EMPLOYEE STOCK OWNERSHIP: A MICROECONOMIC ANLAYSIS

by

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INTRODUCTION

The objective of this dissertation is to investigate the impact of employee ownership of stock in employing firms. Recent legislation provides tax incentives for firms to promote stock ownership by employees and the debate preceding the legislation reveals an absence of understanding of the long-run impact of employee stock ownership on the internal processes of the firm.

The in-depth study of two newspapers is undertaken here with special emphasis given to the changes that occurred in each during over 40 years of extensive employee ownership. This method of investigation lends insight into the important questions of the long run characteristics and problems of employee-owned firms.

The emphasis on newspapers provides analysis of one alternative ownership structure of enterprises which constitute an important part of the supply side of the market for ideas. The First Amendment of the Constitution puts important restraints on governmental limitation of competition in ideas. To the extent that varied ownership structures facilitate a broadening of competition among ideas in the communications media, an investigation of employee ownership of newspapers is of increased significance. Investigation of the impact of employee stock ownership on the operation of the Milwaukee Journal and Kansas City Star are important to considerations of the possible externalities resulting from the ownership structure of the communications media.

The study establishes a theoretical framework for the investigation of employee ownership of employing firms in the early chapters and applies this framework in subsequent empirical investigations of two firms. The first chapter provides an analysis of the recent federal tax inducements to employee ownership of stock and a subsequent section describes the treatment of voting right and participation as well as labor unions under the current legislation. The potential attractions and pitfalls of this legislation for both employees and employers are analyzed with particular attention given to the considerations of individual employee financial portfolios in relation to employee ownership. Alternative forms of organizations involving employee ownership and participation in oversight and profitability are examined. The concluding portion discusses the macroeconomic and political thrust of recent public policy debates over employee ownership of stock and examines some alternative policy suggestions.

The discussion of economic theory in Chapter II points to four important factors in the decisions of firms to offer and employees to accept employee stock ownership in the employing firm as an ingredient of an optimal employment contract. The implications of employee stock ownership for (1) ownership in the employing firm by employees as part of the preferred compensation package, (2) incentive effects on productivity and information flows in the firm, (3) the potential for participation in the oversight of the firm by stock owning employees, and (4) job and financial portfolio mobility considerations of employees are important considerations that are indicated by a thorough analysis of the literature of the theory of the firm. In firms where ownership shares are not publicly traded, the control of the firm with respect to potential interference by parties outside the organization often is found to be an important consideration of firms adopting employee stock ownership.

Since specific federal tax advantages accrue to plans which qualify under the law, tax induced adoption of employee ownership would be an additional consideration suggested by economic theory. The tax advantages given employee stock ownership in the tax laws could induce acceptance of the plans by firms and employees purely on tax related financial grounds. When the employee ownership plans are used as a substitute for alternative and potentially more expensive ways of providing employee pension plans under regulatory and tax requirements of the Employee Retirement Income Security Act of 1974 (ERISA), the tax and related regulatory financial aspects of employee stock ownership are of increased importance in understanding the motivations for adoption of employee stock ownership in a business enterprise.

The two newspapers predate the relatively recent developments of special tax treatment and standing under ERISA that apply to qualify employee stock ownership plans. As a consequence, these organizations provide an opportunity to focus on the four important theoretical aspects of employee stock ownership rather than recent tax policy, and to study them in a longer time framework than plans stimulated by the tax and regulatory developments of the last decade.

Alone among employee incentive and benefit plans, voting stock ownership arrangements allow employee participation in the oversight process that establishes the goals of the firm. The classical theory of the firm posits profit maximization as the goal of the firm while alternative theories suggest sales and growth maximization or a target rate of return to invested capital as the goal of firm behavior. The choice process in firms that produces the object of maximization is largely unexplored in traditional microeconomic theory of profit maximization and the alternative maximization objectives of the firm more recently prevalent in theoretical exchanges. For this reason, Chapter III explores the applicability of the literature of Pubic Choice in the political process to the goal setting and monitoring process of oversight carried out by corporate boards. The concluding portion of Chapter III expands the theoretical implications of employee participation in the oversight of the firm to both unionized and non-unionized firms.

Chapter IV provides an analysis of the small amount of existing empirical work on firms with extensive employee stock ownership in the United States. Chapter V is organized to consider each of the four non-tax related considerations brought out in Chapter II and to discuss the important implications of the oversight process as suggested by Chapter III in an empirical investigation of long term employee stock ownership in the Milwaukee Journal and the Kansas City Star. In conclusion, Chapter VI discusses the microeconomic implications for organizations considering employee stock ownership and the macroeconomic considerations important to the public policy debate surrounding employee stock ownership.

CHAPTER I

THE LEGISLATIVE AND PUBLIC POLICY ENVIRONMENT OF EMPLOYEE STOCK OWNERSHIP

Employees may be owners of stock in the corporation in a number of direct and indirect ways including profit sharing and stock bonus plans that contain at least some stock of the organization for which they work. Employee Stock Ownership Plans (ESOPs) are intended to invest primarily in the stock of the employing firm and the tax qualified ESOP was first recognized in the law in 1973. The Employee Retirement Income Security Act of 1974 (ERISA) sets forth a definition of ESOPs to be adopted into the Internal Revenue Code which states in part that an ESOP is "designed to invest primarily in qualifying securities" with the purpose "to give the employee-participants an interest in the ownership and growth of the employer's business."[1] In much of the resource literature on employee stock ownership, the term ESOP is used to refer to similar plans that do not qualify for tax breaks but which operate much the same as legally defined ESOPs.

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[1] ERISA, U.S. Code, Vol. 29, sec. 1107 (1974).

The tax qualified ESOP is a particular version of plans which fall under the IRS classification of stock bonus plans. Stock bonus plans have some characteristics in common with other employee benefit plans such as profit sharing, thrift and savings and stock purchase plans, all of which enjoy some degree of preferential tax treatment. The ESOP is a defined contribution plan rather than a defined benefit plan (i.e., the yearly contribution by the employer is specified rather than the benefit amount paid to the employee). Unlike profit sharing plans, the contributions are not necessarily related to profits and are distributable in stocks of the employer company.

A large degree of latitude in plan design is built into the ESOP legislation and the more recent legislation is clearly aimed at increasing the flexibility of these plans. ESOPs are the only plan that can be used as a technique of corporate finance and enjoys the "ESOP loan exemption" from prohibited transactions under ERISA. This means that using an employee stock ownership trust (ESOT) the firm can borrow money to buy a new issue of stocks for employees and write off both the interest and principal payments for the loan on corporate income taxes.

Transactions of an ESOP must be for the "exclusive benefit of the employees" according to the code. The loan could also be used to buy existing shares of corporate stock, in which case no expansionary financing occurs. In either case, the tax deduction of both principal and interest provides a tax subsidy for the adoption of an ESOP utilizing a loan equal to the effective marginal tax rate of the firm.

Three important events occur that relate to the lawful rights of employees participating in tax qualified employee stock ownership plans. First, eligibility for the ESOPs and other qualified employee benefit plans under ERISA must be granted to the employee by age 25 or after one year of service, whichever occurs later. Second, the vesting of employee rights to the benefits of the plan must meet one of several possible criteria prescribed under ERISA. Third, actual distribution of benefits to employees as specified in the design of the ESOP must conform to ERISA.

Eligibility requirements under ERISA allow employees to exclude younger workers under 25 years of age who may be highly mobile. The one year of service rule also prevents participation by employees of any age who do not stay at least one year in the service of the employer.

Vesting of rights to benefits is the event in which an employee actually receives entitlements to benefits from a given benefit plan, but not actual distributions of benefits. If a substantial lag exists betwen the date of eligibility and the vesting of benefits the individual employees are subject to loss of potential future benefits if they separate from the service of firm prior to vesting of benefits. One allowable option to employers designing ESOPs (and other employee benefits plans) is the full vesting of rights after ten years of service with no vesting required prior to that time. In this option the employee receives no benefits under the plan if he leaves the service of the employer within the ten year period. Clearly when benefit plans are considered as part of a total compensation package the associated vesting requirments would affect both the job mobility and financial decisions of the individual employee.

ESOPs as a stock bonus plan are not required by law to provide retirement benefits and the distribution of benefits to participating employees can occur at times other than retirement. Actual distribution of shares may be made after a fixed number of years greater than two, upon participant employees reaching a stated age or upon the occurrence of an event such as: layoff, illness, disability, retirement, death or separation from service with the employer. Distribution of securities from the ESOP is required to begin within sixty days after the latest of the following events: reaching age sixty-five or normal retirement age if earlier than sixty-five, participation in the plan for ten years, or separation from the service of the employer.

ESOPs, as well as other tax qualified benefit plans to the individual, provide the advantage of income tax deferral until the time of actual benefit distribution.

Contributions to the ESOP by the employer are limited to 15 percent of total compensation paid to participating employees. Individuals who choose to participate may be subject to required employee contribution of up to six percent of compensation. Voluntary employee contributions are limited to 10 percent of the individual's compensation. These tax deferred contributions by employees are immediately and fully vested to individual accounts.

The allocation of shares provided by the employer among individual participants in the plans is restricted in the following ways. An individual may not receive stock worth more than the lesser of $30,050 or 25 percent of the individual participant's compensation. Plans often allocate stock yearly to participating individuals on the basis of compensation levels, but clearly the regulations would allow distributions weighted in favor of higher salaried or lower salaried individuals as long as the plan meets the 25 percent individual and 15 percent overall limits. Limits are placed upon plans which are weighted in favor of individuals determined to be "highly compensated."[1] Rules which allow lags in employee eligibility and lags in the vesting of rights to benefits will make yearly stock distributions to employees with tenure on the job relatively higher than they would otherwise be. Long vesting lags have important implications for individual employee decisions about job mobility and financial planning.

A combination of a tax qualified stock bonus plan and a money purchase plan may also meet the ERISA definition of an ESOP. A money purchase plan has a fixed yearly contribution of a specific dollar amount or as a percentage of compensation for the participating employees. Both the stock bonus plan and the money purchase plan require defined contributions from the employer and in combination as an ESOP the essential characteristics of each plan are maintained. The money purchase plan portion of the ESOP is invested and as in a stock bonus plan the performance of the investment determines the beneficial outcome for participants. In a combination of the two plans an employer may deduct contributions of

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[1] I.R.S. regulations under Section 401(a)(5) indicate that determination of whether a plan discriminates in favor of a highly compensated individual depends upon the facts and circumstances of each case. In general, these individuals tend to be officers, major shareholders or others in the firm who enjoy similar levels of compensation. Prentice-Hall Federal Tax Guide, par. 19,492-D through 19,492-F.

up to 25 percent of the annual compensation of participating employees as opposed to the 15 percent overall rule for a stock bonus ESOP.

The Tax Reduction Act of 1975 named a stock ownership plan, called a TRASOP, for Tax Reduction Act Stock Ownership Plan.[1] A firm with a qualified TRASOP may receive a one percent addition to the investment tax credit if the additional one percent is contributed to the TRASOP, resulting in an effective 100 percent tax subsidy for a firm to establish employee stock ownership. An additional one half of a percent investment tax credit is available if employee contributions for stock purchase match that amount. The TRASOP regulations also place more restrictions on the design of the ownership plan. The only securities that can be contributed to the trust are common shares or securities that can be converted to common shares. The stock must have voting rights which must be passed through by a yearly vesting requirement. As a result, the possible forfeitures that may occur with lengthier vesting requirements are

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[1]The Tax Reform Act of 1976 continued this designation. The Technical Corrections Act of 1979 designated such plans as "tax credit employee stock ownership plans". Senate Committee on Finance "recognizes that this type of plan will continue to be known as a TRASOP." Employee Stock Ownership Plans: An Employer Handbook, United States Senate Committee on Finance, by Russell B. Long, Chairman (Washington, D. C.: Government Printing Office, 1980), p. 1.

prohibited. Allocation of shares to individual accounts must be roughly in proportion to compensation. Salaries up to $100,000 may be considered for the allocation of shares.

Clearly there are significant inducements in existing legislation for firms to make employees into stock owners. The leveraged ESOP provides a percentage tax reduction equal to the effective marginal tax rate of the individual firm. The TRASOP provides tax subsidy of 100 percent of stock purchase price for firms which utilize the investment tax credit, in which case the firm bears only yearly administration costs of the plan. Both the leveraged ESOP and the TRASOP allow employees to become owners of stock of significant amounts in a very short period of time, making the issues of incentive effects to employees, labor mobility and corporate control in an ESOP firm important to the performance of the firm. These impacts of employee ownership are important to the remaining public choice question of the appropriateness of tax subsidies to encourage employee stock ownership. Benefits to individual firms organized as corporations are captured partially by the government as corporate income taxes on the firm's income. Externalities not captured by the firm, such as increased support for the political-economic system, are also important to the evaluation of current tax incentives to employee stock ownership.

Voting Rights and the Status of Unions in Current Stock Ownership Legislation

The impact of employee stock ownership on individual firms will depend in part upon the treatment of voting rights by firms and the interaction of plans upon existing institutions in the firm such as labor unions.

Current legislation makes eligibility and participation in the ownership plans a matter for good faith collective bargaining between unions and management. Union employees may elect to receive higher wages instead of greater deferred benefits through an employee stock ownership plan. Clearly, employees who are union members cannot be unilaterally excluded from participation in the plan by employers if the plan is to qualify for tax benefits. The decision not to participate by unions would have importance if the plan is to qualify. Evidence exists that unilateral exclusion of union employees has been used as a means to weaken existing unions or keep unions from forming in some firms adopting various ownership plans. The theoretical discussion in later chapters indicates that if union leadership perceives the stock plan as providing partial substitutes for union services or otherwise weakening the position of the union leadership, they could be expected to oppose employee stock ownership. The decision by unions not to participate in stock ownership plans may have important implications for the expected results of employee ownership plans in unionized firms.

The regulations regarding ESOPs clearly permit, but do not require, the pass through of voting rights of common shares at vesting. Shares that have been distributed to employees may be voted but this distribution is generally at retirement or death. When share votes do not pass through prior to distribution, the share votes are directed by the ESOP fiduciary. This group of trustees or administrative committee is appointed by the employer and may direct the share votes of non-allocated shares held by the employee stock ownership trust (ESOT). Shares of stock held by ESOT may be sizable when the trust holder shares are purchased by a loan in a suspense account. Shares are released from the suspense account as the loan is repaid. In all cases where the stock vote is not passed through to employees the ESOP fiduciary is required to vote the shares "solely in the interest of participants" under ERISA.[1]

In ESOPs in which share votes do not pass through to the individual direction of the employee the role of

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[1]For a particularly concise explanation of voting and vesting and an introduction to the technical aspects of ESOPs and TRASOPs in general see Delloitte, Haskins and Sells, U.S.A., "Employee Stock Ownership Plans: Expanded Opportunities for Employers, Shareholders and Employees," reprinted in U.S. Senate, Committee on Finance, Employee Stock Ownership Plans and General Stock Ownership Trusts, Hearings before the Committee on Finance, United States Senate, on S.3241, H.R. 13882, 95th Congress, 2nd Session, 19, 20 July 1978.

employees in the oversight process as stockholders is ambiguous. For example, consider a situation in which the trustee votes on choice between two courses of action for the firm: one which maintains employment levels and a second which reduces employment but is expected to increase the expected present value of the firm and therefore presumably increase the value of the stock.

In the absence of accurate and detailed knowledge about employee preferences, the voting would not be expected to be representative of the distribution of employee preferences. The interests of outside stockholders and management (particularly if they also hold shares in the firm) would be better served by a decision to maximize the present value of the firm. A vote for the second alternative also would be in line with the "prudent man" requirements of ERISA. It is likely that a board of trustees chosen by management might well vote in a manner consistent with the desires of management and the ERISA fiduciary responsibilities. Such a voting stance is also likely in the interest of employees who retain employment with the firm. When employee preferences are heterogeneous and all shares held in trust are voted the same way, views of part of the employees are not represented as they would be under individual direction of share votes.

A TRASOP, which requires the pass through of voting rights of vested shares to employees and yearly vesting of shares to individual accounts allows for individual voting of shares in the oversight process. A TRASOP thus currently provides no barriers to the employee stock owner's right to control his share votes. The TRASOP is advantageous to capital intensive firms that tend to utilize the investment tax credit; and therefore, while some firms may provide significant dollar amounts of stock to employees by these plans, they are also firms in which the number of shares provided to employees are likely to be a small percentage of total outstanding shares, and the resulting potential impact of employee participation though share votes may be small. The voting right attached to the stock may have a very low value to individual employees or organized employees as a group if the potential impact of exercising the vote is expected to be negligible.

The property right to sell shares (right to corpus) may be restricted under both an ESOP and a TRASOP.[1] The

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[1]The right to sell may be separated from various rights to control in the property rights bundle. Particularly under an employee stock ownership trust (ESOT) arrangement the right to sell may be subject to a right of first refusal of purchase by the trust or the firm. Likewise the right to control bundle may be constrained; for instance when the voting stock held by the trust does not pass through voting rights to vested employees in an ESOP. For a discussion of this topic see "Employee Ownership" (Report to the Economic Development Administration, Department of Commerce, Project Number 99-6-09433, by the Survey Research Center, Institute for Social Research, University of Michigan), reprinted in Ibid., pp. 309-333.

terms of the stock ownership agreement may give the employer and the ESOP or TRASOP a right of first refusal on any sale of shares by the participant after he receives his share distribution. The regulations require that the employer offer a set option for shares distributed to an employee when the stock is not publicly traded. These transactions take place at fair market value which is defined as the market price for publicly traded stock. If no market valuation exists, the stock is valued subject to IRS regulations or the terms of a third party good faith offer to buy.

Tax incentives to employee stock ownership extend the "sole benefit" criteria of employee benefit plans to provide advantages to firms. The role of ESOPs envisioned in the legislation is clearly a dual one that goes beyond the provision of retirement benfits and clearly encourages stock ownership as an incentive program for workers. Tax benefits offset at least some of the employer's cost of these benefits when they take the form of stock in the employing firm, while the tax advantage of deferral of income taxes provides an incentive for employees to demand relatively more of their income in this form of fringe benefit than they otherwise might. The discussion attending the ESOP legislation clearly envisions benefits to the employer as well as the employee and also assumes benefits that will accrue to the federal government through increased taxes collected from employee owned firms if they perform in a manner superior to regular firms.

If the expectations of superior performance are fulfilled, then the results of increased employee stock ownership will aid the macroeconomic public policy goals of more efficient manpower utilization, accelerated economic growth, and control of inflation. Explicit in the legislation is the desire for increased citizen support of a private property free enterprise system and implicit is increased support for the political system so closely intertwined in the operation of the economic system. A thorough examination of externally based arguments for ESOP tax breaks to firms is sufficient material for another research project. The existence of the tax incentives and legislation has resulted in increased incentives for corporations to implement substantial increases in employee ownership of stock in the employing firm and has therefore substantially increased the need for discovery of precisely what changes occur when employees become owners of significant amounts of stock in the employing firm. In this section the investigation of the incentives to individual choice in the area of financial management is undertaken as an aid to predicting the expected behavior of individuals, firms and the macroeconomic economy under increased employee stock ownership.

The value of any stock ownership plan is determined by all forces affecting the value of the firm and therefore the value of the stock. Employees are entitled through stock ownership to a share that theoretically reflects the present discounted value of all future income flows to the firm--flows which are affected by the actions of employees, the actions of management, and many actions outside the control of individuals working in the firm. ESOPs provide the possible motivation of ownership but the value of ownership is subject to variatons from causes exogenous to the firm. Unlike profit sharing, when employees continue to hold stock, unrealized capital gains from previous periods of work may disappear as new expectations are formed about the future cash flow of the firm. Partial implicit compensation for these risks borne by any stockholder is provided by the right to participation in the control of the firm. These rights may be considered to have positive value to employees who invest time in exercising the right of participation in the oversight of the firm.

Since stock prices reflect (properly discounted) anticipated future profits of the firm, the positive or negative motivational effects of employee ownership are captured by employees as a group in proportion to the percentage of total outstanding shares that the group holds.

The stock ownership therefore internalizes to employees some portion of the results of their actions, but also subjects employees to externalities (negative or positive) that result from the other factors that affect the firm's expected future cash flow and the resulting stock price.

In an employment environment marked by employees with given skills and a number of firms offering compensation packages with various levels of stock ownership (including zero), it is expected that employees choosing a firm with a given portion of total compensation in the form of employing firm stock would be those employees who value that level of stock ownership most highly. Individuals holding stock that they valued negatively would require at least an offsetting compensating increase in some other aspect of the compensation package.

The benefits to employers include, in addition to any tax savings, the employer captured portion of any changes in production levels resulting from stock ownership by employees. If the benefits to employers were judged to be negative, then employees would be offered a lower total compensation package when it included stock. The compensation packages observed in the real world contain appropriate positive or negative compensating differentials to the employees net of positive or negative compensating differentials required by the employer as a result of employee participation in ownership of the firm. Firms that offer a compensation package including employee stock ownership would tend to attract the employees who valued that feature more highly than other workers with similar skills. Employers would tend to be those individuals who valued worker participation in ownership more positively (or less negatively) than employers at other firms.

Employers could be, of course, owners who did not participate in the day-to-day management, but rather hired managers to run the firm. In the case of employer (owner) hired managers, the concept of compensating differentials is again applicable to the determination of management compensation, and the firm would tend to attract hired managers who tended to have relatively higher positive (or lower negative) evaluations of managing stock owning employees.[1]

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[1]For a discussion of the relationship of manager utility to worker participation see: Alfred Steinherr, "On the Efficiency of Profit Sharing and Labor Participation in Management," The Bell Journal of Economics, Vol. 6, No. 2 (Autumn 1977), p. 547. Bellas (1972) found that the manager of cooperatively owned plywood manufaturing firms tended to have a specialized personality make-up. In the present context they would be those individuals among all managers who experienced the maximum utility (or minimum disutility) as a result of ownership of shares by employees. Carl J. Bellas, Industrial Democracy and the Worker-Owned Firm: A Study of Twenty-One Plywood Companies in the Pacific Northwest (New York: Praeger Publishers, 1972), pp. 85-87.

The lack of diversification of employee holdings of stock and the restriction on stock sale in an ESOP impose opportunity costs on employees in the form of the higher risk of holding an individual security. Two components of risk exist in an individual portfolio: market (systematic) risk which is positively correlated with the movement of the market and cannot be diversified away; and, non-market (non-systematic) risk associated with an individual security. Diversification normally allows the portfolio owner to eliminate non-market risk of an individual stock and, therefore, this risk is uncompensated in market evaluations of securities.[1] An individual holding a non-diversified portfolio thus suffers a deadweight loss if he is risk averse.

The employees hired by a firm with an ESOP should tend to be employees who require the least compensation to hold a portfolio heavily weighted with shares in the employing firm. Thus an ESOP would attract individuals who value the benefits of ownership in the employing firm relatively more highly and also individuals who are less averse to risk. Compensation of this additional risk may occur within the individual calculus of the worker if he values other aspects of stock ownership highly enough.

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[1]For a concise explanation of this, see Richard A. Posner, Economic Analysis of Law, 2nd Edition (Boston: Little Brown and Company, 1977), pp. 315-324.

If partial ownership in the firm by its employees results in net positive benefits in output by the firm, then the firm could be expected to provide compensating differentials to employees who hold portfolios with relatively large amounts of employee stock. If individual firms tend to specialize and attract employees with relatively homogeneous preferences for stock ownerhsip and risk, but these preferences vary across the labor market, then the compensating differential required to induce employees of a greater number of firms to hold stock will increase while the gains of the firms from the stock ownership may remain constant or decrease. If at some point costs outweigh benefits, then stock ownership would not be a part of the efficient compensation package in a portion of these firms. Within each firm, assuming decreasing marginal productivity from incremental units of stock in the hands of employees, some optimal level of stock ownership within each firm should obtain.

In summary, firms offering compensation packages that include employee stock ownership in the employing firm as a motivational device may wish to include compensation for systematic market risks and also for at least a portion of non-market risk that is absent in a plan funded by a diversified portfolio. Non-market risks for firms can be caused by any of three sources: (1) events outside the influence of the firm but which are not market-wide, (2) events inside the firm but not controlled by employees, and (3) events controlled by employees. An optimal compensation package would also insulate or compensate employees for reasons one and two listed above. Employers might want to insulate employees from the costs associated with events inside the firm not controlled by employees in the interest of employee relations since the responsiblity for such costs rests ultimately with management. An optimal compensaton package would also insulate the employees from (or compensate them for) costs that are both market and non-market related but which have a source that is exogenous to the firm. For example, a decline in overall demand in the macroeconomy, a drop in industry demand for the product of a particular firm and an increase in the costs of inputs by outside suppliers are all sources of external costs to the firm which are not related to employee productivity. In this instance, any resulting reduction in the stock value is a negative incentive to employees.

This line of reasoning also suggests that a normal observed business practice of a layoff of some employees is more efficient than a reduction in the payment to all employees in the absence of strong independence of utility functions among workers. If, in fact, workers prefer reduced benefits (including a lower stock price) to the laying off of fellow workers, then such a course of action is preferred from a motivational (efficiency) aspect. This sentiment, if expressed to management, can be taken into account by employers in their response to changes in the firm demand for labor, and there are examples where employees have elected to take temporary cuts in pay to avoid layoffs for some of the work force.

Externalities and Incentive Plans

The existence of market risks and non-market risks external to the control of the firm impose potential costs on workers for which employers are often unwilling to compensate employees. Since the cause of at least a portion of the cyclical disturbances in the economy and disturbances in individual industries can be traced to governmental fiscal and regulatory policies, attempts to reduce the disincentive effects of these disturbances may be justified. This provides an argument that favors some form of government relief for incentive plans such as stock ownership and profit sharing that are affected by government policy. Any additional positive externalities generated by employee stock ownership but not captured by the firm (for example that portion of improved profitability paid in taxes) would also provide an argument in favor of a lower tax burden on stock owned by employees. The benefits of increased support for the existing political-economic system are widely cited to society by proponents of tax breaks to employee stock ownership.

