Statement before the House Small Business Committee

On

S is for Savings: Pro-Growth Benefits of Employee-Owned S Corporations

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Chairman Chabot and Ranking Member Velázquez, thank you for the opportunity to appear before the Small Business Committee to discuss the role of S ESOPs in the US economy. My name is Alex Brill, and I am a resident fellow at the American Enterprise Institute, a think tank in Washington, DC.[1] In my testimony this morning, I will address four questions:

- What is an S ESOP?
- What are the trends in S ESOPs' economic performance?
- How are S ESOPs good for small business?
- How are S ESOPs good for the US economy?

The key conclusions of my testimony can be summarized as follows:

S ESOPs, which are defined contribution retirement plans that allow employees to become owners, are increasingly popular in the US. As a complement to a diversified portfolio of retirement assets, S ESOPs can improve the well-being of workers and the productivity of firms by strengthening employee commitment. S ESOPs exist across a wide spectrum of industries and include a meaningful number of US employees. As the US seeks to rebound from a period of tepid productivity growth, tools such as S ESOPs can improve worker commitment, reduce worker turnover, and lower production costs. In addition, S ESOPs proved resilient in the face of the most recent recession and thereby helped mitigate the adverse effects of the recession on S ESOP suppliers and related business activity.

What Is an S ESOP?

An employee stock ownership plan (ESOP) is a type of defined contribution retirement plan that must invest primarily in employer securities. Since 1998, chapter S corporations have been permitted to sponsor an ESOP, commonly referred to as an S ESOP. S ESOPs offer a myriad of benefits to employers and employees in the realms of tax, financing, and retirement security. The structuring and operations of S ESOPs are governed by numerous rules and regulations, many similar to the governance of other tax-qualified retirement plans such as 401(k) plans. For example, S ESOP participation must be broadly available to employees over the age of 21 with at least one year of service, and the plan must not discriminate in favor of "highly compensated" employees. Other complex regulations dictate allocation rules, anti-cutback rules, and record-keeping requirements generally. An S ESOP can own as little as 5 percent of the equity and as much as 100 percent of a business. S ESOPs with 100 percent ownership are commonplace, while S ESOPs with a minority share are relatively uncommon.

While the legal and regulatory issues related to S ESOPs are important, this testimony will focus on the economic effects of S ESOPs and in particular the effects of employee ownership on employee commitment, firm productivity, and firm resilience.

What Are the Trends in S ESOPs' economic performance?

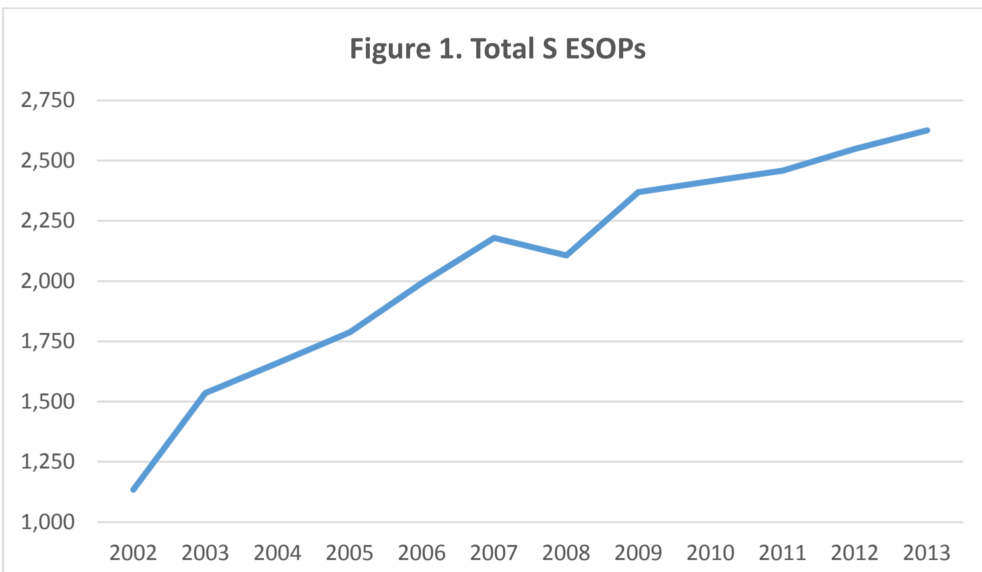
Before delving into the economic evidence with respect to the effect of S ESOPs on the welfare of employees and the success of firms, it is important to recognize the depth and breadth of S ESOPs in the

[1] Previously, I served as the chief economist and policy director to the House Committee on Ways and Means and on the staff of the White House Council of Economic Advisers. In addition, I have previously consulted to S ESOPs through their trade association. The views expressed here are mine alone and may not reflect the views of my employer, the American Enterprise Institute (AEI); my colleagues at AEI; or any entity to which I am affiliated or to whom I have consulted.

