

Center for American Progress



# Growing the Wealth

How Government Encourages  
Broad-Based Inclusive Capitalism

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David Madland and Karla Walter April 2013



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**Cover photo:** Airline workers celebrate receipt of \$111 million in profit-sharing checks Wednesday, Feb. 14, 2007, at Houston's Bush Intercontinental Airport. (AP Photo/Pat Sullivan)



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# Introduction and summary

American companies use a variety of financial incentives, from broad-based profit sharing and stock options to worker cooperatives and employee stock ownership plans, to reward their employees with a portion of the wealth those workers help generate. This kind of compensation goes well beyond simply paying wages or providing individual incentives, but rather involves granting workers ownership stakes in the company or a share of its profits based on workers' collective performance—a concept we describe as inclusive capitalism.

Inclusive capitalism, when partnered with democratic workplace practices, has a proven record of helping workers and businesses alike in a myriad of ways. Additionally, it is an economic philosophy that can draw bipartisan support. Yet policy to advance inclusive capitalism has not been part of the national dialogue for quite some time.

The purpose of this report is to change this dynamic and jump-start a policy conversation aimed at promoting inclusive capitalism. While we do not advocate for specific policy changes in this report, our hope is that it will spark dialogue among policymakers and advocates about how inclusive capitalism can help address some of the most fundamental problems facing our economy; what government can do to encourage employers to use it more; and how to ensure that inclusive capitalism is done right so workers can enjoy the upsides of broad-based sharing and having an increased say on the job without being exposed to undue risk.

Inclusive capitalism is by no means a new or rare phenomenon in the United States. Companies and workers have practiced inclusive capitalism since the founding of our nation.<sup>1</sup> Today almost half of U.S. workers receive some sort of inclusive capitalism compensation—though in most firms its use is quite limited.<sup>2</sup>

Companies practicing broad-based inclusive capitalism range from unionized American steel manufacturers and air carriers to leading technology firms to growing, socially minded companies. The United States Steel Corporation, for

example, pays quarterly cash profit-sharing payments to its unionized workforce, while a significant portion of Southwest Airlines' stock is owned by its employees.<sup>3</sup> Likewise, the high-tech firm Intel Corporation rewards its employees with both cash profit sharing and broad-based stock ownership through restricted stock and stock options.<sup>4</sup> And then there are the socially minded companies such as the tea and coffee purveyor Equal Exchange and the beer maker New Belgium Brewing that are both employee-owned, the former through a worker cooperative and the other through an employee stock ownership plan.<sup>5</sup>

At its best, inclusive capitalism aligns the interests of workers and employers in ways that benefit both parties. Workers are respected and compensated for their contributions toward the firm's success. Firms benefit from increased worker productivity, greater worker satisfaction, and employees with the drive to suggest and make changes to improve company performance.

Consequently, inclusive capitalism can improve company performance while at the same time improving worker wellbeing. As such, these programs are not about redistributing wealth but about creating additional wealth shared between American workers and businesses.

Studies of inclusive capitalism bear this out. For both lower- and middle-income workers, inclusive capitalism is associated with higher pay, expanded benefits and greater job security, participation in decision making, trust in the company and management, and better labor-management relations.<sup>6</sup>

For businesses, inclusive capitalism is often associated with increased productivity and profitability and a greater likelihood of corporate survival. In addition, companies benefit from greater worker loyalty and effort, lower turnover rates, and an increased willingness on the part of workers to suggest innovations.<sup>7</sup> Looking specifically at one type of inclusive capitalism—employee stock ownership plans, or ESOPs—Douglas Kruse, professor and director of the doctoral program in industrial relations and human resources at Rutgers University, found that productivity improved by 4 percent to 5 percent on average in the year of ESOP adoption and continues after adoption, more than doubling the rate of annual productivity growth of the U.S. economy over the past 20 years.<sup>8</sup>



Another study examining the effects of stock options found that companies that offered options broadly to their employees showed significant improvements in their firm's operating performance.<sup>9</sup>

Investors also come out ahead when companies adopt capital-sharing programs. Companies and investors that adopt partnership approaches make profits over and above the cost of sharing ownership with employees, according to a review of more than 70 empirical studies.<sup>10</sup>

Finally, inclusive capitalism in the form of worker-ownership is often thought to benefit democracy by giving workers a real, participatory role in their work life that can translate into their civic life.<sup>11</sup>

In short, inclusive capitalism can encourage competition and profit-seeking behavior that can benefit investors, managers, and workers, which is why the concept has attracted believers of all political stripes. Former President Ronald Reagan called these sorts of programs “People’s Capitalism” and argued that the “energy and vitality unleashed by this kind of People’s Capitalism—free and open markets, robust competition, and broad-based ownership of the means of production—can serve this nation well.”<sup>12</sup>

Similarly, the liberal icon Sen. Hubert Humphrey Jr. (D-MN) called capital sharing one of the “twin pillars of our economy.”<sup>13</sup>

Not only can inclusive capitalism help workers and business and draw bipartisan support, but it has the potential to address at least partly some of the most fundamental problems facing our country: weak economic growth, excessive speculative economic activities that fail to build societal wealth, high unemployment, stagnant worker compensation, and the dramatic differences in income and wealth between the struggling middle class and the very rich.

Today policymakers continue to support inclusive capitalism. A bipartisan list of advocates ranging from Sen. Bernie Sanders (I-VT) and Rep. Chaka Fattah (D-PA) to Sen. Kelly Ayotte (R-NH) and Rep. Dana Rohrabacher (R-CA) separately introduced legislation in the 112th session of Congress to expand government support for inclusive capitalism.<sup>14</sup> But only the most modest of these bills received any legislative action and inclusive capitalism has not yet become a part of the larger national debate on how to address the nation's economic problems.

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Despite this across-the-board support for the concept of wealth sharing, far too few workers enjoy the benefits of broad-based sharing programs. More than half of American workers do not have access or choose not to participate in inclusive capitalism programs and most participating workers receive only very modest amounts of income from these programs.<sup>15</sup>

What's more, sharing programs are sometimes implemented in ways that take advantage of workers. On occasion companies have implemented sharing programs that expose workers to excessive risk, using the programs as a substitute for good wages and benefits or providing their workers little say on the job. Neither workers nor firms benefit from inclusive capitalism when workers are marginalized.

Research suggests that the most successful broad-based sharing programs are those in which workers have a high level of trust of management, are paid wages at or above the market rate, and have a high level of job security and involvement in decision making over their work at the job and department level.<sup>16</sup> A recent study of 780 companies employing more than 300,000 workers confirms that the best results happen when broad-based inclusive capitalism is combined with a supportive company culture.<sup>17</sup>

Yet today most companies provide generous incentive pay only to top executives providing rewards for the short-term success of the company.<sup>18</sup> While strong evidence suggests that providing workers with a stake in a firm's performance leads to good results for both the firm and the workers, paying executives based on company performance has a very mixed record and is a major cause of the growing income gap between the middle class and the top 1 percent.<sup>19</sup>

Government should do more to limit excessive top executive pay and ensure that incentive pay for corporate executives encourages decision making to support the long-term, sustainable growth of the company. The Center for American Progress has recommended closing loopholes in the tax code that allow firms unlimited deductions on executive compensation in the form of incentive-based pay.<sup>20</sup> Similarly, Germany passed a law in 2009 reining in excessive executive compensation, which included provisions stipulating that management boards should reduce executive compensation when companies perform poorly and requiring that incentive compensation be determined based on longer-term performance.<sup>21</sup>

While the debate surrounding reining in executive pay has received a good deal of attention, how to encourage real broad-based sharing has not been included in this conversation and outside the personal knowledge of a narrow group of experts, little information is available for interested parties seeking to understand the relevant policy issues.

The purpose of this report is to provide baseline knowledge that is essential to creating a broad discussion about inclusive capitalism policy. To help achieve this goal, the report describes the types of inclusive capitalism that firms currently practice and briefly reviews the history of federal policy in this area.

Most importantly, our report catalogs existing government policies that support inclusive capitalism programs providing one-stop shopping for those seeking to understand what governments are doing in this area. Both federal and state governments have a long history of supporting inclusive capitalism programs—with policy mechanisms that range from federal tax incentives to state technical assistance programs—but these efforts have not been compiled in a comprehensive way.

Additionally, we highlight some key questions about how existing inclusive capitalism policy is working and the challenges to ensuring that inclusive capitalism helps all workers. Addressing these questions will be important for any future policy development. Lastly, we discuss the potential of inclusive capitalism to address at least partly some of the most fundamental problems facing our economy.

This report is an initial analysis of the current policy landscape supporting inclusive capitalism. We hope that it helps provide a path forward for policymakers to support broad-based and sustainable capital-sharing programs.



# Inclusive capitalism 101

The private sector has adopted a variety of programs to share capital ownership and capital-related income with their workers. These practices range from employee stock-ownership plans and worker cooperatives, which allow workers an ownership stake in the company, to cash-based profit- and gain-sharing programs, which pay workers a portion of the capital-related income they helped generate but do not grant ownership.

The connection between all types of inclusive capitalism is that they compensate a broad base of workers—not just top executives—on the basis of group performance rather than individual performance. Some of these programs fundamentally change workers’ relationship with their employer and provide significant capital payments, while others have fairly modest effects on workers.

