Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Committee on Small Business

From: Committee Staff

Date: April 25, 2016

Re: Hearing: "S is for Savings: Pro-Growth Benefits of Employee-owned S Corporations"

On Wednesday, April 27, 2016, at 11:00 a.m. in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet to discuss employee-owned S corporations and H.R. 2096, the Promotion and Expansion of Private Employee Ownership Act of 2015, which has been referred to this Committee.

S corporations that sponsor employee stock ownership plans (S ESOPs) are vital economic players in the United States.[1] The hearing will examine how S ESOPs establish employee ownership, and the benefits that may accrue to the small business and the economy as a result. This hearing will also consider possible measures to encourage S ESOP proliferation.

I. Introduction

S corporations have been permitted to maintain employee stock ownership plans (S ESOPs), a type of defined contribution plan, since 1998.[2] S ESOPs operate similarly to ESOP plans offered by C corporations in that they allow the company to provide compensation to employees and enhance their retirement security in the form of an ownership interest in the company.[3]

II. A Look at the Data: Performance of S ESOPs

An ESOP is a tax-exempt defined contribution retirement plan designed to facilitate employee ownership of a company.[4] S ESOPs have been in existence for just under 20 years, including the period now known as the Great Recession, but the data from this short period gives rise to some pretty remarkable observations. S ESOPs have been shown to have a significant multiplier effect on the economy, and to outperform other companies by several other measures.[5] Not surprisingly, S ESOPs are the fastest-growing employee-ownership structure and the most prevalent form of ESOP.[6] This memorandum will focus on three different studies that analyze the data from three different perspectives, all of which similarly conclude that S ESOPs are beneficial in a variety of different ways.

A. Macroeconomic Effects

A 2013 study conducted by AEI Resident Fellow Alex Brill examines the macroeconomic impact of S ESOPs on the economy as a whole.[7] His analysis finds that S ESOPs are vital economic players in the

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[1] Alex Brill, *Macroeconomic Impact of S ESOPs on the U.S. Economy* 1 (April 17, 2013) [hereinafter Brill].
[2] EY, CONTRIBUTION OF S ESOPS TO PARTICIPANTS' RETIREMENT SECURITY 1 (March 2015) [hereinafter EY].
[3] *Id*.
[4] Brill, *supra* note 1 at 2.
[5] *Id*.
[6] *Id*.
[7] *Id*. at 1.

United States.[8] S ESOPs help establish employee ownership, which cultivates loyalty among employees and, in turn, enhances firm prosperity.[9] The S ESOP structure has been shown to lead to greater firm longevity and higher wages, wage growth, job stability, retirement plan contributions, employment, and sales than would otherwise be predicted.[10] S ESOPs are more resilient to economic downturn than other private employers, and their structure benefits not only themselves but the broader U.S. economy as a whole.[11]

Brill examines the impact of S ESOPs and attempts to quantify the effects by measuring direct and downstream effect, often referred to as the multiplier effect.[12] As S ESOPs employ workers, their workers spend their wages in other places (e.g., grocery store, dry cleaners, gas station, etc.). As S ESOPS purchase from various suppliers, those suppliers in turn hire workers and buy from their own suppliers, and so on. As these rounds of expenditures take place, federal, state, and local taxing authorities collect income, sales, property, and other kinds of taxes and fees.[13] While this multiplier effect is present with any type of business, it is notably so with S ESOPs.

From 2002 to 2010, both the number of S ESOPs and the level of active participation[14] more than doubled.[15] Brill finds that the effect of these firms is very significant and broad-based.[16] As the Brill report details, the 2010 positive effect can be quantified as follows:

- **1.4 million jobs.** 2,643 S ESOPs directly employed 470,000 workers and supported an additional 940,000 jobs.
- **$77 billion in labor income.** S ESOPs paid $29 billion in labor income to their own employees, with $48 billion in additional income for supported jobs.
- **$246 billion in output.** Total output was equivalent to 1.7 percent of 2010 U.S. GDP. $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).
- **$27 billion in tax revenue.** Tax revenue initiated by S ESOPs amounted to $11 billion for state and local governments and $16 billion for the federal government.[17]

Due to limited data availability, Brill used active participation in S ESOPs as a surrogate for actual employment levels.[18] Given that one survey found that employment was as much as 39% higher than active participation, these number are likely significantly understated.[19]

B. Retirement Security

In 2015, global tax advisors EY's Quantitative Economics and Statistics practice released a report on the impact of S ESOPs on retirement security.[20] The report demonstrates that in an era when many workers have little or no retirement savings,[21] S ESOPs can be an important solution to the problem.

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[8] *Id*. at 2.
[9] *Id*. at 2.
[10] *See* NATIONAL CENTER FOR EMPLOYEE OWNERSHIP (NCEO), RESEARCH ON EMPLOYEE OWNERSHIP, CORPORATE PERFORMANCE, AND EMPLOYEE COMPENSATION (2016), *available at* https://www.nceo.org/articles/research-employee-ownership-corporate-performance/printable. The study compared the performance of ESOP companies with their pre-ESOP performance on factors such as sales growth, employment, and sales per employee to conclude that over ten years, an "ESOP company . . . would be a third larger than its paired non-ESOP match." *Id.*
[11] Brill, *supra* note 1 at 2.
[12] *Id*. at 1. The multiplier effect refers to the increase in final income arising from any new injection of spending.
[13] *Id*.
[14] Active participants are currently employed workers covered by an ESOP. NCEO A STATISTICAL PROFILE OF EMPLOYEE OWNERSHIP (2015), *available at* https://www.nceo.org/articles/statistical-profile-employee-ownership.
[15] *Id*. at 3.
[16] *Id*. at 2.
[17] *Id*. at 1.
[18] *Id*. at 4.
[19] *Id*. at 4-5.