US economy. The data presented next represent the most current evidence of S ESOPs in the US based on Department of Labor (DOL) Form 5500 filings, which provide information about employee benefit plans, including whether a company has an S ESOP, total active participants, the number of retired participants receiving benefits, and the industry in which the firm operates, among other statistics. Using these data, I am able to narrow in on only S ESOP firms.

In previous research, I analyzed Form 5500 data from 2002 through 2009. Here, my analysis is updated through December 31, 2013.[2] The advantage of incorporating newer data is twofold. First, newer data provide the most current indication of the size and scope of S ESOPs in the US economy. Second, additional years of data permit for a more robust comparison of the performance of S ESOPs following the recession of 2007–2008.

Figure 1 shows the number of S ESOPs in the US for each year from 2002 through 2013 using the methodology noted in footnote 3.[3] The number of S ESOPs has increased 231 percent, from 1,135 in 2002 to 2,626 in 2013. In general, the increase has been steady year-over-year, though there was a 3 percent dip in the number of S ESOPs in 2008.



Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

More important than the steady increase in the number of S ESOPs is the increase in the number of employee owners working at S ESOP companies. As Figure 2 shows, from 2002 through 2013, the number of active participants at S ESOPs increased 167 percent, from 195,000 in 2002 to 521,000 in 2013. During the 2007–2008 recession, active participants declined almost 6 percent. However, this

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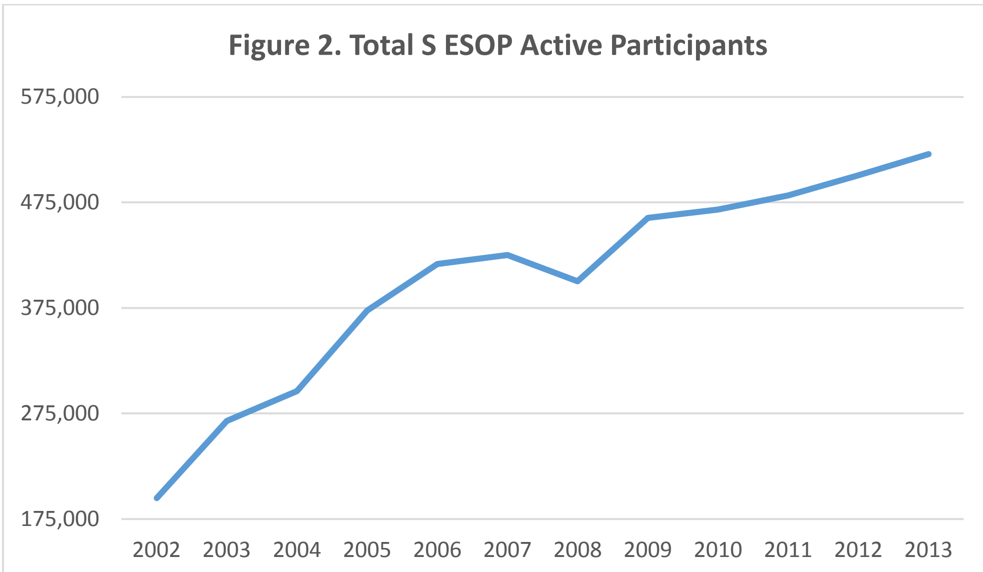
[2] DOL does report Form 5500 data for 2014 and 2015. However, these files are incomplete.

