Employee stock ownership plans can enhance corporate performance, but most ESOPs have not been structured to realize their full potential in this area.

**Employee Stock Ownership Plans: Impact on Retirement Income and Corporate Performance**

Employee stock ownership plans, or ESOPs, are employee benefit plans that provide shares of stock in the sponsoring company to participating employees. They have sometimes been credited with the potential for improving U.S. corporate performance and employee attitudes.

The U.S. General Accounting Office (GAO) released a report in late 1987 finding that most ESOPs have not improved corporate performance as measured by profitability and productivity. GAO acknowledges, however, that when ESOPs include broad employee participation in company decision making, they have a greater impact on corporate performance. Other studies confirm this latter finding (Quarrey, 1986). In addition, a survey by Rosen, Klein, and Young found that the amount of stock contributed to participants' accounts was the single most important factor in boosting employee satisfaction with the ESOP, which, in turn, might be linked with better corporate performance.

Most ESOPs, however, have not been structured to realize their full potential in these areas. Tax-credit ESOPs covered 7 million employees in 1983, more than other types of ESOPs. These plans have been popular with companies, who could take a credit against income tax for employer contributions. But tax-credit ESOPs typically provide only a limited amount of ownership in a company. For example, in 1983, tax-credit ESOPs provided a median account balance of just under $3,000, compared to between $5,000 and $8,600 for other ESOPs. Moreover, only 5 percent of tax-credit ESOPs own more than 25 percent of their companies, compared to 44 percent of leveraged ESOPs.

Leveraged ESOPs, which borrow funds to acquire employer securities, typically provide a larger degree of ownership. These ESOPs may increase in popularity as a result of the elimination of tax-credit ESOPs in the 1986 Tax Reform Act and the increased tax incentives to leverage included in other recent legislation.

ESOPs have also attracted increased attention of federal policymakers, who have voiced concern about their use as a corporate financing tool in leveraged buyouts and about their relative riskiness as retirement income vehicles because of the concentrated investment in a single corporate stock.
Introduction

An employee stock ownership plan, or ESOP, is a tax-qualified employee benefit plan that provides shares of stock in the sponsoring company to participating employees. ESOPs resemble other employee benefit plans in that they supplement other forms of employee compensation. Like other compensation supplements, ESOPs have implications for employee recruiting, performance, and morale. Like other tax-favored benefit plans, they represent forgone tax revenues to the federal government.

ESOPs (and stock bonus plans) are sometimes credited with greater potential than other forms of compensation to improve employee motivation because ESOP participants acquire an ownership interest in the company for which they work. In addition, ESOPs are sometimes established in conjunction with programs that encourage greater employee participation (work place "democratization"), further affecting the incentive structure. Some critics assert, however, that ESOP use rarely involves a substantial change in employee relations or work place philosophy but instead primarily reflects interest in bottom-line tax advantages. Furthermore, some who favor more traditional management styles oppose work place programs that give rank-and-file workers more control.

An ESOP is a type of defined contribution plan. Like other defined contribution plans, ESOPs are designed to provide deferred compensation and can provide cash benefits at retirement or a portable benefit upon separation from service. However, because ESOPs must be invested primarily in the stock of the sponsoring company, they are often characterized as riskier than other defined contribution plans, which usually hold more diversified portfolios.

ESOPs are a unique type of benefit plan because they are permitted to borrow money on a tax-favored basis to purchase employer stock. (ESOPs that exercise this option are called "leveraged ESOPs.") Thus, an ESOP can be an advantageous corporate financing tool under some circumstances. ESOPs can be used to create a market for a retiring owner's stock, to finance capitalization, or to finance acquisitions. In isolated cases, ESOPs have been used to help save struggling companies.

Leveraged ESOPs can participate in multi-investor leveraged buyout transactions. Under such transactions, two or more investors each buy a large block of stock in the target company. The use of ESOPs in these transactions has been controversial, with critics sometimes charging that ESOP abuses outweigh potential benefits and calling on policymakers to regulate ESOP use more strictly, or to curtail or eliminate ESOP tax breaks.

ESOPs have been advocated as a way to broaden the ownership of productive capital and thereby provide the means for more individuals to participate gainfully in the economy with capital rather than through labor alone.

ESOPs have been advocated as a way to broaden the ownership of productive capital and thereby provide the means for more individuals to participate gainfully in the economy with capital rather than through labor alone. Some ESOP advocates contend that the existing concentration of stock ownership is a reflection of fundamental institutional flaws and a cause of many of the nation's current economic problems, and they advocate ESOPs as a way to correct some of these flaws. But just how far ESOPs could potentially broaden ownership is not yet clear, and there is disagreement about the economic benefits of such broadening.

In recent years, use of ESOPs and other stock ownership plans has grown rapidly. The U.S. General Accounting Office (GAO) identified 4,174 active ESOPs in 1985. These plans covered 7.1 million participants in 1983. The elimination of the tax-credit incentives for ESOP contributions under the Tax Reform Act of 1986 (TRA ’86) could reduce these numbers significantly, however, because 26 percent of these ESOPs, covering 90 percent of participants in 1983, took advantage of the tax-credit incentives.
Many forces have contributed to this rapid growth. Perhaps most significant is the legislation enacted by Congress to encourage employee ownership. Currently, leveraged ESOPs enjoy more liberal deduction limits than other defined contribution plans, and lending institutions enjoy favorable tax treatment for loans made to ESOPs. Former Sen. Russell B. Long (D-LA), a long-time advocate of ESOPs, has written that during his tenure with the Senate Finance and Commerce committees, “19 separate pieces of legislation were enacted improving the prospects for employee ownership” (BNA/NCEO, 1987).

After defining ESOPs, this Issue Brief will provide a brief history. It will explain how ESOPs work, outline current legal provisions that encourage or regulate ESOP use, and discuss current trends. Issues confronting employers, employees, and policymakers will be highlighted. This Issue Brief will examine the effects of ESOPs on employee attitudes and corporate performance and will review public perceptions of ESOPs. Finally, this Issue Brief will consider the outlook for ESOPs in the near future, summarizing current federal legislative and regulatory developments affecting ESOPs and state employee ownership initiatives.

### Background

#### Definition

ESOPs are qualified with the Internal Revenue Service (IRS) as stock bonus or money purchase pension plans. In addition, ESOPs are sometimes structured as profit sharing or 401(k) plans. ESOPs differ from pure stock bonus plans in two important ways: a stock bonus plan (1) is not required to invest primarily in employer securities; and (2) does not use leveraging. ESOPs are often distinguished by their use of the leveraging provision. An ESOP that elects to borrow money to acquire stock is called a “leveraged ESOP”; one that does not is sometimes called a “leverageable ESOP.” (If a leverageable ESOP makes no provision for leveraging in its plan document, it may be called a “nonleveraged ESOP.”) Another type of ESOP, the tax-credit ESOP, is not permitted to use leveraging but may take a tax credit for employer contributions to the plan. Tax-credit ESOP provisions, enacted as part of the Tax Reduction Act of 1975, have since expired.

The most important characteristics that distinguish ESOPs from other defined contribution plans are the requirement that an ESOP invest "primarily" in employer stock and the ability of an ESOP to borrow money on a tax-favored basis.

As defined contribution plans, ESOPs are granted certain tax advantages under the Internal Revenue Code (IRC). These include the deductibility, within certain limits, of contributions to the plan trust and the tax-deferred build-up of asset earnings in the trust. ESOPs are also restricted by many of the same laws that govern other tax-qualified defined contribution plans, including nondiscrimination requirements, distribution rules, and minimum participation and vesting standards. However, there are important exceptions (detailed later in this Issue Brief).

The most important characteristics that distinguish ESOPs from other defined contribution plans are the requirement that an ESOP invest “primarily” in employer stock and the ability of an ESOP to borrow money on a tax-favored basis. Other legal restrictions unique to ESOPs are generally designed to address these two special features.

#### History

Although the ESOP has been recognized as a distinct employee benefit only since the passage of the Em-
ploys Retirement Income Security Act (ERISA) in 1974, the concept of employee ownership is not new. The tie between ownership and work is deeply rooted in the history of the U.S. economy, in such institutions as family farms and family-owned retail businesses and among independent tradesmen.