What follows is an overview of the various types of inclusive capitalism that U.S. firms currently practice following the categorizations outlined in the book *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-Based Stock Options*, edited by Douglas Kruse, Richard Freeman, and Joseph Blasi and published by the University of Chicago Press in coordination with the National Bureau of Economic Research.<sup>22</sup>

**Employee ownership:** Employee ownership refers to relationships where employees own shares of their company. The extent of ownership ranges from workers having complete ownership of a firm to a minority stake, which is usually managed through a trust or another legal entity.

- **Worker cooperatives:** Co-ops are typically started by ideologically affiliated workers and are owned and democratically controlled by their member-owners. Co-op members elect their board of directors from within the membership. Cooperatives pay taxes on income kept within the co-op for investment and reserves but not on any surplus revenues that are returned to individual members who pay taxes on that income.

- **Employee stock ownership plans:** Tax-qualified employee benefit plans that, with some exceptions, offer workers an ownership stake in their company without having to spend their own money to purchase stock. ESOP companies set up a trust fund into which they contribute new shares of its own stock or cash to purchase existing shares.<sup>23</sup> When workers retire or leave the company, they receive their stock, which the company must buy back at its fair market value unless the worker is able to sell it in the public market.<sup>24</sup>

The ESOP trust may also borrow money to buy shares, with the company making payments to the ESOP trust in order to repay the loan. Private companies typically use “leveraged” employee stock ownership plans to buy out company founders and other shareholders.<sup>25</sup> These benefit plans can be adopted by both public and private companies.

**Individual employee stock ownership:** Workers buy or are given shares from their employer and are often able to vote those shares privately.

- **Employee stock purchase plans:** Employers subsidize the purchase of stocks outside of the retirement system, typically offering workers stock at a 10 percent to 15 percent price discount, usually at the lower price over an “offering period” of three months to as many as 27 months.<sup>26</sup> Enrolled employees buy company shares with after-tax contributions deducted from their paychecks over the course of the offering period.
- **401(k) plans with ownership of company stock:** Retirement plans in which workers and companies make pretax contributions from their pay to buy company stock or the company gives employees company stock as a match to employee contributions. The government has increasingly scrutinized 401(k)s with investments in employer stock as these plans have become the primary retirement vehicle for many workers. The government has made a number of changes to regulations in order to encourage investment diversity.<sup>27</sup>

**Profit sharing:** Payments can be either in cash (such as annual cash bonuses) or employer contributions of stock, but payments are a specified share of the profits when the firm makes money. Profit sharing becomes employee ownership when profits are received in the form of stock.

- **Cash plan:** Contributions, known as stock grants, are paid directly to employees at the time profits are determined in the form of cash or stock. The award is

taxed as ordinary income.<sup>28</sup> In the case of stock grants, what is received becomes employee ownership.

- **Deferred plan:** Profit-sharing contributions are not paid out immediately but are instead placed in individual, tax-qualified retirement accounts for each employee where investment earnings accrue tax-free until withdrawal. Payments into these plans, however, need not be based on the employer's current or accumulated profits.<sup>29</sup> Benefits are distributed at retirement, death, disability, or sometimes at separation from service.
- **Combination plan:** Allows plan participants the option of deferring all or a part of the profit-sharing allocation.

**Gain sharing:** Workers receive payments based on the performance of their unit rather than the entire company. Performance is typically measured as productivity or costs savings. Payments are typically made in cash.

**Stock options, restricted stock, phantom stock, and stock appreciation rights:**<sup>30</sup> Benefits are tied to either the value of shares (as in restricted stock and phantom stock) or increases in stock prices (as with options and stock appreciation rights) in these hybrid inclusive capitalism programs. Workers may or may not ever actually own shares except for a very short period once the awards are exercised.

- **Stock options:** Stock options are contracts between employers and employees that give employees the right to buy stock at a set price during a specified period of time. Companies began granting stock options in the 1960s, but stock options gained popularity in the 1990s when high-tech startups began using stock options to recruit talented staff who would otherwise receive better pay from established technology firms such as IBM and Hewlett Packard. The number of employees receiving options in broad-based stock options declined in popularity after the dot-com bubble burst in 2000 and subsequent changes in accounting rules. Approximately 9 million workers participated in stock option programs in 2010, down from about 12 million in 2001.<sup>31</sup>
- **Restricted stock awards and restricted stock units:** Restricted stock award plans allow employees to buy shares, sometimes at a discount, or, more often, grant employees awards. But these plans do not allow employees to take actual ownership until after certain requirements have been met. These requirements can include working a certain number of years or meeting corporate or individual

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performance goals. Restricted stock can carry dividend or voting rights if the company chooses and retains some value for workers if share prices go down, unlike stock options. Restricted stock units—like restricted stock awards—are grants valued in terms of company stock, but the employee does not receive conditional shares at the time of the award. Rather, employees have the right to a certain number of shares that will be delivered only when vesting or other requirements are met.

- **Phantom stock and stock appreciation rights:** Phantom stock provides a bonus (in cash or stock) based on the value of a specified number of shares, which is awarded at the end of a specified time period. Stock appreciation rights parallel stock options, paying an award (cash or stock) based on the increase in value of a company's common stock. Stock appreciation rights have a base price. The award equals the difference between the base price of a stock appreciation right and the price of company stock at the time the right is exercised.

All totaled, a significant portion of American workers participate in these sorts of programs. Almost half of workers participate in some sort of inclusive capitalism compensation—38 percent participate in profit sharing and 27 percent in gain sharing; 18 percent own company stock; 9 percent hold stock options; and 5 percent receive options in any given year, according to the 2006 General Social Survey and a 2010 update of that survey.<sup>32</sup> Approximately 53.4 million American workers participate in inclusive capitalism programs according to these figures.

Still, more than half of the American workforce does not have access or chooses not to participate in inclusive capitalism programs and participation varies greatly by occupation and industry.<sup>33</sup> Moreover, most participating workers receive only very modest amounts of income from these programs.<sup>34</sup>



# History of American policies promoting inclusive capitalism

Since the founding of our nation, American policymakers of all political stripes have supported private-sector inclusive capitalism programs both through their words and policies. Their ideas about how and why inclusive capitalism helps strengthen our nation have varied greatly, but policymakers have agreed broadly that our democracy and marketplace are stronger when workers can share in the capital their labor helps create.

Albert Gallatin, treasury secretary under Presidents Thomas Jefferson and James Madison, was the first proponent of inclusive capitalism within our government. He is sometimes credited with introducing the concept in the United States after adopting a plan at his New Geneva, Pennsylvania, glassworks in 1794.<sup>35</sup> Gallatin explained that “the democratic principle on which this nation was founded should not be restricted to the political process, but should be applied to the industrial operation as well.”<sup>36</sup>

Since then support for inclusive capitalism programs has crossed ideological and political divides and has been supported for a variety of reasons. Policymakers have argued that these programs boost profits and productivity, promote workplace participation, improve labor relations, bolster our capitalist system, ensure sustainable economic growth, deliver equitable compensation for workers, and even provide a bulwark against communism.

In the years emerging from the Great Depression, Sen. Arthur Vandenberg (R-MI), representing the industrialized state of Michigan, argued that profit sharing could “preserve the profit system of capitalism” and “maintain a partnership between capital and labor.”<sup>37</sup>

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Compare this to former Vice President Hubert H. Humphrey Jr., who served as chair of the Joint Economic Committee after returning to the Senate in the 1970s when it convened hearings on expanding employee ownership. Vice President Humphrey argued that broad-based ownership was one of the pillars of our economy:<sup>38</sup>

*... capital and the question of who owns it and therefore reaps the benefit of its productiveness, is an extremely important issue that is complementary to the issue of full employment. ... I see these as the twin pillars of our economy: Full employment of our labor resources and widespread ownership of our capital resources. Such twin pillars would go a long way in providing a firm underlying support for future economic growth that would be equitably shared.*<sup>39</sup>

During the Cold War President Ronald Reagan compared employee ownership to the Homestead Act's ability to bring widespread farm ownership to Americans, arguing that employee ownership could help prevent the spread of communism in Central America:

*The energy and vitality unleashed by this kind of People's Capitalism—free and open markets, robust competition, and broad-based ownership of the means of production—can serve this nation well. It can also be a boon, if given a chance, to the people of the developing world. Nowhere is the potential for this greater than in Central America.*<sup>40</sup>

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## Federal policies to promote inclusive capitalism

The current policy framework for inclusive capitalism started in the 1920s and has advanced episodically in a few infrequent waves of popularity. Policymakers have generally focused on supporting specific types of inclusive capitalism programs—especially deferred profit sharing and employee stock ownership plans—rather than promoting inclusive capitalism broadly. Moreover, both Republicans and Democrats have taken lead roles in advocating for policies to support inclusive capitalism.