[3] DOL's Form 5500 data contain observed duplicates (and triplicates) of filings for the same business as well as filings for firms with fewer than 15 active participants. As described in Brill (2012), the data reported here reflect the removal of duplicate filings based on the reported employer identification number (EIN) and the removal of firms with fewer than 15 active participants. If duplicate forms reported conflicting, non-zero data with respect to the number of active participants, the results were averaged.

drop was reversed by 2009, while the decline in US employment lingered into 2014. Since 2008, active participants in S ESOPs have increased 30 percent. It should be noted that, because not all employees are necessarily S ESOP owners,[4] the number of active participants in S ESOPs is a conservative estimate of employment by these firms. Brill (2012) compared active participants from DOL Form 5500 data with firm-level survey data for a sample of S ESOP firms and found that actual employment averaged 40 percent higher than active participant numbers. If those survey results are generalizable to the entire S ESOP sector, total S ESOP employment would exceed 725,000 for 2013. While conservative, active participant data represent a reliable indicator of the trend in employment over time.[5]

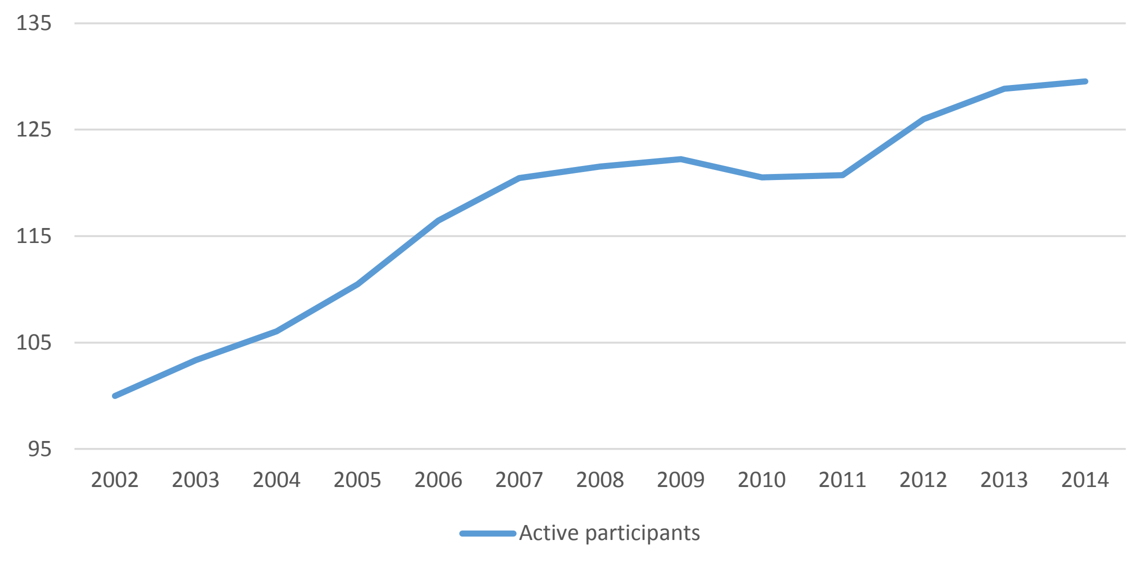


Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

Some of the growth in S ESOP employment is attributable to firms hiring more workers, and some of the growth is attributable to the rising popularity of S ESOPs generally. In other words, the large increase in S ESOP employment from 2002 through 2013 does not entirely represent organic growth in jobs within S ESOPs; it also reflects firms converting to S ESOPs. To disentangle these two drivers of S ESOP employment growth, Figure 3 presents results from a subset of S ESOPs: firms that existed in 2002 and continued to exist every year through 2014. Within this subset of S ESOPs, active participants increased 30 percent during this period.

[4] Part-time workers, workers younger than 21, workers with less than one-year of tenure, and unionized workers may be excluded from S ESOP participation.
[5] The Brill (2012) analysis of the reliability of active participant counts as a proxy for employment also indicated that changes in the number of active participants were highly correlated with changes in the reported number of employees.

