

# **An Analysis of the Benefits S ESOPs Provide the U.S. Economy and Workforce**

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## Executive Summary

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Policymakers' interest in tax reform has increased dramatically in recent years as a consensus on broadening the tax base and lowering marginal tax rates has emerged. As such base broadening would necessitate curbing or eliminating certain tax expenditures, this paper examines the economic impact of the preferential tax treatment of employee stock ownership plans (ESOPs). Through a comprehensive literature review as well as a new analysis of ESOPs sponsored by S corporations (S ESOPs), this paper demonstrates how ESOPs—and in particular S ESOPs—contribute positively to job creation in the U.S. economy by promoting employee commitment.

The existing academic literature confirms that the level of employee commitment is an important driver of firms' productivity, growth, and job stability. ESOPs have been shown to facilitate firm performance and job stability in large part because they foster loyalty to the company among employees. This evidence of the connection between worker loyalty and firm performance begs the question: how can companies foster employee commitment? One answer is through employee ownership, and one proven way of successfully establishing employee ownership of firms has been through S ESOPs, which are often 100 percent employee owned. S ESOPs foster a workplace culture of participation and commitment. Previous research has shown that, by facilitating employee ownership of firms, S ESOPs can lead to higher wages, greater job stability, and higher retirement plan contributions.

This paper presents original analysis of both a proprietary survey of S ESOPs and Department of Labor (DOL) data on S ESOPs. The key findings of this analysis include the following:

- A survey of members of the Employee-Owned S Corporations of America (ESCA) demonstrates that S ESOPs showed more employment growth in the prerecession period of the previous decade than private U.S. firms generally.
- The surveyed ESCA members regained momentum more quickly after the recession than private firms.
- On net, employment among the surveyed firms increased over 60 percent during 2001–2011, compared to roughly no change in total private, nonfarm employment in the United States during the same period.
- DOL data show that the number of S ESOPs and the number of S ESOP active participants have each more than doubled since 2002.
- Active participation among S ESOPs that have existed since 2002 is also up. In particular, in 2007, when the recession hit, private U.S. employment took a dramatic downward turn while active participants among this subset of S ESOPs actually increased.
- Many S ESOPs are in the manufacturing industry, where employment has been trending downward in the United States for the last decade. Compared to U.S. manufacturing employment generally, the S ESOP structure has buffered S ESOP manufacturing firms.

## Introduction

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Tax reform has come to the forefront among policymakers, as evidenced by the recent Simpson-Bowles Commission, President Obama's recent framework on corporate tax reform, proposals by Republican presidential candidate Mitt Romney to reduce statutory tax rates, and a series of important tax reform hearings held by both House Ways and Means Committee Chairman Dave Camp and Senate Finance Committee Chairman Max Baucus. Lawmakers in both parties have been considering eliminating or curtailing preferential treatments in the tax code.<sup>1</sup> Gone from the current tax reform debate, except among academics, are questions about the merits of various consumption tax alternatives. Instead, lawmakers are seeking opportunities within the income tax structure to lower statutory tax rates, remove distortions, and possibly reduce the deficit.

Given this attention on and emerging framework for tax reform, and in light of the sluggish pace of the economy's recovery, it is appropriate for policymakers to examine carefully the economic effects of existing tax expenditures on the U.S. economy and, by extension, the economic consequences of preserving, reforming, or eliminating them.<sup>2</sup>

The recent recession was the worst the United States has experienced since the Great Depression, and the economy remains stunted relative to prerecession measures of economic performance. Experts across the political spectrum recognize that the current tax code is an impediment to economic growth. The narrowing of the tax base that has occurred in the last twenty-five years through the proliferation of tax credits, deductions, and exclusions has yielded a system that adversely distorts economic decisions and discourages investment and risk taking. Yet, many tax expenditures are appropriate and effective tools for promoting economic growth or addressing negative externalities. With this in mind, this paper examines the economic impact of the preferential tax treatment of employee stock ownership plans (ESOPs).

An ESOP is a tax-exempt defined contribution retirement plan comprising shares of a company's stock held on behalf of the company's employees. In other words, ESOPs facilitate employee ownership. Since 1998, the law has allowed ESOPs to be sponsored by S corporations. These corporations are not publicly traded and generally have a much more meaningful percentage of ownership belonging to the ESOP—in many cases 100 percent. S ESOPs have represented the fastest-growing employee-ownership structure since the structure became available and are now the most prevalent form of ESOP. As this paper demonstrates, firms that employ S ESOPs have been shown to outperform other companies by several measures.