The idea of worker ownership in larger companies with more concentrated means of production is also not entirely new. The first formal stock ownership plan on record in the U.S. was started in 1879 by Rand McNally and Co., the Chicago publishing firm. Although the plan was initially limited to supervisory personnel, by 1886 the firm had distributed 560 shares of stock to 47 employees (Gilman, 1889). Between 1918 and 1925, more than 338,000 employees of railroads, utilities, and manufacturing firms (mostly managerial or sales personnel) became participants in stock subscription plans, under which stock was acquired through salary reduction (James et al., 1926).

**Kelso's Theories and the ESOP Idea**—Louis O. Kelso, a San Francisco lawyer, is generally credited with the ESOP concept. He first described it in *The Capitalist Manifesto*, which he wrote with Mortimer Adler in 1958. In this and later writings he suggests that the high concentration of wealth ownership in the U.S. is morally unacceptable and destructive to the economy (Kelso and Kelso, 1986). He criticizes as false the concept advanced by some economists that the benefits of the growing U.S. economy should be broadly distributed on the basis of “the increasing productivity of labor.” He argues that because increased output is more attributable to capital than to labor, higher wages represent a misallocation of economic resources.

Inflation, unemployment, surplus productive capacity, and other economic problems are all attributable to these institutional misconceptions, he contends. Kelso concludes that, in order to have efficient allocation and broad opportunity for participation in an increasingly capital-intensive economy, it is necessary to modify existing institutions so that all individuals can earn income through both labor and capital ownership.

Kelso proposed the leveraged ESOP as one way to open what he perceives to be a closed circle of capital ownership. He contends that leveraged ESOPs can help broaden the ownership of productive capital and, in so doing, strengthen and stabilize the economy.

Before the passage of ERISA in 1974, Kelso constructed the ESOP as a type of qualified defined contribution pension plan that invested more in the employer’s stock than a typical plan. However, between 1959 and 1974 only about 275 ESOPs were established (Profit Sharing Research Foundation, 1985).

Kelso proposed the leveraged ESOP as one way to open what he perceives to be a closed circle of capital ownership. He contends that leveraged ESOPs can help broaden the ownership of productive capital and, in so doing, strengthen and stabilize the economy.

**Sen. Long and Congressional Initiatives**—In 1973 Kelso met Sen. Long, then chairman of the Senate Finance Committee. At that time, the committee was considering the legislation that would eventually become ERISA. Because of Long’s efforts, ERISA recognized ESOPs as qualified employee benefit plans and made employee ownership law a part of retirement law. It further provided qualified ESOPs with the unique ability to leverage. Including ERISA, Congress has enacted 17 ESOP tax laws (Rosen, 1987). Some of the more important ESOP-related public laws are summarized below.

**Tax-Credit ESOPs**—The Tax Reduction Act of 1975 allowed an extended investment tax credit equal to qualified contributions to a special nonleveraged ESOP.

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called a TRASOP (Tax Reduction Act stock ownership plan). The Tax Reform Act of 1976 increased the allowed credit. Under the 1981 Economic Recovery Tax Act, beginning in 1983 the basis for the allowed tax credit was shifted from investment to payroll, replacing the TRASOP with the PAYSOP (payroll-based stock ownership plan). The tax credit allowed for PAYSOPs was repealed for compensation paid or accrued after Dec. 31, 1986, by the 1986 Tax Reform Act.

Participants’ Rights—In 1978, closely held companies (those whose stock is not traded on an established market) were required to attach “put options” to ESOP stock distributions. This meant that ESOP participants receiving stock distributions could require the company to buy back the stock at a fair market price within a specified period. It was feared that, without this provision, retiring or terminating participants would not be able to sell their nonpublicly traded stock. Also in 1978, legislation was enacted requiring publicly traded firms to “pass through” full voting rights for allocated ESOP stock to ESOP participants and requiring privately held companies to provide such rights on major corporate issues, including the sale of the company, refinancing of major debts, and proposed mergers.

Chart 1
Nonleveraged ESOP

<table>
<thead>
<tr>
<th>Stock</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Company</td>
<td>Employees</td>
</tr>
</tbody>
</table>

(1) Each year, the company gives stock to the ESOP or (2) gives cash to the ESOP to buy stock. Employees pay for nothing. ESOP holds stock for employees and periodically notifies them how much they own and how much it is worth. (3) Employees collect stock or cash when they retire or otherwise leave the company, according to the vesting schedule.

Dividends—The Tax Reform Act of 1976 authorized ESOPs to pass through dividends on allocated ESOP stock to ESOP participants. The Deficit Reduction Act of 1984 (DEFRA) further encouraged this by allowing companies to deduct cash dividends passed through to ESOP participants.

Lender Incentives—DEFRA provisions allow banks to deduct 50 percent of the interest earned on ESOP loans. The TRA ’86 extended this provision to regulated investment companies.

In contrast to a nonleveraged ESOP, where stock is acquired slowly through employer contributions, a leveraged ESOP generally acquires a large block of stock purchased with the borrowed funds.

Incentives for Sale of Stock to ESOPs—DEFRA allows owners of closely held companies to defer capital gains taxes when selling stock to an ESOP. It further allows employers to assume an estate’s tax obligation in return for an equal amount of employer stock transferred from the estate to the ESOP. TRA ’86 permits the exclusion of 50 percent of the qualified proceeds from the sale of employer stock to an ESOP from the taxable value of an estate. IRS guidelines and the recently passed Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), restricts this provision retroactively to stock held by the decedent immediately before his or her death.

How ESOPs Work

There are two major types of ESOPs: nonleveraged and leveraged.2 The tax-credit ESOP had been gaining popularity but was eliminated as of year-end 1986.

Nonleveraged ESOPs

The operation of a typical nonleveraged (or leverable) ESOP is shown in chart 1. The company sets up an ESOP trust and periodically contributes to it. The company may contribute stock directly or contribute cash, which the fund uses to purchase stock. The stock is immediately allocated to the accounts of employees, who are periodically notified of their account balances. Subject to vesting schedules, retiring or terminating participants generally can elect to receive the stock allocated to their account or the cash equivalent of the stock’s fair market value.

Leveraged ESOPs

In a leveraged ESOP, funds are borrowed to acquire employer securities. This can be accomplished in one of two ways (chart 2). An employer may arrange to sell the ESOP a specified amount of qualified employer securities at fair market value. The ESOP then borrows the funds needed to purchase the stock. The lender may be a bank or regulated investment company or the employer or shareholders in the employing company. The loan may be guaranteed by the employer, or the stock may be pledged as collateral. The loan is repaid with the employer’s tax-deductible contributions to the ESOP. As the ESOP loan is repaid, shares of stock are allocated to the participants’ accounts. Unallocated shares remain in the ESOP trust and can continue to serve as collateral for the remaining loan balance.

Alternatively, the employer may borrow the money and transfer stock to the ESOP in exchange for a promissory note. The employer makes deductible contributions to the ESOP, which uses these contributions to pay off the note. These repayments to the employer, in turn, are used to pay off the employer’s loan.

In contrast to a nonleveraged ESOP, where stock is acquired slowly through employer contributions, a leveraged ESOP generally acquires a large block of stock purchased with the borrowed funds. This means that a leveraged ESOP can acquire a large share of ownership in a company much faster than a nonleveraged ESOP. Furthermore, if the loan is used to buy stock from the employer (rather than from outside existing stockholders), the ESOP transaction provides a cash infusion to the employer.

2 The following discussion draws heavily from Sophie Korczyk, "Employee Stock Ownership and Recent Policy Changes," Peat Marwick Spectrum 9 (November 1986).
Tax-Credit ESOPs

The 1987 budget reconciliation bill did not include a provision related to termination of tax-credit ESOPs that had earlier caused controversy in the employee benefits community. Because the 1986 Tax Reform Act eliminated tax-credit ESOPs, many employers have considered terminating existing plans altogether. However, an early version of a technical correction to TRA '86 (originally included in budget reconciliation) proposed to limit termination of tax-credit ESOPs with assets held less than 84 months to instances where lump-sum distributions are made and no successor plan is established. Some interpreted the provision as regarding any defined contribution plan as a successor plan, even if the plan were established prior to PAYSOP.

termination. Thus there was a question as to whether an employer sponsoring an ongoing defined contribution plan could legally terminate a PAYSOP without first fulfilling the 84-month waiting requirement.