The EY report analyzed trends in S ESOP retirement plans from 2002 through 2012.[22] It did so by examining several measurable factors over that period: net asset value, number of participants, average account balances, and distributions to participants.[23] Their analysis concluded that by all of these measures, S ESOP plans performed exceptionally well.[24]

The EY study found that S ESOPs outperformed the S&P 500 Total Returns index during this period. S ESOPs experienced a compound growth rate of 11.5% from 2002 through 2012, while the market grew at a compound annual rate of only 7.1%.[25]

Additionally, the report observed that S ESOPs are playing a bigger role in retirement security.[26] Both net assets and participant numbers rose substantially over the same period. Net assets were 318% higher in 2012 than in 2002,[27] and the number of participants increased by 165%.[28]

The data similarly revealed that distributions to participants increased almost six-fold from 2002 through 2012, totaling nearly $30 billion during that period.[29] S ESOPs also performed better than their 401(k) counterparts. Over this period, per-participant distributions were 56% higher for S ESOPs than for 401(k) plans.[30]

Finally, the numbers show that S ESOP companies are more likely to offer an additional retirement plan than all private sector establishments are to offer a single retirement plan. By definition, all S ESOPs offer a single retirement plan, but 65% of S ESOPs also offer an additional retirement plan. Only 45% percent of all organizations offer any retirement plan.[31]

C. Economic Inequality

The third and most recent study actually considers ESOPs more generally rather than the S ESOP specifically. However, its findings also support the expansion of S ESOPs.[32] The January 2016 report by Jared Bernstein, Senior Fellow, Center on Budget and Policy Priorities, examines the issue from the perspective of economic inequality.[33]

Bernstein's primary concern is that there has been a shift in national income from compensation to profits.[34] His interest in the ESOP issue stems from the extent to which these vehicles might help to rebalance the recent shift.[35]

Most notably, Bernstein concludes that as the extent of employee ownership rises, wage inequality among worker-owners declines.[36] Also, these workers do not appear to trade off one form of income for another, i.e., wages for ownership shares.[37]

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[20] EY, *supra* note 2.
[21] Melanie Hicken, *Income Inequality Hits Retirement Confidence* (March 18, 2014), *available at* http://money.cnn.com/2014/03/18/retirement/retirement-confidence/index.html.
[22] EY, *supra* note 2 at i.
[23] *Id*.
[24] *Id*.
[25] *Id*. at 10.
[26] *Id*. at 4.
[27] *Id*. at 2.
[28] *Id*. at 4.
[29] *Id*. at i.
[30] *Id*. at 8.
[31] *Id*. at 5.
[32] Jared Bernstein, *Employee Ownership, ESOPs, Wealth and Wages* (January 2016).
[33] *Id*.
[34] *Id*. at 1.
[35] *Id*.
[36] *Id*.
[37] *Id*.

He further affirms two critical observations made by the previously-referenced reports. First, he notes that firms with ESOPs appear uniquely resilient in recessions relative to non-ESOP firms.[38] Also, he concurs that ESOPs can be an important part of the solution to the problem of retirement insecurity, since ESOPs more often contribute not just to the ESOP but to 401(k) plans as well.[39]

He notes that the magnitude of these effects is still small, partly because ESOP ownership is still small. Based on these conclusions, Bernstein argues that employee ownership should be further encouraged.[40]

III. The Promotion and Expansion of Private Employee Ownership Act of 2015

On April 29, 2015, Representatives David Reichert (R-WA) and Ron Kind (D-WI) teamed up with six additional original cosponsors to introduce H.R. 2096, the Promotion and Expansion of Private Employee Ownership Act of 2015.[41] As of this writing, the bill has a total of 66 cosponsors.[42] A companion bill, S. 1212, was introduced in the Senate on May 6, 2015, by Senators Benjamin Cardin (D-MD) and Pat Roberts (R-KS), along with an additional 12 original cosponsors. It now has a total of 28 cosponsors.[43] The House bill was referred to three committees: the Committee on Ways and Means, the Committee on Education and the Workforce, and the Committee on Small Business.[44] The purpose of the bill is to foster employee ownership of S corporations through ESOPs.[45] It does so by:

- Encouraging owners of S corporations to sell their stock to an ESOP;
- Expanding financing opportunities for S corporation ESOPs;
- Providing additional technical assistance for companies that may be interested in forming an S corporation ESOP;
- Ensuring small businesses that become ESOPs retain their SBA certification; and
- Acknowledging the importance of preserving the S corporation ESOP structure in the Internal Revenue Code.

The Committee will hear testimony on H.R. 2096 and examine the bill on its merits.

IV. Conclusion

The data seem to demonstrate that S ESOPs are outperforming other incentives to drive success in a number of different areas. They improve employee loyalty, firm longevity, base wages, wage growth, job stability, retirement security, employment, sales, and wage disparity. They also have a measurable effect on the economy as a whole. This hearing will examine whether S ESOP proliferation should be a legislative policy goal, and, if so, whether H.R. 2096 will help to accomplish that goal.

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[38] *Id*.
[39] *Id*. at 1-2.
[40] *Id*. at 2.
[41] www.congress.gov *query* H.R. 2096. Twenty of the cosponsors are Members of the Committee on Ways and Means.
[42] *Id*.
[43] *Id*. *query* S. 1212.
[44] *Id*. *query* H.R. 2096.
[45] H.R. 2096, §2, 114th Cong. (1st Sess. 2015).