Marginal tax rates on individual income, of course, reduce the benefits to the firm of providing employee stock ownership as well as other incentives to increased marginal productivity by employees. To avoid allocational distortions, tax breaks for ESOPs that are larger than those given to other forms of compensation must be based on the externalities of employee stock ownership discussed above that cannot be captured by the firm. Since these benefits are not captured by the firm, individual employees who exhibited increased support of the system as a whole would not necessarily be the individuals who responded with increased productivity in the firm with ownership, but it is quite possible that the two traits are highly correlated. If this is true, then firms which offer stock ownership in the absence of tax breaks are also producing as a joint product, the public good of increased support for the system, but at suboptimal levels. Also, if the two traits are highly correlated the response of imposition of tax subsidization of ESOPs would tend to offset part of the marginal costs to the firm of providing the public good. The marginal benefits to the firm of increased stock ownership would depend on the slope of the marginal benefit curve in the relevant area where the subsidy shifts the marginal cost curve downward. Tax subsidies would thus induce different levels of ownership in different firms and perhaps zero stock ownership in some firms.

Considerations of portfolio balance and corporate control are also important to owners who consider employee stock ownership. Closely held firms allow control of a corporation by one or a few owners but may make these individuals' portfolios unbalanced. Sale of stock on the market (going public) can result in loss of corporate control and also may subject the firm to more government regulations such as filing with the Securities Exchange Commission. The ESOP can represent a way for a private firm to remain private or a publically held firm to "go private" particularly in plans which do not pass through voting rights to employees. It has also been used to spin off a division of a larger corporation and sell it to the employees when other ready buyers may not exist.[1] The leveraged ESOP allows a large

[1] This was the case of South Bend Lathe, spun off of Amsted Industries and sold to 500 employees using a loan from the Economic Development Administration of the U. S. Department of Commerce.

change in ownership structure of a firm to be accomplished quickly. Many benefits exist for closely held firms in special situations such as settling the estate of a major shareholder. These tax advantages are in addition to any advantages the firm expects to gain through motivational effects of employee ownership as part of a well designed compensation package.

Externalities and Employee Stock Ownership

The previous discussion indicates that stock ownership may occur as a result of the decisions of individuals associated with specific firms. If substantial positive or negative externalities result from employee stock ownership, then the level of stock ownership resulting from the decisions of persons wholly within the firm may not be optimal from a broader perspective of the local, regional, and national level. The locality (and to a lesser degree the region) of a plant would receive the most immediate impact of any change in productivity resulting from employee stock ownership in a particular firm. Less specific externalities such as greater or lower interest by employees in the welfare of the community could result from employee ownership of a part of his place of employment. In the situation of a marginally productive plant, increase in productivity resulting from employee stock ownership could make the difference between a viable source of employment for the locality or a plant closing that results in the decline of the local economy. Both individuals and governments in a locality experience positive results from viable local industries through the circular flow of incomes and any attendant taxes on economic activity.

If the local externalities of employee ownership of local business are substantial, a locality may desire to provide some kind of subsidization or other encouragement. This has been suggested for localities that face a shutdown by a major employer where the loss of jobs, and potentially population, affects all local institutions including businesses, religious organizations, private clubs, and governmental organizations. If community as well as employee ownership replaces extra-community ownership of a firm, then many of the relevant externalities become internalized through ownership. If economic externalities as well as the preferences of people to live and work in a specific geographic location are great, they may be willing to take a return on investments and jobs at a local plant that is less than the competitive rate of return elsewhere. If worker and community ownership results in better oversight of firm management, then rates of return after the change in ownership may be competitive locally and nationally. If the plan does not result in sufficient substantive change in a marginal plant, then the plan represents only a delay of an economically efficient plant closing.

An assessment of regional ownership also relies on the costs and benefits to the region from a given business firm. More specifically, at the state level politicians generally dislike high levels of unemployment that reduce economic activity, taxes, require unemployment compensation, and make voters more likely to replace incumbents. These kinds of concerns are reflected in the substantial incentive that states and localities provide to lure new businesses.

Implementation of local and regional subsidies to attract and retain employers, which may be rational from the local and state perspective, may result in a negative externality at the national level. The mobility of labor is important to efficent allocation of that resource.
If employee ownership or community ownership improves the internal efficiency of a plant through better oversight or because morale and productivity are better, then it is potentially efficient.. Even local ownership for local industries that results from positive personal preferences of individuals to live in a particular area is potentially efficient if individuals voluntarily accept any lower than

average returns on the investment in order to work in a particular community.

Local and state governments, however, benefit most immediately from the taxes that they levy on businesses within these borders. If the prevailing tax rate is driving a marginal firm from its borders,the state or locality has an incentive to reduce the tax burden on that firm.

The resources represented by that firm may be more productive in another location or perhaps in another organization producing a different product in the same location, but politicians tend to be risk averse to a plant closing even when the second scenario seems the likely outcome of the event. In effect, it is rational marginal analysis for politicians to say better reduced revenues than a high probability of no revenues from a given set of resources. Also, since population is an important determinant of the power, prestige, and transfers that can be commanded by the politicians for a given region or state, they will resist the loss of any marginally profitable part of their constituency. For example, the greatest support for a bailout of an ailing firm such as the Penn-Central Railroad, Lockheed Corporation, or Chrysler Corporation seems to come from the politicians in the states where the firm is most heavily concentrated.

The federal government, on the other hand, has an incentive to promote efficient allocation of resources within its borders because it collects taxes from all the states, and efficient production is a federal tax maximizing strategy.[1] Calls for federal assistance to promote employee ownership of a firm that is not efficient (or any other subsidy to an inefficient producer) as a way to save jobs may actually be an invitation to subsidize a reduction in the net creation of jobs in all the states.[2] Community investment would provide some incentive for efficiency since the community would benefit from more local persons being employed. Existing employees at a firm have incentives to keep the firm in business, but also to restrict the level of employment in the firm in order to maximize income per employee.

The community has an interest in increasing total employment and, when given a choice, in promoting efficient firms over inefficient firms within the locality. The

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[1] The Federal government faces a set of incentives analogous to that of a locality or state when it deals with the rest of the world in the absence of a binding collective agreement among countries for free trade. Note the intense political pressure generated for government subsidy of production for export and protection against imports in almost all countries.

[2] See for example: "Employee-Community Ownerhsip to Save Jobs When Firms Shut Down." Congressional Record, Vol. 124, No. 94, 19 June 1978. This testimony by William Foote Whyte emphasizes the importance of questions about long run viability of employee owned firms and the absence of in-depth studies on the subject.

community would opt for an inefficient firm in the community over an efficient firm somewhere else in the country because of the local externalities to employment and economic activity. States would tend to favor plans which increased employment and economic activity within the state. Efficiency from the perspective of the country demands the allocation of labor among the states subject to allowances for the geographic preferences of individual citizens.[1] These geographic preferences would tend to be absorbed into prices such as wage rates and property values in the absence of constraints on these markets.[2] Important to consider is the distinction between promoting employee ownership if it increases productivity in firms regardless of location in the country and a program that promotes geographically selective incentives as a policy that may not necessarily yield net positive benefits to the country.

The issue of geographic preferences may be implicit in the argument for employee stock ownership to increase the support for the free market and the political system. Individuals may be less favorably disposed toward a system

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[1]It is not surprising to find that a group of senators and congressmen called the Northeast-Midwest Congressional Coalition seek more federal aid to halt the decline in their areas of the country.

[2]Unions appear to constrain the adjustment of relative wages that might be expected over time in the Northeast and Midwest.

that requires uprooting of family from familiar surroundings. Pressures on the economic and political systems may develop not only in areas that tend to lose population rapidly, but also in the rapidly growing areas that receive population. The promotion of employee stock ownership in only specific areas of the country or in specific industries will likely lead to production inefficiencies. If stock ownership is targeted toward established industries which are tending to decline in importance, then capital misallocation will result. Recent history has suggested that a disproportional share of innovation and growth comes from smaller firms in newer industries. If employee stock ownership has a motivational impact, it may be most important in these smaller innovative firms. The existence of geographic preferences by employees seems to provide insufficient justification for propping up failing firms in less productive industries since employees have ample opportunity to express their geographic preferences in differential supply prices of their labor.

Alternatives to Stock in the Employing Company: Some Macroeconomic Considerations

The previous discussion has suggested that substantial investment in the firm that is also the source of employee's job may pose serious problems of financial risk for workers.

As part of support for employee stock ownership plans is based on expected macroeconomic and macropolitical benefits, it is prudent to consider alternative ways to broaden the ownership structure of private sector productive capacity. Chapter II discusses the potential dilution of possible incentive effects of stock ownership as the risks and rewards are shared over larger groups. For the macroeconomic and macropolitical components of desired results from broadened stock ownership a more diversified stock ownership structure for individuals may be preferred.

Kelsonian Macroeconomics

The primary intellectual force for tax incentives for the concept of ESOPs, Louis O. Kelso, has written extensively on the macroeconomic as well as microeconomic aspects of increased stock ownership. Kelso recognizes the problem of risk to the individual worker's portfolio and suggests risk policy as a form of insurance at the national level through a Congressionally created insurance fund called the Capital Diffusion Insurance Corporation. In the spirit of Irving Fisher he suggests that associated interest rates will reflect a premium to cover average risk. His concept is clearly aimed at directing incentives (and direct government allocation of capital) toward "self-liquidating new capital formation" financed by what is called "pure credit."[1] Kelso clearly seems to be making arguments that precede but resemble some of the notions labeled under the rubric of supply side economics but apparently supports a good deal more government involvement and direction of the process.[2] What seems to be missing is a discussion of the possible disincentive effects of complete or partial insurance against the risk of financial loss in the purchase of stock generally referred to as moral hazard. This proposal of risk sharing does leave open the potential positive incentive to employees of capital appreciation of stock prices net of insurance costs in the event that the enterprise does extremely well. In a sense, the risk sharing can be looked at as an extension of the protection represented by bankruptcy laws and the limited liability of corporate form of organization.

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[1]Louis O. Kelso, testimony found in: Employee Stock Ownership Plans, Hearings Before the Joint Economic Committee, Congress of the United States, Ninety-Fourth Congress, First Session, Part 1, December 11, 1975, pp. 162-163.

[2]Kelso's implication for the price elasticity of aggregate supply in relation to credit creation seems to be another issue that would be of importance in evaluating his proposals.

Alternative Forms of Business Enterprise - Partnerships, Cooperatives, Business Trusts and Corporations

Individuals in small numbers are able to have pooled resources and risk through partnerships, and this method of organization has proven adequate for many enterprises which tend to be labor intensive. Raising large amounts of investment capital in relatively more capital intensive enterprises often is accomplished more readily through other forms of organizations in which there is diversification of the sources of capital. Tax treatment and the extent of individual liability are other factors which tend to discourage partnerships in many undertakings involving more than one individual. Even when a firm is closely held by a few individuals, alternative structures are often preferred because the different levels of activity by various individuals are not in keeping with the highly personal relationship that the management of a partnership implies. Limited partnerships are a recognition of this potential variation in involvement where both the management rights and the financial liability are limited for some partners.

An alternative form of organizaiton with a separate standing in the law are agricultural cooperatives which have been expected to provide an alternative to the corporate form of organization and to retain smaller, more local ownership and control of production and marketing of agricultural goods. The reality of cooperatives is that they have often tended toward growth to sizes comparable to their corporate competitors and for many of the same reasons, some of which involve expected economies of scale.[1] Cooperatives of workers in industrial production also have been tried extensively in the United States with efforts dating back to late Nineteenth Century when the Knights of Labor established over 100 production cooperatives. These cooperatives received outside infusions of capital but faced a number of problems that often led to their failure.

> Cooperative enterprises that proved financially successful tended to lose their cooperative features until they more closely resembled closely held stock companies with a few shareholders (sometimes still working in the plant) and a large number of non-owner workers employed with no opportunity to buy stock.[2]

With the growth of the agricultural cooperatives it may be that much of the local control and participation in the organization will be lost.

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[1] See for example "Farm Co-ops Aim at a $3 Billion Merger," Business Week 4 August 1980, p. 24.

[2] Katrina Berman, Worker-Owned Plywood Companies (Pullman: Washington State University Press, 1967), p. 12.

Cooperative ownership of large organizations is more comparable with the ownership structure of larger corporations. From a macroeconomic standpoint a valid comparison could be made between the distribution of ownership shares in cooperatives among rural farming families and the distribution of shares of industrial corporations among those families employed in industry. One important result of such a comparison would be to point out the more macroeconomic and political concerns that underlie legislative attempts to increse the ownership of shares among both rural and urban citizens. It is not surprising to find that Senator Russell B. Long, who has been the prominent force in the legislation aimed at increased employee stock ownership, would also be supportive of the concept of the broadened ownership structure represented by cooperatives.

> I have always believed in farmer cooperatives. They represent one of the major achievements in self-help, and are a vital part of our capitalist system.
>
> They provide the marketing support, production supplies, and critical financing needed by our family farmers to feed this country and much of the world. I would oppose any attempt to weaken or reduce the effectiveness of cooperatives.[1]

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[1]Senator Russell B. Long in a public speech 24 April 1980 quoted in an advertisement by the National Council of Farmer Cooperatives, Washington Post, 15 September 1980, p. A-4.

Cooperatives would raise the same kinds of questions asked about corporations in this dissertation: Does ownership associated with some sort of participation in an organization (worker or resource supplier) make a difference in the way the organization performs and if so, how?[1]

If the benefits of increased dispersion of organization ownership are not a result of ownership in the organization that an individual is most closely associated with in his work, then alternative schemes of broadened ownership, which reduce portfolio risks to workers, should be considered.

Business trusts represent a form of organization that limits liability and specifically excludes those who have beneficial interest in the firm held in trust from exercising management control. The trustees have the exclusive right to manage the firm as well as personal liability for business debts but the liability can be reduced by

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[1]Buyers of products also have a relationship with the firm and information about the performance of the firm. Some of this information is reflected in demand patterns in markets. Additional information may be revealed by involvement of buyers in the monitoring process. See Nancy L. Jacob and Alfred N. Page, "Production, Information Costs, and Economic Organization: The Buyer Monitoring Case," American Economic Review 70 (June 1980): 476-478.

a number of legal actions and by insurance.[1] In such a case the rights to residuals is separated from the right to manage which is concentrated in the hands of the trustees.

The business trust accomplishes in law what is alleged to happen in fact in large corporations: the separation of actual management from residual claimant status, but further takes away the potential for exercise of the oversight role of control.

Corporations create a full separation of individual shareholders from extensive liability by recognition of the corporation as a separate entity while shareholders retain management rights through a representative system that allows them to elect a board of directors. This form of organization is well suited to individuals who own a small percentage of total shares in larger organizations because it lowers the cost of representation of their interests.[2]

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[1]Len Young Smith and G. Gale Robertson, Business Law, Fourth Edition (St Paul: West Publishing Co., 1977), pp. 699-700. A trust set up by the Kansas City Star for stock ownership in 1926 provided certificates of participating interest in lieu of actual stock ownership so control of the organization was by the trustees. This trust was influential in the design of a similar trust for the Milwaukee Journal.

[2]This is the business analogue to the economic analysis of representative democratic government. The use of direct decision making becomes costly in any but closely held firms with a small number of stockholders. See James M. Buchanan and Gordon Tullock, The Calculus of Consent, Logical Foundations of Constitutional Democracy, (Ann Arbor: The University of Michigan Press, 1964), pp. 213-222.

In corporate decision making a simple majority rule is often used in an attempt to lower the cost of decision making in electing board members or making corporate decisions. Changes in the articles of incorporation (which is analogous to a constitution in a representative democracy) often require a larger majority; often a 2/3 majority.[1] If the analogy to the political system is correct, then increased costs can be expected as the number of participants to corporate decision making rise while diversification of individual portfolio assets reduces the incentive for an individual stockholder to invest resources in the decision making process. If lower costs of production can be obtained at higher outputs and bigger plant sizes due to economies of scale then ways to counter the accompanying increase in stockholder decision making costs would be sought as the organization grows.

In both cooperatives and corporations the important macroeconomic questions require a microeconomic analysis of the impacts of ownership and control on the individuals

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[1]In common law the decision making rule for all corporate decisions was unanimity. As the courts retreated from the rule of unanimity to a simple majority rule as the number of shareholders per firm increased the established remedy for minority stockholders became the cash value of the stock.

who have rights in these organizations. If the incentive effects resulting from ownership of shares by employees in a number of organizations produces at least equal productivity increases when compared with the results of employee or ownership and control of a particular organization, then from a macroeconomic standpoint there are important alternatives to corporations with ESOPs and cooperatives. Working business trusts are examples of organizations where the ownership issue is separated from corporate control while profit sharing and stock ownership schemes which involve multiple companies provide a comparative alternative with which to gauge the importance of ownership of a particular organization vis-a-vis a number of organizations and the attendant pooling of financial risks.

Alternative Forms of Incentive Plans

All alternative incentive plans to employee stock ownership provide some degree of portfolio diversification. This section starts with alternatives that are closest to ESOPs in nature and proceeds to those that are directed at larger aggregate groups. The expansion of the benefiting group beyond the employees of a single firm to include the citizens of a state or nation is considered.

Profit sharing plans often offer the ownership of shares of a number of different organizations through a trust financed with profits from the employing firm. A profit sharing trust can own limited amounts of own company stock so that a continuum of options exists from only an ESOP to the combination of a profit sharing plan with an ESOP and ending with only a profit sharing plan that contains no own company stock. A fully diversified profit sharing trust represents a diversified alternative to a trust invested solely in own company stock where the vote does not pass through such as an ESOP or business trust where trustees control the vote. Profit sharing plans may not pass through voting rights, even on the own company stock in the portfolio, and thus the participation issue is eliminated leaving only structure of portfolio as a potential variable for investigation for any given set of employees.

To separate the issue of participation in the oversight of the employing firm from the issue of ownership and residual claimant status, investigation of worker participation in the management of European firms can be undertaken. In the European case the legal system allows a separation of control from ownership that is not consistent with property rights structures in the United States. An applicable example in the United States would require investigation of firms where voting rights have been voluntarily put under control of non-owning employees, for example, significant amounts of stock put into a trust with employees as the trustees controlling the vote.

To investigate the implications of benefit plans where the number of plan participants is allowed to increase beyond the employees of the firm, multi-employer pension and benefit plans and industry-wide or geographically organized union benefit schemes are of interest. Such plans provide instances where the focus is clearly beyond the individual firm or any group of its employees.

The western European history features many instances where plans for stock ownership, profit sharing and/or participation in management have been suggested for industry-wide groups or all citizens of a country.[1] A plan that covered all citizens of the countries belonging to the European Community would be comparable in size to a plan covering all citizens of the United States.

Two important aspects of the possible incentives of employee stock ownership plans are the monetary value of the stock and the voting rights that come with the stock.

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[1]For a review of the European situation see "Prepared Statement of Hans Brems: Wage Earners' Investment Funds-Alternative Forms and Their Economic Effects" in Employee Stock Ownership Plans (ESOPs), Hearings Before the Joint Economic Committee, Congress of the United States, 94th Congress, 1st Session, 11 December 1975, Part 1, pp. 524-526.

One possible way for employees to obtain voting rights in the firm without upsetting individual portfolio diversification or usurping the property rights of current shareholders is to create a pool of shares in various firms held by the employees of those firms and allow trade of proxy rights between the members of the pool. This allows the reduction of market risk by diversification, but may reduce the work incentive effect of stock ownership in the employing firm. This type of scheme represents a way to obtain worker participation in the oversight of the firm under existing property rights structures, but is probably best suited for those firms where (1) discretionary effort on the part of an individual employee is less important, (2) risks associated with employee actions as a group tend to be small in relation to other non-market and market risks, and (3) managers are relatively favorably disposed to employee input into the oversight process. Profit sharing is an alternative scheme for consideration by firms where voting rights in the hands of employees do not produce net benefits in the firm.

Broadly based stock ownership plans and profit sharing plans have been suggested for the United States. Peter Drucker argues that they already exist in the form of pension funds and that by 1985 over 50 percent of all U.S. equity capital will belong indirectly to U. S. workers through their pension and benefit plans.[1] The connection between pension funds and the average U.S. worker's stake in the stability and efficiency of the private sector of the U.S. economy is not often made, perhaps in part because neither the public servants nor corporate executives wish to draw attention to the overhang of unfunded pension liabilities and the erosion of purchasing power of pension benefits denominated in fixed nominal dollar amounts. The connection between the efficiency and productivity of the system and the value of any benefit fund for workers would have to be clearly established to individual workers if the positive macroeconomic effects desired from the plans are to be realized.

The goal of increased support of the political process might also be attempted through a more direct participation by workers in the allocation of tax revenues. Several authors have suggested plans that reduce the bias of the political budgetary process to spend public revenues excessively on public projects rather than effect more efficient direct redistribution of funds.

At the state level, Alaska has instituted an annually distributed dividend to be paid from oil lease reserves

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[1]Peter E. Drucker, The Unseen Revolution (New York: Harper and Row, 1976), p. 1.

and various other revenues from the production of crude oil in Alaska. This plan approximates profit sharing on the rents accruing as a result of production using the natural resources of the state as inputs.[1] This plan clearly encourages the state's citizens to use the dividends for personal saving or the purchase of private goods as opposed to government supplied or produced goods. The plan features no real linkage between individual production of oil (the source of the tax) and benefit amounts.

National budget referenda that provide a voting mechanism that allows a cash redistribution of tax revenue to all citizens of the country have been suggested as a way to allow the redirection of federal revenue by individuals in a way that does not promote free-riding by taxpayers.[2] In this proposition, the source of the benefit fund (taxpayers) is linked in an efficient way to the distribution procedure of the fund in a more voluntary manner suggested by the work of Wicksell.[3] The referendum process allows voters

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[1]"Alaska Abolishes State Income Tax, Promises Rebates", Washington Post, 17 April 1980, Section 1, p. A-10.

[2]Randall G. Holcombe and Paul C. Taylor, "Tax Referenda and the Voluntary Exchange Model of Taxation: A Suggested Implementation", Public Finance Quarterly 8 (January 1980): 107-114.

[3]Ibid., pp. 107-108.

to allocate their tax dollars among various broad categories of public goods and also to vote a portion of taxes to a common pool for redistribution in the form of a cash distribution. Such a plan would help to counterbalance the tendency of the public sector to grow as a result of taxpayers' attempts to capture public resources through the political process. Since redistributions can occur in cash expendable for private goods and savings, at least a portion of such redistributions would be saved or invested and provide the basis for capital formation.

Another suggested way to reestablish links between taxes and macroeconomic incentives for capital formation is the National Dividend Plan devised by John H. Perry, Jr.[1] This plan suggests placing all corporate income tax revenues into a National Dividend Trust to be distributed among all registered voters. The trust fund would be reduced by any federal budget deficit providing a direct link between benefits of government programs and direct costs to taxpayers to be reestablished in the fiscal exchange setting of Wicksell. The plan also suggests elimination of personal income taxation

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[1] John H. Perry, Jr., "How to Control Inflation through Earned Profit Sharing", an address to the Second National Forum on Jobs, Money, and People, December 8, 1978, published as a pamphlet under the same title (Riviera Beach, Florida: Fiscal Policy Council, 1979).

of corporate dividends which would stimulate broadened stock ownership among citizens. Since the corporate income tax is the source of the national dividend, a broader constituency for capital formation through private corporate enterprise could be established.[1] The plan also suggests putting a ceiling on the tax rate on the corporation to avoid any disincentive to capital investment and suggests a moratorium on new federal expenditure programs while the National Dividend Plan is established.[2]

The National Dividend Plan and direct voter participation in the budgeting process through referenda are attempts to "align the voter with the free market system," a sentiment similar to Senator Long's expectation for ESOPs.[3] All three ideas are compatible and suggest that reestablishment of the link between costs and benefits of various outcomes in the firm or in the political process can encourage a more efficient voluntary exchange process.

Stock ownership, capital formation, employment and growth could be encouraged to various degrees through such institutional reforms as discussed above. ESOPs attempt

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[1]Ibid., p. 15. Discussion of this plan by numerous scholars is found in: Martin R. Gainsbrugh, ed., <u>The National Dividend Plan, Pro and Con</u> (New York: The Conference Board, 1971).

[2]Ibid., p. 14.

[3]Ibid., p. 15.

to reestablish the link between costs and benefits of individual or collective employee actions in the firm. The National Dividend Plan and budget referenda attempt to link costs and benefits of citizen actions through the collective choice process of government. Innovations aimed at increasing aggregate efficiency through restructuring of the incentive systems faced by individuals as workers and voters are necessary if public policy goals of greater productivity and employment are to be sought by voluntary action.

CHAPTER II

ECONOMIC THEORY AND EMPLOYEE STOCK OWNERSHIP

The previous discussion suggested that four important issues involved in employer and employee acceptance of employee stock ownership plans are (1) preference for ownership in the employing firm by employees as part of the compensation package, (2) incentive effects on productivity and information flows in the firm, (3) the potential for participation in the oversight of the firm by stock owning employees, and (4) job and portfolio mobility considerations of employees. The purpose of this chapter is to apply the existing theorectical research on the firm to the particular case of firms in which employees are stockholders. The participation issue in firm oversight is not addressed by traditional existing theory and for that reason Chapter III is devoted to adapting research in other disciplines notably Public Choice and Industrial Relations to understanding the decision process that produces a set of objectives to be pursued by the firm.