ESOP Regulations and Restrictions

General ERISA Rules—ESOPs are subject to many of the general ERISA and tax code rules governing qualified retirement plans, including minimum participation and vesting standards. ESOPs also must adhere to additional qualification requirements aimed at recognizing the special uses and characteristics of these plans.

ESOPs are subject to many of the general ERISA and tax code rules governing qualified retirement plans, including minimum participation and vesting standards.

Investment of Assets—ESOPs must be designed to invest primarily in qualifying securities of the employer. In practical terms, this means that at least 51 percent of a plan’s assets must be so invested. Qualified employer securities may include readily tradeable common stock, stock with voting power and dividend rights, preferred stock that is convertible into qualified common stock, and stock of affiliated corporations. Debt instruments are not included.

Diversification—For stock acquired after 1986, ESOPs must provide means for qualified participants nearing retirement to diversify part of their ESOP account balance and must offer a choice of at least three nonemployer investments. (Proposed Department of Labor rules may change this requirement. For further information, see “Legislative and Regulatory Initiatives.”) In general, beginning with the plan year following the participant’s attainment of both age 55 and 10 years of participation, the participant must be provided the opportunity to diversify at least 25 percent of the total account. Five years later, the participant must be allowed to diversify at least 50 percent. Alternatively, the ESOP may distribute the amount that could be diversified.

Fiduciary Responsibility—Fiduciaries must meet ERISA standards by acting in the exclusive interest of participants and in a prudent manner. However, they are generally not required to diversify assets, except in response to self-directed diversification options elected by qualified participants nearing retirement. The special nature of ESOPs creates the potential for many violations of fiduciary responsibility. For example, an ESOP can be used to privatize a publicly traded company by buying shares from the public market. If acquiring all the shares requires paying a premium price, doing so may not be in the best interest of participants. Similarly, if an ESOP buys a company’s stock to defend against a hostile takeover attempt, a premium price might be paid. Recently, concern has grown over how to apply ERISA’s fiduciary rules to ESOP fiduciaries in the context of multi-investor leveraged buyouts. This issue is discussed in more detail below.

Voting Rights—ESOP participants must be allowed certain voting rights. For stock that is readily tradeable (stock of a public company), full voting rights for all allocated shares must be passed through to participants. For stock of closely held companies, voting rights must be passed through on all major corporate issues, specifically those that must be decided by more than a majority vote. Shares not voted by participants are voted by the ESOP trustee.

Distributions—ESOPs are permitted to make distributions in either stock or cash. Unless the sponsoring company’s charter or bylaws require that substantially all of the company’s stock be owned by employees, participants must be allowed to take their distribution in stock.3 Generally, the full amount must be paid out over no more than five years, although the participant

3 Unless the separating participant elects otherwise, distributions attributable to stock acquired after December 31, 1986, must begin within one year following the plan year in which the participant retires, dies, or becomes disabled, or within five years after the participant separates from service for any other reason (if not reemployed with the same company).
can elect to extend this period. Also, the period can be extended up to an additional five years for account balances in excess of $500,000.

A participant receiving nonpublicly traded stock must be given an option to sell the stock to the employer at an independently appraised fair market value.

A participant receiving nonpublicly traded stock must be given an option to sell the stock to the employer at an independently appraised fair market value (a put option). For stock acquired after 1986, the employer can pay for the stock in annual installments, over a period of up to five years, beginning no later than 30 days after the sale, paying reasonable interest. The employer must provide security for the unpaid balance of deferred payments. The employer and the ESOP may exercise a right of first refusal to repurchase nonpublicly traded stock distributed by the ESOP.

Valuation—For stock acquired after 1986, all valuations of employer securities that are not readily tradeable on an established securities market must be made by an independent appraiser. Contributions, purchases, and distributions must be made at the value determined by the independent appraiser.

Loans—Special exceptions in ERISA and the tax code allow ESOPs to leverage, or borrow funds, to acquire stock. ESOP loans must bear a reasonable interest rate and be secured by the employer or by unallocated employer securities in the ESOP trust. The loan must not allow recourse to allocated shares in the event of default. The lender can be a bank, a regulated investment company, the employer, or shareholders in the employing company.

Integration with Social Security—An ESOP established after November 1, 1977, may not be integrated with Social Security.

ESOP Tax Advantages

Liberal Deduction Limits—ESOPs generally enjoy more liberal tax advantages than those granted other defined contribution plans. For example, ESOP contributions that are used to repay an ESOP loan are not subject to the usual 15 percent of covered compensation deduction limit. Instead, employers can deduct contributions used to pay the loan principal up to 25 percent of compensation. Unlimited deductions are permitted for contributions used to pay loan interest. Employers generally may also deduct dividends paid on ESOP stock to the extent that the dividends are distributed in cash to participants or used to repay the principal on the ESOP loan. These liberal deduction limits help accelerate the rate at which ESOPs can repay loans, thereby allowing more rapid allocation of ESOP stock to participants’ accounts. Also, by encouraging the pass-through of dividends, these provisions promote the use of ESOPs to provide a current benefit in addition to the usual deferred benefit.

Lender Incentive—Banks and regulated investment companies can deduct 50 percent of the interest earned on ESOP loans. Some of this advantage can be passed on to the ESOP through lower interest rates.

Incentives for Sale of Stock to an ESOP—Major shareholders of stock in a closely held company can defer all taxes on the sale of employer stock to an ESOP if, upon the completion of the sale, the ESOP owns at least 30 percent of the company and the seller reinvests the proceeds in qualified domestic securities within one year after (or three months before) the sale. The shareholder must hold the employer stock for at least one year and must not have received the stock in connection with employment. This provision allows owners of closely held businesses who are approaching retirement age to effectively create a market for their stock and to diversify their investments while providing their employees with a benefit and promoting the continued independence of the business.

ESOP companies are permitted to assume an estate’s tax obligation in return for an equal amount of employer stock transferred from the estate to the ESOP. The tax may then be paid by the ESOP on more favorable terms, generally over a 14-year period. In addition, an estate
may deduct for tax purposes 50 percent of the qualified proceeds from the sale of employer stock to an ESOP. Effective February 26, 1987, the 1987 budget reconciliation bill provides that the deduction may be taken only if the securities were owned by the decedent immediately before his or her death.

**Tax Deferral for Participants**—As with other defined contribution plans, ESOP participants are not taxed on ESOP allocations to their accounts until they actually receive distributions. Until January 1, 1990, ESOP participants who receive lump-sum distributions before attaining age 59 1/2 are exempt from the 10 percent tax imposed on such distributions from other defined contribution plans. If dividends on ESOP stock are passed through in cash to participants, however, they are taxed as current income.

**Asset Reversion Exemption**—Through December 31, 1988, companies may avoid the 10 percent excise tax imposed on the excess assets recovered from terminating defined benefit plans to the extent that the excess assets are transferred to an ESOP. If the ESOP in turn buys stock from the employer, the cash infusion is tax free. The only "costs" are increased employee ownership and possibly dilution of previously issued shares.

### Current Trends in ESOP Use

ESOP use has grown steadily over the last decade, according to several studies. The National Center for Employee Ownership (NCEO) estimates that by 1986 there were 8,046 employee ownership plans (including nontax-credit ESOPs, stock bonus plans, and money purchase and profit sharing plans that invest in employer stock but excluding tax-credit ESOPs), with 7.9 million employees participating. This represented a gain from the 1,601 plans covering just 248,000 employees in 1975 (chart 3).

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**Chart 3**

**Cumulative Growth of Employee Ownership Plans,* 1975–1986**

![Chart 3](chart3.png)

Source: National Center for Employee Ownership, Inc.