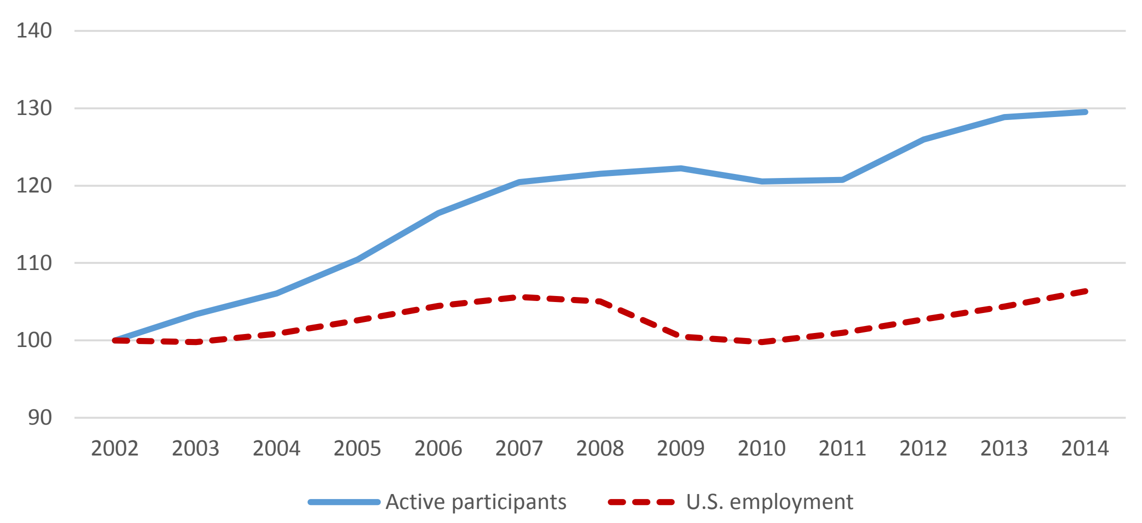
Figure 3. Active Participants in S ESOPs in Existence 2002–2014
(2002=100)



Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

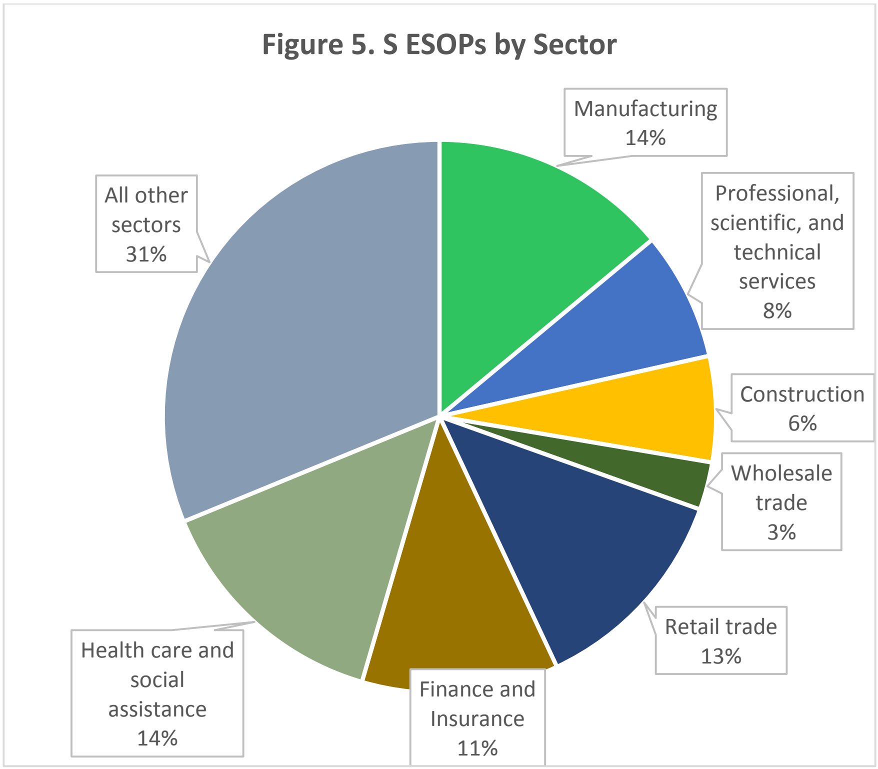
To put the growth of S ESOPs in context, Figure 4 presents the annual change in US employment and S ESOP active participation, normalized to 100 in 2002 for the same subset of S ESOPs in Figure 3. Unlike overall employment that dropped from 2008 through 2010 and only regained its historic level in 2014, employment at this subset of S ESOPs only plateaued through the recession before increasing 8 percent from 2011 through 2014.