The theoretical basis for analysis of Employee Stock Ownership Plans assembled here contains component parts from the early literature beginning with Marshall (1925), Knight (1921), Schumpeter (1942), and Coase (1937).[1] Many of the ideas portrayed as conflicting in the literature prove to be complementary in this analysis. For example, both Knight's notion of the importance of uncertainty in determining the residual claimant and Schumpeter's competing theory based on factor mobility help explain which factors of production might choose residual claimant status.[2]

Although the contractarian framework of Alchian and Demsetz (1972) is found useful, the analysis here is a synthesis of the literature that often points to conclusions

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[1]Alfred Marshall, Principles of Economics, 8th edition, (London: Macmillan and Company, 1925). Frank H. Knight, Risk Uncertainty and Profit (Chicago: University of Chicago Press, 1971), originally published 1921 by Houghton Mifflin Company. Joseph A. Schumpeter, Capitalism, Socialism and Democracy (New York: Harper and Brothers, 1942). Ronald H. Coase, "The Nature of the Firm," Economica 4 (November 1937): 386-405.

[2]Schumpeter (1942) in Capitalism, Socialism and Democracy argues that the immobile factor (capital) bears at least part of the risks of failure. Mueller (1976) extends the mobility notion to all factors. Both relative preference for risk and immobility are plausible explanations for employees' opting for residual claimant status, particularly the extreme case where pension assets are invested in the employing firm. Dennis C. Mueller, "Information, Mobility and Profit," Kyklos 29 (1976): 419-448.

in conflict with theirs.[1] The extension of the Marshallian notion of joint supply by Buchanan (1966) to cover externalities is important in explaining the impact of worker produced information whether it is sought by management or ignored.[2] The citation of literature following is restricted to topics that contribute to the analysis of employee stock ownership in the firm.[3]

The existence of substantial tax inducement could persuade firms to adopt employee stock ownership plans even if the plans were expected to produce no benefits that could be captured by the firm other than a reduced tax burden. Firms are observed in the real world to have adopted employee ownership in the absence of the current stimulus provided for ESOPs and TRASOPs based on externalities. The evaluation of benefits to society of increased employee ownership, particularly in relationship to the ownership

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[1]Armen Alchian and Harold Demsetz, "Production Information Costs, and Economic Organization," The American Economic Review 62 (December 1972): 777-795.

[2]James M. Buchanan, "Joint Supply, Externality, and Optimality," Economica 33 (November 1966): 404-415.

[3]A useful recent review and extensive bibliography on this general subject area is found in Robbin Marris and Dennis C. Mueller, "The Corporation, Competition, and the Invisible Hand," Journal of Economic Literature 18 (March 1980): 32-63.

structure of the media, requires an understanding of the impact of stock ownership on the internal process of the firm.

Incentive Effects and Information

The most basic result of an incentive to employees is to get them to work "harder" in some physical sense. In a very simple situation where the worker's individual output is easy to monitor, piece rates can serve as an incentive plan. In more complex situations the output of an individual may not be directly observable and the production process may require interaction among workers. If, however, the output of the group (but not of individual members) is observable, then incentive schemes to the group as a whole to surpass a similar group involved in the same process or to surpass previous output of its own are the smallest scale of organization to which an incentive plan can be applied. This is the type of situation where group incentive plans such as Scanlon Plans are applicable. In such a situation cooperation and communication among group members are necessary, and incentives spread among the group for increased group output provide at least a partial incentive for individuals to think about more efficient ways to do a job and to provide self and peer monitoring within the group. Information flow between group members has become important to the productivity of the group.

More complex production situations may be non-competitive and non-repetitive and monitoring of group output becomes more difficult (costly). In the presence of high information costs to management, the importance of correct incentives to members of the group to promote both group monitoring and innovation increases.[1] As the sophistication of the production process increases, the opportunity for discretionary mental effort on the part of the individual is likely to increase.

The trend in the most developed countries has been greater emphasis on more complex, human capital intensive production where the monitoring of mental effort is costly. Alfred Marshall (1925) contributed the famous example of joint producers (beef and hides) from one input (cattle). Workers may be considered as producers of both completed tasks and information concerning the productive process. The information that workers develop while completing tasks could impact on subsequent task completion (in a positive

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[1]Information cost considerations will include information about work organization costs (i.e., the comparable desirability of various technologies or production functions when more than one exist), as well as the separability of factor outputs and the detection of shirking. Thus, both the emphasis of Coase (1937) and Alchian and Demsetz (1972) are contributory.

or negative manner). Buchanan (1966) shows externalities to be a special case of joint supply.[1] Worker produced information is not visible to the monitor unless the worker reveals it some way. It can be assumed to have zero disposal costs and could be used to make shirking less detectable and impose negative externalities on the employer or other workers. Worker produced information can be considered as a possible input into the production of positive or negative externalities. If monitoring of the use of this information is expensive, then it may go undetected.

In the traditional corporate organization, workers have incentive to provide the monitor with information about shirkers only when such shirking externalities impose direct costs on the workers. Situations in which other workers must make up for the reduced output of a shirker are likely to generate complaints (information). In other situations some change in incentive structures must be made in order to get workers to reveal information about the externality of shirking. Buchanan's approach focuses on the decision process of the person exerting the potentially relevant externality, a proper focus for an examination of informational difficulties concerning worker produced

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[1]Buchanan, "Joint Supply," p. 409.

information about the productive process that is potentially relevant to the monitoring function and in the selection of the optimal way to organize production.

The joint producers of task completion and information about the productive process may be non-separable to the monitor. Thompson (1970) points out that if a worker is involved in a continuous learning process from production activities that impacts immediately on future production, then models using comparative statics are inappropriate.[1] Such modeling problems in theory are monitoring problems to an operating firm. The use of a larger number of shorter periods to measure output changes would likely drive up monitoring cost prohibitively. The non-separability problem of the joint products of individual workers is in addition to the non-separability problem of joint inputs discussed by Alchian and Demsetz.[2] Both problems are examples of joint products which are not separately marketed and help explain one of the reasons why firms (operating with less than perfect information about employee products) might

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[1]Earl A. Thompson, "Nonpecuniary Rewards and the Aggregate Production Function," The Review of Economics and Statistics 52 (November 1970): 395-404.

[2]Alchian and Demsetz, "Economic Organization" (1972), pp. 778-781.

choose a compensation method that includes partial sharing of a residual computed after a comparatively lengthy period.[1] Information costs are the important consideration that prevent the organization of production relationships that may not be specified contractually in great detail. If the nature and specifications of the production process are constantly in flux, the organization of production will take place within the firm as suggested by Coase.[2] The exact outcome of the production process is only known *ex post*.[3]

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[1] Risk preference of employees and management's desire to alter the relative mobilities of factors will be shown to be other possible influences that promote extension of residual sharing computed at the end of fairly lengthy periods. Thompson's discussion of non-pecuniary rewards also provides support for later discussion of worker input into design of the production process and reveals areas of empirical difficulty when benefit packages change. Ibid., pp. 395-404.

[2] Coase, *Nature of the Firm* (1937).

[3] Fama (1980) also notes the need for ex post settling up with managers in a more complex production process. Stock options, profit sharing and other forms of delayed compensation lend themselves to ex post adjustment of compensation. Eugene F. Fama, "Agency Problems and the Theory of the Firm," *Journal of Political Economy* 88 (April 1980): 288-307.

Alchian and Demsetz place great emphasis on monitoring costs as the crucial information costs to the firm. Although they recognize that it is "probably possible for existing team members to recognize the shirking" they do not feel that employees could make a net contribution to the information stream.[1] They dismiss the implicit purchase of this monitoring information by residual sharing.

> ...general sharing in the residual results in losses from enhanced shirking by the monitor that exceed the gains from reduced shirking by residual-sharing employees. If this were not so, profit sharing with employees would have occurred more frequently in Western societies where such organizations are neither banned nor preferred politically.[2]

Plans which involve profit sharing are a growing phenomena in Western societies. Employee Stock Ownership Plans are currently preferred politically, based on externality arguments cited in Chapter I.

An ESOP is an example of variation in the internal contractual relations of the firm. Alchian and Demsetz assume "that the cost of team production is increased if the residual claim is not held entirely by the control monitor."[3] The basis of their argument is that shirking

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[1]Alchian and Demsetz, "Economic Organization" (1972), p. 781.

[2]Ibid., p. 787.

[3]Ibid., p. 786.

has the qualities of a negative externality and in a large group shirkers will escape most costs associated with their actions. In specific terms, the Alchian and Demsetz argument says that for all but small scale productive activities each percentage point of the residual claim that is diverted from the central monitor to employees results in a net decline in the efficiency of the firm.

The blanket assumption that the equation of the benefits at the margin from a given residual share often results in a corner solution is contrary to observable business practices. Profit sharing and stock options are extended to lower levels of management. An argument for extending residual sharing to all employees is supported if self and peer monitoring sufficiently augment central monitoring. Alchian and Demsetz suggest that "assembly line workers can be monitored by varying the speed of the assembly line" but even casual empiricism (the General Motors Assembly Plant at Lordstown, Ohio, for example) suggests that the monitoring is not so simple a task.[1] Exchanges for information are made by firms using methods such as cash awards for employee suggestions, but evidence suggests that in many firms this information is often not obtained by management.

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[1]Ibid., p. 786.

In cases where labor-management relations are extremely poor, workers' insights into the productive process may be used to impose negative externalities (in addition to shirking) on owners and reduce productivity in a plant. An article in the Washington Post by a former assembly plant employee of Ford Motor Company provides an example.

> Sabotage against the cars themselves is common. As a matter of course, we used to force the trunks closed in such a way that insured that the cars couldn't be painted properly. But most sabotage takes place in the trim department. . . sabotaging in a way that is not immediately discovered. As work is done further down the line it becomes progressively harder to repair the original problem...Workers are united in one thing--hating Ford.[1]

In this instance the workers show a sophisticated knowledge of the productive process that is used against the firm to redress general labor dissatisfaction. The firm is paying an implicit price in an involuntary exchange that is detrimental to productivity. Clearly Ford management would be interested in a voluntary purchase of information useful in the organization of production and in detecting shirking and sabotage.

The level of employee knowledge about the productive process may often be higher than managers or theoretical economists generally assume. This information, if properly

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[1] Washington Post, 5 September 1976, p. B5.

channeled, could result in innovations that increase rather than decrease productivity. The conventional wisdom, presented against purchases of information, is that the workers do not appropriate the full value of the use of such information and thus have less than optimal incentive to produce it. This argument, which suggests less than an optimal amount of this information will be obtained, is not a reasonable argument against the purchases of infra-marginal units of information.

Workers obtain a certain amount of information about shirking and the productive process in the routine completion of their jobs and may consider the cost of production of this information to be virtually zero. The firm is a monopsonistic buyer of this information and the value in an alternative use, if any, is the non-pecuniary gain to workers to using the information to disrupt production. If the value of the marginal product of higher residual shares to the monitor is decreasing, then it is extremely likely that the optimal amount of employee information to purchase is positive. The public goods aspect of the transaction should tend to reduce but not eliminate the amount of this inexpensively produced information that is offered by employees. Greater amounts of information would be supplied if purchases were made directly from individuals, but such purchases require the expense of solicitation and evaluation by management. Firms could be expected to employ both directly solicited information and information induced by the incentive of the ESOP up to the point where marginal benefits were in equation with other revenue increasing options of management.

A possible problem with direct purchases of information using incentive schemes for employee suggestions is the resistance of low level managers to ideas of employees. The immediate superior of an employee might be threatened or embarrassed by an innovative suggestion. The manager would have an incentive to dismiss the idea as unworkable simply to avoid potential criticism of the "why didn't you think of that" variety. Suggestions for which there are direct payments might be best reviewed by a person or persons other than the immediate superior of the employee making the suggestions. An incentive plan for informal (indirect) suggestions would be less subject to sabotage by low level managers because any improvements in the performance of his workers would tend to reflect favorably upon the manager.

The direct and indirect (via the incentive of ESOPs) purchase of informaton is likely to be approved by stockholders if it provides them a net benefit. In cases where management holds rights to part of the residual, there are incentives for management to purchase information when the prospect exists for a net gain to managers in pecuniary return or reduced monitoring effort (leisure).

Externality arguments have been advanced for the government subsidy of stock ownership by managers to bring their incentive levels up to an efficient level. Tax incentives for stock ownership by highly paid managers are unlikely to be approved in the political process without being extended to include a wider constituency. This is, in fact, what happened in the ESOP legislation which prevents qualifying stock plans from benefiting only managerial employees. The informational theory presented here indicates that stock ownership by managers and employees may be justified on grounds of economic efficiency.

The separation of ownership and managerial control has figured prominently in the literature of management, industrial organization and the theory of the firm. Although there is room for much more research on the efficient structuring of management and employee compensation packages, existing empirical studies indicate that managers appear to do at least as well as owners might do themselves. Theorists have worried that the high cost of information important to absentee owners for oversight purposes results in slack.

Information about shirking on the part of hired managers would seem to be more readily available to persons inside the firm than persons outside the productive setting.

Williamson argues that "perquisites are a much less visible reward to the management than salary" and hence are less likely to provoke stockholder or labor dissatisfaction.[1] A possible inference from the empirical evidence on performance of manager-controlled firms is that managers drawing undetected perquisites have a higher productivity that tends to compensate for the cost of the perquisites. Such perquisites are quite likely to provoke stockholder and labor dissatsifaction if they are discovered, and it is quite likely that employee-stockholders have an advantage in discovering any such incomes to management. The market for managers and the degree of firm specificity of managerial skills should determine the total compensation package needed to keep managers on the job. Better information about management performance would allow outside stockholders to capture at least a portion of any excess rents to the specialized managerial factor and reduce the ability of management to distort the objective function intended by the owners.

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[1]Oliver E. Williamson, The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm (Englewood Cliffs: Prentice-Hall, 1964), p. 1035.

The empirical evidence suggests that there are no significant differences in the behavior of owner-controlled and manager-controlled firms.[1] The explanation offered for these results argue that the combination of market discipline in the external market for managers, the threat of take-over bids, and the internal contractual and monitoring arrangements of the firm (including management incentive programs) result in at least equal net efficiency in manager-controlled firms as compared to owner-managed firms. If managers are superior specialists in their assigned tasks, there is reason to question why manager-controlled firms do not provide superior performance to their owner-controlled counterparts. This is the classic problem of who monitors the monitor and concerns the information flow between individuals in the firm and outside owners. If managers are able to distort the objectives of absentee stockholders, it is not measurable by the aggregate measurements that are typically available to academicians or stockholders.

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[1]For a review of this literature and further empirical tests see: John J. Kania and John R. McKean, "Ownership, Control and the Contemporary Corporation: A General Behavior Analysis," Kyklos 29 (1976): 272-291.

The input by employees into the informational processes of firms with ESOPs is not viewed as contradictory to management's right to manage and, in fact, in at least one of the firms in this study, the desire of employee-owners is clearly to avoid any breakdown of the discipline in the firm. Participation in the mangaement of the firm might be expected to be limited to only the oversight role of employees owning voting stock.[1] ESOPs may restructure incentives in the firm so that employees, under more self and peer monitoring, require less hierarchical control and would be resisted by managers who would become surplus under such a scheme. Also, if employee-owners are better able to recognize consumption of unauthorized perquisites, managers consuming such goods would be expected to be opposed to ESOPs. The absence of conclusive evidence documenting owner-manager goal conflict derived from standard measures of firm performance indicates a need for a closer look at the membership and choice processes

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[1] In the United States participation in the management of the firm traditionally has not been a goal of organized labor, which prefers to concentrate its emphasis on increases of wage and benefit packages. The conflict over property rights generally concerns the setting of wages and work practices. In contrast, European workers often challenge managerial perogative.

of corporate boards.[1] The conflict of owners and managers with employees tends to be less elusive and requires further innovative research efforts.

In firms with employee stock ownership, conflicts with labor could be expected to be voiced in the board room prior to undertaking more drastic actions. Workers may have a comparative advantage over absentee owners in the production of information important to the oversight choice process. In firms with mixed ownership, outside owners would have another possible source of inside information about the firm. In a situation where labor and mangement were opposed, outside stockholders would receive information from each party desiring support which would reduce the cost of information to outsiders. Outside stockholders who benefit from self monitoring incentives of management ownership of stock and the monitoring of management by stock owning employees, would be likely to choose an efficient combination of the two. Cooperation or collusion between managers and labor would produce less beneficial results for absentee owners.

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[1]Kania and McKean, "Ownership", p. 288, suggest that the representation of management on the Board of Directors may be a measure of manager control of corporations. A later section of this chapter speculates about the decisions that might be expected with a mixed ownership and representation structure composed of employees, managers, and outside stockholders.

The property rights approach to organization of the firm has concentrated on the monitoring costs of the firm. Recent research under the rubric of the agency relationship utilizes a similar contractarian approach to relationships in the firm, but attempts to provide a more general framework for analysis of the varied relationships found in large corporations.[1] The relationship of stockholders (principals) and managers (agents) is one of a number of agency relationships present in the firm. Employees are the agents of managers in firms where authority over labor decisions is delegated to managers. When employees are in the dual role of employee-owners, the relationship is one of reciprocal agency.[2] The reciprocity of the relationship provides common incentives to workers and managers, partially reducing the normal

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[1] See for example Michael C. Jensen and William H. Meckling, "The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," Journal of Financial Economics 3 (October 1976): 305-360. Frank Knight pointed to the importance of this approach to the firm and other topics ten years prior to its serious pursuit: "More needs to be said about the agency relationship which pervades modern society in most spheres; in fact it is practically the main essence of a free social order, in politics and economics and quite generally." Frank H. Knight, "Methodology in Economics, Part II", Southern Economic Journal 27 (April 1961): 274-282.

[2] Knight, "Methodology," p. 280 notes the more general case: "In effect the entrepreneur acts as the agent at the same time of employees and property owners and of the consumers of the product."

conflict between labor and management.[1] The enforcement costs of agreements are expected to be lower in firms after the introduction of an ESOP.

Jensen and Meckling (1976), in a discussion of the costs associated with the agency relationship, note three broad categories of agency costs. All enforcement and monitoring costs fall under the label of monitoring costs while the term "residual loss" covers all costs (expressed in terms of money) to the principal resulting from divergence from the contract by the agent. Discussion of these two categories of costs is common to the agency and property rights literature. A third category of costs associated with the agency relationship, bonding costs, offers an interesting alternative approach to the problem of controlling the monitor that reduces dependence upon residual claimant status as a tool to control management.[2] The monitor could "expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if

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[1] In terms of game theory the situation changes from a zero or negative sum game to a positive sum game. Productivity increases are spread among a larger group in the ESOP "game" providing incentives to reduce bargaining costs and the externality costs of sabotage. See further discussion below. It is interesting to note that any person in an agency relationship with the firm may have cheaply generated information valuable to the oversight process and is a potentially more efficient replacement for an "outside" holder of equity.

[2] Jensen and Meckling, "Agency Costs," p. 308.

he does take such actions."[1] The positive costs of such bonding would be reflected in the manager's compensation and is a positive cost to the owner as are monitoring costs. If bonding is a less expensive way of controlling managerial performance, it would be expected to be adopted.

Bonding for a manager requires information about his behavior. If the manager's actions are difficult to monitor, the effect of bonding is to increase the loss inflicted upon the manager if he is caught in violation of the contract, but it does not reduce the costs of monitoring his activities. Persons providing bonding services would be those who enjoy a comparative advantage in gathering information about the performance of the manager. Bonding activities contracted for by managers and direct monitoring undertaken by stockholders require similar information of which workers may be comparative least cost producers.

More efficient collection and use of information are central factors to increased efficiency in the production process and in the oversight process of the firm. Employee stock ownership provides an incentive to employees to volunteer information useful in increasing production and improving oversight of the firm, but the provision of such information creates a public good which benefits all stockholders.

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[1] Jensen and Meckling, "Agency," p. 308.

The "public good" nature of the stock ownership means that the financial motivation of an individual to provide self-monitoring, peer monitoring, and innovation on the job is less than would be optimal if individual incentives could be designed and administered costlessly. They cannot. Some individual offers can be made cost effectively. Many firms evaluate major employee ideas on an individual basis in a direct exchange providing cash awards, but this process is costly. Less substantial bits of information and innovative action can be encouraged by the "public" incentive of an ESOP, particularly when useful information is a joint product of the work experience and is considered by the employee to have an extremely low cost of production.

An efficient incentive plan is expected to reward in proportion to marginal effort and contribution. The number of shares given to employees under ESOP plans usually rises with levels of pay and seniority. If pay levels and seniority (as a proxy for firm specific human capital) are reflective of marginal productivity, then ESOPs can assist a movement toward efficiency across groups of workers. Peer and self monitoring incentives under an ESOP provide pressure to reduce shirking by individual members of groups. The discussion of suggestion plans often suggests that the problems associated with structuring precise individual offers to buy information from employees is a problem of such magnitude in most firms as to remove it from practical consideration. This dissertation suggests that the unique supply considerations of worker produced information mitigate problematic demand considerations. If information is routinely produced as a joint product along with the assigned tasks of workers and has little value to them in alternative uses, then even imprecise and diluted (via the "publicness" of the incentive) offers to buy should induce the supply of some information and increase efficiency (i.e., induce voluntary Pareto moves toward an optimum).[1] The object here is not to dismiss the importance of reaching the Pareto frontier, but rather to suggest that movements toward it with a less than perfect vehicle are a preferable alternative to inaction, and will contribute to a better understanding of the complex relationships in the firm. American corporations, with or without the encouragement of tax incentives, are increasingly making the decision to adopt stock ownership incentive plans in an attempt to reduce barriers to the exchange of information. The importance of such exchanges increases as production processes become more complex and difficult to monitor.

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[1] In the absence of competitive buyers for this information some inefficiency is bound to remain. Outside stockholders are one possible additional demander of information when it is useful to the oversight function.

In production situations where benfeits of both individual purchases of information and less formal purchases via an ESOP exceed their costs, a firm would be expected to utilize both techniques. Each technique would be utilized up to the point where for an equal marginal expenditure the values of each of the marginal products were equal and also in equality with the results from a similar expenditure on other monitoring and motivational techniques. Private audits and managerial incentive programs represent other techniques available to firm owners.

A properly structured incentive plan may induce an individual to work "harder" in some physical sense. In a more complex production environment higher productivity will require employees to make decisions in which they process and communicate information as well as perform assigned tasks. If the production process is characterized by joint inputs of labor where individual products are hard to measure and individual employees produce undetectable information as a joint output along with the task, then the successful operation of an incentive plan will be marked by increased and more efficient information flows within the firm. Rough indicators of employee attitudes toward the physical aspects of a job may be revealed by such measures as absenteeism and turnover of employees. Evidence of information flows in a firm can be sought in the volume of direct purchases of information obtained from any suggestion plans utilized by a firm and from evidence of voluntary provision of information where incentives to produce and reveal information are less structured and more "public" in nature. The purchase of information by the employer would be expected to be above and beyond the payment for task completion regardless of the structure of the incentive system or form of payment. This should be borne out in comparisons of employee benefit packages in both firms that do and do not attempt to purchase employee produced information.

Risk, Mobility, and the Employment Relationship

The existence of the firm was explained by Coase (1937) as arising when the costs of organizing production were found to be cheaper within the firm than in market contracts. Malmgren (1961) emphasized the increased certainty of factor supplies if they are hired for long periods rather than frequently in a market.[1] This extension of Coase implies that factors lose some degree of mobility when they are hired by a firm. Alchian and Demsetz argue that

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[1] Harold B. Malmgren, Information, Expectations and the Theory of the Firm," Quarterly Journal of Economics 75 (August 1961): 339-361.

superior power of firms to regulate contracts compared with market contracts is a "delusion" and thus imply that factor mobility is not affected when a factor contracts with a firm. Although they may be correct to state that "neither the employer nor the employee is bound to continue their relationship" their position fails to acknowledge the possible costs associated with the movement of factors between firms.[1] The failure of Alchian and Demsetz to regard cost constraints on factor mobility is a primary reason some of their conclusions are questionable.[2] Costs associated with mobility will tend to make some factors behave as if they were on long-term contracts even if there is a contractual structure that would allow continuous renegotiation.

Alchian and Demsetz deny the value of incentive plans (the carrot) and also strenuously deny the use of superior force by managers (the stick). It is not clear from their analysis how the firm becomes an "efficient market in information" when very few informational transactions occur. The one

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[1]Alchian and Demsetz, "Economic Organization," p. 777. The benefits of any firm specific human capital acquired on the job are lost to employee and employer if the option of mobility is exercised.

[2]Alchian and Demsetz's analogy to teams, especially sports teams, should have illuminated the problem of costs associated with mobility. The sports pages are filled with references to the costs as well as the benefits to players who change teams.

managerial device held by the central agent is the right continuously to renegotiate input contracts independently. In the absence of any discussion about informational purchases or transfer costs (associated with factor immobility and imposed by a termination of contract), it is hard to imagine how "better recombinations or new uses of resources can be more efficiently ascertained" in the Alchian and Demsetz conception of the firm.[1] "We conjecture . . . . . the specific system of reward which is relied upon stimulates a particular productivity response."[2] Further considerations along these lines might have prevented Alchian and Demsetz from dismissing the value of residual sharing incentive programs.

The research of labor economists emphasizes the importance of mobility considerations. Oi (1961) identified labor as a quasi-fixed factor of production to the firm. The effect on the firm fixity of the quantity of labor can be partially offset by a factor payment that is partly

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[1] Alchian and Demsetz, "Economic Organization," pp. 794-795.

[2] Ibid, pp. 778-779.

variable with firm output and profitability.[1] The literature on internal labor markets emphasizes the costs of labor mobility to the firm and the employee.[2]

Mueller (1976) places emphasis on the importance of factor mobility as well as information in the organizational structure of the firm.

> Previous theories of profit depict entrepreneurship as a proclivity for risk taking, daring, ingenuity and other similarly randomly distributed characteristics. In contrast, the present theory streses the role of the more tangible information and mobilty. Information and mobility play a central role in recent theories of both the internal and external labor markets. 'Job search,' 'signalling,' 'shirking,' and 'X-efficiency' can all be related to a concept of profit emphasizing information and mobility. Similarly proposals to introduce worker participation in profit and control sharing should be analyzed, in the light of the present theory, in terms of the types of information the different members of the firm possess, their potential for discretionary contributions of information and effort, and so on.[3]

In the spirit of Shumpeter, risks are borne by immobile factors and if labor is immobile then a labor contract that is in fact subject to some variability may be unavoidable.

