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NEW IDEAS FOR A DO-SOMETHING CONGRESS — NO. 8

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Enable More Workers to Become Owners through Employee Stock Ownership

Despite growth in gross domestic product, corporate profits, and the stock market over the past several years, American workers today capture a historically low share of those economic benefits. The labor share of income today is several percentage points lower than the postwar average and, after adjusting for inflation, median compensation today is only about 10 percent higher than in the mid-1970s.

More American workers would benefit directly from economic growth if they had an ownership stake in the companies where they work. To help achieve this goal, Congress should encourage more companies to adopt employee stock ownership plans (ESOPs), which provide opportunities for workers to participate in a company's profits and share in its growth. Firms with ESOPs enjoy higher productivity growth and stronger resilience during downturns, and employees enjoy a direct stake in that growth. ESOP firms also generate higher levels of retirement savings for workers, thereby addressing another crucial priority for American workers.

While the tax code encourages employee ownership through certain policy incentives, not all businesses benefit equally from these measures. Expanding ESOP tax incentives for S corporations, a large and growing share of U.S. companies, can help ensure that more Americans have access to the economic benefits that ESOPs provide.

THE CHALLENGE:
AMERICAN WORKERS AREN'T FULLY BENEFITTING FROM ECONOMIC GROWTH

In the last two months of 2018, average hourly earnings for American workers rose by three percent (year-over-year). This was the first time that nominal wage growth had broken the three percent mark in nearly 10 years.[1] Yet on an inflation-adjusted basis, the real hourly wages of Americans have been more or less flat for 40 years. Today, they're only about 10 percent higher than in the 1970s.[2]

Wage stagnation fuels economic anxiety, as workers and their families find it difficult to pay bills and cover the basic costs of living. Partly as a result, Americans take on debt: aggregate household debt reached a new peak in September 2018, surpassing the previous high (in 2008), of $12.68 trillion.[3] More and more people feel like they're running faster but not getting ahead, and loading up on debt just to stay in place. This exacerbates political anger, as Americans get frustrated with government's apparent inability to help them escape this vicious cycle.

WORKERS' SHARE OF ECONOMIC GROWTH IS HISTORICALLY LOW.

From the late 1940s through the 1980s, the share of economic output accruing to workers as compensation was fairly constant at between 61 and 64 percent but has since fallen to between 56 and 58 percent.[4] That translates into billions of dollars of economic value that would have formerly gone to workers. Meanwhile, GDP and corporate profits have grown strongly in recent years—thanks in part to corporate tax cuts—with the latter even setting new records in 2018.[5]

WAGE STAGNATION HAS WORSENED WORKERS' RETIREMENT SECURITY.

One especially worrisome consequence of the lack of wage growth is that workers have less capacity to save. In particular, Americans face a crisis in retirement security: nearly two-thirds of working-age Americans have no retirement assets of any kind.[6]

The median amount saved for retirement is, in fact, $0; if only workers with retirement savings are counted, the median is only $40,000.[7] Just 51 percent of workers have access to an employer-provided savings plan, such as a 401(k).[8] Small business employees have the least access: according to some estimates, less than 20 percent of businesses with fewer than 50 employers offer retirement plans.[9]

THE GOAL:

PROVIDE MORE AMERICAN WORKERS A CHANCE TO SHARE IN THE PROFITS AND GROWTH OF THEIR EMPLOYERS

How can workers get a bigger share of the economic growth they help create, along with stronger financial security? One way to achieve this goal could be to impose rigid top-down mandates on companies requiring higher wages or benefits, but this approach invites resistance, potentially stifles growth, and may not achieve the intended aims of improving workers' economic security. A better approach is to encourage more companies to provide workers with an ownership stake in their employers, such as through an employee stock ownership plan (ESOP).

ESOPs are a proven way to help workers participate in business growth while generating a host of social and economic benefits, including greater opportunities for economic security. Research has consistently found that companies with ESOPs enjoy stronger growth in productivity and profits than other firms, so employees get a larger share of a faster-growing pie.[10] The wage distribution at employee-owned firms is tighter than in non-ESOP companies, meaning that greater employee ownership can help put at least a small dent in income inequality.[11] ESOP companies have also demonstrated stronger economic resilience and job stability than other firms, particularly during economic downturns.[12]

Employee-owned companies also offer greater retirement security. Critics of ESOPs have raised the possibility of a lack of diversification in employees' retirement holdings if a large share is concentrated in their company's shares. Yet research has established that ESOP companies are actually more likely to also set up diversified 401(k) accounts as secondary retirement plans.[13] And, ESOPs are legally required to help plan participants diversify their investments.