This type of bipartisan support continues today among conservative leaders such as Rep. Dana Rohrabacher (R-CA) and Sen. Kelly Ayotte (R-NH) and progressives such as Sen. Bernie Sanders (I-VT) and Rep. Chaka Fattah (D-PA), who all support legislation to expand government support for inclusive capitalism.<sup>41</sup>

## Deferred profit sharing

The concept of profit sharing started in the private sector. Large companies such as Proctor & Gamble, Sears Roebuck and Co., Eastman Kodak Co., and S.C. Johnson & Son, Inc., began adopting profit-sharing plans in the late 19th and early 20th centuries in an attempt to combat labor unrest and unionization and to improve worker performance (for more on the relationship between inclusive capitalism and unions see text box).<sup>42</sup> Profit sharing was first popularized in France in the 19th century and adopted in companies throughout Europe but became more pervasive in the United States than in other countries.<sup>43</sup>

Initially no government policies to encourage this type of sharing existed. But Congress passed the Revenue Act of 1921, which provided tax incentives to stock bonus and profit-sharing plans.<sup>44</sup> Congress primarily intended the provisions as a way to motivate workers to be more productive, but had the secondary goal of increasing savings among workers.<sup>45</sup> The new policy was intended to benefit companies and workers alike. Employer contributions into stock bonus and profit-sharing plans, as well as the earnings within those plans, were exempted from income tax. At the same time, companies could claim a tax deduction for contributions into these plans, just as they could for wages paid to workers and contributions to employee pension funds that were not tax exempt. Employees delayed paying taxes on this income until they withdrew the money from their accounts under the new law.<sup>46</sup>

These tax incentives, however, did little to encourage the adoption of these sharing programs at the time. Income tax rates on companies and individuals were so low and so few workers paid income tax that companies and workers gained little benefit from the favorable tax rules for sharing plans. Moreover, once the Great Depression hit, many employers terminated their sharing plans or failed to pay out the benefits.<sup>47</sup>

As the economy slowly began to recover, companies returned to profit sharing and federal policymakers looked to incent these practices further. In 1938 the Democratic-controlled U.S. Senate convened a “profit-sharing” committee, but it was the Republican representing Michigan, Vandenberg, who became the de facto leader of the committee.<sup>48</sup>

During the hearings, *The Milwaukee Journal* conjectured that profit sharing would be the “Republicans’ New Deal,” speculating that Republicans might try to use

this private-sector benefits program in the same way Democrats were setting up public-sector social safety net programs.<sup>49</sup> Vandenberg even toyed with the idea of providing broad tax incentives for profit sharing but the final committee report recommended only that profit-sharing contributions be exempted from payroll taxes, which Congress approved in 1939.<sup>50</sup>

Profit sharing's real comeback took place during World War II, when companies adopted generous deferred profit-sharing programs to attract scarce labor since fringe benefits were exempted from the wage and price controls the U.S. government instituted to protect against inflation. Furthermore, the War Labor Board gave employers even more encouragement by allowing them to transfer excess profits to deferred profit-sharing plans, thus avoiding government taxes designed to limit corporate profits to their prewar levels.<sup>51</sup> Half of all the profit-sharing plans in existence in 1947 were created during the war, according to labor historian Sanford Jacoby.<sup>52</sup>

During the 1950s and 1960s, the number of profit-sharing plans continued to grow with federal government support.<sup>53</sup> Companies adopted these programs to serve as a supplement to other retirement programs and were further encouraged because government allowed income from deferred profit-sharing plans to be taxed at lower rates for capital income.<sup>54</sup>

Subsequently, policymakers have taken less of an interest in encouraging the use of profit-sharing. But employers still take advantage of the tax incentives available for deferred profit-sharing programs and today profit sharing remains popular. About 20 to 30 percent of workers participate in deferred profit sharing plans according surveys from the Bureau of Labor Statistics.<sup>55</sup>

### Employee stock ownership plans

Employee stock ownership plans are the other type of inclusive capitalism that have a long and enduring history of government support. These plans are today one of the most prevalent forms of employee ownership, and their growth could not have happened without government interventions.

San Francisco lawyer and investment banker Louis Kelso started the first leveraged employee stock ownership plan, which enabled the employees of Peninsula Newspapers in Palo Alto, California, to buy the company from its founders in 1956.

Kelso's idea—to use financial leverage to allow employees to purchase the company they worked for without having to spend any of their own money—had never been done before. Peninsula Newspapers needed a special exemption from the Internal Revenue Service in order to do so since the 1954 tax code prohibited borrowing by a tax-qualified plan from the plan sponsor or related entities.<sup>56</sup> Peninsula Newspapers and all subsequent employee stock ownership plans created over the next 20 years had to prove to the IRS that the transaction was done at “arm’s length” and in the best interests of the participants.<sup>57</sup>

The IRS exemption allowed a limited number of companies to institute employee stock ownership plans, but Kelso was a true evangelist for these plans and supported more widespread employee ownership. He believed that by allowing workers to “sell” their labor in exchange for capital, policymakers could ensure stable income for workers—even as technological change exerted downward pressure on wages. Owning part of the firm, Kelso argued, would allow workers to receive compensation for their labor as well as their capital. Kelso said these types of arrangements would help stabilize the economy and promote democracy.<sup>58</sup>

Kelso won over a crucial supporter in Sen. Russell Long (D-LA). Long, like his father Huey Long, the populist Louisiana governor, was concerned about inequality and economic justice. Long had a front seat in the crafting of tax policy as chair of the Senate Finance Committee—overseeing the design and reconciliation of the Employee Retirement Income Security Act of 1974, or ERISA. Although both the House- and Senate-approved versions of the act prohibited transactions between a qualified plan and a party-in-interest, Long was eventually able to insert the ESOP definition and an exemption to the rule in the final version of the act.<sup>59</sup>

Long was a proponent of employee stock ownership plans until his retirement in 1987. During his time in the Senate, thousands of these plans were established and Congress addressed the plans in 15 separate pieces of legislation, including legislation to increase financial incentives for companies to participate in employee stock ownership plans, ease transition for small-business owners who wish to sell to their workers, and the use of employee ownership to bail out both the Consolidated Rail Corporation, or Conrail, in 1974 and the automaker Chrysler in 1979.<sup>60</sup>

To date, federal policymakers have continued to support the expansion of employee stock ownership plans and have remained focused on using tax incentives to do so.

Indeed, American policymakers from across the ideological spectrum continue to support specific types of sharing for the same reasons supporters have championed throughout history: inclusive capitalism can be good for businesses and workers, it can be a boon to capitalism, and it can ensure sustainable economic growth.

Unfortunately, even though employers frequently adopt multiple types of sharing programs within the workplace policymakers and activists also continue a siloed approach to the promotion of sharing policies.<sup>61</sup> Policy advocates lobby solely for their specific brand of inclusive capitalism rather than advocating for a broader support for all types of sharing programs. Likewise, only a small minority of academic research studies the effects of more than one type of sharing,<sup>62</sup> and niche industries have developed to support private-sector development of single types of sharing.

As a result, sharing policies tend to be viewed as serving niche communities rather than promoting broader economic goals. What's more, government policies to support sharing are very uneven across the various types of programs and policymakers have not tackled some tough questions about how to ensure government policies to encourage inclusive capitalism also protect workers' interests.

## Unions and inclusive capitalism

Organized labor's relationship to inclusive capitalism programs has evolved over time. Some of the earliest American unions were formed by skilled workers responding to decreasing access to capital income. But unions' attitudes toward inclusive capitalism shifted over time and they opposed these programs for a number of reasons during the first half of the 20th century. Today unions offer measured support for some types of sharing programs, evaluating their willingness to participate on a case-by-case basis.

In the decades following the founding of the United States, skilled workers protesting diminished access to capital income led to some of the earliest American strikes and the establishment of employee-owned companies.<sup>63</sup> These workers were responding to decreasing wages and apprenticeship opportunities that could eventually lead to capital ownership and income. These opportunities were drying up as master craftsmen found that they could increase their profits by dividing tasks previously performed by skilled apprentices among low-paid, low-skilled workers.

Employee-owned cooperatives—the first of which were formed in Philadelphia by the Union Society of House Carpenters in 1791 and the Philadelphia “cordwainers” (or shoemakers) in 1806—allowed skilled workers to escape the low wages paid by master craftsmen and a chance to the full profits associated with capital ownership.<sup>64</sup> These first employee-owned enterprises were formed in protest of unfair conditions offered by master craftsmen and the inability of workers to bargain for higher wages. However, trade union cooperatives became increasingly popular in the 1830s and many were successful<sup>65</sup>

This support for employee-ownership programs, however, shifted as the country industrialized and unions increasingly represented workers employed by large, antiunion companies. For the first half of the 20th century, unions opposed sharing programs. Unions took that stance when companies began developing and implementing “welfare capitalism” programs that included profit-sharing and stock rewards programs in part to limit the spread of unionism. Companies with employee ownership and other employee benefits programs would still resort to spying and firing workers who wanted to organize a union.<sup>66</sup> Additionally, unions were suspicious that what capital

rewards companies were offering was a substitute for good wages, rather than an added benefit of employment.

Union firebrand Samuel Gompers, president of the American Federation of Labor from 1886 until 1924, argued:

*... some employers who have inaugurated systems of so-called profit sharing have pared down the wages of their employees so that the combined sharing of profits and their wages did not equal the wages of employees of other companies in the same line of industry. What we are especially interested in more than profit sharing is a fair living wage, reasonable hours and fair conditions of employment.<sup>67</sup>*

While union leaders hold many of these same concerns today, since the 1950s unions have taken a more nuanced approach to inclusive capitalism and evaluate these programs based on the total effects on the workforce. Indeed, unions have developed their own brand of sharing programs and there is evidence that unionized companies that adopt inclusive capitalism plans enjoy measurable benefits.