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[1]Walter Y. Oi, "Labor as a Quasi-Fixed Factor", Journal of Political Economy 70 (1961): 538-555.

[2]In Doeringer and Piore the internal laor market serves to reduce the cost of employee turnover. Peter B. Doeringer and Michael J. Piore, Internal Labor Markets and Manpower Analysis (Lexington: Lexington Heath, 1971), p. 63.

[3]Mueller, "Information, Mobility and Profit," p. 443.

The variation may come from unanticipated influences on the firm performance (uncertainty in the spirit of Knight) or from variation that is anticipated (risks), but borne involuntarily. Employees, for technical reasons such as transportation costs, often cannot diversify among several jobs to reduce these risks. Knight (1937) portrays risk taking as a voluntary action taken by entrepreneurs because of optimism or preference for risk. Employees who accept employment where firm specific human capital is developed on the job or where stock of the employer is a signficant part of the total compensation are also voluntarily accepting risks, but are doing so as part of a tie-in sale of the total employment contract. If the employer is willing to provide significant compensating differentials, the employer can always induce the employee to accept a compensation package that includes stock that is required to be held by the employee until the employment relationship is terminated. In accepting such a contract the employee is voluntarily accepting the restrictions of any forced savings aspect of the stock ownerhsip plan and the risks associated with holding an undiversified portfolio (firm-specific capital accumulation) over the length of employment as well as risks related to any firm specific human capital associated with the job.

A related argument is advanced by Thompson and Thompson (1975) for the government subsidy of stock ownership by managers if they are not owners.[1] They argue that owners of corporations are those individuals most optimistic about firms. The separation of ownerhsip and control results in sub-optimal incentives to managers although it "is socially advantageous in that it has kept the more objective individuals in control of our companies."

> Nevertheless, the controlling individuals have too little incentive to work because, given their relative pessimism about the firms, they are unwilling to hold sufficient stock, stock options, profit shares, etc. This suggests an explanation for the government subsidy to the use of stock options and profit sharing plans in order to raise managerial work incentives to the efficient level, that which would exist if the managers were as optimistic as the owners.[2]

This argument follows the Knightian interpretation of optimism being a determinant of the ownership structure of the firm, but implies that the insiders (specifically managers) have more accurate information. In the absence of different levels of optimism the owners would have an incentive to induce some stock ownership by managers without need of government subsidies. If the resulting efficiency gains

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[1]Velma M. Thompson and Earl A. Thompson, "On the Efficiency of a Competitive Equilibrium with Education as a Screening Device," Rand Corporation research paper P5356-1, August 1975, p. 14.

[2]Ibid., p. 14.

from manager held shares were significant to compensate for the differentials in the expected value of the shares for risks borne by managers, then some transfer of stock to managers would obtain without government subsidies.[1]

Portfolio theory in light of job immobility rather than different levels of optimism may explain why managers and employees do not voluntarily hold optimal levels of stock from an incentive aspect. Diversification can eliminate the risk in an individual's portfolio that is uncompensated by the market. In the absence of compensation, managers and employees have incentives to diversify away from holding large portions of their individual portfolio in a firm where they also bear risks of possible job loss if the firm fails.

Owners may have an incentive to compensate managers and employees and induce them to hold optimal amounts of stock in the employing firm. If S^m, S^l, S^o equal the proportion of total stock held by management, labor, and outside stockholders,

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[1] A firm which held all equity in the hands of insiders (managers and employees) and issued only bonds to outsiders would be the extreme case. Such firms represent an ironic twist to Knight's description of a "system under which the confident and venturesome . . . insure the doubtful and timid by guaranteeing to the latter a specified income . . . those with confidence in their judgment and disposition to 'back it up' in action specialize in risk taking." Knight, <u>Risk</u>, pp. 269-270.

then the proportion of total profits (π) available to outside stockholders would be equal to $(1 - S^m - S^1)\pi$. Outside stockholders would be willing to increase S^m and S^1 to the point where $S^o(\pi)$ reached a maximum. Since S^o decreases as S^m or S^1 increases, total profits must increase proportionally faster than S^o declines if the S^m and S^1 chosen by outsiders is to be positive. This analysis above is sufficient to explain share prices in a one period world where share values are purely a function of profits per share and not affected by the dilution of share voting power.

It makes no difference whether the stock certificates given to management and labor are newly created or represent the transfer of existing shares to employees. In the former case profits must increase to at least offset the dilution of existing shares so that the value of claims held by the original stockholders remains the same. If current shares are transferred to employees, then the value of individual shares would have to increase to at least offset the loss of value to the original stockholders of the portion of the shares transferred by outside owners. Over a multi-period horizon the logic is similar; the discounted value of increases in future income streams expected as a result of the transfer of a portion of shares (or creation of additional share claims) must equal the current value of the shares transferred. This analysis suggests that outside owners of the firm have an incentive to subsidize stock purchases by employees and managers as long as productivity gains resulting from the transfer offset the value of the transferred shares. Note that if the stock value predicted on multi-period earnings increased because of employee stock ownership, then outside shareholders are likely to want to restrict sale of transferred stock by employees. Thus the requirment of immobility of part of the individual's portfolio is added to any immobility present in the employment relationship. A requirement of holding shares during the entire employment relationship would likely reduce the employee's valuation of the stock and increase the amount of subsidy required. The minimum amount of subsidy required by employees would be that which compensated the employee for holding an abnormally risky portfolio over a fairly lengthy time horizon.

If the expected efficiency (productivity) gains were sufficient the outside owners would offer to subsidize all the cost of the stock and perhaps even offer cash and stock differentials to employees to accept a compensation package including stock in the employing firm.[1]

Corporate Control, Participation in Management and Stock Ownership

The previous analysis ignored the issue of the valuation of corporate control. In some instances the purchase of stock from outsiders and sale to employees in a way that precludes the voting of many of the shares can insulate a firm from pressure of inside or outside stockholders and could eliminate the possibility of a takeover bid. Such is the case when shares are held in an Employee Stock Ownerhsip Trust (ESOT) and the vote does not pass through. Major shareholders of a firm could control it with fewer shares if a portion of shares were held in a trust where the trustees were or voted with the major shareholders of the firm. This would allow the firm to insulate itself from the threat of a takeover by the purchase of outside shares and allow major stockholders to diversify their personal wealth.

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[1]The employees that accepted employment with ESOP firms would be those most favorably disposed toward risk and toward risk in the specific form of stock in the employing firm.

Under a simple majority rule the employees would pose no inside threat to control until they actually could control the vote on over 50 percent of the shares. The potential for and implications of coalitions and employee control are discussed in Chapter III; here it is important to note that where the vote does not pass through until retirement or the number of voting shares held by employees is small, the effect of an ESOP can be to reduce the potential of outside take-overs without introducing the potential for inside control of the corporation by employees.[1]

Changes in the property rights associated with ownership have been significant in the last 50 years as has the nature of ownership of shares. Although many employees have indirect claims on equity shares through such institutions as pension funds, they do not control the vote or experience any personal connection between their productivity and the value of their pension. The meaning of ownership of the equity shares of a firm has also become less tangible in recent

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[1]This is potential motivation for major stockholders to cause the firm to "go private" via an ESOP; even if share votes pass through the ESOP to employees, the major shareholders may enjoy a right of first refusal and be insulated from an outside takeover. The efficiency of such insulation at the macroeconomic level depends upon a settlement of the controversy over the efficiency aspects of takeovers in general. The potential microeconomic implications of employee control are discussed in Chapter III.

years. Particularly as the developed countries move toward relatively more complex, dynamic, and human capital intensive production, the nature of corporate control changes.

> . . .the importance of the organization property and the potential significance of its ownership as a source of authority have increased, while the importance of the property in th firm's assets and of authority derived from the ownership have decreased . . .
>
> Thus, what the shareholders of a corporation actually own is rather a curious form of property, the functional essence of which is the elimination of impediments to the flexibility, liquidity, permanence, and freedom of action required by the corporation as actor.[1]

Employees in many unionized firms have usurped a good deal of the control of the firm through collective bargaining. Management, if the separation issue has validity, is another important separate force in the organization of the firm. Outside supplies of input, customers of final output, and the government are all forces which have increasing impact on the operation of the firm. Stock ownership by employees and management place them in the position of being residual claimants to the results of their interaction in the firm and serves to partially reconstruct the relationship between ownership and control.

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[1]Barry A. Stein, "Collective Ownership, Property Rights, and Control of the Corporation," Journal of Economic Issues 10 (June 1976): 311-312.

This chapter has suggested that the literature of microeconomics has much to contribute to a discussion of the impact that can be expected from employee stock ownership. An attempt has been made to collect the relevant parts of this literature for a more illuminating explanation of the relationships that make up business organizations. The results of this inquiry support the contention that there is ample theoretical support in the microeconomic literature for all four considerations of employees and employers important to decisions about employee stock ownership in the firm.

CHAPTER III

CHOICE PROCESSES IN THE FIRM

The literature on firms, whether owner-managed, managed by hired managers, or worker-managed, generally assumes a single maximand for the firm which implies unanimous agreement among the individual owners of voting shares of stock. The literature, with few exceptions, ignores the fact that the goals of the firm emerge from individuals acting through a choice process and are subject to change over time. Extreme diversity among owners is often elimianted in the exercise of the exit option by selling of shares.[1] In a broad and active market for share ownership buyers would purchase shares in firms with policies that were most nearly in agreement with their own.[2] The remaining

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[1]Exit, in the terms of Hirschman (1970), through the sale of stock is the traditional low cost option exercised by stockholders. For employees, managers (and absentee stockholders provided with cheap information by these other two groups) in an ESOP, voice through the choice process may be a more attractive option. If stock markets adjust instantaneously, stockholders absorb the loss resulting from any difficulties in the firm before they can exit (sell) to avoid it. Albert O. Hirschman, Exit, Voice and Loyalty (Cambridge: Harvard University Press, 1970).

[2]An obvious exception is a takeover bid where an effort is made to buy a controlling block of votes and change the behavior of the firm through the choice process.

divergencies in opinion among owners would be resolved through the particular choice mechanism used in oversight of the firm.

Williamson and others have discussed the incentives to managers to distort the objective function of owners by taking undetected perquisites. This incentive exists for the whole range of employees. Stock ownership by employees would tend to reduce (but not eliminate) this incentive in individuals and promote peer monitoring among groups of workers.

Stock in an individual ESOP account usually cannot be sold until retirement or other separation from the firm, which gives the worker an incentive to consider the long run viability of the firm in any actions that he takes. Although some workers might prefer a completely liquid income, the firm will likely prefer to have all employees in the incentive program. If productivity gains from the program are significant, an all wage employment contract (if offered at all) would have a significantly lower value so as to induce employees to choose the combination of wage and stock.

Any requirment for mandatory participation in an ESOP by all employees reduces the range of individual choice in the firm. Any firm that was not a monopsonistic buyer of labor would be expected to offer a competitive combination of compensation level and structure. Some workers would voluntarily choose a firm in which partial compensation in stock was mandatory if the productivity benefits of such a collective agreement were significantly high. The requirement of participation in the stock ownership plan, even though it may require no action or actual cash outlays on the part of the employee, is used to insure a common incentive exists among all workers.

The incentive of an ESOP will not guarantee that a worker will not chooose to shirk, but does insure that there is a positive cost to fellow workers and himself associated with shirking. The fact that workers are subject to cost consciousness in their actions and suggestions may help mollify any resentment managers have about employee input into the information and decision processes of the firm. Productivity increases from an ESOP plan must be high enough to allow the firm to compensate workers for the restriction on the liquidity of the compensation package and the added risk assumed by workers in comparison to a similar firm offering a compensation package consisting of only a contractually guaranteed wage.[1]

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[1]The induced savings aspects of these plans have microeconomic and macroeconomic implications that require consideration.

The board of directors of most modern corporations provides representation for the view of stockholders. Both voting rules for the selection of directors and voting rules for decision making by the directors are important in determining the character of corporate policy. Opinions of individual stockholders are represented indirectly by board members except in cases where issues are put directly to shareholders in a referendum. The decisions from such a process are compromises, and it is incorrect to conceptualize a firm as an entity with a single objective function to which all individual subscribe. The expense of exit from the corporation underscores the importance of the option of voice through the choice mechanism. The effect of a representative system for stockholders is examined in the analysis of political decision making found in the Public Choice literature.[1]

The Public Choice approach focus on the results of specific designs in choice processes indicates that the decision rules on issues need to be explored. For example, four of many possible voting rules for decisions by a board of directors are simple majority, two-thirds majority, four-fifths majority, and uninimity rules. In a situation where the directors mirrored the division of shares among the three intrest groups, each rule could produce

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[1]For a complete review of this literature see: Dennis C. Mueller, "Public Choice: A Survey," Journal of Economic Literature 24 (June 1976): 395-433.

a different decision about corporate policy. The decision rules would also influence the make-up of any coalitions that developed and influence the power of non-majority coalitions in reaching compromise solutions. Voting rules are important in the election of directors and the decisions that they make for stockholders. An optimal rule for a decision will equate marginal increases in decision costs with the expected losses of those individuals not favoring the decision. Decisions which have larger losses associated with them would require a larger percentage majority to be efficient.[1]

Earlier discussion noted that costs are associated with exit as an individual's adjustment to unfavorable decisions. In the Public Choice literature the notion of voting with the feet was explored by Tiebout (1956).[2] Employees with firm specific human capital have a higher cost of exit than investors who do not also have jobs with the firm. The unique characteristics of a firm will tend to attract individuals who relatively prefer the characteristics of that particular firm. Employees with a higher cost of exit would be expected to exercise the option of voice relatively more than outside stockholders.

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[1] Buchanan and Tullock, The Calculus of Consent, pp. 110-116.

[2] Charles M. Tiebout, "A Pure Theory of Local Expenditures," Journal of Political Economy 64 (October 1956): 416-24.

The problems of cycling and strategic behavior, which are critical in the Public Choice analysis of political decisionmaking, are diminished when votes are exchangeable in a market. The marketability of shares and the proxy right are important to efficient decision making in an ESOP. The assignment of shares based on marginal productivity and seniority gives greater weight to the voice of those with a high cost of exit. This assignment is an implicit weighing of preferences based at least partially on efficiency criteria as a norm.

When exclusion (dismissal) of individuals from a firm is possible, one of the major problems in Public Choice theory is eliminated. In such a case, the firm may be treated as a club in which members' actions may be constrained in ways that benefit the group. The labor union in a firm can be treated as a smaller club within the club that is the firm.[1] Individuals may want to assure themselves of some safeguards against arbitrary exclusion from the union or the firm. The latter service is a private good often supplied by unions.

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[1]The pathbreaking article in club theory was James M. Buchanan, "An Economic Theory of Clubs," Economica 32 (February 1965): 1-14. The application of club theory to the union has been largely neglected. For a useful recent survey of club theory that reflects the omission of the firm and unions see: Todd Sandler and John T. Tschinhart, "The Economic Theory of Clubs: An Evaluative Survey," Journal of Economic Literature 18 (December 1980): 1481-1521.

Analysis of the decision processes in ESOPs is benefited by the application of Public Choice theory, however, firms with ESOPs often have design features that can be used to escape some of the vexing problems found in the political process. Decision making involving explicit quid pro quo in firms is not stigmatized as it often is in political negotiation. ESOPs represent mechanisms that allow for some application of market principles to exchanges within the firm. In the next section the unique aspects of worker ownership and control are explored.

The Impact of Worker Ownership on the Firm

The literature on worker managed firms also neglects the decision process of owners, generally assuming that the firm maximizes income per worker. This literature assumes a one worker-one vote rule in decision making will be used to choose the maximand of the worker managed firm, but it fails to provide any explanation of the process of choice.

Another problem with existing literature about employee participation in ownership and oversight in the firm is that it is modeled with the institutional constraints of government present in such countries as Yugoslavia. The actions of firms and the capital market are greatly restricted by government in these countries. Constraints in these models are overly restrictive for application to the situation in United States firms with ESOPs, and the results of the models are dependent on the constraints specified.

A small but growing literature is developing that recognizes the importance of individual incentives and the impact of ownership on the objectives and actions of firms. Furubotn (1976) argues that the process of choice is more complex in a worker managed firm and would be dominated by a coalition of more senior workers and that the simple maximand of income per worker is naive under these circumstances.[1] Furubotn points out that the specific choice of the maximand and functional forms in this literature is crucial for the particular results of these models. He suggests that adequate support is not presented to justify the assumptions made by the authors of this literature when the practical consideration of individual self-interest is taken into account, indicating the need for analysis of the structure of choice processes in the firm.

Shapley and Shubik (1967) make an early contribution that appears to have been largely ignored because the discussion in terms of game theory and the agricultural enterprise.[2] The

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[1]Eirik G. Furubotn, "The Long-Run Analysis of the Labor-Managed Firm: An Alternative Interpretation," American Economic Review 66 (March 1976): 101-103.

[2]L. S. Shapley and Martin Shubik, "Ownership and the Production Function," Quarterly Journal of Economics 81 (February 1967): 88-111.

discussion could easily be generalized and it reveals the importance of individual incentives, private property, joint products and externalities and the implications of game theory in understanding the decisions of enterprises. One important result is similar to one mentioned earlier in this paper - if externalities are present, then a collective agreement that restricts strategy sets of individuals may be appropriate.

Steinherr (1977) attempts a very useful generalization of the labor managed firm and the manager controlled firm based on workers' and managers' utility functions rather than a particular objective function of the firm.[1] The model allows for discretionary behavior on the part of labor as well as management and discusses optimal levels of worker participation in decision making and profit sharing. The publicness aspects of participation are discussed, and it is shown that optimal participation levels may not be directly proportional to optimal levels of profit sharing. In ESOPs rights to residual shares and oversight rights come with stock ownership, but employee owners, on the basis of rational individual cost and benefit calculus, may choose not to exercise all oversight voting rights.

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[2]Alfred Steinherr, "On the Efficiency of Profit Sharing and Labor Participation in Management," Bell Journal of Economics 8 (Autumn 1977): 545-555.

The analysis of Steinherr suggests that profit sharing will include both labor and managers and discusses the optimal division of claims between these two groups. His discussion of the costs and benefits of participation in management recognizes the importance of information and monitoring costs as well as potential productivity effects.

> Participatory organization as compared to hierarchical or vertical decision making may also require greater resources for information processing, meetings, and extensive discussion. Such costs are likely to increase more than proportionately with higher levels of participation. However, they could be offset partly or wholly by the achievement of more consistent and better integrated company goals, thus diminishing internal conflicts...
>
> On the positive side, one may find a reduction of monitoring costs (collecting information, metering, and policing), possibly reduced managerial slack due to labor control, and increased productivity of labor inputs. The increase in labor productivity stems from more careful or efficient use of labor and material inputs, better performance through greater understanding of the job as part of a complex production process or through greater motiviation.[1]

This conception of the firm needs to be extended to include a third group; owners of voting shares outside of the firm. For this group information cost can be expected to be higher, since information is not a joint product of the work activity within the firm, and participation in votes as a result should be lower.

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[1] Steinherr, "On the Efficiency of Profit Sharing and Labor Participation in Management," p. 548.

The literature of Public Choice suggests that decision making costs can be expected to rise disproportionately as the size of the participating group increases.[1] The voluntary abstinence of some shareholders because of individual information costs considerations can be expected to lower the costs of decision making in the firm. Labor, as a group, and outside shareholders could be expected to seek ways of reducing the costs of representation of their interests.

Choice Processes in Unionized Firms with ESOPs

In firms which have labor unions, the basis for a coalition of labor already exists. The ownership of stock by employees provides an entree into the collective choice process of the board of directors. A question arises as to whether unions and ESOPs are substitute or complementary goods for the worker. In cases where the ESOP might lessen the importance of the union, opposition from union leaders might be expected. If the ESOP added to the scope of influence of the union, then support by the leaders of the union would be expected. In this section the interaction of union and ESOP functions are discussed, including differences that result from differences in internal organization and control of unions. The existence

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[1] Buchanan and Tullock, Calculus of Consent, pp. 69-72. Steinherr suggests that in "a participatory firm this problem could be particularly serious." Steinherr, "Efficiency of Profit Sharing," p. 546.

of a union membership disciplined by union leaders in an ESOP firm provides the possibility of block voting of union members' share votes in decisions within the firm. If share votes are in control of the individual, then the situation in an ESOP is similar to union leaders' attempts to marshall votes in political contests. The degree of control and influence exerted by union leaders on members is important to understanding union interaction with other participants in firm decisions. The discussion here focuses on local unions which have some autonomy to bargain with an individual employer rather than cases where union members are bound to an industry-wide or nation-wide agreement.

A discussion of possible overlap in services provided by unions and an ESOP must begin with an understanding of the services that union members expect of the local union. The available evidence suggests that grievance processing is the single issue most important to union members and involves the most time on the part of local union officers. An existing study of five local unions indicates that dealing with grievances took up to 80 percent of time spent by an officer on union business and was considered by the officers to be the most important function that they perform.[1] The security of workers in their jobs,

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[1] Robert W. Miller, Frederick A. Zeller, Glenn W. Miller, Local Union Leadership (Columbus: Ohio State University Press, 1965). pp. 59, 81, 84.

their working conditions, and benefit packages may be more important to workers than increases in wages.[1] The services desired by union members tend to be personal services that directly affect the life of the individual worker. A general increase in wages is a public good to the entire group of union members. Specific work rules in a labor contract may benefit specific subsets of the union, and these subsets of the union could be expected to take a greater interest in these more specific and direct benefits that exhibit less "publicness." The processing of grievances concerns the application of rules to a specific individual and is the most "private" good supplied by the local union. The processing of an individual's grievance may produce a precedent (and thus a spillover to other members with the same grievance), but the transaction is perceived for the most part as a direct benefit to the individual union member.

The notion that collective groups must provide private goods to induce individuals to join groups rather than to free ride on the benefits produced by the group is found in the Public Choice literature. The specific problems of unions in this regard are discussed in Mancur Olson's

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[1] Ibid., p. 44.

The Logic of Collective Action.[1] The private good of grievance processing is in effect tied to the goods of the union with more public characteristics to reduce free riding (non-membership) by employees. Unions also seek favorable laws to compel membership. The service of grievance processing is that of a third party enforcer of the contract between the firm and the employee, a service that is unlikely to be provided adequately inside the firm because of conflict of interest.[2] Even in the case of a firm that is 100 percent employee owned the individual may want some intermediation in a case where he is being dismissed by the rest of the group. A dismissal by fellow workers is of no less concern to the worker than dismissal by a "boss."

The determination of work rules is a good with more publicness than the grievance about the application of work rules to an individual. In a union organized along craft lines, favorable work rules may benefit the entire group while in an industrial union work rules may directly benefit sub-groups within the union. For some sub-groups

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[1]Mancur Olson, Jr., The Logic of Collective Action: Public Goods and the Theory of Groups (Cambridge: Harvard University Press, 1965).

[2]Alchian and Demsetz (1972) suggest that the role of unions is to monitor the contract between employees and the firm. they do not point out that unions also make their notion of continuous renegotiation of the contract highly unrealistic. Their question of "who will monitor the monitor?" is an interesting aside to apply to the monitoring functionsof unions as well as central monitor.

concern with favorable work rules (which provide non-pecuniary income) may be relatively greater than concern for a more "public" general increase in wages.

Work rules, wages, and fringe benefit packages are traditionally negotiated using collective bargaining in unionized firms. The expected value and specificity of an issue often determine the level of active interest that individual union members show toward such issues.[1] For issues of limited importance to a large group of individuals, indirect representation rather than direct participation is a preferable choice. This representation of workers' interests may be handled through the union by traditional collective bargaining processes or through some alternative mechanism within the firm. Representative participation and proxy assignment of share votes are rational cost-effective substitutes for direct participation of union members in decisions of low expected value to the individual.

In employee stock ownership plans, the effects of productivity, profitability and wage demands are reflected in the employee's claim on the long run value of the firm. Some unions have made attempts to connect these important elements in traditional collective bargaining setting through

[1]Miller, Zeller, Miller, Local Union Leadership and Joel Seidman, Jack London, Bernard Karsh and Daisy L. Tagliacozzo, The Worker Views His Union (Chicago: University of Chicago Press, 1966) both support this point.

the use of productivity and integrative bargaining. The possibility exists for overlap between functions of an ESOP and labor unions; the degree of conflict (substitutability) in roles would depend upon the institutional configuration of both the collective bargaining mechanism and the ESOP. Workers might be interested in an efficient combination of union representation and representation through the ESOP. Union leaders would be expected to oppose any situation in which their positions are less influential after the advent of an ESOP.

Productivity bargaining within the framework of traditional collective bargaining was an attempt to improve British industrial relations in the 1960's that met with only limited success. Problems demonstrated by many British case studies were caused by inflexible national labor agreements and the efforts of craft unions to "protect" their work by restrictive practices. When these problems were overcome, however, the results of experiments in productivity bargaining were "the endorsement and pursuit of problem solving" by work groups.[1] This is similar to the behavior expected in groups under the self monitoring incentive of employee stock ownership. A plethora of implicit attempts at forms of productivity bargaining in the United States have been

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[1] R. B. McKersie and L. C. Hunter, Pay, Productivity and Collective Bargaining (London: Macmillan Press, 1973).

made which involve negotiation of quid pro quo reductions of restrictive practices for higher total benefit packages. If a relationship exists between productivity and profitability as was suggested by the previous chapter, then the various residual sharing schemes that exist in some United States firms represent "productivity bargaining."[1]

Cooperation of unions appears to be essential in the successful implementation of productivity agreements with or without stock ownership. Edelstein and Warner have pointed out the apparent paradox that although unions represent a possible existing vehicle for institution of worker input into the productive process, such activity might undermine the role of unions as bargainers for individual employees.[2] This is the important monitoring role of unions in behalf of employees discussed by Alchian and Demsetz. The previous discussion has shown that the ESOP is an unlikely substitute for the union in providing this largely private goods (such as grievance processing) to separate individuals. ESOPs could and are (as shown in later chapters) often

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[1] For a survey see Bert L. Metzger, Profit Sharing in 38 Large Companies, Volume I (Evanston: Profit Sharing Research Foundation, 1975).