*Includes nontax-credit ESOPs, stock bonus plans, and money purchase and profit-sharing plans that invest in employee stock. Does not include tax-credit ESOPs.
The U.S. General Accounting Office (GAO) estimates that as of March 1986, there were 4,799 ESOPs in 4,700 companies, and 2,405 stock bonus plans, for a total of 7,204 employee ownership plans (GAO, 1986). GAO reports that 26 percent of ESOPs active in 1985 were tax-credit ESOPs, 16 percent were leveraged, 35 percent were leverageable, and the remaining 22 percent were nonleveraged (legally qualified to leverage, but with no provision for leveraging in the plan document).

Based on 1983 survey results, GAO estimates that ESOPs active in 1985 covered 7.1 million participants and had assets of $18.7 billion. Tax-credit ESOPs accounted for 90 percent of the participants and 79 percent of the assets, but had the lowest asset value per participant—a median of $2,952. Leveraged ESOPs, which accounted for 2 percent of participants and 8 percent of assets, had the highest median asset value per participant—$8,660 (table 1).

The Bureau of Labor Statistics' 1986 employee benefit survey found that 30 percent of full-time employees in medium and large firms, or about 7.2 million workers, participated in ESOPs (DOL, 1987). Twenty-eight percent participated in PAYSOPs; the remaining 2 percent participated in other types of ESOPs. Less than 0.5 percent participated in stock bonus plans.

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The ESOP Survey 1987 covers a nonrepresentative sample but provides some insight into the widespread use and diverse design of ESOPs (ESOP Association, 1987). The survey identified ESOPs in 10 broad industrial categories. Forty-two percent of surveyed companies with ESOPs were in manufacturing. The banking and communications industries together accounted for

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Participants and Assets of ESOPs, 1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type</td>
<td>Participants (thousands)</td>
</tr>
<tr>
<td>Tax-credit</td>
<td>6,391</td>
</tr>
<tr>
<td>Leveraged</td>
<td>158</td>
</tr>
<tr>
<td>Leverageable</td>
<td>293</td>
</tr>
<tr>
<td>Nonleveraged</td>
<td>238</td>
</tr>
<tr>
<td>Total</td>
<td>7,083</td>
</tr>
</tbody>
</table>

Source: U.S. Government Accounting Office

| The Pros and Cons of ESOP Use |

A broad range of issues must be addressed by those considering ESOP use. The goals of policymakers, employers, and employees sometimes overlap and sometimes differ. Each group must ask to what degree ESOPs can achieve its desired goals and at what costs.

Questions policymakers face include:

- Can ESOPs significantly broaden the ownership of corporate stock?
- Can ESOPs help corporate performance and, therefore, U.S. economic competitiveness and growth?
- Can ESOPs improve labor-management relations?
Can ESOPs save failing companies and boost declining industries?

How beneficial are ESOPs to participants?

When does the participation of ESOPs in multi-investor leverage buyouts represent an abuse? How are participants affected by these transactions?

What do ESOP tax advantages cost in forgone revenue collections?

Is an ESOP primarily an employee benefit or a tool of corporate finance?

Employers must ask a number of questions, including:

Can an ESOP boost company performance and profitability?

How would an ESOP affect employee attitudes and labor-management relations?

Can an ESOP help defend a company against a hostile takeover? Is an ESOP a good financing tool for other purposes?

If an ESOP is adopted, will management lose control of the company?

Are the tax advantages of an ESOP substantial enough to offset the costs of contributions, administration, and (for closely held companies) repurchase liability?

Questions facing employees include:

How large a benefit will an ESOP provide? Is it worth trading wages or pensions for an ESOP?

Will ownership provided by an ESOP make my job more satisfying? Will I have more say over my job or other company matters?

If my company is going to close, can an ESOP save my job?

Recently, a great deal of research has been directed at answering some of these questions. Information is now available on the attitudes of ESOP participants, employers, and the public, and studies have been undertaken to ascertain whether employee ownership affects corporate performance.

Why Employers Sponsor ESOPs

In its 1986 survey, GAO asked ESOP employers why their companies established ESOPs. (Respondents could choose as many reasons as they deemed applicable.) The three reasons cited most frequently were (1) the desire to provide an employee benefit, (2) the tax advantages afforded by ESOPs, and (3) the wish to improve employee productivity (chart 4). These were cited by 91 percent, 74 percent, and 70 percent of respondents, respectively. Only 3 percent indicated that the ESOP was adopted in exchange for wage concessions. Just 4 percent cited saving a failing company as a reason, and only 5 percent cited protection against hostile takeovers.

The most often reported advantages to having an ESOP were improved employee morale (66 percent) and tax savings (60 percent) (chart 5). Higher productivity and reduced turnover were each mentioned by about one-third of respondents; improved employee-management relations, capital for investment, and improved profitability each were reported by about one-fourth. The most-often cited disadvantages to having an ESOP, each mentioned by 16 percent of respondents, were dilution of stock value and repurchase liability (chart 6). Fifty-seven percent indicated that there were no disadvantages to having an ESOP.

Among respondents who had terminated an ESOP, the reason given most often was adverse business conditions (32 percent). Only 14 percent blamed the disadvantages of having an ESOP (chart 7).

The 1987 ESOP Association survey of 211 companies found that the factor most often cited as the single most important benefit of ESOP sponsorship was improved employee motivation (39 respondents). Thirty-one respondents mentioned the effect of ownership on business environment. Fifty respondents indicated that the biggest problem associated with their ESOP was employee communications.
Empirical Evidence: How Do ESOPs Measure Up?

**Federal Revenue Loss from ESOPs**—According to GAO, the revenue losses attributable to ESOPs over the period 1977 to 1983 are between $12.0 billion and $13.3 billion. Of these losses, $11.8 billion, or between 89 and 97 percent, are attributable to tax-credit ESOP provisions, which expired year-end 1986. As the GAO report points out, ESOP tax incentives are designed, in part, to broaden the ownership of corporate stock. In addition, they are intended to facilitate capital formation. The GAO provides evidence as to whether ESOPs are achieving these goals in sufficient degree to justify the revenue losses. The study concluded that tax-credit ESOPs, in particular, represent a disproportionate revenue loss compared to the benefits realized.

The Reagan administration had expected a revenue loss of $2.6 billion from tax-credit ESOPs in 1987. Following the repeal of tax-credit ESOP provisions under TRA '86, the administration estimated losses from these plans under reformed tax rates to be just $665 million in 1987 and $230 million in 1988 (Executive Office of the President, 1986, 1987). The Joint Tax Committee of Congress projects that revenue losses from all ESOPs (including tax-credit and other ESOPs) will decline from $0.8 billion in 1988 to less than $500 million by 1992 (U.S. Congress, 1987).

**ESOPs and the Broadening of Capital Ownership**—Ownership of capital in the U.S. is concentrated within a relatively small fraction of the population. According to the Joint Economic Committee of Congress, the top 10 percent of households, on the basis of wealth, held 90 percent of household-owned corporate stock in 1983 (chart 8). Some contend that the skewed distribution is not consistent with U.S. ideals of social justice and, therefore, regard broadened ownership as a goal in and
of itself. Others argue in more practical terms that broadening ownership would provide greater economic opportunity to more people and might reduce, therefore, the need for redistributional taxes and social programs. In addition, some point out that the U.S. market economy is driven primarily by consumption and that broadening ownership might financially empower more consumers, spurring economic growth.

Employee ownership in general, and ESOPs in particular, are seen by some policymakers as a way to approach their goal of broader ownership. But can ESOPs accomplish this goal? How much does the use of ESOP’s broaden ownership? Do ESOP participants become owners of substantial capital? This question is of particular interest to employees as well as policymakers.

According to GAO, ESOPs held about $18.7 billion in assets in 1983 (table 1). This is equivalent to about 1.9 percent of the total household-owned corporate stock that year, or less than 1 percent of all stock outstanding (GAO, 1986). GAO concludes that, as of 1983, ESOPs had had relatively little impact on the distribution of stock ownership in the economy. GAO attributes this, in part, to the fact that ESOPs covered less than 7 percent of employees.