### Inclusive capitalism to increase worker compensation

Given the labor movement's historic opposition, it was big news when iconic labor leader Walter Reuther, president of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America, or UAW, included profit sharing as a major demand in the 1958 contract negotiations with Detroit automakers. Reuther was concerned that there was an increasing imbalance between what American workers could produce and their purchasing power. He saw profit sharing as an effective way to expand workers' purchasing power.<sup>68</sup> Though ultimately unsuccessful, Reuther argued that 25 percent of the automakers' excess profits should be shared with workers to finance fringe benefits and another 25 percent should go back to car buyers at the end of each year in the form of rebates.

Since then, labor unions have become increasingly willing to consider the adoption of inclusive capitalism programs. Still, labor unions are vigilant of workers' interests when it comes to bargaining for inclusive capitalism programs and try to ensure that:<sup>69</sup>

- Financial incentives are a bonus on top of—rather than instead of—adequate pay and benefits
- Sharing agreements are transparent so that workers understand the plans and companies cannot manipulate financial reporting in order to reduce worker compensation
- Workers have a voice in designing, implementing, and reviewing the plans
- Workers' efforts control the final payout to the maximum extent possible

Let's consider the example of United Steel Workers, who worked with employers to develop their own brand of gain sharing that evaluates improvements at the team level. This approach allows workers a maximum amount of control over the final payout. Scanlon plans—named after a local union president—were designed to supplement wages of workers in companies that could not pay union wages without undermining firm competitiveness.<sup>70</sup>

Also, Reuther's UAW union (formerly the United Auto Workers and now the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America) was ultimately successful in obtaining profit-sharing agreements for its members, which were first included in a contract with the now-defunct American Motors Corporation in 1961.<sup>71</sup> More than 20 years later, in 1982, Ford was the first of the Big Three automakers to adopt a sharing agreement.<sup>72</sup> Since then, the union has worked with automakers to adopt both profit-sharing and gain-sharing programs and in 2011 it bargained the most generous profit-sharing agreement with the Big Three automakers in UAW's history.<sup>73</sup>

### Inclusive capitalism to prevent company failure

Labor unions have also participated in employee-ownership agreements to prevent company failure and the associated job losses. This is not the most common reason for unions to negotiate sharing

arrangements, but it is the most visible. This model, in many cases, has provided companies with needed capital to return to profitability. Capital sharing, however, cannot make a sick company—or industry—well again. Unfortunately, unionized firms implementing employee-ownership mechanisms to save their companies have not always been successful. High-profile failures have risked too much of workers' savings and as a result turned some in labor against employee stock ownership plans.

Just two years ago when Ford, General Motors, and Chrysler faced bankruptcy, workers adopted an employee-ownership arrangement. Prior to the economic downturn that would put automakers on the brink, the UAW and the Big Three automakers in 2007 negotiated a Voluntary Employee Benefits Association to administer health insurance for retired autoworkers that would relieve the burden of retiree health care obligations on the companies and reduce the risk to workers of relying on a severely underfunded system.

The companies originally agreed to a stream of payments to the benefits association to be paid primarily in cash. But when the downturn occurred, the UAW and the automakers agreed that a significant portion of the companies' remaining obligation would be paid in equity. While this is an indirect form of employee ownership—the Voluntary Employee Benefits Association is an independent trust—workers shoulder significant risk since their retirement health benefits are affected by the financial performance of the companies.<sup>74</sup>

This was not the first time one of the Big Three automakers was bailed out by its workers. When Chrysler faced bankruptcy in 1979, unionized workers agreed to a 30 percent wage reduction in exchange for a 20 percent to 25 percent ownership share of the company through an employee stock ownership plan. Chrysler workers' investment paid off. When the company repaid the debt several years early, the plan sold its Chrysler shares for a threefold gain.<sup>75</sup>



Yet these types of worker-led bailouts can subject employees to too much risk, and high-profile failures have soured a number of labor activists to employee ownership. A prime example is the 2002 bankruptcy of United Airlines, which was a major blow to public confidence in employee stock ownership plans. United's largely unionized workforce became the company's beneficial owners when it was facing bankruptcy eight years earlier. In exchange for a 55 percent ownership stake in the company, workers agreed to major wage concessions.<sup>76</sup> The company's ultimate failure caused its employees to lose virtually all their retirement savings invested through the company's employee stock ownership plan.<sup>77</sup>

The United Airlines employee stock ownership plan was poorly designed and implemented but the case is still viewed as failure for these types of plans.<sup>78</sup> Many outside experts recommended that United implement a far-reaching employee involvement program and that it address opposition among management to employee ownership.<sup>79</sup> Also, United could have fostered the development of an ownership culture among employees by adopting cash profit sharing to supplement the plan so that workers, like other shareholders, would enjoy the rewards of company performance improvements immediately if the reorganization was successful.<sup>80</sup> Yet none of these recommendations was fully adopted and the U.S. Department of Labor commissioned a report found that "cultural change efforts ... have been largely symbolic and incremental rather than systemic."<sup>81</sup>

Moreover, the United Airlines plan—in which workers traded wage and benefits concessions for a majority stake in a large corporation that remained public—exposed workers to far more risk than the typical ESOP sale. Under a traditional employee stock ownership plan, sale workers take ownership of a private company using leverage, rather than wage concessions, to finance the deal.

Research shows that these types of horror stories are exceptions to the rule.<sup>82</sup> Union workers frequently participate in inclusive capitalism programs but approach them—particularly employee stock ownership plans and other types of retirement plans that include employee ownership—with caution.<sup>83</sup> In 2002 Richard Trumka, now president of the AFL-CIO, testified before Congress and argued that "an ESOP or other employee stock plan makes sense as a supplement to a defined benefit plan and a properly diversified defined contribution plan, or as a medium term investment."<sup>84</sup> Employee stock ownership plans sponsored by unions typically are structured in this way and unions generally oppose any attempts to convert defined benefit pension plans to an employee stock ownership plan or a defined contribution plan.

Still unions continue to pioneer new types of sharing. The United Steelworkers announced a new union co-op model last year that combines worker ownership with a progressive collective bargaining process and are in the process of developing projects in Cincinnati and Pittsburgh.<sup>85</sup> Leo Gerard, president of the steelworkers' union, argued that these arrangements offer a sustainable way to rebuild local economies: "To survive the boom and bust, bubble-driven economic cycles fueled by Wall Street, we must look for new ways to create and sustain good jobs on Main Street."<sup>86</sup>

What's more, union workers usually prosper within these sharing arrangements. In highly unionized establishments, less compensation is put at risk through profit sharing and employee ownership and outcomes are generally positive for employers and workers even when organized workplaces do have riskier forms of inclusive capitalism.<sup>87</sup> Perhaps most importantly, sharing programs are generally more successful in terms of improving worker satisfaction and company performance when employee participation programs are in place,<sup>88</sup> which often means union involvement.



# Policy mechanisms

Our federal and state governments have instituted a variety of mechanisms that encourage inclusive capitalism programs. Certainly governments adopted some of these policies with the explicit goal of boosting private-sector adoption of inclusive capitalism programs, but other policies have enabled the growth of sharing programs even though this was not necessarily the intended goal of policymakers.

Policies that encourage inclusive capitalism programs in the workplace include:

- Tax advantages for companies and selling owners
- Tax advantages to workers to encourage widespread participation and savings for retirement
- Programs to increase awareness of employee ownership and provide assistance to new and existing employee-owned companies
- Designation of a privileged company structure
- Direct government financing or encouraging private lending to companies with inclusive capitalism policies
- Government purchasing to support inclusive capitalism
- Regulatory oversight to reduce costs for companies with inclusive capitalism programs and influence the types of sharing programs adopted

These policy levers could be used to encourage all types of inclusive capitalism programs but are most often geared toward increasing employee ownership. Fewer facilitate the use of stock rewards programs—such as broad-based stock options, restricted stock, or stock appreciation rights—and we were unable to uncover any federal or state programs to increase the use of immediate cash profit sharing or gain sharing among employers. Both policy development and the endorsement of existing policies to support inclusive capitalism are beyond the scope of this report, but this gap indicates a clear need for additional work to develop policy around broad-based profit sharing and gain sharing.

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## Tax advantages for companies and selling owners

Federal tax advantages for companies and business owners are arguably the most generous policy levers being used to stimulate the growth of inclusive capitalism practices. Tax advantages for companies range from granting various deductions to tax status that can eliminate all corporate-level taxes. The government awards the most generous of these benefits to companies with employee ownership structures. Moreover, the tax advantages for employee stock ownership plans are particularly robust.