This paper begins by establishing a basis in the academic literature for the link between employee commitment, firm performance, and employee ownership. For example, one way an ESOP enhances a firm's performance is by fostering commitment to the firm among its workers by allowing

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<sup>1</sup> See, for example, Smith 2012 and Calmes 2012.

<sup>2</sup> For a more thorough discussion of the economic opportunities presented by income tax reform, see Brill and Viard 2011.

them to participate in ownership of the company (Freeman 2007). The paper then looks specifically at the performance of firms that maintain ESOPs, reviewing the existing literature on ESOPs and the benefits they provide to employees, firms, and the broader economy.

The second half of the paper presents a new analysis of employment among S ESOPs firms, examining whether employment levels among S ESOPs fared better than the overall private-sector U.S. labor market during the recent recession. It does so by comparing trends in participation in S ESOPs from 2002 to 2009 with U.S. labor market trends during the same period. This analysis draws on data from the Department of Labor and the Bureau of Labor Statistics, as well as data from a private survey of S ESOPs.

## Part I: Literature Review

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### *Employee Commitment and Firm Performance*

The academic literature on employee commitment—“the psychological attachment of workers to their workplaces” (Becker et al. 1996)—is extensive. Essential to understanding the link between employee commitment and firm performance is determining whether employee commitment facilitates firm performance, or vice versa. In other words, are employees committed to a firm because it is successful, or does a firm succeed because its employees are committed? Research points to the latter.

Employee commitment has been found to be a driver of job satisfaction, motivation, and attendance (Becker et al. 1996), and human resource management scholar Daniel Koy (2001) finds that positive employee attitudes and behaviors lead to positive business outcomes (i.e., profitability and customer satisfaction). “Specifically, [Koy’s findings] imply that organizational citizenship behavior influences profitability and employee satisfaction influences customer satisfaction” (p. 112).

*Employee commitment has been found to be a driver of job satisfaction, motivation, and attendance.*

Other studies have shown that loyal employees work with greater efficiency than uncommitted workers. For example, economist Francis Green (2008) finds that loyal employees do not require as much supervision. Green writes that “it therefore profits employers to allow employees some leeway in their jobs. But . . . leeway permits self-interested employees to take advantage and work less hard. Autonomy can be more effectively granted, therefore, to those workers who are less likely to behave opportunistically—that is, those whose preferences are to identify with the company’s objectives, share its values and to show loyalty” (p. 3).

In addition, firms with loyal employees incur fewer expenses because turnover is low. Mathieu and Zajac (1990) and Meyer et al. (2002) confirm that organizational commitment among employees is negatively correlated with turnover, meaning that turnover is low among employees committed to the company for which they work.

Brown et al. (2011) examine the effect employee attachment has on workplace performance and find that “in so far as employees who exhibit commitment and loyalty towards their employer may have interests which are aligned with those of their employer, the agency costs often associated with the employee-employer relationship are reduced” (p. 3). These positive effects of employee commitment, including worker efficiency and lower operations costs, lead to increased profitability, which in turn allows companies to grow at a faster rate because they can invest more, hire more workers, and increase output.

### ***Fostering Employee Commitment***

Given the causative relationship between employee commitment and firm performance, it is clearly in a firm’s interest to cultivate commitment to the firm among employees, thereby promoting positive worker attitudes and behaviors. This connection is not lost on managers—a common means of promoting commitment to a firm is providing financial incentives, of which two popular methods have been cash bonuses and stock options.

Cash bonuses, however, are often not consistent and do not necessarily reflect how well the company is performing as a whole. They provide a relatively weak incentive to employees to make sure

the company thrives. In addition, lower-income workers, who are by necessity more risk averse than those with higher incomes, can find the uncertainty associated with cash bonuses unhelpful for financial-planning purposes.

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Stock options—the other popular financial incentive to promote loyalty among employees—use company stock as a financial reward for employees. However, stock options are usually given only to those in positions of management. In addition, according to

Akerlof and Kranton (2005), stock options create incentives that are not necessarily targeted at the good of the firm as a whole.