ESOPs qualified to leverage had median account balances per participant in 1983 ranging from $5,098 for nonleveraged ESOPs to $8,660 for leveraged ESOPs. Total account balances of these plans were $3.9 billion, while associated forgone revenue to the federal government was between $0.2 and $1.5 billion over the preceding seven years. Tax-credit ESOPs provided a smaller median account balance per participant—just $2,952. Tax-credit ESOPs’ total account balances of $14.8 billion in 1983 are small compared to the $11.8 billion in forgone revenue that they represented during the preceding seven years, according to GAO.

Although ESOPs have had little impact on the distribution of capital ownership in the economy, GAO concludes that ESOPs do significantly broaden the owner-
ship of stock within the pool of employees who participate. Because ESOPs are subject to IRS coverage and nondiscrimination rules, ESOP participation cannot be limited to any special group of employees. Nor can an ESOP provide disproportionately large benefits to highly compensated individuals. (In addition to general nondiscrimination requirements, ESOPs cannot be integrated with Social Security.) According to GAO, the median rate of employee participation for all ESOPs is nearly 71 percent. (For tax-credit ESOPs, the median rate, 63 percent, is somewhat less than for other types.) Thus, GAO concludes that “assuming that the employees of firms with ESOPs include workers who differ widely in levels of wealth and income, then the high proportion of these workers participating in stock ownership through ESOPs suggests that these plans do broaden stock ownership within sponsoring firms.”

The degree of ownership resulting from ESOP use can also be measured by the share of ESOP ownership in sponsoring companies. GAO found that only 25 percent of ESOPs held more than a 25-percent ownership share in the sponsoring company. Forty-four percent of leveraged ESOPs held more than 25 percent of their companies, as did just 5 percent of tax-credit ESOPs (GAO, 1986). These findings are supported by Marsh and McAllister (Rosen, Klein, and Young, 1985), who found that 10-15 percent of ESOP companies are more than 50 percent employee owned. Rosen, Klein, and Young have suggested that estimates of current ownership share among ESOPs may be misleading because ownership share generally increases over time (Rosen, Klein, and Young, 1985). The 1987 ESOP Association survey identified 21 closely held companies that were 100 percent employee owned. Seventeen of these sponsored leveraged ESOPs. The survey further identified 45 ESOP companies, including one publicly traded company, that were between 50 and 99 percent employee owned.

**ESOPs and Benefit Levels**—The effectiveness of ESOPs in providing capital ownership can also be viewed in terms of the account balance that might be accrued over the career of a typical participant. Based on data obtained from ESOP practitioners, NCEO projected that an employee earning the 1983 median wage of $18,000 per year would accumulate $31,000 worth of stock in the average ESOP in 10 years (Feldman and Rosen, 1985). After 20 years, the same employee would have an account value of over $124,000. Quarrey contends

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### Chart 6

**Disadvantages of ESOPs by Type of ESOP**

<table>
<thead>
<tr>
<th>Cumulative Percent of all ESOPs:</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
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<tr>
<td>---</td>
</tr>
<tr>
<td>Dilute value of stock</td>
</tr>
<tr>
<td>Repurchase liability</td>
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<tr>
<td>Lose control of company</td>
</tr>
<tr>
<td>Poor performance of stock</td>
</tr>
<tr>
<td>Difficulty getting loans</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>None</td>
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</table>

Number of ESOPs: 0 200 400 600 800 1,000 1,200 1,400 1,600 1,800 2,000

**Type of ESOP:** □ Leveraged □ Leverageable □ Nonleveraged □ Tax credit

Chart 7
Reasons for Terminating, Converting, or Discontinuing Contributions to an ESOP by Type of ESOP

<table>
<thead>
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<th>Reason for Termination</th>
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<th>10</th>
<th>15</th>
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<th>25</th>
<th>30</th>
<th>35</th>
<th>40</th>
<th>45</th>
<th>50</th>
<th>55</th>
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<tr>
<td>Dilute value of stock</td>
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<td>Repurchase liability</td>
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<td>Lose control of company</td>
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<td>Poor performance of stock</td>
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<td>Difficulty getting loans</td>
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</tr>
</tbody>
</table>

Number of ESOPs:

- 0
- 200
- 400
- 600
- 800
- 1,000
- 1,200
- 1,400
- 1,600
- 1,800
- 2,000

Type of ESOP: [ ] Leveraged [ ] Leverageable [ ] Nonleveraged [ ] Tax credit


that this represents a significant benefit, particularly when viewed in the context of the median net financial assets of a family at retirement age (excluding home equity), which he reports to be $11,000. Quarrey suggests that these findings are not inconsistent with the lower median per participant account values reported by GAO, because GAO figures relate to current account balances while the NCEO estimates reflect projected future values, and because many of the ESOPs studied by GAO had been in existence for only a few years (Quarrey, 1986).

Logue and Rogers have suggested that estimates such as Quarrey's might be too optimistic, because ESOPs with high contribution rates might be more likely to participate in studies than those with lower rates (Logue and Rogers, 1987). In a survey of Ohio ESOPs that enjoyed a 61 percent response rate, they found contribution rates significantly lower than those that underlie NCEO estimates. They project median account values for a worker earning $18,000 per year to be $12,500 after 10 years and $40,600 after 20 years. However, in alternative estimates based on only those companies that are more than 30 percent employee owned, Logue and Rogers project median account values comparable to NCEO's—$24,000 after 10 years and $100,000 after 20 years. Neither NCEO nor Logue and Rogers adjust projected account balances for inflation. Although both sets of projections are based on nominal stock growth during periods of relatively low inflation, inflation-adjusted estimates would be somewhat lower. Adjusting for inflation beginning when distributions are made, an account balance of $100,000 with a real interest rate of 2 percent could provide 20 annual payments of about $6,000 constant dollars. (For a discussion of benefit levels realized under different retirement arrangements and circumstances, see EBRI, "Pension Portability and What It Can Do for Retirement Income: A Simulation Approach," EBRI Issue Brief 65 (April 1987).)

These projections are generally based on average contributions and average stock value growth and, therefore, fail to encompass the special circumstances that might be faced by a participant receiving a distribution immediately after a large decline in the value of employer stock. The volatility exhibited by the stock market during October 1987 highlights this concern.
Reasons for Terminating, Converting, or Discontinuing Contributions to an ESOP by Type of ESOP

Cumulative Percent of All ESOPs: 0 5 10 15 20 25 30 35

- Adverse business conditions
- Burdens of ERISA
- End of TRASOP credit
- Disadvantages of ESOPs
- Merger
- Change in ownership
- Liquidation of company
- Collective bargaining agreement
- Other

Number of ESOPs: 0 20 40 60 80 100 120 140 160 180 200 220 240 260

Type of ESOP: □ Tax credit □ Nonleveraged □ Leverageable □ Leveraged
The existence of such risks could reduce the value of an ESOP as an employee benefit—particularly as a retirement plan. This issue is discussed in more detail below.

In evaluating the level of benefits provided to ESOP participants, GAO also considered the payment of dividends on ESOP stock. Overall, 32 percent of ESOP companies paid dividends to ESOPs on a continuing basis; 58 percent never paid dividends. Among ESOPs paying dividends, only 8 percent passed through dividends paid before June 1984 to participants, while 86 percent retained those dividends in the plan trust. (Eight percent had not paid dividends before June 1984.) In 1984, DEFRA provided for the deduction of dividends paid before June 1984 to participants. Despite that incentive, in late 1985 only 5 percent of those ESOPs that had retained dividends before June 1984 had begun passing them through to participants (chart 9).

ESOPs as Retirement Plans—The use of ESOPs as retirement income vehicles has been criticized on at least two grounds: (1) the inadequacy of benefits provided, and (2) the inherent riskiness of concentrated investment in employer stock as compared to the diversified investment of other qualified defined contribution retirement plans. The greater risk of ESOP investments is an important issue, particularly in light of recent stock market volatility.

