Job-creating performance of employee-owned firms

Data from a recent survey suggest that companies can use employee ownership to improve economic performance and equity; employee-owned firms create jobs three times faster than their conventional counterparts

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Contrary to popular belief, employee buyouts of troubled companies actually represent only a small percentage of all employee-owned companies—most employee ownership plans are set up in profitable ongoing companies. Further, employee-owned firms have an impressive record of job creation, with an average annual employment gain three times that of comparable conventional firms. Most of the plans provide for substantial employee control over company policy, giving employees full voting rights on their shares. The average employee-owned firm has 630 employees; all industries are represented, although there is some concentration in both durable and nondurable goods manufacturing.

These are conclusions from a recent survey conducted by the National Center for Employee Ownership. Although they are preliminary and must be regarded cautiously, they seem to support the contention that employee ownership can be a mechanism to improve business performance and economic equity.1

Survey techniques

Because the current interest in employee ownership only dates back to the mid-1970's, there have been few methodologically sound evaluations of such plans. In particular, there have been no studies focusing only on firms in which a majority of the workers own a majority of the business (majority employee-owned firms). Many advocates view this type of firm as the most theoretically interesting and desirable. If employee ownership is to work at all it should be especially effective in these companies. Moreover, the notion of an employee-owned company presents an intriguing alternative both to the traditional capitalist and socialist models of economic organization.

As part of a 3-year project to evaluate the dynamics of employee-owned companies, the National Center for Employee Ownership conducted a special survey of the structural characteristics and job-creation performance of majority employee-owned companies.

The center surveyed 130 such firms with 10 or more employees in 1977 and each subsequent year to 1982. We chose the companies from newspaper, by word-of-mouth, and from other research. As a result of this compiling technique, we ended up with a disproportionate number of employee buyouts of failing companies (as the drama of buyouts attracts media attention). We do not believe, however, that there are other major sampling biases.

The survey was performed between October 1982 and January 1983. Of the 130 firms identified, eight were too new for meaningful responses (other than certain structural characteristics), eight had gone out of business, four had...
been sold to another firm, and two were no longer majority employee owned, reducing the usable universe to 108 firms. Sixty-three of these firms answered the survey, with 43 providing usable employment data. We also acquired information by telephone on the structural characteristics only of 35 additional companies. The 43 firms supplying employment data were basically similar to the 98 (63 respondents plus 35 from a telephone survey) for which we have structural information, except that buyouts were overrepresented among them (30.2 percent, compared with 18.5 percent). However, we have controlled for this factor in our analysis.

To analyze the employment data, we looked at the annual average percentage change in full-time employment in the 43 firms providing such data from the time the plan was established until the present (1982). If a company's plan pre-dated 1973, however, we used that date as a base. (This decision contributed to a conservative bias, of course, because the hypothesis is that the establishment of the plan will spur employment increases.) Eight of the 43 companies providing written employment data fell into this category. We then took the average annual employment percent change and compared it to the annual average employment percent change for the basic economic sector to which the company belongs. (Eight broad sectors were used.) The difference between the two figures was noted for each company. The sums of these differences for the 43 firms and for various sub-categories formed the basis for the evaluation.

Companies that started as employee-owned firms after 1973, or companies that closed were not used in the analysis. Total employment gains and losses from startup and closings were noted separately, however.

How the plans work

There have been periodic waves of interest in employee ownership over the past 10 years, but only in the last decade did the idea achieve the potential to become a significant part of the way companies do business. In large part, this new interest stems from a series of tax incentives created for the most popular plan—ESOP (Employee Stock Ownership Plan). At the same time, growing interest in creating a more participatory and productive workplace has spurred many companies to consider extending ownership to employees. In some cases, employee ownership has been used to save jobs in companies that might otherwise close; the employees either buy out the company or trade wages for stock. Also, a number of worker cooperatives were formed out of the "alternative lifestyle" movement of the late 1960's and 1970's.

ESOPs. In an ESOP, a company sets up a trust and contributes stock or cash to buy stock to it. The trust allocates the stock to the accounts of individual employees, either on the basis of relative compensation or some more egalitarian approach. Employees acquire vested rights to these allocated amounts over time, but usually must become 100 percent vested within 10 years. Generally, all full-time employees with 1 year of service are eligible to participate in the ESOP, although members of collective bargaining units can be excluded, provided they have the right to bargain to be included. Companies receive tax deductions (or in some cases, tax credits) for their contributions. The most common ESOP is simply one in which an ongoing firm contributes varying amounts of stock to make employees at least partial owners. ESOPs have a number of other uses as well:

- Unlike other employee benefit plans, ESOPs can be used to borrow money. In this approach, the ESOP borrows funds and purchases new issues of company stock, which the company uses to acquire assets. The company then makes tax-deductible contributions to the ESOP to enable it to repay the loan. In effect, this means the company is deducting the principal and interest portions of the loan, not just the interest, from its taxable income.
- Employees can set up a shell corporation, which in turn sets up an ESOP, which then borrows funds to buy the assets of a company which might otherwise close. In some cases, employees may take wage reductions in order to help assure that the new company can repay the loans, but rarely do employees directly purchase stock.
- ESOPs can be used to transfer stock in closely-held companies. In this situation, the business' owner has the firm contribute cash to the ESOP trust, or has the trust borrow the money. The trust uses these tax-deductible contributions to purchase the owner's shares at fair market value. The owner need only pay capital gains tax on the transaction, and the employees acquire the firm without putting up their own money.²