A broader and more comprehensive means of facilitating employee commitment is through employee ownership of a firm. Employee-owners are interested in overall profitability, not simply stock prices. Akerlof and Kranton (2005) find that identity is key to motivating workers and enhancing employee commitment, and employee ownership can help achieve this goal by tying employees’ identities to the firm as owners. According to Pierce, Kostova, and Dirks (2001), “Feelings of responsibility include a responsibility to invest time and energy to advance the cause of the organization—to be protective, caring, and nurturing. When an employee’s sense of self is closely linked to the organization, as in the case of psychological ownership, a desire to maintain, protect, or enhance that identity results in an enhanced sense of responsibility for work outputs” (p. 303).

## ***Employee Stock Ownership Plans***

One proven way of successfully establishing employee ownership of firms has been through employee stock ownership plans (ESOPs), particularly those sponsored by S corporations. ESOPs represent the most prevalent form of employee ownership in the United States (NCEO 2012a). The structure was originally established to promote employee ownership and retirement savings in the Employee Retirement Income Security Act of 1974. In the late 1990s, Congress decided to begin allowing S corporations, which are taxed only at the shareholder level like other pass-through entities, to sponsor ESOPs. Since that time, S ESOPs have become the most popular form of ESOP.

Like a 401(k), an ESOP is a defined contribution retirement plan, but an ESOP is generally company funded and invests primarily in company stock. Like 401(k) contributions, contributions to an ESOP are tax exempt. In addition, loans ESOP firms take out to purchase company stock, as well as interest on the loans, are exempt from taxation (Ivanov and Zaima 2011).

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For employee ownership to promote diligence and loyalty among employees, and in turn yield positive outcomes for firms, employees must have not only a share of their firm's ownership but also a high level of employee engagement (NCEO 2012b). Given this, it is not surprising that S ESOPs often have 100 percent ownership of firms and promote a workplace culture centered around employee ownership. The result, as described below, is that S ESOPs provide benefits to the firm, the worker, and the broader economy.

## ***Existing Evidence on the Benefits of ESOPs***

By facilitating employee ownership of firms, ESOPs have been shown to lead to higher wages, wage growth, job stability, and higher retirement plan contributions, among other positive outcomes. NCEO has compiled a number of studies of the various benefits ESOPs yield for firms and employee-owners alike, concluding, "Researchers now agree that 'the case is closed' on employee ownership and corporate performance. Findings this consistent are very unusual. We can say with certainty that when ownership and participative management are combined, substantial gains result" (NCEO 2012b).

Among the studies NCEO cites on ESOPs and their effect on corporate performance is a study conducted by Douglas Kruse and Joseph Blasi in 2000. Kruse and Blasi find that ESOP companies enjoy greater longevity as well as 2.3–2.4 percent higher sales, employment, and sales per employee annually than would otherwise have been anticipated (NCEO 2012b).

Kruse, an economist at Rutgers University, has done extensive work on ESOPs and employee ownership generally. Reviewing over thirty other studies on employee ownership, Kruse (2002) finds that "productivity improves by an extra 4–5% on average in the year an ESOP is adopted, and the higher

productivity level is maintained in subsequent years. This one-time jump is more than twice the average annual productivity growth of the U.S. economy over the past 20 years.”

Kruse and colleagues also find that employee ownership enhances firm and possibly employment level stability (Blair, Kruse, and Blasi 2000). And in yet another study, Kruse and coauthors confirm a higher survival rate among ESOP companies compared to non-ESOP companies (Park, Kruse, and Sesil 2004). In addition, Ivanov and Zaima (2011) find that adopting an ESOP adds value to a firm because the ESOP decreases the cost of both equity and debt capital for the company as well as the weighted average cost of capital.

Swagel and Carroll (2010) assess how S ESOPs in particular weathered the recent recession. The authors confirm that S ESOPs in 2008 fared better compared to other companies in terms of job creation, revenue growth, and retirement contributions. “S-ESOP firms were resilient employers in 2008, with employment growing by 1.9 percent among surveyed S-ESOP firms even as it fell by nearly 3 percent in the overall U.S. private sector.” In addition, the authors find that employees of S ESOP firms enjoyed higher wages during the recession than employees of other companies.

In another analysis of S ESOPs, Freeman and Knoll (2008) quantify the financial gains to firms and employees of S ESOPs. Specifically, they estimate that S ESOPs yield \$33 billion in productivity gains yearly and are responsible for \$14 billion in annual equity contributions. In addition, the authors note that the benefits owing to S ESOPs extend to the economy at large, given the increases in productivity and sales S ESOPs induce.