Some ESOP portfolios suffered large losses in the October 1987 market decline. The ESOP owning 32 percent of the publicly traded FMC corporation lost $239 million, or 32 percent of total ESOP value, between October 15 and 27. During that same period, the ESOP owning 30 percent of Lowe’s Companies, often praised

4 Potential benefit levels from ESOPs are discussed above.

---

**Chart 8**

*Assets of the Wealthy* As a Percentage of All Household Assets, 1983

- Corporate stock
- Trusts
- Business assets
- Bonds
- IRAs and Keoghs
- Money market accounts
- Land contracts
- Certificates of deposit
- Real estate
- Checking accounts
- Insurance cash surrender value
- Savings accounts
- Automobiles
- Miscellaneous
- Gross assets

Source: EBRI tabulations based on Joint Economic Committee data, as revised and reported by the General Accounting Office.

* Excludes stock in pension trusts.

* Top 10 percent of U.S. households.
by ESOP advocates for the very high account balances realized by some rank-and-file participants, lost $73 million, or 26 percent (Dutton and Robertshaw, 1987). It is likely that a significant proportion of ESOP participants in publicly traded companies saw their account balances fall by 20 percent or more. (The Standard & Poor's 500 Index fell by 22 percent in October.) If stock prices recover, most ESOP participants will regain these losses. However, participants receiving distributions immediately after stock price declines face a difficult choice between holding the stock and hoping it will recover its value, or selling the stock and accepting the loss.

Stock market volatility probably has less impact on most ESOP participants than on most other investors, however. The majority of ESOPs (although not the majority of ESOP participants) are in closely held companies that do not trade stock on public markets, and whose stock may be less affected by occasional market volatility. In addition, publicly traded companies appear to provide only supplemental benefits through their ESOPs. While an estimated 1,000 publicly traded companies sponsored ESOPs in 1983, these included 700 tax-credit ESOPs, which had a median per-participant account balance of only $2,952. Among other ESOPs in publicly traded companies, the median balance was just $1,464 (Blasi, 1987). Although account balances in these ESOPs might be expected to grow, it appears that most of the participants do not currently have a substantial amount to lose.

The issue of ESOP risk was addressed by TRA '86, which required provision for partial diversification of the accounts of qualified participants nearing retirement. But this requirement addresses neither the risk facing participants who are not yet qualified for diversification nor the 50 to 75 percent of qualified employee account balances that might remain undiversified.

ESOPs thus remain a more risky retirement income...
vehicle than other qualified retirement plans, although proposed Labor Department regulations may change the diversification requirements of defined contribution plans, including ESOPs (detailed in “Legislative and Regulatory Initiatives”).

The issue of ESOP risk was addressed by TRA '86, which required provision for partial diversification of the accounts of qualified participants nearing retirement.

Advocates argue that, despite inherent risks, ESOPs can have a legitimate role as an employee benefit. The risk might not be severe in companies that provide ESOP participants with other retirement income protection. In fact, only a small fraction of ESOPs trade wages or pensions for employee ownership. GAO found that just 3 percent of ESOPs were established in exchange for wage concessions. The Labor Department reports that in 1986, among all full-time participants in retirement and capital accumulation plans in medium and large firms, just 1 percent relied on an ESOP or stock bonus plan alone. In contrast, 29 percent participated in a defined benefit or money purchase pension plan in addition to an ESOP or stock bonus plan. Another 2 percent or more participated in a profit sharing or savings and thrift plan in addition to an ESOP or stock bonus plan (U.S. Department of Labor, 1987). The 1987 ESOP Association survey identified just 23 ESOPs that had been converted from pension plans, compared to 79 converted from profit sharing plans, and 133 which were not the result of a plan conversion. Sixty-three respondents indicated that their ESOP was currently supplemented with a defined benefit pension plan, 45 with a profit sharing plan, and 52 with a 401(k). Five respondents indicated that wage or benefit concessions had been made in exchange for the ESOP, compared to 233 reporting no reductions in other compensation.

Logue’s 1986 study of Ohio ESOPs similarly found that only 3 ESOPs out of 63 were converted from pension plans and that 46 companies established the ESOP as a new, additional employee benefit. Thirty-four also maintained pension plans; profit sharing and 401(k) plans were each sponsored by 18 ESOP companies. Fifty-eight of the ESOPs involved no current or future wage concessions (Logue and Rogers, 1987).

ESOPs, Participation, and Employee Attitudes—ESOP advocates often contend that ESOP use can improve employee-management relations. Some contend that endowing employees with an ownership share in the company where they work will favorably affect employee attitudes and enhance company performance. Others suggest that employee ownership should go hand in hand with increased employee participation in corporate decision making, as part of a consistent philosophy of employee ownership, and that the combination of ownership and employee participation can favorably affect employee attitudes and corporate performance.

ESOPs and Employee Participation—According to GAO, most ESOPs have not led to greater employee participation in company decision making. Sixty-eight percent of ESOP companies reported employee involvement in company decision making to be about the same as before the ESOP was established. Only 27 percent indicated that the involvement had increased. Among those reporting increased involvement, only 23 percent reported that participation occurred through formalized channels, such as committees or task forces. More than three-quarters indicated that the increased involvement took place informally, through casual meetings or conversations. Notably, 42 percent of leveraged ESOPs, more than any other type, reported increased involvement through formal structures. Where committees or task forces existed, 42 percent provided for employee input into decisions involving safety, compared to 34 percent for those involving working conditions, 33 percent for management-employee relations, 30 percent for cost reduction, and 19 percent for product quality. In contrast, input into decisions involving new products, corporate planning, and budget or finance were reported by only 14, 13, and 11 percent of ESOPs, respectively. Thirty-three percent indicated that employees had no input into company decisions. For those that reported some input, 95 percent of ESOP companies indicated that employees could make suggestions, while 33 percent reported that employees
shared decision making with management. Only 10 percent indicated that employees could make some managerial decisions on their own.

Of the 211 ESOP companies responding to the 1987 ESOP Association survey just 28 indicated that employees gained more involvement in corporate policy decisions. Fifty-two indicated that employees have more direct input on job-related issues, 87 reported that management met more with employees, and 143 indicated that they now provided more financial information to employees.

The single most important factor in boosting employee satisfaction with their ESOP and with their employment situation, notes NCEO, was the size of the company contribution to the ESOP.

ESOPs and Employee Attitudes—In a recent study, NCEO evaluated the effect of ESOP use on employee attitudes (Rosen, Klein, and Young, 1985). NCEO interviewed 2,800 employees in 37 ESOP companies over four years. In general, the study found that employees endorse the idea of ownership and appreciate the financial benefits it provides. Employees also report that the ESOP encourages them to stay with the company. However, employees generally do not report improved employee-management relations, nor do they report that the ESOP motivated them to work harder, or that the ESOP made their job more satisfying. Furthermore, employees tended to disagree with suggestions that the ESOP improved their status relative to that of managers or that the ESOP provided them greater involvement in decision making.

The single most important factor in boosting employee satisfaction with their ESOP and with their employment situation was the size of the company contribution to the ESOP. Another important factor was management's self-reported commitment to employee ownership as a corporate philosophy. The existence of formal participation groups was not strongly related to employee satisfaction, though workers' perceptions that they have influence was.

ESOPs and Corporate Performance—In a later NCEO study, Quarrey sought to evaluate whether ESOPs affect corporate performance and, if so, what characteristics distinguished more effective ESOPs from less effective ones (Quarrey, 1986). The study is divided into two parts. In the first part, data for 45 ESOP companies for five years prior to ESOP adoption are compared to 1985 (post-ESOP adoption) data. In addition, each company in the sample is matched to similar non-ESOP companies as a control group to evaluate the impact of ESOP adoption on corporate performance. The second part of the study relies on more detailed post-ESOP adoption data for 30 companies to assess what factors might contribute to making an ESOP successful.

The study found that after the ESOPs were adopted, companies with ESOP's realized employment growth 5.05 percentage points higher than the control group. In contrast, before adopting an ESOP, employment growth of the ESOP companies exceeded that of the control group by just 1.21 percentage points (table 2).