[2] J. David Edelstein and Malcolm Warner, Comparative Union Democracy (London: Allen and Unwin, 1975), p. 356.

designed as a mechanism capable of reaching settlements of questions about more "public" issues of work rules and terms of the labor contract.[1] Clearly a relevant role for the union would have to be maintained in order to receive union leadership support for the ESOP. The ESOP could be used to reduce the importance of the union in a firm, and there are rare examples of ESOP firms where union members are excluded from the stock plan at the insistence of the union or of management.

Unions, for the most part, have cooperated in firms that have instituted ESOPs, which suggests that the plans have not seriously eroded the position of the union. A union official of the Printing and Graphics Communications Workers has suggested that the ESOP at the Milwaukee Journal has made his union members less militant and reduced severely the chances of a serious strike, but that the ESOP is a very good investment for union members.[2] Unions understandably have resisted any move to weaken the collective bargaining process. The emerging opinion of the AFL-CIO is suggested

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[1] See the discussion of the Milwaukee Journal in a later chapter. This is highly developed two tier representational system for employee-owners.

[2] "When the Workers are Bosses." Dun's Review, June 1977, p. 88.

by the following portion of a memorandum from its research department.

> The AFL-CIO has not taken any official position for or against such plans. The plans themselves as well as the circumstances under which they would be used vary so substantially that it is difficult to give them a blanket condemnation or endorsement . . .
>
> We suggest first of all, that such programs be considered only within the context of the collective bargaining agreement. Such programs are typically initiated by the employer and frequently offered as a means to get something for nothing. We do not feel this is true and such a program should be evaluated critically and viewed as part of the compensation package. It should not be used to divert attention from needed improvements in wages and other benefits -- particularly pensions.[1]

The ESOP expands the opportunity set of employees to include gains resulting from the productivity and vitality of the firm as reflected in the stock price.

A common benefit shared with other owners of the firm would tend to provide at least some additional common ground in the collective bargaining process and perhaps reduce the cost of agreements. Such a gain in efficiency could benefit workers but leave union officials with decreased influence. As a result, autocratic unions would be expected to be opposed to ESOPs in the absence of side payments

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[1] AFL-CIO Research Department memorandum dated 22 October 1976.

while it is likely that a majority of members of a democratic union might vote in favor of such a plan when it increased the real income of members. Leaders of an autocratic union could actually have increased influence in a situation where they controlled all proxies for voting shares of union members; however, this form of control might be harder to enforce on union members than the internal manipulation found typically in non-democratic unions.

The existence of unions provides a ready-made coalition of labor to participate in the voting of shares. If the union controls all members' proxies, then it would represent a much more potent force in decisions by boards of directors. The block vote of union members' shares would require that union leaders represent a counsensual stand or exercise autocratic control over the members.

The attitudes of unions about participation in management differ little from the one posited earlier in Chapter II. Workers are concerned with and can add to input in the immediate area of their job. They also have interest in the oversight of the firm to assure the health of their investment and job security. American unions have not been interested in participation in management as an idiological pursuit, but rather in the pragmatic pursuit of higher incomes for workers, and the literature on union behavior reflects this approach. Miller, Zeller and Miller indicate that union officers spend their time delivering the divisable (private) good of processing grievances and that union members take relatively less interest in competing with management in running the firm.[1] Seidman et al. again point to the importance of individual incentives in determining the level of interest and participation of union members. The futility of voting, given its low expected value is documented in union decision processes.[2] The union may well be an existing organization that, through the assignment of proxy statments, reduces costs to share owning workers. The lack of strong opposition to ESOPs by unions indicates that union members and union officers are probably better off or at least not worse off in a firm with employee stock ownership. In the cases where the union has not opposed the ESOP the potential representative mechanism of stock ownership has not significantly eroded the representative function of the union.

In firms which do not have unions but are potential targets for union organizing the mechanism of participation and representation available through stock ownership could substitute for part of the array of union services.

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[1]Miller, Zeller, Miller, Practice of Local Union Leadership, pp. 44, 80-81.

[2]Seidman et al., The Worker Views His Union, p. 198.

Representation in the oversight of the firm and the capture of part of the pecuniary gains of the firm do not substitute for the private good of individual grievance representation. The individual services provided by unions would have to be replicated inside the firm to compete with the services that workers desire from unions.

An ESOP appears to provide a partial substitute for some of the more collective goods provided by unions and could conceivably reduce the incentives of workers to seek union representation when it was not already present. The ESOP could possibly provide some reduction in the potential for loss of corporate control to the union by majority stockholders. If the ESOP represented significant amounts of stock then it might also reduce the potential for or loss of control over the firm through a take-over attempt. When an ESOP stock is held in a trust that did not pass through voting rights it could shield a group of majority stockholders from outside attempts to gain control and also keep the oversight rights of the stock from internal employees. In a closely held corporation use of an ESOP trust could allow majority stockholders of a firm to diversify their personal portfolio without risking immediate loss of control of the firm. The issue of corporate control on the part of major stockholders is a significant consideration in addition to the four issues discussed in Chapter II and the tax incentives provided to ESOPs.

CHAPTER IV

OWNERSHIP STRUCTURE AND FIRM PERFORMANCE: A SURVEY OF EXISTING EMPIRICAL WORK ON EMPLOYEE OWNERSHIP

The scarcity of empirical investigations of employee owned firms in the United States results from problems in identifying possible candidate organizations and the tendency of many employee-owned firms to be closely held and not publicly traded. These facts makes it difficult to locate the firms and information about them is generally available only when they consent to provide it. Normal sources of information for corporations that are publicly traded (such as the Securities Exchange Commission 10-K form) are not required for privately held firms and even annual reports are often not available to persons outside the firms. The following discussion covers four studies that have been conducted on ESOP firms that are predominantly closely held. These studies suggest that the four considerations of Chapter II are important to the existence of employee stock ownership in the firm, but also suggest that tax incentives and the issue of corporate control, particularly in closely held companies, are important motivators of management support for compensation packages containing employee stock ownership.

Survey of Employee Stock Ownership Plans Conducted by the U.C.L.A. Graduate School of Management[1]

This survey provides results from 180 firms that responded to a mail survey of 850 companies identified as having ESOPs. Most of the firms turned out to be closely held corporations with less than six principal stockholders.[2]

Preferences by employees for ownership in the employing firm

The notion that ownership in the organization for which an individual works has intrinsic appeal to workers regardless of the tangibles that result might receive considerable support from the history of agricultural and industrial

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[1] A concise version of the results of this survey are available in "Summary of the Results of the 'Survey of Employee Stock Ownership Plans' Conducted by the U.C.L.A. Graduate School of Management," December 1977. Complete results are available as "Survey of Employee Stock Ownership Plans". Both documents, in mimeo, are available from the ESOP Association of America, 47 Kearny Street, Suite 204, San Francisco, California 94108.

[2] U.C.L.A., "Survey of ESOPs," p. iii.

enterprise in the United States. If ownership, in and of itself, is somehow important to individual workers then it would likely be cost effective for employers to include ownership as part of the total compensation package offered to employees. If employees in aggregate own significant amounts of the ownership shares of an organization they may become, in effect, collectively self-employed. The potential exists for employers to have lower total compensation costs with some ownership sharing than without if employee preferences for ownership were extremely strong.

The U.C.L.A. study found the following five benefits most commonly cited as important to a firm's use of employee stock ownership as part of the compensation package offered to employees.[1]

	Percent of Companies Citing
Improved employee motivation	70
Tax advantages	64
Cash liquidity of company	43
Market for closely held stock	41
Estate planning	35

The expectation of improved employee motivation suggests the belief that employers perceive a preference of employees

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[1] Ibid., p. 13.

for some ownership share. The first three benefits cited can be taken as an indication that employers were interested in lowering the costs of employee compensation to the organization. Cash liquidity as well as marketing closely held stock and estate planning can be taken as an indication of the predominance of small closely held firms in the sample, and the need of a small number of stockholders to diversify their personal portfolios.

The top four problem areas suggested by the study were:[1]

	Percent of Firms Citing
Changing governmental regulations	64
Administrative complexity	45
Employee reaction	26
On-going costs	25

Three of these four also show the concern of firms with reducing compensation costs. Employee reaction as a problem area, however, suggests that expectations of the plans often were not met and the survey reported that "statistically there appeared to be little difference in employee opinion from the time of the plan installation to the present."[2]

[1] Ibid., p. 14.

[2] Ibid., p. 19.

Productivity

Since improved employee motivation was listed as the most important reason for adopting an ESOP, it is clear that productivity gains were an expected benefit of stock ownership by employees. The study states that the "effect of the ESOP on employee motivation seems to be a distinctly individual phenomenon, which is related more to the company's prior condition than to the event of ESOP installation."[1]

> Many companies indicated no difference in the level of employee motivation resulting from the plan. The greatest number of these claimed that the complexity of the plan and the difficulty of making an intangible benefit appear real was responsible for the apparent indifference or confusion on the part of the employee. ... Further, the more closely involved the employee is in the outcome of the operation of which he is part, the more interest he will have in the plan.[2]

The conclusion of the survey is that "it did not seem that the ESOP by itself measurably improved employee morale or motivation unless the work atmosphere and employer/employee communications were good to begin with."[3]

Information Flows

The absence of consistent documentable improvements in production and morale should be analyzed from two distinct, but related, standpoints. First, that the plans do have

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[1]Ibid., p. 19.

[2]Ibid., p. 19.

[3]Ibid., p. 22.

the intended motivational effects on employees and second, that ESOP plans are not implemented by firms and communicated to employees in a way that employes can readily understand. In the second case, the lack of results can be connected with a lack of sufficient employee knowledge about the plan and suggests that information flows to employees are not well executed. If the expected results in productivity depend upon better flows of information from employees into the management of the production process, and two way channels of communication are not well established, then increased productivity would be unlikely to occur as a result of any employee incentive program. The lack of understanding of ESOP plans by employees in the U.C.L.A. survey indicate that communications to employees about the ESOPs are often impaired.

> Many companies indicated no difference in the level of employee motivation resulting from the plan. The greatest number of these claimed that the complexity of the plan and the difficulty of making an intangible benefit appear real was responsible for the apparent indifference or confusion on the part of the employee. ...Even in those companies where perceived employee response was considered good, management stressed the importance of an on-going educational program to sell the ESOP concept. As employee understanding of the plan was rated fair to poor by 71% of the companies responding, the need for better communications is further underscored.[1]

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[1]Ibid., pp. 19-20.

The impaired flow of information about ESOPs are a likely indicator of poor information flows in general between management and employees.

Considerations of Job and Portfolio Mobility

The impact of stock ownership on employee firm attachment appears to be fairly small in the U.C.L.A. survey. Of the respondents, 80 percent believed there was no effect on employee turnover while 20 percent believed there had been some effect.

The survey suggests that stock ownership may be more important to white collar professionals.

> Managerial employees and other professionals (accountants, lawyers, etc.) may be more inclined to stay with a firm because of the ESOP (exception: in one case, several employees left as soon as they were fully vested in order to start their own, competing business).[1]

The impact of extensive stock ownership in a corporation may be similar to becoming a partner in a partnership professional firm in which case the difference between organization type becomes mostly a matter of tax and regulatory considerations.

The impact of the ESOP on mobility decisions by employees appeared also to be dependent on the age of the worker.

> The decision to remain with the firm may be age related. Younger people may not consider the ESOP a relevant factor in their life (Many comments were offered that they would prefer a cash bonus at Christmas); older employes (those approaching 40 years or older) are concerned with the quality of their life in retirement.[2]

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[1] Ibid., p. 18.

[2] Ibid., p. 18.

This is consistent with the theoretical suggestion that firms with ESOPs will tend to select employees with lower rates of time preference. Importantly, it also suggests that aging of the workforce in ESOP firms could happen more rapidly than in a similar firm featuring less deferred compensation. Liquidity of the firm and markets for closely held stock were important to major stockholders in selecting ESOPs and yet exactly those problems may arise if significant numbers of employees approach retirement at the same time. Since the average age of a firm's employees may increase and the population as a whole in the United States is aging, this question of marketability of stock over the course of time is extremely important.

Participation in the Oversight Process and Corporate Control

The firms responding to the U.C.L.A. survey indicated that 87 percent of securities in the ESOPs were common stock. While 62 percent of the firms failed to specify the voting or non-voting status of the common stock for those that did, voting stock was twice as prevalent as non-voting stock.[1]

The vesting procedure of shares to individual employees followed by the firms was as follows: 6 percent immediate vesting; 9 percent delay total vesting the statutory maximum of 15 years;

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[1] Ibid., p. A-13.

and, 85 percent of the firms had some form of gradual vesting falling within the 15 year maximum period.[1] Over 51 percent of the total responses indicated that the plans followed a vesting schedule of 10 percent per year for 10 years. Exclusion of union members from plan eligibility occurred in 11 percent of the plans responding to the survey.

The combination of long vesting and the use of non-voting stock by a number of firms suggests that the normal ownership voting rights may be somewhat attenuated for many workers in many employee stock plans. In the closely held companies that dominate the U.C.L.A. survey, effective control of the firm may be maintained by major stockholders with a smaller number of shares when an ESOP is installed in the firm. Diversification of the individual portfolio of major stockholders may be accomplished by increasing the risk of variability in return to employees for whom both job and partial level of their wealth depend directly upon the performance of the employing firm.

In cases where a trust held stock is not vested to individual employee accounts, the following categories of trustee relationship were found.[2]

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[1]Ibid., p. A-14.

[2]Ibid., p. A-23.

Category of Trustee	Number of Firms	Percent
Individual	41	23.3
Committee	69	39.2
Institution	66	37.5
Sample:	176	100.0

Of the 176 respondent companies, 43 percent indicated a prior business relationship by the firm with the trustee and many of the firms indicated a current relationship of the firm and the trustee.[1] Often, officers of a corporation will act as trustee for the ESOP which accentuates the ability of the firm to insulate itself from outside control and at the same time not relinquish that control to the employees.

United States General Accounting Office Study of Employee Stock Ownership Plans[2]

The Comptroller General's report to the Senate Committee on Finance contained a study of operations in 16 firms with ESOPs. The study concluded that for 13 closely held firms that it examined, three major problem areas existed. First, the companies had a tendency toward overevaluation

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[1] Ibid., p. A-24.

[2] U.S., Comptroller General, "Employee Stock Ownership Plans: Who Benefits Most in Closely Held Companies," Report to the Committee on Finance, United States Senate (Washington, D.C.: Government Printing Office, 1980).

of company stock contributed to the ESOP.[1] Second, questions of employee portfolio liquidity arose because, in closely held firms, "participants were not assured of a market for company stock distributed by the Plan."[2] Third, at those times when voting common shares were used, "participants generally were not permitted to vote or direct the voting of company stock allocated to their Plan accounts."[3] This study, in general, underscores the results of the U.C.L.A. study that corporate control seems to be the predominant concern in the design and implementation of ESOPs in closely held firms.

Productivity

Only four of the 16 firms studied by the Government Accounting Office established plans for the purpose of improving employee motivation and productivity and none of these four firms had studied the impact of ESOP implementation on employee behavior.[4]

Information Flows

Since the improvement of productivity was not an important consideration of the surveyed firms' decision

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[1]Ibid., p. i.

[2]Ibid., p. ii.

[3]Ibid., p. ii.

[4]Ibid., p. 37.

to implement an ESOP, it is not surprising that information about the plan to employees as well as employee understanding of the plans tended to be poor. An interview of 98 employees who were plan participants found that the employees were "unfamiliar with the basic elements of the ESOP" and that some participants were "totally unaware of their ESOP."[1] The impact of the ESOP in such an informational environment tended to be minimal and "most employees interviewed did not perceive the ESOP as influencing their work or the work of others."[2] The study found that none of the 13 closely held companies had provided the minimum information to plan participants required by ERISA, and that six plans did not inform participants regularly of the current value of stock in their accounts.[3]

Participation in the Oversight Process and Corporate Control

Investigation by the GAO indicated the franchise of stock ownership was significantly reduced for many employers in the ESOPs surveyed. The following five points were made:[4]

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[1]Ibid., p. 39.

[2]Ibid., p. 39.

[3]Ibid., p. 38.

[4]Ibid., p. 38.

> Eleven plans did not give participants the right to vote or to direct the voting of their stock.
>
> One company contributed only nonvoting stock to the ESOP.
>
> Eleven companies had provided no formal mechanism for ESOP stockholders to have any input to management decision processes.
>
> Only one company had a rank-and-file ESOP participant on the board of directors.
>
> Only five companies had rank-and-file representation on the ESOP committee (generally appointed by the board of directors).

For the most part, the firms in the GAO study did not facilitate two-way communication between management and employees in the implementation of employee stock ownership. In the absence of employee understanding of the plans, it is unlikely that employee motivation, productivity or contributions to management information streams were improved by the implementation of stock ownership. Only one plan had established a formal communication mechanism for stock owning employees to communicate their wishes, ideas or other information to company management or the committee controlling the vote on shares of stock held in an ESOP trust.[1] In this sort of environment, it is unlikely that the expected positive externalities to the economic and political system would occur since employees exhibited little knowledge or feeling

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[1]Ibid., p. 25.

of being participants in the plans. The link of ownership of the firm and part of the economic system has not been made by employees through stock ownership plans studied by the GAO.

University of Michigan Survey Research Center Survey of 98 Firms with Employee Ownership[1]

This survey of 98 employee-owned firms provides some insight into specific operational characteristics of these firms. Of the firms surveyed, 68 had stock ownership plans (no information on the tax qualification status of these plans was provided) and 30 had direct ownership. The median size of firms was 350 employees with 25 percent of the firms with 1,000 or more employees. In roughly 78 percent of the companies, 50 percent or more of the equity was owned by employees including managers. Firms with stock plans were more likely to have the entire equity held internally than were directly owned firms.

Productivity

The survey did not measure directly productivity in any of the firms but rather asked managers in these firms whether they believed employee ownership increased

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[1]"Employee Ownership," reprinted in U.S., Senate, Committee on Finance, Employee Stock Ownership Plans and General Stock Ownership Trusts, pp. 309-333.

profits and productivity. As in the U.C.L.A. study, managers indicated firmly that they believed productivity and profits were increased by employee ownership.[1]

Profitability is, in part, a reflection of productivity in the firm and was the direct measure of firm performance used in the study. Profit data was supplied by ony 30 of the companies using pretax profits divided by sales as the measure. This ratio was divided by the similar industry ratio. After an adjustment for five companies who pay higher wages to avoid corporate tax, this ratio was found to be 1.5 indicating that these firms as a group may be more profitable than comparably sized firms in the industry although this result is not significant at the .02 level. This adjusted indice of profitability was predicted using six variables: (1) a dummy variable set equal to one if the firm is directly owned, zero if a trust; (2) the percent of employees who participate in the plan; (3) the percent of company equity owned by employees (managers and workers); (4) the percent of company equity owned by the workers themselves; (5) the presence of representatives on the board of directors; and (6) the presence of voting rights for employees.[2] The sign was negative but statistically

[1]Ibid., p. 319.

[2]Ibid., p. 317.

insignificant at the .02 level for each variable except percent of equity owned by workers which was significant (at the .02 level) and positive.

The positive sign and statistical significance of the degree of equity owned by workers is congruent with economic theory; the incentive effect of ownership would be expected to be positively related to the degree of ownership. The negative signs for variables (2), (5) and (6), if they were statistically significant, would argue against the value of participation in the oversight role as a means of increasing profitability. The most startling suggestion of this study with respect to economic theory is the negative (but insignificant at anything less than the .25 level) sign of the percent of equity owned internally. This variable actually reflects variation in the amount of equity owned by management because the ownership of workers has been controlled. The authors state that a "possible implication, therefore, is that increases in the amount of equity owned by managers may have a negative effect if this increase in the equity is not accompanied by an increase in the equity owned by the workers."[1] This result, if found significant in a larger sample, would provide evidence in support of the tendency of plywood cooperatives to hire managers and depend upon the discipline of employees, inside managers

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[1]Ibid., p. 317.

and the outside market for managers rather than the incentive of ownership income for management.

The small sample size and the profitability data for only 30 firms makes any sample splitting by scale of firms or industry impossible. The relatively small size of the firms result in a study that may have application to many U.S. businesses but not application to firms that account for a large percentage of the total volume of business in the U.S. The efficient markets literature indicates that market data on securities prices would provide more insight into the robustness of firm performance under employee ownership than the accounting measures used in this study. Unfortunately many of the firms of the relative sizes found in their study are not publicly traded. On the other hand, the study does not provide sufficient detail as to what actual changes in the organization and operation of the firms occur under employee ownership that would make them any more or less profitable than comparable, conventionally owned companies.

Participation in the Oversight Process and Corporate Control

The study does not explore information flows from workers to management. Communications from employees through participation in the oversight process of the firm is prevalent but not a dominant state of affairs in firms that have stock ownership plans. Employee participation in this process is greater in firms that are directly owned by employees. The following data on participation was collected for the 98 firms in the survey.[1]

	Percent of Stock Plan Companies	Percent of Directly Owned Companies	Percent of All Companies
Employee-owners have:			
Stock-voting rights	27	97	50
Representatives on Board of Directors	36	77	49
Union representation	32	33	32
Influence on important decision other than through a union	51	77	56

The Survey Research Center study contained firms that exhibited a wide variety of differences in the participation of employees in the oversight function of corporate control and contrasted with firms investigated by the GAO in which full exercise of the voting rights of ownership were rarely exercised. Any changes in the internal decision making and information flows in these firms were not clearly documented and suggest that a more in-depth look at the internal processes of firms with employee ownership are required.

Analysis of Twenty-One Cooperative Plywood Companies

A successful in-depth analysis of 21 plywood cooperatives in the Pacific Northwest was conducted by Carl J. Bellas and published

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[1] Ibid., pp. 316-318.

in 1972.[1] This study provides an explanation of the internal organization of these cooperative firms. The empirical investigation uses longitudinal data for five years and cross-sectional comparisons of 21 cooperative firms as well as comparisons of cooperative performance with traditionally organized mills.

Preference by Employees for Ownership in the Employing Firm

The plywood cooperatives offer a fairly unique opportunity to observe worker preferences for employment in a firm owned by employees. The typical firm guarantees the owner of a share in the enterprise rights over available employment over non-owners. Often the shareholder is allowed to retain his share while temporarily taking advantage of alternatively higher paying employment in another firm. The firms may rarely allow workers to hold more than one share in the enterprise but each shareholder is allowed only one vote in corporate affairs.[2]

The non-working shareholder is often allowed to continue to vote. Most of the mills employ non-share owning workers as the most variable component of the firm's labor force.[3]

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[1]Carl J. Bellas, Industrial Democracy and the Worker-Owned Firm: A Study of Twenty-One Plywood Companies in the Pacific Northwest (New York: Praeger Publishers, 1972).

[2]Ibid., pp. 24-25.

[3]Ibid., p. 25.

The essence of share ownership is a reduction in the risk of layoff, and participation in the oversight of the firm, as well as residual claimant status to a portion of the firm's profits. Since shares have a positive price in profitable cooperatives, it is possible to compare worker evaluation of working in the cooperative organization with the more conventional benefit packages offered by traditionally organized firms in the industry. Normal market forces in the market for jobs and shares results in share owning cooperative owners who preferred working in the cooperative environment more than workers who take employment in conventional plants.

Productivity

Productivity in plywood cooperatives, as measured by output per man-hour, is thought to be higher than that in conventional firms but no compelling evidence has been presented to that effect.[1] Obviously, if the firm hires marginal workers who are non-owners, wage discrimination is possible in factor payments or through undistributed profits, and owning workers could receive a higher infra-marginal wage. This behavior would be encouraged by tax laws as a means of shifting tax burdens to the lower marginal income or capital gains tax rates of individual workers. There is evidence of this in cooperative behavior.[2]

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[1]Ibid., p. 29.

[2]Ibid., p. 29.

In this environment, the cooperative mills also might be expected to be more capital intensive as a means of increasing after tax income of worker-owners, but the available evidence suggests that capital investments lagged behind conventional mills.[1] The higher wage, rather than dividend payments, as an effort to avoid taxation has been sustained by the courts.

When the yearly return to a worker is used as a measure of productivity in the plywood cooperative, we find a good deal of variability in their performance. The measurement of cooperative performance used by the Bellas study was the five year return to an average worker-owner in each firm. For the period of study (1963-1967) the mean yearly return to workers was $8,600 with a standard deviation of $7,000 per year indicating fairly great differences among cooperative performance.[2] Wages tended to be about 30% higher in the upper half of the cooperative mills when compared to the industry average that reflects conventional mills.

Information flows

The cooperatives clearly attempted to encourage better information flows through informal channels at the work station, but no measurement of such shop floor communication

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[1]Ibid., p. 29.

[2]Ibid., p. 47.

was documented by the Bellas study.[1] Since employees as owners have the right to dismiss managers through the formal channels of participation in the board of directors, the managers have a greater incentive to maintain open channels of communication.

Participation by Employees in the Oversight Process and Corporate Control

The cooperatives are designed so that each worker-owner has an equal voting share of the concern and often the practice has been equal pay to all worker-owners regardless of the position they hold in the firm.[2] Job rotation is often used to help even out hours worked and also to familiarize owners with all parts of the operation in preparation for service on the board of directors. Bellas constructed an index of participation of worker-owners in the firm that included: (1) the percentage of worker-owners who served on the board of directors during the five year period; (2) the percentage of worker-owners serving on committees; (3) the number of board meetings per year; (4) the number of general meetings per year; and (5) a measure of the effectiveness of methods used to communicate minutes of board meetings to worker-owners.[3]

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[1] Ibid., p. 39.