There are two main types of these plans: C-corporation and S-corporation employee stock ownership plans. Both types provide valuable but differing tax advantages to participating companies. In addition, many state laws magnify these effects by having statutes that mirror federal provisions. These tax benefits include:

- **Deductibility of ESOP contributions:** Employer contributions to an employee stock ownership plan are tax deductible up to a limit of 25 percent of covered payroll, and for leveraged C-corporation plans, contributions used to pay loan interest are not subject to this limit.<sup>89</sup> This allows a company to use pretax dollars to buy out its owners and does so without workers having to risk their savings.<sup>90</sup> In this situation an employee stock ownership plan would secure a loan to purchase securities from the sponsoring employer. The employer thereafter would deduct contributions to the plan, which are used to repay both the interest and principal on the loan.

Note: S-corporations with leveraged employee stock ownership plans may not exclude interest from the 25 percent limit.

- **Deductibility of dividends:** Companies with C-corporation employee stock ownership plans may deduct dividends paid on ESOP-held stock that is paid out in the following ways: cash dividends paid to participating workers; dividends used to pay a leveraged plan's loan payments; or dividends employees voluntarily reinvest in company stock. This encourages companies to provide short-term stock ownership benefits to workers in addition to the long-term benefits of capital ownership.<sup>91</sup>

Note: S-corporation distributions—the equivalent to dividends—are not deductible but may be used to repay ESOP loans.

- **ESOP rollover:** Owners of closely held C-corporations can sell the company to an employee stock ownership plan and defer federal taxes on the gain from the sale. Rollover benefits allow retiring owners selling to a C-corporation plan to defer federal taxes on gains arising from the sale by reinvesting in qualified replacement property.<sup>92</sup> This tax advantage is often an important benefit to retiring owners of closely held private businesses who would like to preserve jobs and their legacy by ensuring the company stays in operation; gradually withdraw from the company by selling off the business slowly; or sell only a portion of the company—allowing heirs, key managers, or others to have a partial ownership interest.

Note: In 2012 Iowa passed bipartisan legislation to provide sellers to employee stock ownership plans with additional tax benefits.<sup>93</sup>

- **The S-corporation advantage:** Congress provided a significant benefit to ESOP owners when it enacted legislation that allowed S-corporations to be owned by employee stock ownership plans beginning in 1998. S-corporations are “pass-through” entities, and therefore the profits of S-corporation plans are not subject to federal income tax.<sup>94</sup> The thinking being that when profits flow through the company to its owners—rather than being retained by the company—those profits should only be taxed once. This tax advantage is particularly valuable for employee stock ownership plans because they are also tax-qualified plans—meaning that worker-owners defer income tax payment until the funds are distributed to them usually at retirement.<sup>95</sup>

The S-corporation plan—with its pass-through tax treatment—motivated many employee stock ownership plans to convert from C-corporations to S-corporations. According to one industry survey, 73 percent of these plans were S-corporations in 2010—though other industry experts estimate the figure to be around 40 percent to 50 percent of all employee stock ownership plans.<sup>96</sup> Also, because the tax savings is so great, often S-corporation plans are either 100 percent worker-owned or moving toward becoming fully worker-owned.

Several other types of businesses that may or may not be employee-owned—cooperatives, limited liability companies, partnerships, and S-corporations not owned by an employee stock ownership plans—receive pass-through tax treatment from the federal government. In the case of employee-owned firms, the worker-owners pay income tax on the profits they receive from the company, but the company is not subject to the federal income tax.

Likewise, the same law—that allows business owners to sell to an employee stock ownership plan and defer federal taxes on the gain from the sale—provides these benefits to owners selling to a cooperative.<sup>97</sup> This law could potentially be extremely helpful to owners of very small businesses who would like to sell to their employees but who could not afford the costs associated with administering an employee stock ownership plan. To date, however, very few companies have taken advantage of these benefits.<sup>98</sup>

The federal government also makes valuable tax advantages available to companies that have sharing policies but are not employee-owned. The tax code, for example, grants employers offering certain types of stock options—whether or not they are broad-based—tax benefits for the gain recognized as compensation by the employee at the time the option is exercised.<sup>99</sup> Employers can deduct these payments just as they would wages, but they are able to compensate their workers without having to deplete the company's cash reserves and receive the benefit of a cash infusion from employees when they exercise their options to purchase stock.<sup>100</sup> In 2001 Cisco Systems Inc., the multinational computer networking equipment manufacturer, received \$1.2 billion from its employees—exercising their option to buy company stock at a discounted rate—and \$1.4 billion in accompanying tax benefits.<sup>101</sup>

### Tax advantages to workers to encourage widespread participation and savings for retirement

The federal government provides tax advantages to workers who participate in sharing programs. Many of these benefits are specifically geared toward encouraging capital-sharing programs to fund retirement savings for workers. In some cases the government also requires that employers fulfill basic guarantees ensuring that sharing formulas do not unfairly benefit highly paid workers.

All inclusive capitalism programs that defer income until retirement—including deferred profit-sharing plans, 401(k) plans with ownership of company stock, and employee stock ownership plans—allow workers to avoid immediate taxation. Employers hold workers' funds in individual accounts that cannot be withdrawn except under certain well-defined conditions. The money and interest in the funds is not taxed as long as those funds remain in the account—as is the case with most retirement plans. Workers' incomes—and consequently their taxes—tend to be lower when the funds are finally taxed at retirement.

Workers are encouraged to participate in stock incentives programs in two ways. First, as is the case with other shareholders, if workers hold onto their shares for a given period of time, gains from the sale of qualified stock purchase plans and qualified stock options can be taxed at capital gains rates—which are usually lower than ordinary income tax rates that workers must pay on their wages.<sup>102</sup> Second, qualified stock purchase plans allow workers to purchase stock at a discount from fair market value without any taxes owed on the discount at the time of purchase.<sup>103</sup> But the discount workers receive is generally considered additional compensation and they have to pay taxes on it when they sell the stock.

Finally, the federal government has instituted regulations to encourage employers to adopt incentive pay programs broadly among their employees. All workers with at least two years of service, for example, must be included in employee stock purchase plans in order for the plan to be considered “qualified” and carry special tax advantages.<sup>104</sup>

Further, according to Internal Revenue Code requirements, for an employee stock ownership plan or another type of retirement plan to qualify for favorable tax incentives, it may not discriminate in favor of highly compensated employees by providing more favorable benefits or contributions to them than to other employees.<sup>105</sup> Additionally these sorts of plans are subject to “top-heavy” rules. Generally a plan is considered to be top heavy when more than 60 percent of total account balances are owned by highly compensated employees. Top-heavy plans must satisfy minimum vesting and allocation requirements in order to ensure that lower-level employees receive some benefits.<sup>106</sup>

### Programs to increase awareness of employee ownership and provide assistance to new and existing employee-owned companies

Shared-ownership structures are not always well understood by the business community. The federal and state governments have enacted programs aimed at increasing awareness and providing education and technical assistance to new and existing employee-owned companies. These programs function to facilitate word-of-mouth about shared ownership; assist owners converting to an employee-ownership structure (through preliminary feasibility studies, technical training and advice, and locating financial assistance); help workers and employers adopt an ownership culture; and bring together existing employee-owned businesses.

Several states funded employee-ownership programs aimed primarily at encouraging ESOP development in the mid-1980s.<sup>107</sup> Subsequently, many of these programs were victims of budget cuts or the programs were allowed to sunset. The programs that continue to exist have become less reliant on government funding or are housed within state agencies.

The success of these programs has varied. The Ohio Employee Ownership Center and the Vermont Employee Ownership Center have been successful in increasing awareness of employee stock ownership plans throughout the country and in facilitating company conversions—particularly in small, privately held firms where owners are facing retirement.<sup>108</sup> Other programs, however, have been less successful often due to insufficient funding.

In the 1980s a number of states passed policy declarations generally supporting employee ownership. Most of these declarations had the goal of broadening ownership, stabilizing local economies, and preventing plant closures.<sup>109</sup>

At the federal level, the Workforce Investment Act's regulations—previously the Job Training Partnership Act—allow states to use federal funding for preliminary studies to determine whether an employee buyout is feasible in shutdown and job-loss situations. But a survey by the Ohio Employee Ownership Center showed that 33 states and the District of Columbia are not using and potentially did not know about federal funding availability for these studies.<sup>110</sup>

Finally, the Department of Agriculture awards Rural Cooperative Development grants for the establishment and ongoing operation of centers for cooperative development. These centers aid in the development of new cooperatives and improve the operations of existing ones.

### Designation of a privileged company structure

Traditional business structures can inhibit companies from adopting inclusive capitalism policies. Stockholders, for example, could in theory sue chief executive officers if profit making is not their sole objective,<sup>111</sup> and worker cooperatives often lack sufficient capital to leverage private financing. State governments have enacted laws to both allow businesses to more easily adopt sharing policies without fear of shareholder reprisal and to leverage capital for startups.



Since 2010 twelve states have passed laws creating a new class of corporation known as a benefit corporation—which offers legal protection to owners to look beyond short-term financial gains.<sup>112</sup> By law, these companies must create a material positive impact on society; consider how decisions affect employees, community, and the environment; and publicly report their social and environmental performance.<sup>113</sup> Companies applying for this status must complete a third-party assessment that may evaluate—among other things—whether firms have an employee-ownership structure or offer broad-based stock, stock equivalents, or stock options to employees.<sup>114</sup> This does not guarantee that every benefit corporation will offer inclusive capitalism programs, but it can provide a significant legal protection to companies with sharing programs.