## Part II: Analysis of S ESOP Participation and Employment

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### *Measuring S ESOP Growth*

As the previous section established, S ESOPs contribute to economic growth in positive and significant ways. In this section, I use data from the last decade to look at trends in S ESOP participation and employment before and during the recent recession. The time period in this analysis, which begins shortly after Congress allowed S corporations to sponsor ESOPs, highlights the economic benefits of the S ESOP structure.

Using data on S ESOPs and employment drawn from several sources, the analysis presented here demonstrates (1) the popularity and success of S ESOPs generally, (2) the growth in employment among S ESOPs, and (3) the contrast between the relative health of S ESOP employment levels during the recent recession with the national employment picture during the same period.

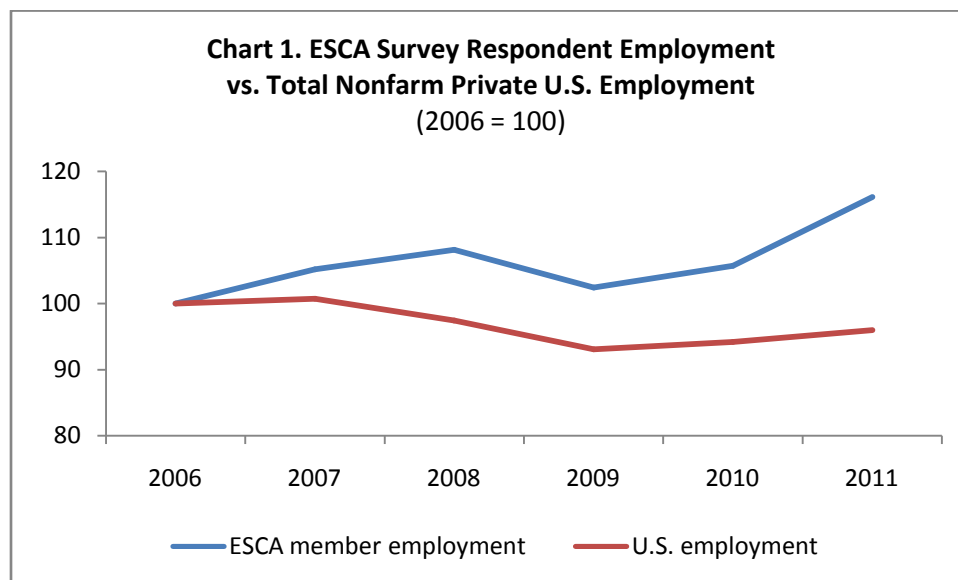
*S ESOP firms fare better than  
non-S ESOP companies across  
multiple comparisons.*

This section first examines employment trends among a sample of surveyed S ESOPs. Next, I broaden the focus to include growth trends among S ESOPs throughout the United States. This allows for comparisons of S ESOP data with employment data for private U.S. firms generally. S ESOP firms are shown to fare better than non-S ESOP companies across multiple comparisons.

### ***Employee-Owned S Corporations of America (ESCA) Survey***

For this portion of the analysis, I conducted a survey in 2012 in which I asked S ESOP firms that are members of ESCA to provide their annual employment levels over the last decade. This survey yielded a sample of 56 firms out of the organization's roughly 120 members. The sample includes small, midsized, and large firms in a variety of industries, with employee totals ranging from under 50 to over 7,000. In 2011, 29 percent of the workers were employed in manufacturing; 23 percent in professional, scientific, and technical services; and 18 percent in wholesale trade. As of the end of 2011, all 56 firms combined had a total of nearly 70,000 employees spanning 22 states.

As Chart 1 shows, for the period 2006–2011, compared to employment among private U.S. firms, S ESOPs showed more growth in the pre-recession period. In addition, despite a dip in employment for the surveyed S ESOP firms during the recession, these companies regained momentum more quickly after the recession than non-S ESOP firms.



Source: BLS and ESCA member survey.

On net, employment among the surveyed firms increased over 60 percent during 2001–2011, compared to roughly no change in total private nonfarm employment in the United States during the same period. While this survey did not capture job loss arising from firms that shut down during this period, the magnitude of the performance of the surveyed firms is significantly greater than the lackluster performance of the aggregate U.S. labor market.



