." As we spoke in October of 2020, he spoke eloquently about what this sense of ownership and the clear signal that the company cared about the health of the workforce meant during the pandemic. Not only did people willingly show up for work, but they collaborated on ways to make the workplace safer. "People buy into this culture from a very early time" in their employment.

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In response to my question about the relative burden of internally managing the ESOP, Nestegard answered that compared to the 401(k) plan the company also provides, administering the ESOP is "more complicated" (SEL does not do a 401(k) match as they make such large contributions through the ESOP; also, SEL's 401(k) is an opt-out structure, which behavioral studies have shown to boost participation). Like others, he spoke of the valuation challenge, which is unique to ESOPs, and reported that it takes some extra work to get auditors and the board familiar with the process. For example, ESOPs require the application of "repurchase obligation analysis," or long-term estimates of payouts to employees and retirees (audits of ESOP companies require such analysis).

Another theme Nestegard stressed, one common to all these discussions, was the more input before a transaction from outside advisors and others who've set up ESOPs, the better. He strongly recommended having an external trustee overseeing the plan, and making sure that isn't "your favorite banker," but someone who examines lots of companies with an eye towards valuation. "Like any business model, unfortunately there've been some bad ESOPs out there and a good way to avoid common pitfalls is to learn from others what's worked and what hasn't. Fortunately, the strong regulatory environment helps to ensure that, even in rare circumstances where an ESOP is not structured to prioritize the interests of employee-owners, these businesses broadly benefit workers' interests. Additionally, there are a lot of really good, passionate advisors in the ESOP industry who help ensure employee-owners get a fair deal." A related problem, he argued, one I return to below in thinking about policies to promote ESOPs, is the lack of well-informed government officials, such as those at the IRS, from whom owner-sellers can get guidance on issues like ESOP tax or financing implications.

Nestegard made a final point that struck me as important in a sense that goes beyond the narrow topic of ESOPs or employee ownership in general: The correct mindset for a successful ESOP is

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longer term thinking than is common in business these days. Owners "sell to an ESOP because they want their employees to run it and grow it, see their dream fulfilled, and have a stake in that outcome. And if that is the objective, then an ESOP is a perfect business model for them... It's a model completely designed for long-term employee engagement, long-term employment...you're not chasing short-term anything...and our customers know we're in it for the long haul...has nothing to do with this quarter's earnings and that just changes how you think."

There is some evidence in the macroeconomic literature, supported by common sense, that short-termism driven by incentives to maximize quarterly results has dampened economy-wide investment, innovation, and productivity. The narrower ESOP literature is quite clear that the investments in the workforce and the skin-in-the-game common to ESOPs lead to more productivity outcomes at the micro, or firm, level. I would not go so far as to suggest ESOPs cause deeper investment and productivity, as much as owners who set them up and executives like Nestegard who expand, value, and promote them, come "prepackaged" with an orientation to longer-term business strategies. But his comments in this regard are consistent with these positive outcomes and suggest another reason why I suspect there are potential economy-wide spillovers from ESOPs, should they significantly scale up.

Summary and Policy Recommendations

Though the survey results showed some degree of ESOP awareness among business owners and managers, those percentages fell among smaller firms. Not surprisingly, it's also the case that there's a range of "awareness," with larger shares of respondents having heard of ESOPs and considerably smaller shares with a deeper understanding of their utility and the processes involved in setting one up. Combining these results with the interviews, one of the main answers to the question posed by this study — why aren't there more ESOPs? — is awareness. For ESOPs to grow, owners and managers must learn more about their upsides, their tax advantages, their skin-in-the-game characteristics, and the process for setting them up.

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Regarding process, Baker's point that it can be hard to find service providers with experience and acumen in the ESOP space is also a likely barrier to entry.

Such barriers can and should be reduced through education and information dissemination. The most effective forms would be both private and public campaigns to inform more potential sellers of their businesses about the benefits of ESOPs and processes involved in setting them up, including leverage options and tax advantages. As I and other scholars in this area have suggested, it would be helpful to set up a government office, housed perhaps in the Small Business Administration or the Commerce Department, that provides direct assistance to small businesses that want to set up ESOPs or other shared ownership plans. This office would not only inform and disseminate information on the benefits of ESOPs; it would also make sure potential sellers knew of potential pitfalls, like the importance of employees' maintaining diverse portfolios well beyond their company's stock. It could also keep a reference list of experienced service providers who knew the lay of the land in setting up ESOPs.

Such a public function would complement the work of private organizations, such as NCEO, ESCA, and the ones Baker mentioned. These private, non-profit organizations could perhaps also step up their outside dissemination efforts relative to client services, not to skimp on the latter of course, as that is their "raison d'etre," but given their deep knowledge of the processes and barriers, to do more of the former.

I conclude with three final points. First, it is surely the case that ESOPs are not for everyone. Owners who want to make a quicker, and at least initially, bigger buck, are likely not to want to go through the process of selling their company to the ESOP trust, especially given financing issues. As the survey results suggested, non-family businesses probably down-weight legacy concerns and values relative to family-owned businesses. Second, as I've written in earlier work, I do not advocate for additional tax breaks to incentivize owners to sell into an ESOP. The existing tax breaks, both for borrowing to set up ESOPs and for running them, are generous enough[6] and the U.S. Treasury has very significant revenue needs, so my bar for further tax breaks in this and any other space is high.

Finally, the more granular information ESOP advocates can collect on the costs and benefits of the program, the better. While I have identified awareness and process barriers as important answers to the question at hand, these are quite broad areas. Future research should drill down on more precise information deficits, through more surveys and case studies. For example, while the survey for this study intentionally excluded companies with ESOPs, a future survey might focus specifically on those like Roark and Baker who have sold into ESOPs to glean more systematic information on the barriers they faced and how they overcame them.

6 - *See the section "ESOPs and tax policy" in Bernstein (2016).*

About the Author

Jared Bernstein

Jared Bernstein has been a Senior Fellow at the Center on Budget and Policy Priorities since 2011. From 2009 to 2011, Bernstein was the Chief Economist and Economic Adviser to Vice President Joe Biden, Executive Director of the White House Task Force on the Middle Class, and a member of President Obama's economic team.

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