Iowa, Minnesota, and Wisconsin have all passed laws to help cooperatives leverage capital to finance their businesses.<sup>115</sup> Most states allow cooperatives to have only one class of voting member-owners—often making it difficult for them to raise sufficient capital to obtain loans. By allowing cooperatives to have at least two classes of members—patron and investor members—these states help cooperatives more easily raise the capital necessary to secure loans.<sup>116</sup> This is particularly valuable during the incubation period when co-ops typically have difficulty accessing credit.

### Providing direct government financing and encouraging private lending to companies with inclusive capitalism policies

Private lenders and even government agencies may be hesitant to provide financing to current and startup worker co-ops because they are unfamiliar with the company structure; fear that workers will have too much influence over governance; and are confused about who the responsible parties are in the event of a default. Although employee stock ownership plans do not share the same challenges, their unique ownership structure can preclude them from participating in government programs. The federal and state governments have created programs to provide direct funding and encourage private lending to cooperatives and employee stock ownership plans.

The federal government has crafted regulations to ensure that co-ops and employee stock ownership plans are able to compete for federal grants that are available to all businesses. The U.S. Department of Agriculture's Business and Industry Guaranteed Loan Program provides assistance to companies to improve the economic and environmental climate in rural communities. Program guidelines specifically encourage worker cooperatives to participate.

Likewise, the U.S. Small Business Association’s Small Business Innovation Research program offers grants to small businesses to engage in research and development that has the potential for commercialization. In order to participate in the program, a company must be majority- owned by American citizens or legal permanent residents. Federal regulations clarify that for ESOP-owned companies, each stock trustee and plan member is considered to be an owner—without this clarification companies that are majority ESOP-owned could be excluded from participation.<sup>117</sup>

At the state level Indiana’s ESOP “linked-deposit” program allows the state treasurer’s office to link its routine purchase of certificates of deposit, or CDs, from state financial institutions to companies in need of capital to complete an ESOP transaction. The Indiana treasurer’s office regularly invests state funds by purchasing certificates of deposit. In order to assist companies forming an employee stock ownership plan to borrow funds at a low interest rate, the treasurer purchases certificates of deposit that provide a slightly lower interest rate but in exchange requires the financial institution to reduce the interest rate on the loan made to the company.

Previously, federal law also encouraged private-sector lending to employee stock ownership plans by allowing lenders to deduct 50 percent of the interest received on ESOP loans from their taxable income as long as the loan was used to purchase a majority stake in the company.<sup>118</sup> Consequently, loans to employee stock ownership plans carried a lower interest rate than a conventional loan. This incentive, however, was eliminated in 1996.

### Government purchasing to support inclusive capitalism

State and federal governments spend hundreds of billions of dollars each year to purchase goods and services. Governments leverage this spending to support various types of businesses—such as small, minority- and women-owned businesses, and businesses in disadvantaged areas—often by creating contracting set-aside programs. Frequently the unique ownership structure of employee-owned companies precludes them from qualifying for these programs. Because of government guidelines a company that is majority-owned by an employee stock ownership plan—even if most of its employee-owners are people of color—the company wouldn’t qualify for federal contracting set-asides for minority-owned businesses.

The federal government, however, has enacted regulations to ensure that companies with shared ownership structures are eligible to participate in competitions

for certain types of contract set-asides. The Historically Underutilized Business Zone, or HUB Zone, program—a federal contracting set-aside program that benefits economically disadvantaged areas—includes regulations to allow ESOP participation. In order to be eligible for the HUB Zone program, a small business must be located in a historically underutilized business zone, owned and controlled by one or more U.S. citizens, and at least 35 percent of its employees must reside in a HUB Zone. Like the Small Business Innovation Research program, regulations clarify that for ESOP-owned companies each stock trustee and plan member is considered to be an owner.<sup>119</sup>

On the state level Virginia passed a law to encourage the formation of employee stock ownership plans to perform services previously provided by the government. In 1995 Virginia created the Commonwealth Competition Council to investigate ways of privatizing services previously run by the state.<sup>120</sup> The council issued a plan advocating for spinning off functions performed by the government into worker-owned employee stock ownership plans. The plan was modeled after a process the U.S. Office of Personnel Management went through to spin off background investigations previously performed by the government to an employee stock ownership plan.<sup>121</sup> It is unclear whether any state services were actually converted to employee stock ownership plans as recommended by the report, and the state is not currently working on any projects to do so.

### [Regulatory oversight to reduce costs for companies with inclusive capitalism programs and influence the types of sharing programs adopted](#)

Several government and quasi-governmental agencies—including the Securities and Exchange Commission, private self-regulatory organizations such as the Financial Accounting Standards Board, and the New York Stock Exchange—have regulatory powers that can influence the prevalence of inclusive capitalism. These bodies have passed rules to influence the types of broad-based sharing policies companies adopt and that reduce the cost of sharing ownership with employees by exempting companies that issue stock to their employees from reporting requirements.

The Securities and Exchange Commission, for example, exempts small, privately held companies that issue stock to employees through vehicles such as stock options and employee stock purchase plans, or ESPPs, from federal reporting requirements, arguing that it would be an “unreasonable burden” to require these companies to incur the same expenses and disclosure obligations as public com-

panies when their only sales were to employees.<sup>122</sup> Several states have also passed laws exempting these sorts of companies from securities regulations.<sup>123</sup>

Regulations by the Financial Accounting Standards Board and the New York Stock Exchange also influence what types of inclusive capitalism programs companies adopt.

In the wake of the Enron scandal, the Financial Accounting Standards Board—the accounting industry’s self-regulatory organization—changed its rules to require companies to expense the cost of stock options on their income statements.<sup>124</sup> Previously companies did not have to charge stock option costs against their earnings. Many progressives lauded these changes as an important disclosure that would give investors a more accurate picture of the cost of executive compensation, but others predicted that the new rule would prompt companies to restrict stock options to only their top executives.<sup>125</sup>

The New York Stock Exchange also changed regulations that affect the prevalence of stock options. Public companies must receive shareholder approval in order to adopt stock option plans for their employees. The New York Stock Exchange rules were amended in 2003 to prohibit brokers from voting on stock option plans unless the beneficial-owner of the shares has given them voting instructions.<sup>126</sup> Previously brokerage firms were allowed to vote clients’ stock as a block without owner approval, which made it easier for companies to receive approval of stock option plans. Companies, however, may adopt other types of stock-sharing mechanisms—employee stock ownership plans and employee stock purchase plans—without shareholder approval.

The Financial Accounting Standards Board and New York Stock Exchange rule changes—along with changing market dynamics—led to a reduction in stock options. A study looking at the prevalence of workers holding stock options before and after the Financial Accounting Standards Board rule change fell by 26 percent—or 3.7 million workers—after the expensing rule was enacted.<sup>127</sup>

Stock options continue to be a very common form of equity compensation, but by increasing the public and stockholder oversight of stock option plans, these rule changes may have encouraged companies to adopt other types of stock-sharing programs—such as restricted stock and stock appreciation rights.<sup>128</sup>

## Summary of existing policy mechanisms to support inclusive capitalism

Federal and state governments have instituted a variety of mechanisms to encourage inclusive capitalism policies. These policy levers include:

**Tax advantages for companies and selling owners:** Tax advantages for companies and business owners agreeing to the sale of their stock are the most generous policy levers being used to stimulate the growth of inclusive capitalism practices. Employee stock ownership plans enjoy the most extensive tax advantages while the government provides other types of sharing programs much less support.

**Tax advantages to workers to encourage widespread participation and savings for retirement:** The federal government provides tax advantages to workers who participate in sharing programs. Many of these benefits are specifically geared toward encouraging capital-sharing programs to fund retirement savings for workers. In some cases the government also requires that employers fulfill basic guarantees ensuring that sharing formulas do not unfairly benefit highly paid workers.

**Programs to increase awareness about employee ownership and provide assistance to new and existing employee-owned companies:** Shared-ownership structures are not widely understood in the business community. The federal and state governments have enacted programs aimed at increasing awareness and providing education and technical assistance to new and existing employee-owned companies. These programs facilitate word-of-mouth about shared ownership; assist owners converting to an employee-ownership structure; help workers and employers adopt an ownership culture; and bring together existing employee-owned businesses.

**Designation of a privileged company structure:** Traditional business structures can inhibit companies from adopting inclusive capitalism policies. In theory, stockholders could sue chief executive officers if profit making is not their sole objective,

and worker cooperatives often lack sufficient capital to leverage private financing. State governments have enacted laws to allow businesses to more easily adopt sharing policies without fear of shareholder reprisal and leverage capital for startups.

**Providing direct government financing and encouraging private lending to companies with inclusive capitalism policies:** Private lenders may be hesitant to provide financing to current and startup worker co-ops because they are unfamiliar with the company structure and fear that workers will have too much influence over governance. Although employee stock ownership plans do not share the same challenges, their unique ownership structure can preclude them from participating in government programs. Federal and state governments have created programs to provide direct funding and encourage private lending to cooperatives and employee stock ownership plans.