## National Analysis: Data and Methodology

The primary source for the national analysis is the Department of Labor (DOL), which makes companies' annual Form 5500 filings publicly available.<sup>3</sup> Form 5500 requires companies to disclose information about their employee benefit plans, such as the type of retirement plan they offer, including whether the retirement plan is an S ESOP. Other information includes total active participants in the plan, retired participants receiving benefits, and the sponsor's employer identification number (EIN) and NAICS code. For the analysis presented here, all non-S ESOP retirement plans in the Form 5500 data were excluded. To compare national S ESOP trends observed in the Form 5500 data to general U.S. labor market trends, the analysis employs Bureau of Labor Statistics (BLS) data on U.S. private employment.

DOL makes available unedited Form 5500 data for 1999–2011 for research purposes and provides summary analysis of the data through 2009 (DOL 2009 and 2012). The summary analysis, however, does not differentiate between S ESOPs and C corporation ESOPs. For the purpose of this analysis, I rely primarily on 2002–2009 DOL data. I first cleaned the unedited data by removing numerous duplicate records as well as a number of S ESOPs averaging fewer than 15 active participants because both types of observations are likely erroneous. Table 1 summarizes the data and the effects of removing duplicate and small S ESOPs.

**Table 1. Preparing Data for Analysis**

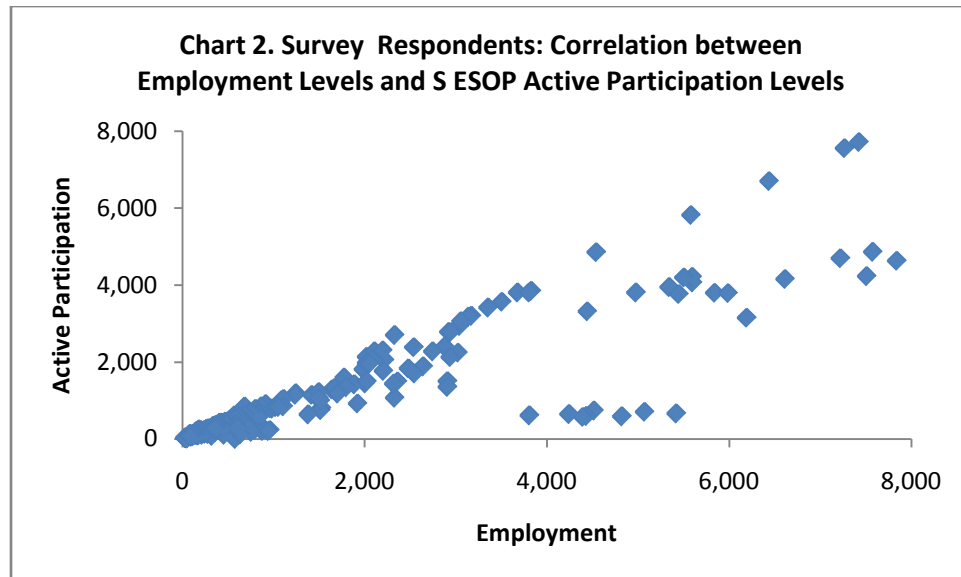
	Original Data		After Removing Duplicates		After Removing Firms with < 15 Active Participants	
	# of S ESOPs	# of Active Participants	# of S ESOPs	# of Active Participants	# of S ESOPs	# of Active Participants
<b>2002</b>	2,674	261,870	2,038	197,936	1,111	193,746
<b>2003</b>	3,160	388,912	2,446	271,024	1,510	266,795
<b>2004</b>	3,185	394,703	2,439	299,268	1,672	295,834
<b>2005</b>	2,970	464,373	2,256	374,509	1,806	371,954
<b>2006</b>	3,105	526,416	2,385	418,159	2,030	416,050
<b>2007</b>	3,224	550,444	2,602	426,935	2,231	424,911
<b>2008</b>	2,662	427,866	2,524	408,234	2,214	406,461
<b>2009</b>	2,862	478,766	2,722	461,502	2,452	459,878

Source: DOL.