[2] Ibid., p. 51.

[3] Ibid., p. 43.

The study tested the correlation of the average return and the participation index and found a positive relationship that was significant at the .005 level. Worker-owners as a percentage of the total work force as a variable was positively signed and significantly related to the cooperatives' return to shareholders at the .05 level. The number of worker-owners as a percentage of the number of total owners also showed a positive significant relationship to return at the .01 level. Correlations of performance (return) and the number of owners was not significant but had a negative sign suggesting the possible importance of considerations of firm size.

The third chapter is of special interest in the Bellas study because it discusses the impact on managers when workers have the power to fire managers. The results indicate that the managers in these firms often do not enjoy all the autonomy or psychological perquisites enjoyed by managers in traditional corporations. The compensation of such managers tended to be up to 40 percent higher than managers of equivalent conventional mills but their tenure was vulnerable and often short.[1] Managers in cooperatives were, in almost every instance, ineligible for the purchase of an ownerhsip share or for seat on the board of directors. The boards

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[1]Ibid., p. 79.

were restricted to working shareholders which resulted in at least one positive benefit for managers: decisions could often be made and approved without a complicated bureaucratic process. Managers found greater constraintson disciplining worker-owners than in conventional plants.[1] Some mills employ non-owners who receive pay (and in some cases individual incentive pay schemes) making direct comparison of different approaches to the design of compensation packages and organization of work possible. The desire of worker-owners to avoid dilution of their share of proceeds or the power of their vote often resulted in decisions to expand the scale of the cooperative by the use of non-owners; a result not out of line with theoretical work on individual maximizers in a collective production setting.[2]

The study of the plywood producers indicated the significance of the level of employee participation in the oversight process of the firm.[3] Although not statistically significant, a negative relationship between cooperative performance and the number of owners suggests the possible importance of firm scale in the study of ESOPs. That incentives

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[1]Ibid., p. 55.

[2]See especially Furubotn, "Long Run Analysis of the Labor-Managed Firm," pp. 106-7. If all additional workers had to be given a vote the employment level of the cooperative would be expected to be lower as a result.

[3]Bellas, Industrial Democracy, p. 49.

to participate in decision making decline as the number of voting individuals in the collective group increases is well documented in the study of cooperative enterprises.

> As a cooperative increases in size, it finds it difficult to maintain a high level of worker-owner participation. To increase participation, a cooperative might consider a system that combines the concepts embodied in the workers' councils and multiple management. Boards or committees, established on a functional basis, would draw their membership from the entire work force, not just from the supervisory personnel. Election regulations would favor a frequent turnover of committee members.[1]

The specialization of the representative function may also change the nature of communications and oversight in the enterprise as size increases.

> Unless growth is consciously restricted, the increased investment usually leads to expansion and possibly vertical or horizontal integration. Because there is a limited number of owners, as the cooperative expands by acquiring other production units, there is an increasing number of non-owner workers. Because they are barred from participating as equals in the decisions affecting the co-op, they tend to upset the established patterns of communication and decision-making. The size of the cooperative itself may require a more "professional" board of directors, and this will tend to reduce the turnover in directors. Communications may become less frequent and those topics discussed at the general meeting may become strategic rather than operational, making it more difficult for the owner to participate in the discussions.[2]

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[1] Ibid., p. 98.

[2] Ibid., p. 95.

The emergence of representative systems of representation to replace direct representation is also clearly a result of changing costs and benefits to individual workers as the size of the enterprise expands.

Success and aging of the workforce are two additional factors that may cause the participatory cooperative nature of the enterprise to disappear. Owners of a successful enterprise may want to sell their equity shares if a sizable but potentially transient capital gain on their investment is available.

Likewise, if many owners reach retirement age simultaneously then continued ownership of the firm by active workers may be impossible.

> Gradually the cooperative comes to resemble a conventional firm with one exception-there is a high percentage of workers who own the organization. As the worker-owners grow older and retire, the high equity built up over the years makes it difficult for them to find ready buyers. If the owners leave the firm and retain their shares, the organization scarcely differs from a conventional corporation. To a non-working owner, the value of his share is not realized until sold, and there is the ever present danger that a share will drop in value if the firm encounters problems. If these owners are to realize the value of their shares, two main avenues appear open to them: a) recapitalize the firm and "go public," or b) sell the firm to another company.[1]

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[1]Bellas, Industrial Democracy, pp. 95-96.

The aging and approaching retirement of a group of employees with large amounts of stock was clearly an important consideration when the decision was made to abandon employee ownerhsip at the Kansas City Star.

The existing investigations of employee-owned organizations suggest great variability in the importance of the considerations such as employee preference for ownership in the employing firm, the impact of ownership on information flows in the firm, and the results of employee participation in oversight of the firm. Considerations of corporate control and tax status are important to many of the firms but do not appear to explain completely why employee ownership was chosen as the form of organization. The implication of the Public Choice literature that the size of the organization and the number of shareholders would affect the operation of participatory mechanisms is clearly borne out by the varied experiences of employee-owned firms discussed here.

The nature of the worker-owned firms clearly can change over time as they become successful and/or the workforce of the firm ages. The preponderant number of these firms are smaller, more closely held firms. Although firms of this size may be less important in terms of their dollar volume of production, they tend to account for a disproportionately large share of technological innovations. The differences in the internal incentive structures of these alternative

forms of business organization may be important to fostering innovation, but such a systematic impact of organizational structure has not been documented by a thorough examination of the internal processes of the employee-owned firms.
The implications and problems of employee ownership in larger organizations are aided by the following investigation of two newspapers with histories that include extensive employee stock ownership.

CHAPTER V

EMPLOYEE OWNERSHIP IN TWO METROPOLITAN DAILY NEWSPAPERS

The Milwaukee Journal and the Kansas City Star are two newspapers with long histories of employee ownership which exceed 40 years. Both newspapers run both morning and evening editions under separate banners, the Milwaukee Sentinel is an afternoon newspaper while the Kansas City Times is published mornings. Although the Milwaukee Sentinel maintains a separate editorial department both the Journal Company in Milwaukee and the Kansas City Star Company publish only one edition on Sunday. The names, Milwaukee Journal and Kansas City Star will be used to refer to Sentinel and Times respectively as well.

The Kansas City Star was recently sold by its employee-owners because of reported management problems and insufficient ability to raise capital, and its history provides a good example of some of the problems that can arise under employee ownership. The Milwaukee Journal represents a highly successful employee owned firm that has grown substantially with employees as the only source of new equity capital and which has a highly developed system of representation of its share owning employees. The two papers serve metropolitan areas which are similar and have comparable circulations, although that of the Journal is roughly 20 percent less than that of the Star.[1] Although the trust for the Milwaukee Journal employee ownership, The Journal Employee Stock Trust Agreement, is based in part on the earlier trust agreements that instituted employee ownership of the Kansas City Star, the two papers differed widely in what employee ownership meant operationally. In the Milwaukee Journal employees own 90 percent of the stock, and it is held by a large proportion of employees. In the Kansas City Star, the stock was never offered to blue collar workers and only occasionally to foremen.[2] In both instances the issue of corporate control is important in the design and implementation of the trust agreement, but the two newspapers vary widely in the effect of employee ownership on the internal processes of the firm. In both stock plans, employees purchase the stock so that the analysis

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[1]This is true in terms of total circulation or circulation within their respective standard metropolitan statistical areas. Source of circulation figures: Audit Bureau of Circulations.

[2]Ben B. Schifman, Treasurer of the Kansas City Star, interview in Kansas City, Missouri, July 1978.

of these firms is not complicated by special tax advantages of the stock ownership plan.

Employee Ownership in the Milwaukee Journal

The history of the Milwaukee Journal, like that of many newspapers, involves risk taking entrepreneurs. Lucius W. Nieman became the paper's half owner and editor in 1882 at the age of 25 when the paper was in its third week of publication.[1] He remained editor for 53 years until his death in 1935. Nieman was succeeded by Harry J. Grant, who became chairman of the board in 1938 and retained that position until his death in 1963 at the age of 81.[2]

The death of Lucius Nieman in 1935 after 53 years in charge of the Milwaukee Journal left his 55 percent of the Journal stock in the hands of two heirs with a mandatory provision that the stock be sold within five years after his death.[3] His successor, Harry Grant, who owned 20 percent of the Journal stock, wanted to extend stock ownership

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[1] Conrad, Wilson and Wilson, The Milwaukee Journal.

[2] Ibid., p. 214.

[3] One of the heirs, Nieman's wife, donated the proceeds of her 27.5 percent of the newspaper stock to Harvard University "to promote and elevate the standards of journalism" in the United States. This bequest became the funding for the Lucius W. Nieman Fellowships. Ibid., p. 176.

to the other employees of the newspaper. A clause in Nieman's will provided that the trustees of his estate in handling the stock:

> shall not be bound to sell to persons or corporations who may bid or be willing to offer the highest price, but may sell to such persons or corporations as in the judgment of said trustee or trustees will carry out the ideals and principles which I have always attempted to maintain and support during my lifetime in the conduct of The Milwaukee Journal.

Grant felt that the persons best meeting this test were the employees of the Journal. The trustees approved an offer to buy the stock from The Journal Company to establish the employee ownership plan even though this offer was about $2.5 million less than the offer from Moses L. Annenberg, owner of the Philadelphia Inquirer.[2]

The Stock Ownership Plan

Like the plan of the Kansas City Star, the Milwaukee Journal employees own stock indirectly through a trust.

> Under The Journal Employees' Stock Trust Agreement, the actual shares of stock are placed in trust. What the employee buys is a "unit of beneficial interest." Each unit embodies all the rights of common stock with one exception: the owner cannot dispose of his units in any way that separates them permanently from the stock trust. The units must be sold to the trustees when the owner ceases to be an employee.[3]

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[1] Ibid, p. 177.

[2] Ibid., p. 178.

[3] Ibid., p. 178.

The first allotment to employees under the trust occurred in 1937 and offered units of beneficial interest "to every employee with over five years of service to the company."[1] The president of the company was given the responsibility of determining the distribution of the offers to buy stock. A definite formula of distribution was established several years later based on responsibility of the individual employees job and included union members.[2] In 1943, then president of The Journal Company, John Donald Ferguson, suggested that:

> "The allotment of stock has been such that no single group, and no possible combinations of two or three groups, including the executive group, could control the company."[3]

If this statement were actually true, then it is clear that the executive group would, de facto, control the company in the absence of any effective winning coalition to control the oversight function.

The Journal employees obtained 55 percent of Journal stock in 1947 as it became available from the estates and heirs of major shareholders. Ownership by employees rose to 80 percent in 1965 and is currently over 90 percent of total shares.

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[1]Ibid., p. 179.

[2]Ibid., p. 179.

[3]Ibid., p. 179.

The costs of direct participation in the oversight process were lowered by the institution of a representational system in 1943.[1] The institutions in place for representation through voting of the employee held units of beneficial interest provide a rather unusual mix of both the normal one share/one vote procedure typical of corporate shares and the one vote per person rule typical of many cooperatives. The system design as well as its actual operation, however, contribute to a certain amount of insulation of the oversight function from many of the owners.

The Journal Company has a board of 23 directors. In an advisory capacity to the board of directors, there is a group called the Unitholders Council whose purpose is "to give Journal Company unitholders an increasing share of the responsibilities which go with stock ownership by:

1. Creating a Unitholders Council, the function of which shall be to consult with the board of directors and officers of the company regarding matters of concern to unitholders, and to keep unitholders informed on company affairs; and

2. Providing for the election of six members of The Journal Company Board of Directors from among unitholders, one to be chosen from each of the five major divisional groups of Newspapers, Inc., and one from WTMJ, Inc.."[2]

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[1] Ibid., p. 180.

[2] "Outline of The Journal Company Unitholder Participation Plan", March 1978.

Newspapers, Inc. is the subsidiary of The Journal Company that operates the _Milwaukee Journal_ and the _Milwaukee Sentinel_ while WTMJ, Inc. operates the NBC affiliate station WTMJ-TV and a number of open air and cable radio stations. The five divisions of Newspapers, Inc., are: (1) advertising and promotion, (2) business, (3) circulation, (4) editorial, and, (5) production. In 1978 the approximate number of unitholders in each group were: (1) advertising and production - 115; (2) circulation - 168; (3) editorial - 213; (4) business office - 151; (5) production - 490; and, (6) WTMJ, Inc. -125. Based on a one man/one vote criterion, the editorial and news staff was somewhat under-represented and the production department, consisting of the unionized mechanical trade employees, was substantially under-represented.[1] Data on number of units (shares) owned by each group were not available but top management controls the allocation of rights to buy specified numbers of units; and, as a result, it is likely that the per share representation of the production department is closer to that of other departments.

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[1] The editorial and news workers are not unionized. The production workers are represented by the Milwaukee Newspaper and Graphic Communications Union, Local 23 (IPGCU), Milwaukee Typographical Union No. 23 (ITU) and Milwaukee Local No. 277, Graphic Arts International Union.

Employees elect 12 of the 24 members of the Unitholders Council to two-year terms each year. Further stipulations in the rules assume some variation in representation of functional subgroups within the group.

> All nominations ballots, to be considered valid, shall contain votes for at least two, but not more than four, candidates.
>
> No more than two persons from any subgroup as defined under the five Newspapers, Inc. divisional groups and WTMJ, Inc., may serve on the Council during a given term, except when there are no candidates from the other subgroups in the same divisional group. ...
>
> In the case of a tie among winners, the nominations chairman is to determine the winning candidate through the flip of a coin, in the presence of the two candidates. ...
>
> The procedure of flipping a coin is followed in all official elections. ...
>
> No major department head nor the principal assistant of a major department head shall be eligible as a candidate. Each unitholder shall have one vote.[1]

Due to the number of potential candidates for the four nomination slots allotted the production department, a primary election is provided for this department.

> Photographs of candidates will be posted as soon as possible in the Production Department. In the week immediately prior to nominations day, members of the Production Department will cast their ballots to select the four Production Department candidates for membership

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[1]"Outline of Journal Participation Plan", p. 2.

> on the Council. More than four unitholders must be nominated in Production Department pre-nomination balloting and at the Newspaper, Inc. divisional group and WTMJ, Inc., meetings and the names of the four candidates receiving the highest number of votes will go on the ballot for the election.[1]

An attempt is made to be particularly representative of the different trades.

> In view of the varied and specialized activities in the Production Department it is desirable that the four Council members chosen in that departmental group be representative of different trades or occupations.[2]

The cost to the entrepreneur who solicits proxies is raised considerably.

> Proxy voting at nominations meetings is permitted, but is extended only to those who are unable to attend their Newspapers, Inc. divisional group or WTMJ, Inc. meetings because of illness, vacation, absence on Newspapers, Inc. or WTMJ, Inc. business, or to those whose "Day off" falls on nominations day. Proxies may be obtained from members of the Elections Committee. One person may vote a maximum of three proxies. Any question as to the legality of a proxy will be determined by the appropriate Newspapers, Inc. department head, or by the president or vice-president of WTMJ, Inc.[3]

It is apparently not possible under this rule for one or several union employees to accomplish the election of one or two members of a given trade through proxy solicitation.

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[1]Ibid., pp. 1-2.

[2]Ibid., p. 2.

[3]Ibid., pp. 2-3.

From among the 24 members of the Unitholders Council one member from each of the six divisional groups is elected to serve on the board of directors of the Journal Company as Unitholder Director for one year. Each unitholder employee is allowed to cast one vote toward the election of a director from his divisional group.[1]

The other members of the board of directors are elected annually.

> Procedure at Stockholders Meetings: The Journal Company's directors and those of Newspapers, Inc. and WTMJ, Inc. are elected by the respective stockholders at the annual meetings held on the first Tuesday of June. Each unitholder is entitled to vote in person or by proxy at The Journal Company stockholders meeting.[2]

The *Journal* has approximately 1900 unitholders, but the annual stockholders meeting is held in a modest size room, and apparently attendance by unitholders is not encouraged by management. Tendering of proxies to the chairman of the board apparently is strongly encouraged by management through supervisors and *Journal* employees suggest that 85 percent to 95 percent of proxies are regularly received by management in most of the divisional groups.

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[1] Ibid., p. 4.

[2] Ibid., p. 4.

Preference by Employee for Ownership
in the Employing Firm

The Milwaukee Journal as well as the Kansas City Star are both firms in which employees voluntarily purchased over 90 percent of the total shares. In the case of the Journal offers to purchase stock have been widely offered and accepted by eligible fulltime employees. Both newspaper publishing companies are privately held and the value of shares has always been a function of accounting data rather than market forces. Each paper enjoys a home market that does not include a competing newspaper from another publisher. As firms that, in recent years, have not faced immediate competition from other firms' major daily newspapers, The Journal Company and The Kansas City Star Company provided very stable investment opportunities for their employees. The value of Journal stock computed from accounting data has never declined.

Since the stock of the Milwaukee Journal is not traded publicly, valuation of the stock for sale to and by employees is accomplished using a formula that uses accounting data.

> The book value of the outstanding common stock (capital plus accumulated undistributed earnings at the close of the preceding fiscal year); plus net income for the current year at the close of the preceding accounting period, less dividends paid in that year; plus 39 times the average accounting period net income of the company available for dividends on Journal stock during the preceding 65 accounting periods, divided by the number of shares outstanding. The result is the option price per unit.

This pricing formula for the Unit Option Price maintained the ratio of the Current Option Price/Current Book Value in the range between 1.35 and 1.40 in each of the years from 1967 through 1976. Since the Unit Option Price for a participating unit in the underlying common share tends to be a constant multiple of book value, critical analysis of the unit pricing scheme would be the same as that made of book value.

The markets for common stock tends to value stock based on anticipated future earnings.[1] The Journal formula for the pricing of units of beneficial interest in common shares uses a moving average of approximately the past five years' earnings. Also, if the book value reflects historical cost data on assets owned by the company, it may seriously understate the true value of the firm's assets. The current market value of the assets of a newspaper company that publishes both major daily newspapers in a metropolitan area and owns a TV station that is a major network affiliate would be reflective in part of the intangible asset's earning power in those particular alternative uses. In general, in inflationary times, book value computed on a cost basis

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[1]Posner, Analysis of Law, p. 325.

will fail to reflect the increase in the real assets of urban land and building values.[1]

The Journal Company financial statements indicate a cost basis for book value and intangible assets.[2] The following note to the consolidated financial report of The Journal Company for 1976 explains the accounting procedure used for goodwill:

> Goodwill arising from acquisitions is being amortized on a straight-line basis over 40 years except for goodwill resulting from business combinations consummated before November 1, 1970 ($6,885,772 at December 31, 1976), which is not being amortized as the Company believes there is no diminution of value.[3]

The acquisition of the Milwaukee Sentinel, as well as the broadcasting, cable television and commercial printing operations all predate 1970.

In 1978, the Supreme Court ruled against forced divestiture in most cases of ownership of two different types of communications media in the same community , but upheld the rights of the Federal Communications Commission to block the formation of cross ownership in the future. This decision, if it

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[1]Leopold A. Bernstein, Financial Statement Analysis: Theory, Application and Interpretation, Revised edition (Homewood, Illinois: Richard Irwin, Inc., 1978), p. 209.

[2]The Journal Company, "Annual Report to Stockholders", 1976, pp. 4-7.

[3]Ibid., p. 7.

has any effect, could only increase the value of The Journal Company's assets.

The understatement of book value provides tax advantages to stockholders since any appreciation of tangible or intangible assets is not realized. For the years 1967 through 1976 the return on Journal Company stockholder's equity has been extremely stable.[1] Yearly dividends are consistently about 60 percent of the amount of increase in the unit option price so that the majority of employee gain is unrealized and therefore not taxed.[2] Since many employees have borrowed money to buy stock, the dividend may be important to them to meet the debt costs.

The impact of conservative understatement of the value of shares of the Journal is advantageous to employees from a tax point of view as long as they remain with the company. Employees who quit or retire and sell shares back to the company have no chance of ever realizing any subsequent capital gain in the value of Journal stock. If the stock were publicly traded then the market price would reflect these potential gains. In the case of a privately held untraded corporation, an internal change would be necessary to increase stock value to reflect more

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[1]Ibid., p. 8.

[2]Ibid., pp. 10-11.

closely market value. Any such move would make it more expensive for employees to own most or all of the company.

Any company in which common shares are undervalued are potential take-over candidates. In both the Milwaukee Journal and the Kansas City Star any reasonable take-over would represent a substantial capital gain to employee stockholders. The Kansas City Star Company, for example, had the option to repurchase Participating Certificates representing common stock from employees in the event of termination, death or in the event the employee attempted a transfer of the certificates without the permission of the board of directors.[1] The offer of Capital Cities Communications for the Star was $139.54 per share or slightly more than double book value of $68.50 per share at the end of 1976.[2] A recently alleged take-over offer for the Milwaukee Journal was reported to be 2.5 times the Unit Option Price which is approximately 3.5 times the book value per share. Offers of this type are likely to be quite tempting to employee

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[1] "Offer to Purchase by Capital Cities Communications, Inc. Any and All of the Outstanding Shares of Common Stock of The Kansas City Star Company", January 18, 1977, p. 4.

[2] Letter from W. W. Baker, President of The Kansas City Star Company to stockholders in reference to the Capital Cities offer dated January 18, 1977, p. 4.

stockholders; employees of the Kansas City Star tendered 100 percent of the outstanding stock of their company.[1]

At some relative price, employees could be induced to purchase stock in almost any reasonably healthy company. Capital Cities Communications offers stock in its company to the Kansas City Star employees at 85 percent of the low market price for the year.[2] In both the Kansas City Star and the Milwaukee Journal newspapers under employee ownership stock were voluntarily purchased by employees who would gain considerably in monetary terms in the event of a successful take-over.

In the face of substantial monetary gains from selling out, it may be difficult for employees to retain employee ownership of their home city or town newspapers. The decision to give up employee ownership at the Star was made by its employees and conditions exist which will likely test the strength of employee preferences for ownership of the Milwaukee Journal. Important questions arise as to what positive aspects of the employment relationship will be lost if employee ownership is given up and also as to what the change in ownership structure implies for the greater communities in these cities.

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[1]Interview with Ben B. Schifman, July 1978.

[2]"Prospectus, Capital Cities Communications, Inc., 1977 Employee Stock Purchase Plan" dated April 28, 1978.

Information Flows and Productivity

The Milwaukee Journal, under employee ownership, has a highly developed representational system through which managers could learn what employees desire in terms of the structure of their job requirements and compensation package. Also, employee ideas for improving productivity could be transmitted through the channels of the employee representational structure.

The functioning of the Unitholders Council of the Milwaukee Journal appears to address many of the considerations through committees. In the area of job, compensation, and productivity, considerations of employees and management, there are committees on: (1) safety, (2) cafeteria, (3) employee events, and, (4) benefits, pension and medical concerns.

Informational flows in the company are the concern of three of the committees: (1) education, (2) communications, and (3) publications. The education committee set two primary goals for itself in 1977:

> (1) To inform Council members and unitholders in general about their company in order to help prepare them for "control and direction" of the Company; (2) to develop and suggest proposals of merit to the Council for submission to management.[1]

[1] Journal Company 35th Term Unitholders Council Education Committee, "Final Report", May 22, 1978.

The communications committee was formulated as a result of a 1977 employee opinion survey. The committee suggested a program of termination interviews to explore the causes of employee turnover.[1] In 1977, the systematic analysis of turnover was not being undertaken by the company and data on this subject was not readily available to management.

The publications committee is responsible for analysis of written communication in the company. Intracompany written communications are accomplished through a monthly newsletter, "Your Business", that is usually 15 to 20 pages in length. This publication contains a good deal of information about The Journal Company and usually features a fairly lengthy article about some aspect of company operations. The articles tend to be very upbeat, but at the same time provide an educational insight into The Journal Company. A section entitled, "Open Exchange", started in 1978, provides management responses to employee questions about aspects of company operations or other employee concerns.

Communication between the Unitholders Council and the employee-owners of The Journal Company are accomplished through a newsletter, "Intercom" that runs about 12 pages and gives regular reports on Council activities. This

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[1] Journal Company Communications Committee, "End of Term Report, 35th Term", 1978.

publication is somewhat less informative about company operations, but it does provide some insight into the Council's role with management and with employee-owners.

In both written and oral form, there is a good deal of communication in The Journal Company between management and the Unitholders Council and between the Council and the employees.

The Unitholders Council has two committees that deal with the representation of employees and the information: the elections committee and the stock and business education committee. The 1978 elections committee statement of April 4, 1978, suggests the following purpose for the Unitholders Council to be elected.

> The purpose of the Council is to prepare Unitholders for broader participation in the affairs of The Journal Company, Newspapers, Inc. and WTMJ, Inc., and to keep Unitholders informed on those affairs. The Council is also your representative in consulting with the Board of Directors and officers of the above-mentioned companies regarding matters of concern to Unitholders.

This is somewhat more ambiguous than the role suggested by the education committee where eventual control and direction of the company was foreseen.

In actual operation, the clear role of the Council appears to be strictly advisory in relation to the board of directors and the board is not bound to implement any of the suggestions of the Unitholders Council. The divergence between an actual controlling oversight function for employees and communications with management that are purely advisory in nature results in some frustration that shows up very occasionally in Unitholders Council committee reports. For the most part, the written communications by management to employee-owners and by the Unitholders Council to employee-owners tend toward self-congratulatory prose. A report to the board of directors at the end of the 35th term in 1978 by the Unitholders Council Chairman provides an example:

> A year ago, addressing the first meeting of the 35th term of the Unitholders Council, Chairman Abert recounted how, in May of 1943, Harry Grant proposed creation of a council to represent The Journal Company's employee owners.
>
> It was recalled that, in instructing his executives to devise such a plan, Mr. Grant emphasized that such a council should be "a link, a clearing house, a contact medium between management and the unitholder group."
>
> The past year has provided much evidence of how effective that idea was.
>
> The council has earnestly endeavored to identify areas of interest or concern to unitholders. It has discussed them with management and made recommendations. And management has responded in a spirit of candor and cooperation.[1]

The results of an employee opinion survey in 1977 and of many of the activities of the Unitholders Council committees is to promote better communication that provides employees and management with better information that could contribute

[1] Journal Company Unitholders Council Chairman, "End of Term Report, 35th Term," 1978.

to productivity and changes in aspects of job structure that are preferred by employees.