**Government purchasing to support inclusive capitalism:** State and federal governments spend hundreds of billions of dollars each year to purchase goods and services and they use this spending to support various types of businesses—often by creating contracting set-aside programs. But the unique structure of employee-owned companies can preclude them from qualifying for some of these programs. The federal government has enacted regulations to ensure that companies with shared ownership can obtain contracts under these programs. In addition, Virginia passed a law to encourage the formation of employee stock ownership plans to perform services previously provided by the government.

**Regulatory oversight to reduce costs for companies with inclusive capitalism programs and influence the types of sharing programs adopted:** Regulatory oversight bodies have passed rules that reduce the costs of sharing ownership with employees by exempting companies that issue stock to their employees from reporting requirements and rules that influence the types of broad-based sharing policies that companies will adopt.

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## Fundamental questions about inclusive capitalism policies

Governments have implemented a variety of policy mechanisms to support inclusive capitalism and these practices hold the potential to both improve business performance and provide workers with higher levels of compensation. Surveys have shown that the American public generally supports the concept of inclusive capitalism, but the base of support among policymakers and advocates for inclusive capitalism policies is relatively narrow.<sup>129</sup>

Policymakers who support expanded use of inclusive capitalism policies often do so because they have personal experience with it—as is the case with Indiana’s state treasurer program to increase lending to employee stock ownership plans—or are focused on serving a specific constituency that lobby on one particular form of inclusive capitalism.

Most telling, even during the current economic downturn—a time when elected officials are especially hungry for economic policy ideas—inclusive capitalism policies are not a part of the larger national conversation. Federal lawmakers introduced nine bills and resolutions that would have expanded government support for inclusive capitalism during the 112th session of Congress. Four bills supported employee stock ownership plans by increasing company tax advantages, expanding access to government contracts, and reducing regulatory requirements for ESOP companies; two bills focused on cooperatives aiming to increase awareness of cooperatives and provide loans and grants to support their development; two bills were aimed at boosting employee ownership through both ESOPs and cooperatives by providing education, outreach, and technical assistance and increasing lending to employee owned firms; and one bill provided valuable tax incentives for workers and employers participating in stock grant programs.<sup>130</sup>

Disappointingly, only the most modest piece of inclusive capitalism legislation received a vote; Senate Resolution 87 designating 2012 as the International Year of Cooperatives was passed by unanimous consent. None of the other bills have even had a committee hearing or received broad public recognition as a way to promote and protect good American jobs.

This lack of legislative action is due in part to the fact that there are several challenging questions that supporters of inclusive capitalism will need to address in order to build a broader base of support for inclusive capitalism policies. These questions include:

### *How much of worker pay should be variable?*

Workers accept an additional measure of risk—with the promise of a potentially larger reward—by participating in inclusive capitalism policies and accepting that a portion of their pay will be variable. But just how much risk workers should take on through variable pay is open to debate and current policy provides few guidelines.

Academic research has found that the financial incentive programs that provide an increase over adequate levels of pay and pensions are more successful than those that put a large portion of pay or retirement income at risk.<sup>131</sup> Workers who feel financially insecure experience less of the positive outcomes associated with inclusive capitalism and are less interested in increasing their participation in such policies. Indeed, excessive economic insecurity, research finds, has the capability of reversing every positive individual and workplace outcome of inclusive capitalism.<sup>132</sup>

Evidence shows that most companies currently providing inclusive capitalism programs are doing so in addition to providing competitive wages. Several studies have found that average pay of workers in employee-owned firms is just as high as or higher than worker pay in non-employee-owned firms.<sup>133</sup> A General Social Survey analysis suggests that a majority of workers participating in inclusive capitalism programs have fixed pay that is either the same as or higher than market rates.<sup>134</sup>

We urge policymakers to consider how to ensure that variable pay supplements good wages as they encourage more companies to adopt sharing programs. Variable pay must be of a significant amount to encourage greater investment by workers in the success of their company, but at the same time variable pay should be looked at as an addition to—and never a substitution for—a living wage. Workers, especially those at the bottom or middle of the wage scale, must be able to count on a reasonable level of consistent pay.

### *How should variable compensation be structured so that workers realize upside potential without feeling they are playing the lottery?*

Under the umbrella of inclusive capitalism, workers' ability to affect their variable pay ranges a great deal from gain sharing—where workers have a great deal of control, receiving payments based on the performance of their unit—to profit sharing at large corporations—where workers have less control and payments may potentially have more to do with the price of commodities than changes in worker behavior.

Both types of sharing have a valid role. It is reasonable for workers to benefit when the company does well regardless of the cause—as do company owners, investors,

and often executives. And when a portion of workers' pay is tied to outcomes they can control, it is a strong motivator for workers to improve their performance.

If variable pay is awarded based only on company-wide performance, there may be less of an incentive for workers to improve individual performance. But workers also shouldn't be excluded from receiving a share of their company's upside profits.

We urge policymakers to consider how government can promote a balance between the portion of workers' variable pay that is tied to outcomes they directly control versus company-wide performance metrics.

*How do you limit the unintended consequences of inclusive capitalism policies?*

Government has adopted a wide variety of policies to support inclusive capitalism. As a consequence, more companies share capital with their workers and companies benefit from a more invested and productive workforce.

Not surprisingly, some companies have taken advantage of government incentives while undertaking actions that may hurt workers and make the business environment less stable. Companies have used employee stock ownership plans, for example, to leverage capital for hostile takeovers that have placed significant additional risks onto to workers.<sup>135</sup>

We urge policymakers to consider how to ensure that government programs reward only companies that achieve the intended goals of inclusive capitalism and not companies that take unfair advantage of legal loopholes.

*Should government only support inclusive capitalism in the form of employee ownership?*

Existing government policies that support inclusive capitalism are primarily focused on providing benefits to companies with employee-ownership structures such as employee stock ownership plans. Far fewer policies promote inclusive capitalism programs without an ownership component—such as gain and cash profit sharing.

Proponents of employee ownership argue that it is the workers' role as owners that provide the unique benefits of inclusive capitalism. While this role must be fostered through education and management structures, workers who see themselves as owners—and not just wage earners—feel fully invested in the future of



the company and consequently have an especially strong interest in improving company performance.<sup>136</sup>

In addition, it is argued that worker-owned companies are anchored to the communities where they are based and as a consequence provide larger societal benefits to that community.<sup>137</sup> As the beneficial owners of their companies, workers can emphasize both return to profits and sustainable growth that considers the needs of other community stakeholders as well as the environment.<sup>138</sup> Also, at a time when so many jobs are going overseas, employee ownership can ensure that local jobs are maintained and that wealth is rooted in the community where it was created. Finally, worker ownership is often thought to be beneficial for democracy—giving workers a real, participatory role in their work life that can translate into their civic life.<sup>139</sup>

In short, there is something special about broad-based worker ownership. Yet many of the benefits of inclusive capitalism—such as increased firm performance and employee compensation—also occur without ownership.<sup>140</sup> Employers recognizing the benefits of short-term and long-term sharing rewards often adopt employee-ownership models along with other types of sharing programs.

We urge policymakers to consider how best to support all types of inclusive capitalism, including gain sharing and profit sharing and not just ownership.

#### *How do you encourage all types of companies to adopt sharing policies?*

There are multiple reasons why companies may not adopt broad-based sharing programs, including: CEOs and top executives lack information about inclusive capitalism programs or expertise on how to adopt them; they are skeptical that inclusive capitalism programs will improve business performance and investor results; or they are unwilling to share power and capital income with their workers.

Most of the recent policy activity around inclusive capitalism has been focused around policies that most affect small and medium-size companies and startups. One area of focus for example—benefit corporation status—is particularly attractive to ideologically motivated startup companies that want to ensure that the wellbeing of workers and other stakeholders does not become subservient to shareholder returns as the company grows. Similarly, ESOP policy has generally motivated owners of small and medium-size businesses to convert their ownership structure upon their retirement.

Less attention has been paid to encouraging the adoption of inclusive capitalism programs at large, established public corporations even though these companies have the power to establish compensation norms throughout their industries and employ more than half of all private-sector workers.<sup>141</sup>

We urge policymakers to consider how to encourage sharing among more companies, especially with large, established companies that are unlikely to change their entire business structure in order to share with workers.

*How much influence should workers have over management of their company?*

Inclusive capitalism programs allow workers to reap the financial benefits of ownership, but don't necessarily grant them influence over the management of the company. Certainly, there are no laws restricting companies from implementing ways for workers to participate in firm governance, but there is little incentive from government to encourage companies to do so.<sup>142</sup>

Companies may choose to extend full voting rights to workers in privately held employee stock ownership plans, but by default, ownership is held in trust for workers. Employee stock ownership plan trustees are chosen by boards. Trustees are required to administer the plan in the employees' best interest and are empowered to vote workers' shares.<sup>143</sup> Generally, only on major corporate issues such as mergers, consolidation, liquidation, and or dissolution must a privately held company pass through voting rights to workers.

Tom Taulli—a principal at Bridgewater Capital, a Newport Beach, California, investment firm—in explaining the lack of influence of worker-owners said, “The nice thing about ESOPs is that owners can have their cake and eat it, too. They get some liquidity, personal tax advantages, and also can retain control.”<sup>144</sup>

Employees receive voting rights in broad-based stock option plans and employee stock purchase plans only if they work for a publicly traded company, and they hold onto their shares after purchase though most sell their shares immediately. Moreover, there is no legal requirement for employees participating in cash profit sharing or gain sharing to receive a governance role since they do not receive stock.