The second part of the study concluded that employee participation in decision making, as measured by the presence of formal participation groups and perceived worker influence, was the strongest determinant of the

<table>
<thead>
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<th>Table 2</th>
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<tbody>
<tr>
<td>Average Percentage Point Difference between Performance of ESOP and Conventional Companies, before and after ESOP Adoption</td>
</tr>
<tr>
<td>Performance Measure</td>
</tr>
<tr>
<td>Employment growth</td>
</tr>
<tr>
<td>Sales growth</td>
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</table>

ESOP’s impact on corporate performance. Management commitment to a philosophy of employee ownership was also important. While confirming the finding of the earlier NCEO study that the size of the company contribution to the ESOP influences employee attitudes most, Quarrey’s study concluded that contribution size is not an important determinant of the ESOP’s impact on corporate performance.

Logue’s study of Ohio ESOPs also concluded that ESOP companies outperform their industries in terms of profit and employment growth.

Logue’s study of Ohio ESOPs also concluded that ESOP companies outperform their industries in terms of profit and employment growth (Logue and Rogers, 1987). In terms of profits, twenty ESOP companies outperformed their industry as a whole, while only nine did worse. Eighteen ESOP companies outperformed non-ESOP companies in their industries in employment growth, while just two did worse.5

In contrast to the NCEO study, Logue found that contribution levels were the most important determinant of ESOP impact on corporate performance. However, he also found a strong relationship between worker involvement in decision making and ESOP impact. He concludes that high involvement and large contributions are highly correlated and that separating their effects is difficult.

Logue’s study enjoyed a higher response rate (61 percent) than most other studies of ESOP performance. He suggests that for this reason his sample included more ineffective ESOPs. While this led to more moderate conclusions about the benefits of ESOP sponsorship overall, it also served to highlight the differences among ESOPs.

The 1987 ESOP Association survey findings are consistent with these results. Improved productivity was reported by three-fourths of respondents, while the remainder reported no impact or were not sure. None reported a negative impact. Forty-six percent of the respondents believed that the ESOP had enhanced their competitiveness, 19 percent believed it had not, and 35 percent were unsure.

A recent GAO study, however, found little evidence that ESOPs affect corporate performance (GAO, 1987). GAO analyzed the profitability and productivity of 111 generally representative companies that established ESOPs from 1976 to 1979. Data for the year the ESOP was established were compared to data for the two preceding and three subsequent years. Data on a control group of similar companies without ESOPs were used for comparison. GAO concluded that in the sample overall, ESOP establishment had no statistically significant effect on corporate performance. However, the report confirms Quarrey’s finding that increased employee participation in corporate decision making has a positive impact on the performance of ESOP companies.

GAO’s failure to confirm the overall positive impact of ESOP establishment reported by Quarrey and others might be explained in part by the composition of GAO’s sample and the design of GAO’s study. The GAO sample is larger and probably more representative of all ESOPs in existence at the time of the study than is Quarrey’s. Therefore, GAO’s findings might more accurately reflect the historical impact of a “typical” ESOP. However, Quarrey’s study, which included a potentially biased sample but also used a control group, may provide useful insight into the potential impact of an ESOP that provides more generous contributions and a larger ownership share.

In some respects, GAO’s analysis of profitability (after-tax return on assets) and productivity (the ratio of value-added to labor compensation) might better reflect corporate performance than Quarrey’s focus on employment and sales growth. However, because ESOPs

Logue points out, however, that these results were based on the appraisals of ESOP company managers, not on actual industry or matched company data.

5 Logue points out, however, that these results were based on the appraisals of ESOP company managers, not on actual industry or matched company data.
are usually established as add-on benefits (with no offsetting reduction in other compensation), GAO’s focus on profitability may neglect some “profits” passed on to participants in the form of ESOP contributions. In addition, add-on ESOP contributions could depress GAO’s measure of productivity.

The GAO report points out that recent changes in tax incentives not reflected in the study, including the elimination of tax-credit ESOP provisions (typically used by lower-benefit ESOPs) and increased incentives for leveraged ESOPs (which typically provide higher benefits), could lead to “dramatic” changes in ESOP benefits. Finally, all comprehensive studies of ESOPs to date include many ESOPs that have been in existence for five years or less and may, therefore, fail to fully capture the potential longer-term impact of ESOP sponsorship.

An ESOP As a Financing Tool—A leveraged ESOP can serve as a powerful tool of corporate finance. Due to favorable tax treatment, an ESOP can provide funds for investment at below-market interest rates and allow liberal deductions for payback of both interest and principal. Thus, under some circumstances, capital expansion might be most effectively financed using an ESOP. For example, assuming a 10 percent interest rate for conventional debt and an 8 percent rate for an ESOP loan, a company seeking to finance a $10 million capital expansion and amortize the loan over 10 years could realize a $472,000 increase in net income for the first year by using an ESOP rather than conventional debt (Gage, 1987) (table 3).

A leveraged ESOP, which can acquire a large block of stock at one time, can participate in a multi-investor leveraged buyout. ESOP participation in such a transaction raises issues in fiduciary responsibility and has recently gained the attention of policymakers, as described below.

ESOPs in Multi-investor Leveraged Buyouts

Multi-investor leveraged buyouts are transactions in which two or more investors simultaneously purchase large shares of stock in the same target company. Because of the varying circumstances of the investors involved, due consideration sometimes requires that different investors pay different prices for the same class of stock.

ESOPs in particular might be asked to pay higher stock prices than other investors due to the distinction some draw between cash investment and an ESOP investment based on future corporate contributions. Because the ESOP often tenders a note rather than cash, and the note is dependent on employer contributions, the note is often discounted from its face value at closing, resulting in dilution of the ESOP’s interest in the transaction and, therefore, a higher price for the ESOP.

ESOP fiduciaries, like those of other qualified employee benefit plans, must invest prudently and for the sole benefit of plan participants. Multi-investor buyouts may create potential conflicts of interest for fiduciaries. For example, other investors, who might include management, stand to gain if the ESOP pays a disproportionately higher price for the same class of stock. Such conflicts could lead to fiduciary violations and participant losses, particularly if the stock price paid by the ESOP is inflated more than adequate consideration of the investors’ different circumstances dictates. Furthermore, perceptions of ESOP participants that

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**Table 3: Income and Expenses for First Year Following Financing of $10 Million Capital Expansion, under Conventional Debt and Leveraged ESOP Financing**

<table>
<thead>
<tr>
<th></th>
<th>Leveraged ESOP</th>
<th>Conventional Debt</th>
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<tbody>
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<td>Operating Profit</td>
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<td>$7,000,000</td>
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<tr>
<td>Interest Expense:</td>
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<tr>
<td>Conventional debt</td>
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<tr>
<td>ESOP debt</td>
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<tr>
<td>ESOP Contribution</td>
<td>1,000,000</td>
<td>n/a</td>
</tr>
<tr>
<td>Pre-tax Income</td>
<td>5,200,000</td>
<td>6,000,000</td>
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<tr>
<td>Corporate Taxes</td>
<td>1,779,750</td>
<td>2,051,750</td>
</tr>
<tr>
<td>Principal Repayment</td>
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</tr>
<tr>
<td>Net Income</td>
<td>$3,420,250</td>
<td>$2,948,250</td>
</tr>
</tbody>
</table>

they paid more than other investors for the same stock could lead to dissatisfaction with the plan and animosity toward management. And if the price paid greatly exceeds the value of the stock, the forgone federal revenue may be disproportionately large compared to the amount of benefit provided to participants. Mandating price parity might preclude ESOP participation in many leveraged buyout transactions, however, because it would decrease the return expected by non-ESOP investors.

Recently, the Labor Department stopped a proposed buyout of the Scott & Fetzer Company before it was completed. The Scott & Fetzer ESOP was to pay $182 million for a 41 percent interest in the company. The company was valued at between $80 and $100 million; the ESOP's interest would have been worth between $32.8 and $40 million. Management investors and investment bankers would have acquired a 29 percent ownership share for an investment of just $9 million (Lerner, 1985). The Labor Department determined that this transaction was prohibited under ERISA because the fiduciary had not acted in the best interests of the participants.

Some observers believe that the intervention of the Labor Department in this transaction has made investment bankers reluctant to include ESOP's in multi-investor leveraged buyouts. Many ESOP supporters advocate ESOP participation in these transactions, arguing that workers should have the opportunity to compete with other investors for ownership of the company for which they work. However, some believe that regulation is needed to ensure fair treatment of ESOP participants in relation to other investors. Proposed regulations and legislation addressing these issues are discussed in the following section.