Figure 4. Active Participants in S ESOPs in Existence 2002–2014 vs. Total Nonfarm Private US Employment
(2002=100)



Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

S ESOPs exist across a broad spectrum of US industries. In total, DOL data indicate that S ESOPs exist in 20 unique industries. The biggest seven industries for S ESOPs, ranked by the number of active participants, are health care and social assistance, manufacturing, retail trade, finance and insurance, professional services, construction, and wholesale trade. Collectively, these represent 69 percent of all active participants in 2014 for which there are data. Figure 5 illustrates the share of active participants in each industry.



Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

How Are S ESOPs Good for Small Business?[6]

ESOP firms, including S ESOPs and C corporation ESOPs, have been shown to perform better than non-ESOPs by a number of metrics. For example, a 2000 study by Douglas Kruse and Joseph Blasi of Rutgers University finds 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 2012). 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." Park, Kruse, and Sesil (2004) find higher survival rates among ESOP companies compared with non-ESOP companies.

The way in which S ESOPs improve firm outcomes is likely multifaceted, but one clear channel is by improving employee commitment. Employee commitment has been found to be a driver of job satisfaction, motivation, and attendance (Becker et al. 1996). Koys (2001) finds that positive employee

[6] This section draws, in part, from Brill (2012).

attitudes and behaviors lead to positive business outcomes (i.e., profitability and customer satisfaction). Other studies have shown that loyal employees work with greater efficiency than uncommitted workers. For example, Green (2008) finds that loyal employees do not require as much supervision and notes, "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."

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 committed employees. 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." 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.

Thus, ESOPs tend to perform better than their peers, and the mechanism by which this occurs is – at least in part – an improved alignment of incentives and additional commitment of effort and dedication by workers. This is particularly important in the small business context. The economic success of small and medium-sized enterprises (SMEs) is often reliant on the ability of firms to ensure that employees work effectively and cohesively for the common good of the business. A high degree of worker commitment and low rates of worker turnover are key components for SMEs' success in an increasingly competitive global marketplace and an often increasingly competitive local marketplace.

How Are S ESOPs Good for the US Economy?

The benefits of S ESOPs are not limited to just S ESOP firms and their employees. As Figures 1–5 above show, S ESOPs are quite resilient in the face of economic downturns, and the benefits of this resilience extend into the community in which an S ESOP operates. Swagel and Carroll (2010) assess how S ESOPs weathered the last recession and confirm that S ESOPs in 2008 fared better than others: "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."

To estimate the macroeconomic "footprint" of S ESOPs on the US economy, Brill (2013) employs the IMPLAN input-output model to quantify the impact of these firms. Relying on Form 5500 data from 2010, Brill (2013) finds that 2,643 S ESOPs directly employed 470,000 active participants (a conservative proxy for employment, as discussed above) and supported an additional 940,000 jobs. Moreover, total output was equivalent to 1.7 percent of 2010 US GDP. Of this, $93 billion (or 0.6 percent of GDP) came directly from S ESOPs, while output in supported industries totaled $153 billion (or 1.1 percent of GDP). Given that S ESOP growth since 2010 has outpaced growth in the overall economy, the role of S ESOPs in the US economy is likely greater now than it was then.

The measurable footprint combined with the demonstrated economic resilience of S ESOPs suggest that these firms yield a tangible stabilizing benefit to the communities in which they operate. During a recession, bankruptcy for small businesses is not uncommon and can have a domino effect, imposing financial hardship on firm suppliers and other local businesses and impeding local housing markets. To the extent that S ESOPs mitigate these effects, they represent a positive economic externality.

S ESOPs in the Broader Context: Why This All Matters

In competing with large corporations who benefit from economies of scale and cost-effective access to capital markets, SMEs are often reliant on business agility, local knowledge, and high-quality workers to remain competitive. By strengthening the ties between workers and managers, the S ESOP structure, like ESOPs generally and other forms of employee stock ownership, can help foster efficiency and increased productivity and output.

The positive effects of S ESOPs should be considered a complement to the benefits of technology gains as a means for overall productivity growth in the US. Given the slow creep of productivity in recent years, S ESOPs are a valuable tool in promoting economic growth not only among small businesses but indirectly to the economy overall.

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