Supporters of this relationship argue that legal regulations should set a modest bar for corporate governance but not a ceiling—which allows companies to become increasingly democratic over time. Limiting regulation, they argue, will encourage

many more companies to adopt these practices than would be the case if worker participation requirements were more stringent.<sup>145</sup>

Additionally, supporters argue that firm executives exert the most influence through the day-to-day management of the firm rather than through voting rights and that the financial benefits component of inclusive capitalism—along with more say of workers over their own jobs—is what is needed. Workers want the income benefits of ownership, not participation in corporate decision making, they say.<sup>146</sup> What’s more, it would be difficult for the companies to obtain financing from private lenders if workers were to have too much influence.

But this can also be a frustrating balance for workers who believe as stakeholders in the company they should participate in company decision making. A similar but broader concern could be applied to the entirety of workers’ retirement savings—whether held in an inclusive capitalism-type account or a standard 401(k) or pension—when workers are company owners with little if any effective influence.<sup>147</sup>

We urge policymakers to consider whether incentives to promote inclusive capitalism should also encourage companies to give workers greater participation in corporate management and if so, what level of influence.

#### *What is the relationship between inclusive capitalism policy and worker decision-making ability?*

Inclusive capitalism programs at their best can imbue workplaces with a collective entrepreneurial spirit, where all workers feel invested and empowered to make decisions in their company’s best interests.

Research on inclusive capitalism programs consistently finds that companies and workers do best when they have more autonomy on the job, greater job security, and are allowed to participate in decision making.<sup>148</sup> This decision making can occur through unions, employee involvement committees, or team production arrangements that allow workers more say over how they achieve work tasks. Workers need to have job security in order to recommend labor-saving improvements that could potentially jeopardize their current position. And they need a measure of autonomy over their individual work along with input into broader workplace systems in order to effectively recommend and implement changes.<sup>149</sup> In short, when workers have a high level of job security and involvement in decision making over their work at the job and department level, they are best able to take advantage of the incentives of inclusive capitalism.

Numerous studies have confirmed this link between the success of inclusive capitalism programs and worker participation. As early as 1987 the General Accounting Office—now the Government Accountability Office—found that employee stock ownership plans are associated with improved corporate performance only when they are combined with participative decision-making structures.<sup>150</sup>

More recently academics Richard Freeman, Joseph Blasi, and Douglas Kruse examined a set of studies based on the General Social Survey and a sample of more than 40,000 employees in companies with inclusive capitalism. The result of their investigation found that inclusive capitalism “works best when it combines monetary incentives with employee decision-making and personnel and labor policies that empower and encourage employees.”<sup>151</sup> Further, an even more expansive 2012 study—reviewing 780 companies employing more than 300,000 workers—by the same authors confirms that the best results happen when broad-based inclusive capitalism is combined with a supportive company culture.<sup>152</sup>

Yet government policies do little to ensure that companies adopt participatory structures along with financial incentive programs—or even to educate companies about the benefits of increased worker participation. And in cases where companies are not adopting these structures, government may well be rewarding practices that provide little public benefit.

We urge policymakers to consider how to encourage more participation by workers in the daily operations of companies with inclusive capitalism programs.

#### *How much transparency and oversight should there be of payout formulas?*

Inclusive capitalism programs allow workers to reap the financial benefits of investment but often grant them little oversight over how these funds are paid out. Complicated sharing formulas may obscure how payments to workers are derived and lead workers to question whether companies are manipulating financial reporting in order to reduce worker compensation. As a result workers may question whether they are receiving their fair share of company payouts.

For this reason General Motors and the United Auto Workers union tied profit-sharing payments for hourly workers to the whole of GM’s earnings before income and tax—a publically available figure—in their last round of contract negotiations.<sup>153</sup>

We urge policymakers to consider how to encourage companies with inclusive capitalism programs to create transparent sharing formulas with fair and easy to understand metrics.

*Is retirement policy the best way to promote inclusive capitalism?*

Government policies to support inclusive capitalism tend to favor programs that are structured as retirement savings, such as employee stock ownership plans, deferred profit sharing, and employer contributions to 401(k)s. This structure allows workers to enjoy the benefits of ownership while encouraging savings for retirement, which is particularly valuable for many Americans who face severe deficits in their retirement savings.

But delivering the benefits of inclusive capitalism through retirement can potentially represent a significant risk to workers since company failure could cause workers to lose their jobs and wipe out their retirement savings as was the case in high-profile failures of Enron, United Airlines, and to a lesser extent, the multimedia corporation the Tribune Company.<sup>154</sup>

Fortunately these sorts of horror stories are rare. Research shows that both public and private companies with employee stock ownership plans are less likely than their counterparts without employee ownership to go bankrupt or disappear for another reason.<sup>155</sup> Moreover, most ESOP retirement benefits are awarded in addition to, rather than as a substitute for other retirement benefits, so company failure would not typically wipe out a worker's entire retirement savings. Employee stock ownership plans are four times more likely to have defined benefit pension plans and more than five times more likely to have 401(k) plans than workers in comparable companies without sharing programs.<sup>156</sup>

But the risk associated with an over-concentration of employer stock in a company 401(k) is more common. Indeed, 401(k) plan employee ownership is the most common form of employee ownership financed by worker savings in contrast to employee stock ownership plans, which generally do not use worker savings. Companies can use stock in this way as a financing tool—there is no cash cost to the employer of providing the stock and the employer can take a tax deduction for the contribution.<sup>157</sup> There is no limit on how much in employer securities 401(k) plans can hold.<sup>158</sup> On average, workers hold 14 percent of their net wealth in employer stock, and almost 16 percent of workers hold twice that amount—28 percent of their net wealth.<sup>159</sup> Most often workers own this stock as part of their

401(k) plan.<sup>160</sup> In comparison, a pension fund generally may not hold more than 10 percent of its assets in employer stock.

When workers are exposed to excessive risk—based on a worker’s level of economic security—all the positive benefits of inclusive capitalism to both workers and the company can be reversed, according to researchers Blasi and Kruse from Rutgers University and Harry Markowitz from the University of California, San Diego.<sup>161</sup>

Conversely, there are significant benefits in allowing workers to receive their benefits immediately rather than waiting until retirement. Immediate sharing can serve as a strong motivation for workers to improve performance and gives them the flexibility to use their capital in the way they see fit—just as other owners would.

Many companies provide both deferred- and immediate-sharing benefits for exactly these reasons. But many immediate-sharing programs, such as gain sharing and cash profit sharing, enjoy little government support.

We urge policymakers to consider how to limit the risks of participation in retirement-based inclusive capitalism programs and how to promote different timelines for when workers receive rewards other than primarily upon retirement.

# Conclusion

Since the founding of our nation, American companies have shared capital with their workers. Policymakers across all ideological lines have long sought to promote this sharing with government incentives. Yet these policies have never taken hold as the predominant way companies conduct business.

Today the American economy is in crisis. As a nation we face weak economic growth, excessive speculative economic activities that don't build societal wealth, high unemployment, stagnant worker compensation, and dramatic differences in income and wealth between the struggling middle class and the very rich.

Inclusive capitalism, when implemented correctly, can begin to address these fundamental problems with our economy while simultaneously improving workers' wellbeing and the performance of businesses.

Despite this potential, however, inclusive capitalism policies are thought of as serving only a small subset of socially concerned business owners rather than as a way to build our entire economy. Part of the problem is that policymakers and advocates who support inclusive capitalism tend to focus on promoting only their particular brand of sharing.

Additionally, the way that the private sector has sometimes adopted sharing practices also contributes to the problem. Headline-grabbing failures of companies like Enron and United Airlines—which have required workers to take on too much risk, without allowing them a say in company management, daily decision-making or the way they receive and invest their capital shares—have soured some on the notion of inclusive capitalism. Although this is clearly a case of a few bad apples spoiling the barrel, these stories skew the public's perception of inclusive capitalism and highlight the fact that government too often supports this type of “bad” sharing.

In order to raise inclusive capitalism as a viable solution to alleviate many of the problems plaguing our economy, policymakers should—building on the success of existing policies to promote employee stock ownership plans—advocate more broadly for policies to promote various types of inclusive capitalism. Further, government should encourage broad-based sharing that empowers workers, both to influence the profits they receive and to participate in company decision making.

This report represents an effort by American Progress’ American Worker Project to jump-start a dialog on government’s role in incentivizing broad-based sharing. We have also released state and federal policies to promote inclusive capitalism, and we will continue conversations on this topic with policymakers, advocates and business owners in the coming months.<sup>162</sup>

Policymakers as diverse as former President Ronald Reagan and former Vice President and Sen. Hubert Humphrey Jr. have lent their rhetorical support to widespread capital ownership. Likewise, today’s legislators, from Sen. Bernie Sanders (I-VT) to Rep. Dana Rohrabacher (R-CA), have continued in this tradition of bipartisan support. Now it is time for American policymakers and policy advocates to elevate these concepts to the larger debate about how government can rebuild our economy to work for all of us.



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