Because Form 5500 filings include total S ESOP plan participants but not actual employment numbers, the analysis assumes that the number of plan participants strongly correlates to the number of firm employees. To establish that active participation is a valid proxy for S ESOP employment, the ESCA survey results (described above) were correlated with each survey respondent's Form 5500 data. These data were shown to be highly correlated, with a correlation coefficient of 0.9. Chart 2 plots the

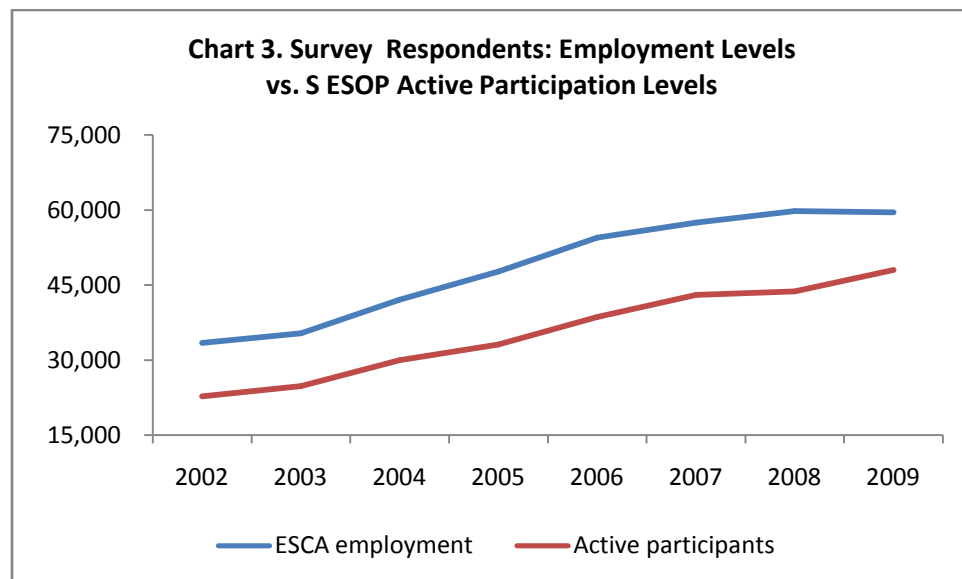
<sup>3</sup> Form 5500 datasets are available at [www.dol.gov/ebsa/foia/foia-5500.html](http://www.dol.gov/ebsa/foia/foia-5500.html).

correlation between employment and active plan participants for each of the 56 surveyed firms for each year of data, establishing active participation as a valid proxy for employment in S ESOP firms.



Source: DOL and ESCA member survey.

Chart 3 shows how closely ESCA member employment tracks with S ESOP active participants from those same firms' Form 5500 data. Given that all employees do not always participate in an ESOP, the employment levels are, on average, 40 percent greater than active participation levels.

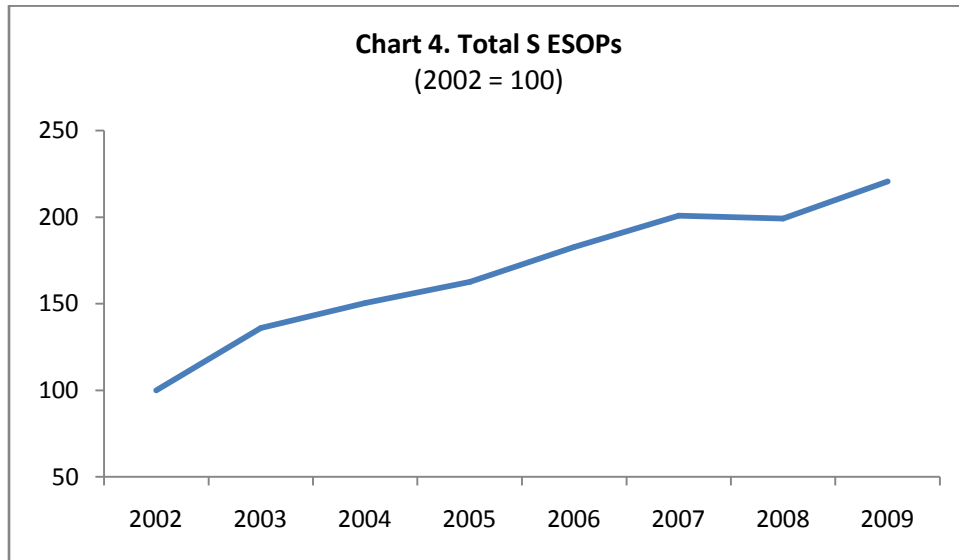


Source: DOL and ESCA member survey.

After confirming the hypothesis that the number of active participants reported on Form 5500 filings could stand in for companies' employment levels, the Form 5500 datasets were compiled and, as described above, cleaned for errors and inconsistencies, such as duplicate entries for the same EIN in a given year, in preparation for the analysis.