While ESOPs might have more public visibility in the context of large employers, more and more small businesses are discovering the benefits of employee ownership as well. Today, roughly 10 percent of private-sector employees in the United States work in ESOP companies.[14] The fastest growth in ESOP adoption has been among S corporations, which are also a fast-growing form of business organization.[15] The ESOP model is promising for employers of all sizes, boosting the ability of their employees to save for retirement. As the Chief Financial Officer of the engineering and construction firm MMC Contractors in Kansas City told PPI: "There's no way [our employees] would have accrued the type of retirement benefits they have but for the ESOP. Some of them will have a nicer standard of living when they retire than they do today."[16]

THE PLAN:
EQUALIZE TAX TREATMENT FOR EMPLOYEE-OWNED BUSINESSES TO ENCOURAGE WIDER SPREAD OF THIS MODEL

Originally authorized in 1974, policy incentives have expanded to encourage ESOP adoption by more companies.[17] Just last year, the 115th Congress passed the Main Street Employee Ownership Act which, among other things, made employee-owned businesses eligible for Small Business Administration loan guarantees.[18] States have also taken action to encourage more employee ownership: in 2017, bipartisan legislation passed in Colorado establishing a new office and revolving loan fund to support transitions to ESOPs.[19]

Yet more can and should be done to incentivize the use of ESOPs—in particular, pass-through S corporations should have access to all the ESOP tax benefits that accrue to traditional "C corporations. While they now represent a small fraction of U.S. companies, C corporations employ nearly half the workforce because they are typically the entity of choice for large companies and are subject to the corporate income tax.

An S corporation, on the other hand, does not pay the corporate income tax; rather, income is "passed through" to shareholders and taxed as ordinary income. S corporations are now the second-most common form of business organization in the United States (after sole proprietorships).[20] There are two-thirds more S corporations than C corporations, and S corporations have grown more rapidly in number and income over the past two decades. In fact, they have been the fastest-growing business entity since the 1980s.[21]

Both types of corporations may sponsor an ESOP, but C corporations enjoy an ESOP tax benefit not currently available to S corporations. When a company transitions to an ESOP, its current shareholders sell their shares to the ESOP, which in turn distributes shares to employees. The difference is in the tax treatment of the profits from the sale of those shares to the ESOP. Under section 1042 of the Internal Revenue Code, the owners of a C corporation who choose to sell stock to an ESOP can put off the tax liability on the gains from that sale.[22] But when owners of an S corporation sell stock (or the entire company) to an ESOP, gains from the sale are taxed immediately.

This erects a barrier to ESOP adoption by S corporations and matters especially for business owners nearing retirement. In the United States, 57.5 percent of the owners of employer firms (that is, those with employees) are between the ages 45 and 64.[23] Another 19.6 percent are over age 65, and more than half of the youngest companies are owned by individuals over age 45.[24] When asked about their exit strategy, selling to employees is low on the list—14 percent say they will simply walk away, and nearly one-third have no exit strategy. Alarmingly, the businesses whose owners have no exit strategy employ the largest number of people.[25] Facilitating the sale of S corporations to ESOPs will give business owners a stronger exit strategy option, and help businesses stay in their communities.

Extending to S corporations the same tax benefit that C corporations receive when adopting an ESOP will create broader awareness of this option for businesses, spreading the benefits of ESOPs to more people.

Congress should extend IRC 1042 to S corporations. This will continue to expand the benefits of ESOPs, not least because S corporations are much more numerous than C corporations. Additionally, S corporations with ESOPs (known as S-ESOPs) have been shown to have high resilience in recessions, higher wages than other firms, and stronger retirement holdings for employees.[26] S-ESOPs are also more likely to offer additional retirement plans than other businesses are to offer any retirement plan. Uneven tax treatment potentially denies these benefits to millions of American workers and business owners.

Such a change was proposed in bipartisan legislation introduced in the Senate in January 2019 at the beginning of the 116th Congress: the Promotion and Expansion of Private Employee Ownership Act would allow S corporations to defer tax upon transition to an ESOP. Sponsored by Sens. Pat Roberts (R-KS) and Ben Cardin (D-MD), the bill has attracted 24 co-sponsors from both sides of the aisle. In the House, in 2017, similar legislation was introduced by Reps. Dave Reichert (R-WA) and Ron Kind (D-WI).

American workers have endured wage stagnation for too long. They deserve a larger share of the growth they help create. ESOPs help deliver that, and they help drive greater business productivity in the process. At the same time, ESOPs increase retirement security, and making their adoption easier will be good for business owners, too.

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Endnotes

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