The generation of this information facilitated by the Unitholders Council is an object of continuous concern in the comments of both management and the Unitholders Council members. This information is costly in terms of time it takes to generate and transmit. Unitholder Council members put in a substantial number of hours beyond that required by their job assignments with The Journal Company. There is no specialized paid function of representation of employees through the Council. The return to the extra time effort put in by Journal employees who serve on the Council is the ability to learn useful managerial knowledge about the company and to attract the attention of management to the Council member's potential for a management job.

In this incentive structure, it is quite likely that the role actually played by the Unitholders Council will be one that is weakly advisory rather than strongly advocatory of employee-owner preferences. The use of information that might improve productivity or the perceived quality of the employees' job depends wholly upon the discretion of management. In The Journal Company an extensive effort is made to make sure information is available to management and management makes a concerted effort to present its views to the employees. What this exchange of communications means in terms of the direction of the corporation requires an analysis of corporate control in The Journal Company.

The Oversight Process and Corporate Control in The Journal Company

Corporate control of The Journal Company is concentrated clearly in the hands of the board of direcors and specifically, the chairman of the board who also bears ultimate responsibility for editorial policy in the two newspapers published by the company. The Unitholders Council acts in a strictly advisory role to the board and employees elect six members of the Unitholders Council to sit on the board of directors. The other 17 seats on the board are filled by the chairman of the board, the president, and various vice presidents of The Journal Company, plus the presidents of several of the wholely owned subsidiaries. Employees also elect five of the Unitholder Council members to the Newspapers, Inc. board of directors and one Unitholder Council member to the board of WTMJ, Inc.

Since the Unitholders Council elects only six of the 23 seats on The Journal Company board of directors, the key to corporate control is the election of the remaining 17 seats on the board at the annual meeting. The election of these seats by shareholders on a one vote per share (non-cumulative) basis indicates the importance of the distribution of shares among employees.

Information on the distribution of shares among employees as well as the exact formula for offering shares to employees is a closely held secret among top management. The general criterion given by management guiding offers for employees to buy stock is the responsibility associated with the job description of the individual. A reasonable proxy in aggregate for the formula might be salary which is used as the formula in many other stock ownership plans. Since The Journal Company ownership plan is not a legally defined ESOP trying to qualify for tax incentives, the plan is not constrained in the amount of stock that can be allocated to highly compensated individual employees. Also, it is quite possible that, for instance, a job in the production division might be considered to have less resonsibility than a job in another functional area at the same salary and therefore, the production employees would have been offered many fewer shares over the years.

If salary times years of service does provide a reasonable rough aggregate estimate of the distribution of shares then an interesting question becomes how far down the management hierarchy could be found a majority of votes. Managers are likely to be employees with long job tenure and should have accumulated significant blocks of stock if they chose to buy those units offered to them over a number of years. If these same managers have an incentive to cast their votes in a way pleasing to top management to help insure the continued longevity of employment and advancement, then it should be quite easy for top management to elect its slate of directors and pursue the program it deems prudent. The six Unitholder directors, if they too aspire to higher managerial positions, also may be quite supportive of the program of top management. The process would be more explicit if proxies of lower level managers were regularly tendered to the executive group.

In the Milwaukee Journal, the Unitholders Council does appear to be an advantage in obtaining higher management positions because it provides both educational and promotional opportunities to prospective managers. The Unitholder directors on The Journal Company board of directors would be expected to be cooperative with the executive group who hold the other seats on the board. Also, since the rate at which proxies of all employees are tendered to the chairman of the board seems to be extremely high, the executive group can easily perpetuate itself in the other 17 seats on the board of directors.

The results of public choice research suggests that individuals will often neglect to vote based on rational individual expectations about affecting the outcome of the election and the value of a change in the individual's life as a result of a change in an election outcome. Such individual calculus of costs and benefits is likely to enter the individual's decision to assign proxy rights to his vote.

In a corporation that is owned by individuals employed with the organization individual costs and benefits may be even more apparent. The Journal Company's two-tiered representational system would not be expected to be an effective system for employee control of the corporation through the oversight process. The system does appear to generate a good deal of information exchange between employee-owners and management. there has never been a vote against management at The Journal Company. Management has an "open door" policy with respect to the grievances of individual employees or groups, as well as a willing ear to the suggestions of employees voiced through the Unitholders Council. Control of the corporation very obviously radiates downward from the executive group rather than upward from the stockholders.

The results of employee ownership as it is practiced at The Journal Company may be efficient from a production aspect because it facilitates two-way information flows without a loss control of operations by management. The employees, as owners, could capture in aggregate the returns to any increased productivity in the eventual value of their stock holdings. The Bellas study of cooperative firms suggested that success often led to a loss of the cooperative nature of the enterprise.[1] A possible threat that arises from The Journal Company's success results from the divergence between the value of company calculated by conservative internal accounting methods and the value of the company to another organization. Employees might be tempted to accept an offer that more than doubled the value of their stock holdings.

The aspect of the operation of The Journal Company that may work to retain the employee ownership is the control imposed by management. The employees were not consulted on the most significant decisions made by management such as the decision to purchase the Milwaukee Sentinel. No referenda system is in place that makes public the aggregate preferences of employees as a yardstick by which to measure management. If the executive group reflects its personal preferences in many decisions, and as a relatively wealthy group has diminishing marginal utility from additional wealth and strong preferences to retain control of The

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[1] Bellas, Industrial Democracy, p. 95.

Journal Company, they might be more likely to resist takeover bids than less wealthy employee-owners.

Job, Compensation and Pension Aspects of Stock Ownership at The Journal Company

The Journal Company provides a broad range of employee benefits in addition to the options of employees to purchase stock. In 1975, the company made the following contributions towards benefits.[1]

Benefit	Contribution of Employer per Fulltime Employee
Time off with pay	$1,716
Retirement benefits	1,400
Insurance benefits	821
Unemployment taxes and employee activities	193
Total	$4,130

During the same year, the normal turnover of stock sold by employees and repurchased by other employees was $1,964 per fulltime employee. Fulltime employees owning stock were 1,531 out of a total fulltime population of 1,910 which means that the average yearly purchase of turnover stock per employee purchasing stock was $2,450.

[1] "Supplement to The Journal Company Annual Report," 1975, p. 1-A.

Of the turnover stock, 74 percent was provided by sales of retired employees.[1] In 1975, the employees percentage share of stock owned increased to 85 percent of total shares with 15 percent of total shares remaining in possession of a private foundation, The McBeath Foundation, which owns shares from the Lucius Nieman estate originally given to his niece, Faye McBeath.[2] These additional shares purchased amounted to $1,204 per fulltime employee or $1,502 per stock owning fulltime employee.

The ownership of employees is now over 90 percent of total shares so that recent purchases by employees other than turnover shares have been significant and total purchases per employee higher than they could be when 100 percent of the stock is held by Journal Company employees. It is significant, however, that considering turnover stock only, employee purchases of stock were equal to almost 50 percent of company expenditures on benefits per employee and is almost equal to the average 1975 company retirement payments per retired employee. The stock plan is a very significant part of the potential total employee and company provisions for retirement income.

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[1] "The Journal Company Annual Report to Stockholders," 1975, p. 19.

[2] Wilson, Milwaukee Journal, p. 181.

The Journal Company compensation package features a Savings and Profit-Sharing Trust that had 1,975 employee account balances equal to $2,018 per fulltime employee.[1] Total value of Journal Company stock held by employees by comparison was equal to $41,836 per fulltime employee when valued at the 1975 Unit Option Price of $26.13.[2] For 1976, the comparable figure was $46,176 with a Unit Option Price of $28.27.[3]

The Journal Company Employees' Pension Trust balance at December 31, 1975 was equal to $9,283 per fulltime employee.[4] The average figure for the value of employee stock holdings is clearly pushed upward by highly compensated members of the executive group who have had long tenures with The Journal Company. More detailed information that excluded executive holdings would provide a more representative set of figures for the typical Journal Company employee. It is clear however that using the conservative internal accounting valuation of all shares in the assets of The Journal Company Stock Plan in 1975 dwarfed the combined

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[1] "Supplement to The Journal Company Annual Report," 1975, p. 4-A.

[2] "Journal Company Annual Report to Stockholders," 1975, p. 19.

[3] "Journal Company Annual Report to Stockholders," 1976, p. 9.

[4] "Annual Report," 1975, p. 3-A.

assets of the Pension Trust and the Savings and Profit-Sharing Trust by a ratio of over 2.4 to 1.[1]

The Journal Company pension benefit levels are computed by a formula that takes into account years of service and final 10 year average monthly compensation of the individual employee and subtracts 75% of the primary Social Security Benefit received by the retired employee. The example given employees in the company pension plan booklet in 1976 suggests that a representative individual with 35 years service would receive $307.50 monthly from the company if they received a Social Security Benefit of $410 a month for a total retirement benefit of $680 monthly. Union members in the production department would receive modest supplemental benefits from their unions. Other employees who elected to participate in the Employees' Savings and Profit-Sharing Plan would receive modest supplemental benefits.[2]

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[1]Ibid., p. 19.

[2]A representative individual who contributed 5% of income from the age of 30 to 65 would receive an additional amount contributed by the company equal to 40% of his contribution would have $68,480 as his account total available as a benefit. "Employee Savings and Profit-Sharing Plan" booklet of The Journal Company. The term profit sharing refers to the option of the company not to contribute if it has no pre-tax profit. This situation has never occurred.

The investment performance of these various retirement plans is important for employees to consider in an inflationary environment. The purchasing power of a $680 monthly combined pension-social security benefit would be severely eroded in a period of at least 10 percent annual inflation as has been the case in recent years. The performance of the supplemental Savings and Profit-Sharing Trust was 7.17 percent in 1974 and 8.16 percent in 1975 while the market value of pension plan funds increased 10.8 percent in 1975.[1] The stock plan unit option price increased $2.44 and provided a dividend of $1.18 for a 14.5 percent return on the 1974 unit option price of $23.69. An average annual return on investment in Journal Company stock held from 1965 to 1975 was 24.8 percent per year.[2]

An assessment of risk should be applied to the performance of these primary and supplemental retirement plans. The portfolio of the pension fund was 60 percent U. S. Government securities, corporate bonds and short term money market instruments and 40 percent corporate stocks. The bonds, if they were held to maturity would have maintained their face value amounts but lost ground to inflation in terms

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[1] "Supplement to The Journal Company Annual Report," 1975, pp. 3A, 4-A.

[2] "Journal Company Annual Report to Stockholders," 1975, p. 9.

of their purchasing power. Bonds not held to maturity would be subject to significant market (systematic) risk of reduced principle as a result of falling bond prices. The diversified common stock portion of the pension fund's portfolio would also be subject to significant systematic (market) risk and is likely to have lost ground to inflation.

The Savings and Profit Sharing had a portfolio of investment in 1975 that contains deposits with Journal Credit Union (35 percent of total investments), Treasury Bills, Notes and Bank Certificates of Deposit (40 percent of total investments) and less than 5 percent Common Stocks. This portfolio is fairly free of systematic and unsystematic risk, but would have lost significant ground to inflation over the last 10 years. In very recent times, a similar portfolio of short maturity government and commercial paper has just about kept pace with inflation. The portfolio of this supplemental retirement plan would have lost much ground to inflation over a period of time more than several years, but features a very safe posture for the nominal principle amount of employee account balances.

Employee investments in Journal Company Stock involve risk of unsystematic variation in the return related to the operation of The Journal Company and the possible resulting fluxuation of its book value. The performance of The Journal

Company net earnings, return to stockholders equity, advertising linage and circulation was remarkably stable in the period 1966 to 1975.[1] The threats to this performance are several but remote. The competition of another major daily newspaper in Milwaukee could be a threat if one was started and able to capture a substantial part of the readership of the Journal and Sentinel. The newspapers as well as the broadcasting operations are subject to potential reductions in profitability due to government regulation. Farther in the future, the Journal must consider the competition of an electronically broadcast video newspaper or a national newspaper "zoned" for Milwaukee readers.

The largest threat to employee ownership at the Journal is a substantial take-over bid which is made more attractive by the contrast with the conservative valuation used internally for unit option purchases and sales. The possibility of a take-over raises interesting questions to which some insight can be gained by an examination of the demise of employee ownership at the Kansas City Star. A similar sell out of The Journal Company or its subsidiary, Newspapers, Inc., at terms of several times the unit option price as

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[1]Ibid., chart entitled "The Journal Company's Record Ten Years of Growth", pp. 8-9.

suggested by the recent alleged offer, would make current stockholders much wealthier. It is not clear what might be lost or gained in the character of the working relationships at The Journal Company. New owners could have a formalized mechanism of employee input to receive information and ideas from employees and accept or reject such advice.

The citizens of Milwaukee area who do not own Journal Company stock might wish to consider what importance they attach to a localized ownership structure for what is easily the most important communications institution in Milwaukee. The potential exists for a partial or complete buyout of current Journal Company stockholders by other members of greater Milwaukee community. Any significant shift in ownership structure would likely change the incentive structure and internal functioning of the organization, affect the oversight process and, perhaps, have important implications for the local market for ideas in Milwaukee.

Employee Ownership in The Kansas City Star Company

The *Kansas City Star* became employee owned under the "Stock Trust Indenture, Dated July 28, 1926," incorporated as the Kansas City Star Company 11 years before the ownership plan at the *Milwaukee Journal* was put into effect. The paper was sold to Capital Cities Communications, Inc. on February 15, 1977 by its employee owners after over 50 years of internal ownership and control.

The experience of the Kansas City Star during those years of employee ownership provides interesting parallels and contrasts with the experience of the Milwaukee Journal.

The Kansas City Star was founded in 1880 by William Rockhill Nelson and Samuel E. Morss. Nelson was the dominant personality; Morss left the paper and Kansas City in 1881 and Nelson held sway as owner and publisher until his death in 1915.[1] The provisions of Nelson's will were such that the newspaper was operated under trusteeship as part of his estate until 1926 when it was put up for bid.[2] Much like the history of the Milwaukee Journal, a group of employees prepared a bid that was approved by the trustees as meeting the terms of will as the "highest and best" offer, although it was not proven that the offer was the highest received.[3] Through the use of the Stock Trust and with credit of about $4 million supplied by Irwin R. Kirkwood, the son-in-law of Nelson, the paper became the property of 87 members

[1]William Jackson Bell, "A Historical Study of the Kansas City Star Since the Death of William Rockhill Nelson 1915-1949," (Ph.D. dissertation, University of Missouri, 1949), p. 181.

[2]Ibid., pp. 181-183.

[3]Ibid., p. 191.

of the staff, with Kirkwood owning 51 percent of the participating certificates under the Stock Trust.[1]

The Stock Ownership Plan

The Stock Trust Indenture of 1926 provides ownership through the use of the Stock Trust, which issues Participating Certificates which represent ownership rights in the underlying common share of the Kansas City Star Company. These certificates pass on all rights of the common shares including voting rights, but they can be sold only to the Company or an individual designated by the Board of Directors at the higher of book value or par value.[2]

> The Company's Articles of Incorporation provide that holders of Common Stock are entitled: (a) to receive such dividends as may be determined by the Board of Directors out of the surplus or net profits of the Corporation; (b) to one vote for each share, with the privilege of cumulative voting in elections of directors; and (c) to share ratably on liquidation or dissolution in assets available for distribution to stockholders. There are no preemptive rights except such right of holders of Common Stock to acquire additional shares thereof as may be provided in any stock trust indenture respecting the Common Stock. As stated above, the Stock Trust Indenture provides for issuance of all Common Stock to the Trustee thereunder.[3]

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[1]Ibid., p. 197.

[2]The Kansas City Star Company, "Prospectus, 150,000 Shares of Common Stock ($15 par value)" dated August 17, 1967, pp. 18-19. Book value is par value plus any undivided profits and has always been greater than par value.

[3]Ibid., p. 16.

The Participating Certificates "are subject to an option to repurchase in the event of termination or attempted transfer to someone not approved by the board of directors."[1]

If the person retires or otherwise ceases to be an employee, he must resell at the book value unless he's "a retired officer or employee who has secured approval for retention of his Participating Certificates."[2] For those retaining Certificates after retirement the price for subsequent resale would be the book value at the time of retirement.[3]

Along with the privilege of cumulative voting for directors, the holders of Participating Certificates are entitled "to vote on all matters coming before" stockholders meetings "including specifically, but not limited to, matters pertaining to any change in the charter, capital structure, election of directors, or any merger, consolidation or dissolution."[4] The voting rights of the Participating Certificates are assignable by the holder to another individual to vote his shares as substitute proxy.[5]

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[1]Ibid., p. 3.

[2]Ibid., p. 18.

[3]Ibid., p. 18.

[4]Ibid., p. 18.

[5]Ibid., p. 17.

The voting rule for a change in the Stock Trust Indenture is a 75 percent majority.

> The Stock Trust Indenture can be amended or terminated by the holders of three-fourths or more of the total number of outstanding Participating Certificates and the trust by its terms terminates twenty years after the death of the last to survive of the owners of Participating Certificates who were parties to an instrument dated January 12, 1967, which amended the Stock Trust Indenture. Upon termination the holders of Participating Certificates are entitled to receive pro rata the underlying Common Stock.[1]

The restrictions on the Participating Certificates against transfer to outsiders and resale at book would be removed when this amendment took effect. The rule would require a 75 percent consensus to pass any amendment that would allow the company to go public and give up complete employee control and ownership. This 75 percent majority was obtained in the 1977 sale to Capital Cities Communications, long before the required delay specified in the amendment quoted above had transpired.

In the Kansas City Star Company employees were also offered a second way in which to indirectly own shares through a trust arrangement. The Associated Employees' Trust (AET) Dated August 9, 1935 established Beneficial Units to represent underlying shares of Participating Interest. This is a twice removed ownership of common shares in which

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[1]Ibid., p. 18.

the underlying vote was voted by trustees of the AET who are the Directors of the Kansas City Star Company.

> The choice between purchase of Participating Certificates or Beneficial Units is left to the individual employee, although the Company may suggest the purchase of Beneficial Units if the employee has any intention of transferring any such acquired intrest to a member of his family, since the Participating Certificates cannot be so transferred . . .
>
> Beneficial Units are subject to an option to repurchase upon occurrence of various option events similar to those applicable in the case of Participating Certificates, which affect either the holder of the Beneficial Unit or, if he is not an employee or retired employee, then also the employee to whom or at whose request the Beneficial Units were issued. In addition, the Trustees may elect to repurchase at any time and create an option event by giving notice of the election. The option period is thirty days and the option price is the current value of the assets underlying the Beneficial Units.[1]

In practice these shares were used for individuals who were ready to retire, were retired, or the surviving heirs of a current or former employee. Since the voting was not a right of these shares and they also were subject to a repurchase by the company with 30 days notice, which was not a condition of the Participating Certificates, the directors could be less concerned about ownership by non-current employees.

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[1]Ibid., pp. 17-19.

Operating under both trusts, it would be possible for the directors of the company, who controlled the offers of both types of ownership shares, to offer a current employee an interest in the company with or without voting rights.

The Kansas City Star Company at the time of its sale to Capital Cities employed just under 1700 full and part time employees in the newspaper operations of which about 1350 were fulltime. The company also wholly owned the subsidiary Flambeau Paper Company and owned 90 percent of the subsidiary Graham Paper Company. These companies employed 516 and 798 persons respectively. Of the full time newspaper employees, 36 percent were represented by unions in 1975.[1]

The preferences of the employees who were offered stock by the directors of the company were insufficient in the last two stock offerings which caused them to be undersubscribed.[2] Since blue collar workers were not offered stock a significant number of potential employee-owners, mostly union members, were never offered share in contrast to the stock ownership by unionized production employees of the <u>Milwaukee Journal</u>.

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[1]"The Kansas City Star Company, Prospectus 100,000 Shares of Common Stock ($15 par value)," dated July 15, 1975, p. 16.

[2]Interview with Ben B. Schifman, 1978.

Information Flows and Productivity

The financial performance of the Star Company stock, as transacted at its book value, although not spectacular in the year prior to the sale of the company, was solid. In the years 1971 through 1975 the book value increased 10 percent, 9 percent, 14 percent and 5 percent on a yearly basis compared to the 9 percent, 8 percent and 10 percent increase in the unit option price of the Milwaukee Journal.[1] Both newspaper companies provided dividends that were between 4 percent and 5 percent of transaction share prices in the respective years.

The Kansas City Star Company faced potential major expenses in the years before the sale. A work stoppage by 98 members of the Web Pressman's Union No. 14 (IPGCU) resulted in their subsequent discharge by the company in May 1974. The company faced possible liability for back pay to the pressmen whose payroll averaged $200,000 prior to their discharge.[2] This was discussed in the offer to purchase the Star by Capital Cities Communications. The final decision in June, 1978 by the National Labor Relations

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[1]Figures for the Kansas City Star computed from book values and dividend data found in: "Offer to Purchase," p. 4. Figures for the Journal Company computed from Unit Option Price and dividend data found in: The Journal Company "Annual Report to Stockholders," 1976, pp. 10-11.

[2]"Offer to purchase by Capital Cities Communications, Inc.," p. 9.

Board was in favor of the company in all but two dismissals, but this was over a year after the sale was concluded.[1]

The Flambeau Paper Company was hit by two simultaneous problems. First, a natural gas shortage faced by it's supplier of steam power resulted in a 30 percent reduction in the plants maximum production capacity.[2] Secondly, the Wisconsin Department of Natural Resources required the plant to reduce its discharge into the Flambeau River which forced the company to undertake a $12 million expenditure for pollution controls.[3]

The specific problems discussed above came on top of what appeared to be significant overall management problems in the years leading up to the sale. Information flows between employees and management and even among management seemed to be poor. The walkout of the pressmen was one indication that productivity was low in the production area. Direction by management at the level of the employees tasks as well as at higher levels seemed to be missing. These problems were recognized within the ranks of management. Communication among management indicated that employees

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[1] Kansas City Star Company and Web Printing Pressman's Union No. 14, June 12, 1978, 235 NLRB No. 119.

[2] "Offer to Purchase," p. 10.

[3] Ibid.

had little knowledge of what was expected of them and that turnover of employees was high.

A memo several months after the pressman's strike indicating that management problems in production of the newspaper was making the transition to more productive cold type printing technology extremely difficult suggested that management needed to formulate basic strategy that would:

> Set reasonable short- and long-term goals for all departments, and make them known to every employee. Not only will employees respond, they also will stop drifting away to other jobs after we have spent the money to train them. We need to retain all the goodwill and special expertise we possibly can, as our pressroom experience sufficiently illustrates.[1]

The Kansas City Star was described by its financial vice president and treasurer at the time of the sale as a newspaper that for 15 years had been run by "good newspapermen but poor managers.[2]

Discussions with management indicated that they felt the newspaper was overstaffed. One comment suggested that 40 or 50 extra people with salaries up to $22,000 a year were on the payroll.[3] In January 1978, under new

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[1]Management memorandum, Jo Hoffman, director of special projects to Cruise Palmer, executive editor and director, dated 10 October 1974.

[2]Interview with Ben B. Schifman.

[3]Ibid.

ownership, employment dropped by 144 employees over 1977 levels.[1]

Problems of turnover and absenteeism were particularly bad in the production of the newspaper. Prior to the pressman's strike absenteeism among the 110 employees of the pressroom was measured at 13 percent of the scheduled hours. By comparison the plant wide rate was 2.8 percent of scheduled hours in the first quarter of 1978.[2] Prior to the takeover, management did not systmatically keep data on quits nor conduct exit interviews about the causes of turnover. These practices were adopted in the first quarter of 1978 under the new management.[3] The internal analysis of management suggested that both the information flows and the reward structure for employees was not conducive to productivity.

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[1]Based on figures supplied by the Personnel Department for full and parttime employees in both years. Separation data indicates 85 separations processed in the first quarter of 1978: 51 quits; 17 discharges; 15 retirements; 1 deceased and 1 for health reasons. Data for the period subsequent to 15 January 1978 through May of that year indicated 44 hires net of separations. Of these circulation gained 59 employees, advertising gained 5, production lost 18, business and editorial stayed about even on net.

[2]Kent Simcosky, Director of Personnel, interview at the Kansas City Star, July 1978.

[3]"The Kansas City Star/Time Separations: Reasons for Leaving and Exit Interview Responses," 1st Quarter 1978, Personnel Department, April 28, 1978.

> We must value and reward those who are willing to work to a high standard.
>
> Make the system more responsive. Get suggestions from everywhere, listen to all ideas, give credit where it's due, and make sure that EVERYONE in management subscribes to this idea.
>
> Take a good look at the kind and quantity of areas that each executive is expected to cover. If any one is stretched too thin (either out of respect for tradition, because he is empire-building, or simply because he can't say no), consider realigning his duties to make him more efficient, or to improve company operations generally.[1]

The management problems, along with concurrent financial burdens due to the advancement of technology in printing, environmental regulation of the subsidiary paper manufacturer had all crept up on a management structure that was slow to respond to change.

One additional financial shock was the regulatory requirement of the Employee Retirement Income Security Act of 1974 (ERISA) that the Star pension trust not invest more than 10 percent of its assets in company stock.[2] The law required that the pension reduce stock holdings to 10 percent of its assets by December 31, 1984. In 1974, 63 percent of the funds assets were in Star stock and under ERISA the trust "must by December 31, 1979 have divested at least one-half of such securities." The book value

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[1]Management Memorandum, Hoffman to Palmer, 10 October 1974.