- Legislative and Regulatory Initiatives

ESOPs in Multi-investor Leveraged Buyouts

Regulatory Developments—The ERISA Advisory Council made recommendations to the Department of Labor regarding regulation of ESOP participation in multi-investor leveraged buyouts. The recommendations are summarized below.

The Labor Department should remain neutral regarding the participation of ESOP's in multi-investor leveraged buyouts.

The department should strongly recommend the appointment of an independent fiduciary and independent financial and legal advisors to negotiate on behalf of the ESOP and to have a say of approval over the transaction, in order to help ensure fair treatment of the ESOP and participants in relation to other investors.

The department should provide for a preclosing safe harbor, which would prohibit pretransaction intervention by the Labor Department as long as certain conditions designed to protect ESOP participants were met. These conditions would be (1) the use of an independent fiduciary and independent financial and legal advisors; (2) the provision that in transactions immediately diluting ESOP stock, an amount equal to the carried interest of management investors be held in escrow for a specified time, to be extended if the Labor Department later investigates; if the department finds that the ESOP paid more than adequate consideration, the carried interest would be available to the ESOP as compensation; and (3) the requirement that notification be provided prior to closing of the intent to use the safe harbor.

The Labor Department should consider other safeguards to protect participants.

Legislative Developments—The Tender Offer Disclosure and Fairness Act of 1987 (S. 1323), reported by the Senate Banking Committee, contains two provisions that would enhance the attractiveness of ESOP's in takeover situations. First, the bill would extend the statutory tender offer period from the current 20 days to 35 days. For a company at least 10 percent employee-owned for the last six months, the period would be extended to 95 days if the ESOP announced its intent to make a competing bid. Second, the bill would allow ESOPs to use surplus assets from a defined benefit pension plan to finance its bid. These assets would not be available to any other bidder.

These provisions reflect the Senate Banking Committee's intent that employees should have the...
advantage in takeover struggles, or at least have the means to compete fairly with high-powered outside and management investors. While critics see the provisions as an invitation for ESOP abuse, proponents respond that even abusive intent on the part of management may not preclude an outcome of expanded employee ownership that is beneficial to employees.

ESOPs in Floor-offset Plans

Under a floor-offset plan, an employer sponsors a defined contribution plan, under which benefit levels vary with investment returns. In addition, the employer promises a minimum benefit level, expressed by means of a benefit formula, and sponsors a defined benefit plan, or "floor plan." If a participant's defined contribution plan account balance is not sufficient to pay the minimum benefit due, the floor plan makes up the difference.

Some policymakers are concerned that the use of ESOPs in floor-offset arrangements might jeopardize the benefit security of participants. ESOPs are exempt from restrictions that prohibit defined benefit plans from investing more than 10 percent in employer stock. Instead ESOPs must invest at least 51 percent and can invest up to 100 percent in these securities. If the value of employer stock drops, floor plans might be hard pressed to pay the minimum promised benefits.

Under the budget reconciliation, the defined contribution and defined benefit portions of a floor-offset plan established after December 17, 1987, are treated as one plan for purposes of the 10 percent limit on investment in employer securities. The act also tightens restrictions on what type of employer securities these plans may invest in. Because ESOPs must be invested primarily in employer securities, these provisions will severely limit the use of ESOPs in floor-offset arrangements.

Other Initiatives

The Labor Department has proposed regulations that may affect diversification of ESOP accounts (Federal Register, 1987). Currently under ERISA, fiduciaries are generally relieved of liability for investment outcomes of participant-directed accounts (most defined contribution plans) if participants exercise control over their individual accounts. Under most interpretations of the proposed regulations, this relief would be available only if the participant were offered a broad range of investment alternatives and were provided sufficient information to make informed decisions. In addition, the participant's exercise of control would have to be "independent," or without influence from a plan fiduciary or sponsor.

The Outlook for ESOPs

Since the passage of ERISA in 1974, ESOPs have generally enjoyed expanded favorable tax treatment under federal law. Some in Congress see ESOPs as a prime target for revenue increases. In addition, some perceive that ESOPs are frequently abused and provide dubious benefits. An earlier House Ways and Means Committee revenue proposal would have drastically curtailed ESOP tax advantages. (The proposal was omitted from budget reconciliation legislation.)

In addition, the general response of organized labor to ESOPs continues to be lukewarm at best. Unions may fear that employee ownership will undermine the adversarial management-employee relationship. And skepticism exists as to how beneficial ESOPs are to union members, particularly when they are offered in exchange for wage or other concessions. An August 18, 1987, statement by the AFL-CIO Executive Council stressed that "any proposal to 'pay' for participation in an ESOP with collectively bargained benefits should be weighed with particular care" (AFL-CIO, 1987). A set of guidelines for negotiating an ESOP issued by the AFL-CIO industrial union department emphasizes ESOPs' riskiness as a retirement vehicle relative to defined benefit pension plans, the importance of employee involvement in decision making, and the importance of an equitable allocation of stock and voting power, among other factors.

Nonetheless, recent survey results suggest that public perceptions of ESOPs are favorable. A survey of 1,001 individuals conducted in August 1987 for the Bureau of National Affairs (BNA) and NCEO provides insight into current public perceptions regarding employee ownership (BNA/NCEO, 1987). Eighty-one percent of those surveyed thought employee owners paid more attention to quality than other workers, and 69 percent believed that employee owners worked harder. Eighty-one percent thought employee owners were more concerned with their company's financial performance. One-half indicated that they would be willing to forgo
their next wage increase for a share of ownership in their company. Forty-one percent indicated that they would rather buy a similar product from an employee-owned company than from a conventional company (51 percent said ownership made no difference).

Widespread support of employee ownership is also reflected by state laws that support the concept. At least 19 states have already passed employee ownership laws (chart 10), and legislative activity at the state level continues. At the federal level, Congress is likely to

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Source: Condensed and updated from Catherine Ivancic and John Logue, Employee Ownership and the States: Legislation, Implementation and Models, Kent State University, September 1986. Updates based on The Employee Ownership Report, a bi-monthly publication of NCEO.

* List may not be complete.
further regulate ESOPs to discourage possible abuses and promote “good” ESOPs. However, continued congressional support for the ESOP concept is likely.

A large decrease in the number of ESOP participants is expected to result from the elimination of tax-credit ESOPs effective as of year end 1986. A March 1987 survey of tax-credit ESOP companies by Hewitt Associates found that only 2 percent of the 125 respondents intended to continue to make contributions to the plan without the tax credit (those contributions would be deductible). However, another 27 percent were undecided (Hewitt Associates, 1987). As reported earlier, tax-credit ESOPs accounted for 90 percent of ESOP participants in 1983. However, ESOP advocates contend that these statistics may overstate the setback for employee ownership, because tax-credit ESOPs have generally provided smaller ownership benefits than other ESOPs.

Despite the repeal of tax-credit ESOP provisions, employer interest in ESOPs is likely to continue because the broad tax advantages still available make the ESOP attractive as a compensation supplement and as a tool of corporate finance. Emerging evidence that well-structured ESOPs can favorably affect employee attitudes and corporate performance might further spur employer interest in the ESOP concept.

**Summary**

Spurred by congressional enactment of tax incentives, ESOP use has grown rapidly since 1974. However, available data suggest that many of these ESOPs, covering the bulk of ESOP participants, provide only modest benefits and little opportunity for increased employee participation, and that they usually coexist with other retirement plans. Yet, a growing body of evidence suggests that well-structured ESOPs can have a positive impact on employee attitudes and corporate performance.

ESOPs may not compare favorably with other qualified retirement plans as a vehicle for retirement income because their concentrated investments may entail more risk. Nonetheless, ESOPs have the potential to broaden capital ownership, improve employee motivation, and provide a substantial financial benefit to participants.

In addition, current legal provisions allowing ESOPs to borrow money on a tax-favored basis continue to make ESOPs an attractive tool in corporate financing strategies.

**References**


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