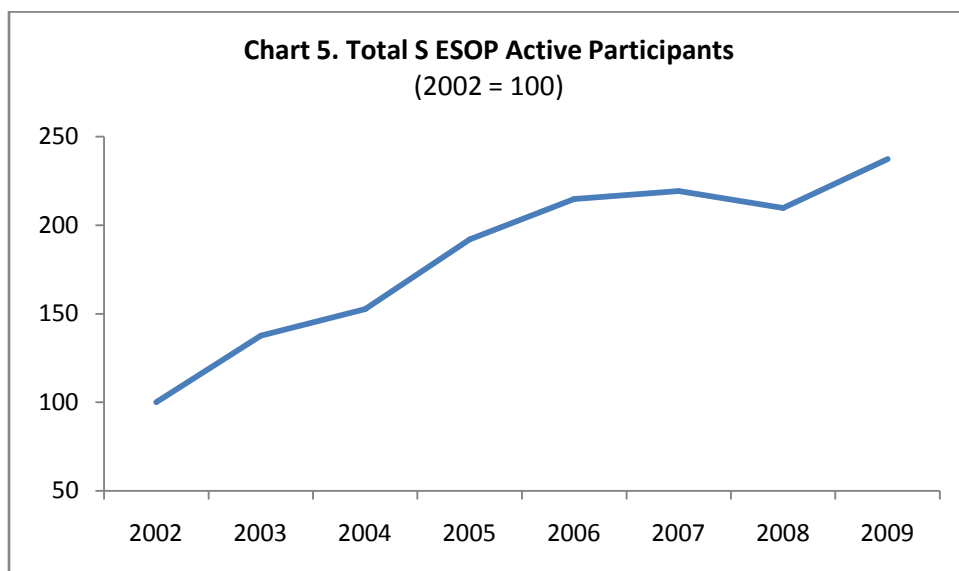
### ***National Analysis: Results***

The dataset comprising aggregate Form 5500 filings for S ESOPs from 2002 to 2009 offers a clear picture of the positive trends among S ESOP firms. As Chart 4 shows, the number of S ESOPs in existence has more than doubled since 2002. The steady rise was interrupted by the recession in 2007–2008 but resumed the following year. It should be noted that this chart and those that follow use a subset of DOL Form 5500 data with duplicate and other likely erroneous records removed, as described above. Therefore, these data are indexed to 2002 levels.



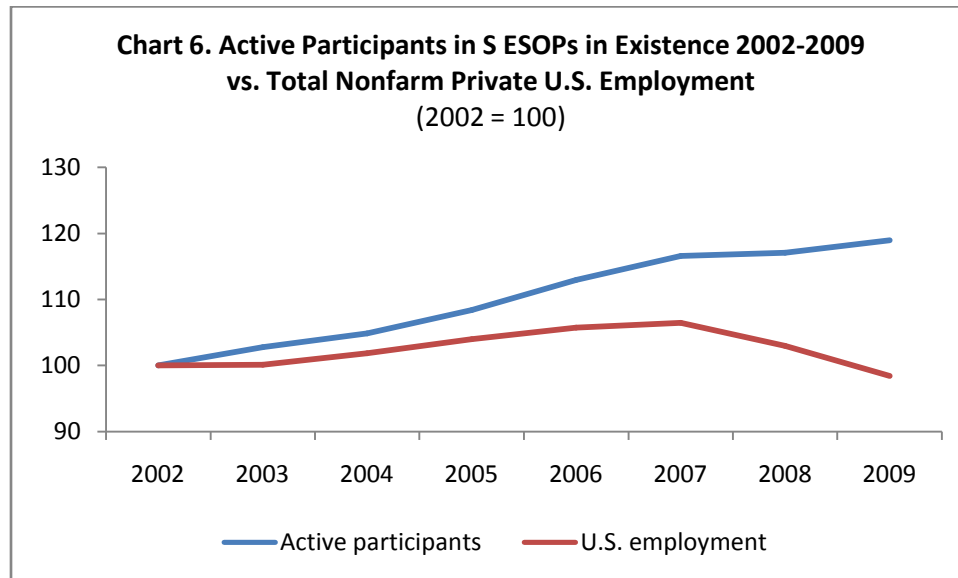
Source: DOL.

As would be expected with the rise in the number of S ESOPs, total active participation also more than doubled since 2002, as Chart 5 shows. The dip in active participants in 2007–2008 mirrors that in total S ESOPs in Chart 4.