[2]"The Kansas City Star Company Prospectus," July 1975.

of Star stock held was $4,231,300 in December 1974 and 10 percent of the pension trust assets were equal to only $673,400 indicating that $3,557,900 in stock would have to be repurchased from the trust.[1] The Pressman's Local No. 14 was seeking $10 million in the labor dispute that was still unsettled in 1976.[2]

The pollution control expenses of the paper plant ($12 million), stock repurchases mandated by ERISA ($3.5 million) and expenses of new printing technology (about $3 million) represented a substantial future burden on a company with a 1975 stockholder's equity of less than $77 million. These costs in conjunction with overall poor management, labor problems and low productivity were certainly sufficient to make management receptive to potential offers to purchase.

> There are many employees at The Star who do not believe that the paper can be "turned around." They believe that within five years the newspaper will have to be put on the block. They cite the balance sheets, examine the inadqequate plant, consider our computer commitment, observe the success of our competitors, compare us with other newspapers, and say: "We have lost our newspaper."
>
> I disagree. Anyone--Newhouse or whoever--who bought this paper would do so expecting to turn it around and fast. He would cut his losses and would restructure the operation, not merely to "save" it but to build back up what may well be the last great underdeveloped newspaper property in the country.

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[1] Ibid., pp. 20-21.

[2] The Kansas City Star Company, "Notes to Consolidated Financial Statements," 1975, p. 91

> We can do the same thing, if we are willing to do what must be done.[1]

In the face of an offer from Capital Cities the employee stockholders decided to let somebody else make the required changes in the management practices of the company.

Corporate Control and Oversight in the Kansas City Star Company

The group of 87 original stockholders who organized under employee ownership in 1926 grew to 117 stockholders in 1939 and 250 in 1949.[2] There were about 530 employee-owners at the time of the sale, still less than one third of all employees and 40 percent of full-time employees.[3] Since the pension fund held *Star* stock, the Securities Exchange Commission held that there were more than 1,500 shareholders of interest.

Control of share votes was restricted to those employees who held Participating Certificates or those who controlled votes as trustees of the Beneficial Units in the Associated Employees and Participating Certificates in the Pension Trust.

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[1] Conclusion to 1974 Management Assessment by Jo Hoffman. Part of this quote appears in *Editor and Publisher*, February 26, 1977, p. 11.

[2] Bell, "The *Kansas City Star*," p. 212.

[3] "Newspaper Sales Brings Sudden Riches to Staff," *Editor and Publisher*, February 26, 1977, p. 11.

> ...Officers and directors of the Company, hold as trustees of the Company's Pension Trust 68,690.02 Participating Certificates, 7.8% of those outstanding. The combined holdings of officers and directors, in their individual and trust capacities represent voting power with respect to approximately 39.35% of the outstanding Common Stock. ...
>
> The Associated Employees' Trust under which Beneficial Units are issued has seven individual trustees, empowered to elect their successors. The Trustees have always been the members from time to time of the Company's Board of Directors. Board members have always been full time employees of the Company.[1]

A significant amount of the oversight authority rests with management. Although cumulative voting is allowed, there has never been an outside director.[2] The directors, in 1976 prior to the sale, had an average tenure as officers of the company of about 12 years.[3]

The representation of employees, other than officers, through the board of directors was slight at the Kansas City Star. There were no employee directors nor an advisory board such as was found at the Milwaukee Journal. Informal communication between management and employees at the Star

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[1] The Kansas City Star Company, "Prospectus," 1975, pp. 20, 25.

[2] Interview with Ben B. Schifman.

[3] Computed from data in Star, "Prospectus," 1975, p. 18.

also seems to have been insignificant. A memorandum in November of 1977 asks:

> Why was the promised employee handbook never completed? Why don't we have an employee publication? Even a cheap one?
>
> ...Why do we put up with such an antiquated telephone system, which effectively isolates the other elements of the company from us?[1]

Further control and isolation of employees from the management process occurred through the screening device that never let the option to purchase be extended to a majority of the firm's employees.

> The Participating Certificate and Beneficial Units covered by this Prospectus are offered by the Company to employees of the Company who (i) on or before December 31, 1975, shall have been employed for at least two years, (ii) have been recommended by the head of the department in which they are employed and (iii) are approved by the Board of Directors.[2]

The management at the <u>Kansas City Star</u> failed to involve the large majority of the stockholder-employees in representation of their ownership interests and failed to provide meaningful and clear guidance to employees about the goals that management had selected for the firm. Ultimately, they managed to retain strict control over the organization's institutions but not its actions.

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[1] Jo Hoffman to Ben B. Schifman, informal memorandum dated 22 November 1977.

[2] Ibid., pp. 4-5.

<u>Job, Compensation and Pension Aspects of Stock Ownership at The Kansas City Star Company</u>

Compensation packages at the <u>Star</u> depended heavily upon stock ownership as a substitute for higher white collar salaries and wages and also as a method for funding the pension plan. This use of the stock as a substitute for other aspects of compensation added to the pressure to discontinue employee ownership. This aspect of <u>Star</u> policy existed from the first days of employee ownership after the staff purchase in 1915.

> Mechanical employees, being unionized, have had a higher beginning wage throughout this period. It has never been the practice to start editorial employees at a high wage, but rather to promote quite rapidly those who, the executives feel, should be kept in the organization. These are also given an opportunity to purchase stock in the employee-owned newspaper on liberal terms.[1]

The option to purchase served the purpose of a partial substitute for higher wages among white collar employees in earlier years of the <u>Star</u>'s 50-year experience with employee ownership.

The <u>Star</u> also provided for fulltime employees with more than three years service, as part of its compensation package, a pension fund that required no contribution on the part of the employee. The assets of this plan were heavily invested in <u>Kansas City Star</u> stock. When valued

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[1]Bell, <u>Kansas City Star History</u>, p. 178.

at cost, this stock was equal to 35 percent of the net assets available for pension benefits.[1] When valued at book value, the stock was equal to 62 percent of net assets available for pension benefits to employees.[2]

The benefits to be provided by this plan were as follows:

> The Kansas City Star Company Pension Trust (Trust) is a defined benefit pension plan sponsored by The Kansas City Star Company (Star). Under terms of the Plan, participants are elegible for monthly benefit payments upon reaching age 65. Early retirement, disability, joint and survivor and death benefit options are available to employees. Normal monthly retirement pension payments are determined by multiplying $3.3333 times the participant's number of years of credited service. The maximum amount of credited service allowable to any participant is thirty years.[3]

This pension would provide a retirement income after 30 years service of $100 per month. As is the case in the Milwaukee Journal any supplementary means of employee saving is likely to be significant. In addition to Social Security benefits, the Star stock purchase plan would be an important part of potential retirement benefits for employees. The following table was calculated from 1975 data on shares owned by active employees but excluded shares owned by

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[1]"The Kansas City Star Pension Trust, Summary Annual Report," Year ended 31 December 1975, Accountants Report dated 9 December 1976.

[2]Ibid.

[3]Ibid.

Kansas City Star Company officers, directors or their families and 1975 data on book values and number of fulltime employees.[1]

VALUE OF ACTIVE EMPLOYEE (NON PENSION TRUST) HOLDINGS OF KANSAS CITY STAR COMPANY STOCK (EXCLUDING OWNERSHIP BY EXECUTIVES AND DIRECTORS)

	Value of Participating Certificates	Value of Beneficial Units	Value of Both
Per fulltime employee (1344)	\$12,511	\$3,267	\$15,788
Per stock owning fulltime employee[2] (530)	\$31,725	\$8,284	\$40,010

The figures for stockholding employees represent significant amounts of wealth for employees before or after retirement. These amounts also suggest the potential attraction of a takeover bid that might increase them significantly.

The potential problem faced by all employee-owned firms of keeping stock ownership among the active employees, particularly if there is an increasing rate of retirements, was found in the Kansas City Star. The figures above represent

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[1]The Kansas City Star Company, " Prospectus," 1975, pp. 20-24.

[2]Figure on stockholding fulltime employees from: "Newspaper Sale Brings Sudden Riches to Staff," Editor and Publisher, 26 February 1977, p. 11.

the non-Pension Trust ownership rights in 53 percent of the underlying common shares of the Star Company by active employees.[1] The percentage breakdown of claims on the total outstanding shares of common stock is shown below.[2]

PERCENTAGE OF TOTAL COMMON SHARES REPRESENTED BY:

	Percent
Participating Certificates held by active employees	43.1
Participating Certificates held by Trustees of Pension Trust	7.6
Participating Certificates held by retired employees under freeze agreements	15.2
Participating Certificates held by retired employees under other agreements	15.6
Beneficial Units held by active employees or members of their families	9.6
Beneficial Units held by retired employeed or members of their families under freeze agreements	5.2
Beneficial Units held by retired employees under other agreements	3.4
Total	100.0

Freeze agreements allowed retired employees or members of their families to keep claims to shares that could be resold to the company at specified fixed prices. Although the book value of stock was $61.60 in 1975, the average price at which, under freeze agreements, shares would be

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[1]This figure of 53 percent is correct for the percentage of total Participating Certificates and percentage of total Beneficial Units owned by employees.

[2]Star Company, "Prospectus," 1975, pp. 20-24.

resold to the company, was $28.78 for Beneficial Units and $28.38 for Participating Certificates.

The problem of an aging and retiring work force was extremely important in the diminution of employee ownership to direct claims representing only 53 percent of total common shares of stock. This problem has thus far been avoided in the Milwaukee Journal but it is a significant problem that results when firms have low turnover. Longer tenure with the firm is one of the anticipated results of the implementation of employee stock ownership. If turnover is reduced significantly, it can result in an aging work force that will put increasing demands on the buy-back provisions of the plan as many workers retire.

In the Kansas City Star, a special aspect of the retention of stock by retired employees created an interesting side effect of the sale. Since the prices of the stock were frozen and the shares were subject to recall, the board of directors had the choice between conferring a significant part of the total capital gain from the sale of the newspaper upon current employees or conferring it upon retired employees or their survivors. Since the shares were not recalled and resold to current employees and retired employees received the full amount of the Capital Cities offer, the capital gain to retired employees that resulted from the result of the sale on average was equal to the offer price minus the average frozen price resulting in a capital gain much greater than that received by most active employees.

As the population in general ages, the problem of continuation of employee stock ownership in a firm with an aging work force becomes more critical. If this phenomena is not overcome then the 50 and 40 year histories of employee ownership at the Kansas City Star and Milwaukee Journal probably define the upper limit of the expected life of ownership of the firm by employees.

CHAPTER VI

CONCLUSIONS AND MACROECONOMIC IMPLICATIONS OF EMPLOYEE STOCK OWNERSHIP

The in-depth analysis of two similar firms indicates that a diversity of results can be expected from the widespread implementation of employee stock ownership in business organizations. Employee Stock Ownership Plans can be expected to be utilized by different firms in many different ways but the results of ESOPs can be expected to reflect the important microeconomic considerations discussed here as well as reflect the results of any favorable tax incentives in the plan design and implementation. The following discussion emphasizes the implications for macroeconomic policy toward employee stock ownership that can be drawn from the results of this microeconomic investigation of the long run impact of employee stock ownership on two firms.

Stock Ownership Structure, Corporate Control and Capital Formation

The discussion of tax incentives for adoption of employee stock ownership through ESOPs, as well as profit sharing and deferred compensation plans, has focused on the macroeconomic goals of increased employment, productivity, and support for the free enterprise system of private property and the parallel democratic political institutions. A second thrust of government support for employee stock ownership through ESOPs has been through the Economic Development Administration of the U. S. Department of Commerce which has encouraged the purchase of companies by employees through the use of loan guarantees and low interest loans to facilitate employment. A third recent and more general interest of government policy has been the return of some functions of government to the state and local level where they can be expected to receive more input from the citizens who are affected by the government action.

These three concerns of public policy are compatible under a suitable implementation strategy for policy aimed at restoration of individual incentives to own stock as a financial asset. When significant external costs and benefits are faced by the community as a result of decisions about development of industrial enterprises and jobs, then employee ownership and extended ownership by the community are ways in which community input into industrial decision making can occur voluntarily under the existing structure of property rights in corporate ownership.

Chapter I discussed the implications of employee stock ownership for local and state development strategies.

Some federal assistance to employee stock ownership may be desired to the extent that employment, productivity and increased support for and efficiency of "the system" are experienced at the national level. Localities and states would be expected to encourage ESOPs to the extent that they capture returns through taxes resulting from increased economic activity. State and local encouragement to employee and community stock ownership, if found to confer sufficient benefits, would likely be selected for funding as a result of any block grants received by these smaller units of government. If the funds were not restrictively earmarked to such uses as investment in particular industries or businesses, then the states and localities might be expected to allocate funds efficiently among firms in proportion to the expected benefits to the unit of government. Funds used for encouragement of employee stock would be compared to the funding of other types of local or state development projects that increased employment, tax revenue, and aided other goals of local residents or their governments.

When local preferences are strong in regard to the continued operation of an enterprise or the operating procedures that it follows, the individuals in the community can purchase ownership shares in the enterprise. Such voluntary purchase of any organization was precisely the way in which employee stock ownership of the Kansas City Star and the Milwaukee Journal was instituted.

Mutual funds of common stocks have been designed that give purchasers of shares an investment in companies that have a particular set of characteristics. Stock ownership in groups of firms in particular industries, in firms with particular regard for social concerns, in firms of a particular size or with specific recent financial performance are all readily available. There is no reason why a fund could not be constructed to fit any preferences of the citizens of a particular state or locality for local ownership of businesses.

On a smaller scale, the purchase of a particular industrial enterprise could be arranged by the citizens of a particular locality in a way that allows easy transfer of shares between individual investors. The sale of these shares could even be restricted, by collective agreement, to members of the community as many employee-owned firms restrict the purchase of ownership shares to active employees in the organization.

The local ownership of the firms involved in local communications media may be of special impact to the preferences of residents of a locality or state. These medias of communication are part of the educational process of the community, and as communities have expressed the desire for local control of their schools and found that it also requires their financial support, they will also find that significant local control of communications can be facilitated by some ownership of these facilities.

Employment Levels and Employee Ownership

In theory the profit maximizing firm hires labor until the value of the marginal product is equal to the wage in maximizing the following:

$$\max \pi = PQ-rK-wL$$

where:

π = profit

P = Price of output

Q = Quantity of output

r = Rental rate of capital

K = Amount of capital used

w = Competitive wage

L = Number of workers in competitive firm

L_1 = Number of worker-owners in a cooperative firm

L_2 = Number of non-owning workers in a cooperative firm

w_2 = Wage of non-owning workers in a cooperative

VMP = Value of the marginal product of labor

NR = Net revenue

The cooperative that maximized average net revenue per worker would tend to employ less labor in order to satisfy:

$$\max \frac{NR}{L_1} = \frac{PQ-rK}{L_1}$$

If non-owning workers (L_2 with VMP > W_2) are added to the payroll employment will increase to satisfy:

$$\max \frac{NR}{L_1} = \frac{PQ-rK-w_2L_2}{L_1}$$

Employment in this case would increase somewhat toward that of the competitive firm. In order for average net revenue to increase there is an incentive to decrease the number of sharing members in the cooperative (L_1). If shares of net revenue are transferable and priced efficiently, then the purchase of a share that also included a job would yield the purchaser a wage equal to the value of the marginal product of L_1 and a normal return on his investment in the share.

In a firm where voting shares were not held in equal proportion by each employee-owner the owners would likely agree to maximize net revenue per share. If abnormally high returns to shares were present there would be an incentive to individuals to concentrate share ownership. The number of workers hired by the employee-owned firm would not be expected to exceed the employment level of a competitive firm unless the employee owned firm utilized a more efficient production technology or other means of increasing efficiency that allowed lower cost production than competitive firms resulting in an expansion of employee-owned firms as well as an expanded (domestic or foreign) market for the product being produced.

In a macroeconomic setting, worker owned firms using existing technology would be advantageous to the goals of increased productivity and employment levels only if they were able to be more productive through more efficient internal operation.

The investigation of employee-owned newspapers undertaken here has suggested that mechanisms of information transmittal in both job performance and firm oversight are possible under employee oversight. These mechanisms need not necessarily be present or active just because there is employee ownership however. An employee-owned firm has the same opportunity to be mismanaged as any other firm, but ownership by employees suggests that the owners are more likely to know about the mismanagement and have an incentive to try to correct it. Also, if workers have strong preferences for ownership then a compensation package with stock shares will provide a more efficient (least cost) compensation package than one that does not include them. The voluntary purchase of stock in the employing firm by employees is evidence of preference for ownership in the employing firm at the relative price at which it is offered.

The impact of employee stock ownership on employment would tend to be a function of the amount of increased efficiency of internal processes of the firm that it encourages. In the case of the Kansas City Star, the evidence suggests that the firm was not more efficient in its internal operation, but rather less efficient, and that this inefficiency in part took the form of overstaffing in a longer period of time. The inefficiency is no less costly to owners of a newspaper which faces less than rigorous competition, but it could exist for longer periods of time as long as owners are willing to forego excess profits as the opportunity cost of inefficiency. In terms of employment gains at the aggregate level, plans that provide ownership shares to employees may have the potential to increase the efficiency of firms and aggregate employment across firms but this potential must be realized by more efficient internal operations and information flows.

Productivity and Information Flows in the Firm

The utilization of worker produced information in the managerial information flow of the Milwaukee Journal suggests that employee stock ownership can be used as an incentive basis for changes in the internal information flows in organizations. The participatory process at the Milwaukee Journal is clearly an educational process for future managers that allows them to learn about the overall operations of The Journal Company to a greater extent than they do in the normal performance of their job. It also requires investments of their leisure time.

The implication of better information flows in the firm are extremely important to aggregate productivity if production processes are becoming more complex. In production where employees may use discretionary judgment an incentive plan that encourages information flows and links rewards at least indirectly with productivity is an important possible way to increase productivity.

Employee Participation in the Oversight Process of the Firm

Inputs of worker produced information can also be used in the oversight process of the firm. In the Milwaukee Journal, this information was sought by management although its use was strictly voluntary on the part of management. In the Kansas City Star flows of information to management through the oversight process were meager. In both papers the oversight process was under the effective control of a small coalition of top management and those who tended to vote with management.

In many of the ESOPs cited by the studies reviewed in Chapter IV, employee input into the oversight of management is non-existent. The research available on ESOPs indicates clearly that the concentration of the corporate oversight function in the hands of management is often the result of employee stock ownership as it is often implemented. In some organizations, employees do not have sufficient incentive to vote while in others the property rights to share voting have been attenuated by plan design, separating the ownership of the firm from the oversight function. In the course of this separation some efficiency loss is likely to occur in at least some of the firms.

Employee Firm Attachment with Stock Ownership

The impact of employee ownership of stock on firm attachment is inconclusive in existing empirical research. The research conducted here would suggest that individual employee ownership of modest amounts of employer stock affects turnover relatively little, however, the evidence available on deferred compensation suggests that the existence of a deferred compensation plan and the worker's probability of receiving benefits from that plan do affect employee firm attachment.[1]

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[1] Bradley R. Schiller and Randall D. Weiss, "The Impact of Private Pensions on Firm Attachment," Review of Economics and Statistics 31 (August 1979): 369-380.

When employee stock ownership is a deferred compensation scheme, as is often the case in an ESOP, firm attachment decisions are likely to be affected. In publicly traded companies, the individual's quit decision will be affected by the variability of the security price which affects the expected value of the benefit. In privately held non-traded firms, the decline in the value of the firm or its threatened failure will affect quit behavior.

The expectation of a significant capital gain should also affect quit behavior and lengthen firm attachment if stock must be sold back to the firm at separation. If employees are risk averse then volatile stocks may not be an efficient incentive.

In the two newspapers examined here, the performance of the stock resembled more that of a public utility stock than that of a corporation with earnings that are fairly volatile. This performance should be expected of a single newspaper company producing both the major morning and evening newspapers in a major metropolitan area. In these cases, the stock ownership plan performed much more as a traditional employee benefit plan might have but with superior rates of return to the alternative plans offered by the company and offering the additional feature of potential for employee input into the oversight of management. The one exception to this stable performance is the effect that could be expected if a successful take-over of the newspaper occurred. This event happened in the Kansas City Star and is a possibility in the Milwaukee Journal. The results of an expectation of the doubling of the value of a benefit plan is likely to prolong employee attachment to the firm in a way that decreases the aggregate efficiency of the macroeconomy.

ESOPs are unlikely, on the other hand, to affect absenteeism to a significant amount since aggregate figures for the economy are extremely stable.[1] The national rates of absenteeism for wage and salary workers show little significant change from 1968 to 1976. Firm size and industry seem to be an important variable in job absences and chronic problems in this area usually are aproached through a change in personnel policy. The experience of the Kansas City Star after its take-over lends support to this contention.

Work stoppages have not occurred in the last 10 years at the Milwaukee Journal. The Kansas City Star, with the exception of the walkout by pressmen, has had a similar uneventful experience. In the Journal, the reporters do not belong to the Newspaper Guild.

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[1] "Special Labor Force Report," Monthly Labor Review, October 1977, p. 16. Comparable data exists for periods 1957 to 1966 and 1968 to 1976.

The significance of employee stock ownership of the Milwaukee Journal is a significant portion of delayed total compensation and it is likely that ownership lowers absenteeism marginally. Newspaper production is an enterprise where daily deadlines are extremely important to the production of an individual's work and it is unlikely that absenteeism would be significantly higher among workers in the absence of stock ownership. Firm attachment is likely extended by the employee ownership of shares of The Journal Company and the potential for a significant capital gain from a successful take-over is likely to heighten this effect.

The aggregate effects of employee stock ownership on firm attachment must be considered as part of a comprehensive analysis of the impacts of current and deferred compensation packages.

Job, Financial Mobility and Pension Coverage Aspects of Employee Stock Ownership Plans

Financial risk to employees is increased when the percentage of stock held in the employing company increases. Thus, unfortunately, risk increases directly as the magnitude of the stock incentive rises. Since the stock is often held until retirement, an ESOP is considered as at least part of retirement income by workers whether they have a separate pension plan or not. The data presented on the value of own company stock as a percentage of total retirement benefits in the Milwaukee Journal suggests that stock ownership is a major portion of retirement income. When one company is in control of the major daily newspapers in a metropolitan area, the stock performance can be expected to be relatively stable. In business organizations subject to greater uncertainty, the risk of significant declines in retirement income are possible as a result of poor firm performance.

If employee stock ownership of the employing firm, by ESOPs or any other type of plan, becomes a significant amount of expected retirement income then creative ways to reduce risk to employees without destroying incentives to productivity must be found.

Government Regulation of Employee Stock Ownership Plans

To qualify for tax benefits on an ESOP loan, the plan must be for the exclusive benefit of employees under Internal Revenue Code, Section 401(a). Regulatory constraint and uncertainty are cited by several large companies (including Mobil Oil, Atlantic Richfield and American Telephone and Telegraph Co.) as reason for delay of the implementation of an ESOP. Senator Long worries that regulations may frustrate congressional intent.[1]

The issues of risk to significant portions of retirement income deserve serious consideration in the use of favorable tax treatment as an incentive to adopt an ESOP. Also, the use of an ESOP to retain corporate control in the hands of a small group of managers while denying employees the right to vote shares vested to them attenuates the property rights inherent in common stock ownership. The preemption of the voting right could be compensated if share voting is not important to employees. An example is higher dividends often given non-voting preferred stock that is issued by corporations.

Conclusion

This study has focused on a number of important considerations in employee ownership of firms in a longer run time frame where recent tax advantages were not a consideration in the adoption of stock plans. The study suggests there

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[1]"The fact that the ...employees' stock ownership program has been able to survive the bureaucracy in the Department of Treasury and the Labor Department speaks well for the program. It takes a really meritorious program to survive all the bureaucracy in those two departments." Senator Russell B. Long in: U.S., Congress, Senate, Committee on Finance, Employee Stock Ownership Plans and General Stock Ownership Trusts, p. 125.

are considerations that, while problematical, have been overcome in many firms with employee stock ownership. The difficulties faced by firms with aging ESOP employees at a time when the entire work force of the United States is aging have not been eliminated and must be dealt with by future research.

Financial risk to employees must be handled adequately in plan design. This study has shown the need for a systematic but not monolithic model for the investigation of aspects of firm performance that are affected by employee stock plans. Future analysis of the impact of employee stock ownership requires a comprehensive evaluation of employee compensation as well as employee participation in the information environment and choice processes of the firm.

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EMPLOYEE STOCK OWNERSHIP:

A MICROECONOMIC ANALYSIS

by

Parl Carter Taylor

(ABSTRACT)

The investigation of employee stock ownership is undertaken using microeconomic theory and the in-depth empirical analysis of two metropolitan newspapers with long histories of extensive employee ownership.

Economic theory suggests that there are four important considerations beyond current tax incentives in employee and employer decisions to institute employee stock ownership: (1) preference for ownership in the employing firm by employees, (2) expected incentive effects on productivity and information flows in the firm, (3) the potential for participation in the oversight of the firm by stock owning employees, and (4) job and portfolio mobility considerations of employees.

A review of existing studies of firms with employee stock ownership suggests that the four important considerations suggested by economic theory have not been empirically documented to a great extent; particularly expected effects on information flows and actual production in organizations.

An in-depth investigation of the importance of the four non-tax considerations in two metropolitan newspapers is undertaken using financial data. The results indicate the importance of the four theoretical considerations in determining the impact of employee stock ownership on the operation of a firm. In the analysis of newspapers the study suggests that important externalities to a locality may be involved in the ownership structure of the local news media.

The microeconomic investigations at a theoretical and empirical level suggests several macroeconomic implications for public policy aimed at increasing employee ownership of stock through tax incentives to firms that adopt employee stock ownership plans (ESOPs). Reaching macroeconomic policy goals of increased production, employment and employee firm attachment as a result of increased employee stock ownership depends upon the inducement of changes in the internal operations of firms with stock plans as suggested and documented by this microeconomic investigation.