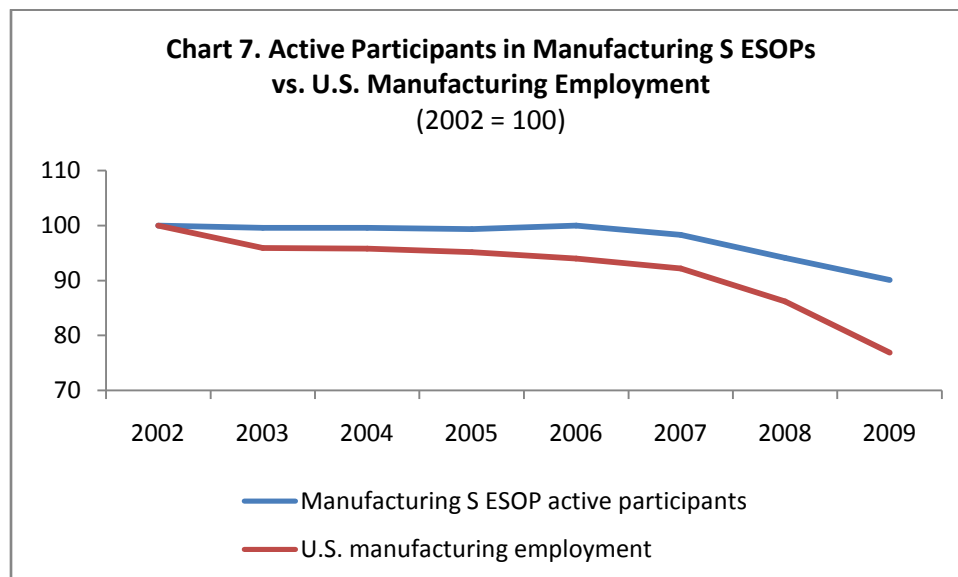
Source: DOL.

Among a fixed set of companies—those that have existed since 2002—participation is also up. Compared to total private U.S. employment, this increase is substantial, as Chart 6 makes clear. In particular, in 2007, when the recession hit, private U.S. employment took a dramatic downward turn while active participants among this subset of S ESOPs actually increased slightly.



Source: DOL and BLS.

Because many S ESOPs are in the manufacturing industry, Chart 7 compares these S ESOPs' active participants with the total number of private manufacturing employees in the United States. Manufacturing employment in the United States has been trending downward for the last decade, but the S ESOP structure has buffered S ESOP manufacturing firms from experiencing the level of employment loss other U.S. manufacturing firms have suffered.



Source: DOL and BLS.

Note: S ESOPs are limited to those in existence 2002–2009.

## Conclusion

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The performance of the U.S. labor market has been the subject of intense scrutiny since the recent recession. Furthermore, the deteriorating fiscal outlook, including trillion-dollar deficits and the approaching entitlement crisis, has brought the tax reform debate to the forefront. While policymakers have not reached a consensus on the appropriate level of taxation, there is an emerging consensus about the nature of a reformed tax code. This consensus envisions a tax reform whereby many, if not most, of the existing tax code preferences (formally called tax expenditures) are repealed, reformed, or curtailed. A broadened tax base would permit lawmakers to lower statutory tax rates, raise additional revenue, or both. The Simpson-Bowles Commission in 2010 invigorated political interest in this approach when it outlined reform proposals that could bring statutory rates down dramatically even while raising significantly more tax revenue.

Beyond deficit reduction, which was the focus of the Simpson-Bowles plan, tax reform holds the promise of economic growth. A broader tax base, achieved by limiting or eliminating preferential treatment in the tax code, would reduce distortions and create a more level playing field across the economy. However, not all tax preferences are undesirable because not all base-broadening promotes economic growth. The value of a tax preference must be assessed based on the positive economic returns of the activities or behavior the preference targets.

S ESOPs, for example, enjoy an important tax benefit. But S ESOPs are a proven way to cultivate employee loyalty, and worker commitment appears to enhance economic prosperity. In fact, as the analysis presented above indicates, S ESOPs have seen an increase in employment and active participants compared to the overall economy both when the economy was adding jobs and when it was in recession. These results strongly suggest that, in the context of the current tax reform debate that seeks to curtail existing tax expenditures in favor of lower statutory tax rates, policymakers should recognize the evidence in support of S ESOPs and their positive economic contribution.

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