There were at least 5,000 companies with ESOPs in 1982, with the typical ESOP owning 15 to 35 percent of the company's stock (this percentage is growing, as ESOPs acquire more stock over time).³ At least 10 percent of these companies had a majority of their stock owned by the employees.⁴

Cooperatives. In a cooperative, each member owns one voting share, but may own any number of nonvoting shares. Only workers can be members, although cooperatives may hire nonmember workers. Cooperative members usually make a financial contribution to join the firm, and share in the company's profits. Net earnings returned to members are nontaxable to the corporation. Many cooperatives were formed as "alternative businesses," but an increasing number are now found in more conventional endeavors.⁵

Others. A diminishing number of companies provide for ownership through direct purchase plans in which all employees participate (sometimes stock is offered at reduced
Characteristics of respondent

The law regarding ESOPs requires that all publicly traded companies provide full voting rights to participants on their allocated shares. Only one of the 98 firms was publicly traded (that is, not surprising because majority employee ownership restricts the market for shares). Privately held firms must pass through voting rights only on limited issues. In our sample, however, 16 of the 54 ESOPs provided voting rights on all issues involving allocated shares; another eight provided voting rights either on vested shares or on a broader range of issues than those legally required. This is interesting in light of a common perception that ESOPs are rarely democratically structured (that is, provide full voting rights). Although many of the ESOPs in the sample were not democratically structured, the significant number that were suggest that the ESOP mechanism can be easily adapted to democratic issues.

Companies were asked to indicate why they set up their ownership plan. Of the 92 responses, 17 (18.5 percent) were buyouts of companies that would have otherwise closed; 27 (29.3 percent) were set up to transfer ownership from a retiring owner in an ongoing business to the firm's employees, 9 (9.8 percent) were divestitures of profitable subsidiaries of conglomerates to their employees, 23 (25 percent) were gradual transfers of ownership in ongoing companies, and 16 (17.3 percent) started as employee owned. Because it was easier to identify buyout cases, we believe the actual percentage of buyouts is overstated.

These results clearly indicate that employee ownership is not primarily a response to plant closings. They also suggest that a number of companies become employee owned as a business strategy. In fact, if "startups" and "gradual transfers" are combined, almost half the firms are accounted for. The use of ESOPs to arrange for business continuity in independently held companies is a major cause for almost a third of the firms becoming employee owned.

These results suggest that ESOPs are the most popular vehicles for creating majority employee-owned companies, although almost a third of the firms are worker cooperatives. The cooperatives are smaller, however, employing only 10.1 percent of the total employees in the sample, while ESOP companies employ 76 percent.

Job growth—democratic vs nondemocratic firms

Data for the 43 firms providing employment information strongly indicate that employee-owned companies grow at a much faster rate than all companies in their economic sector. Overall, employee-owned companies averaged an annual employment growth rate 2.78 percent higher than that of comparable conventional firms. Over a 10-year period, this would mean 31 percent more jobs. To derive this figure, employment growth for individual companies whose plans were started at different times was compared with employment growth in their sector for the same time period; therefore, it is not possible to compare employment growth in employee-owned and conventional companies for a particular year. However, the average annual employment increase for the sectors studied was 1.14 percent between 1977 and 1982. A comparable figure cannot be obtained for the employee-owned companies because plans started at different times. But, the fact that employment growth was 2.78 percent higher per year in employee-owned companies suggests that such firms were growing about three times as fast as conventional firms (about 3.92 to 1.14 percent per year).

The reasons for this growth are, of course, speculative. Previous studies of employee-owned companies have indicated that such companies are more profitable and productive than conventional firms. A 1978 study found that companies with employee ownership plans were 1.5 times as profitable as comparable conventional firms, and that the ratio increased with the percentage of equity the employees owned. A 1980 study reported that ESOP companies had an average annual productivity growth rate 1.52 percent higher than comparable non-ESOP firms. Both of these studies were exploratory, however, and there are no other methodologically sound studies, other than a few case studies, on which to base conclusions about profits and productivity. Still, in the absence of a better explanation, these studies suggest a very plausible explanation for the job-creation success of employee-owned firms.

We also evaluated the employment consequence of startups and shutdowns. Three new companies were created after 1973, and another was started in 1969, but was so small in 1973 that it practically amounted to a startup. Hence, we did not include it in this analysis because its employment growth was so spectacular that the results would have been biased. These four new firms created approximately 4,000 new jobs (3,600 in the one company). Eight companies closed during the 1977–82 study period, eliminating approximately 1,000 jobs. (In some cases, we had to estimate the number of jobs the companies had at their peak employment.) These numbers suggest that startups and closings would not cause a downward revision of the employment for the 43 firms.

The job-creation results are interesting in light of what may be some conservative biases in the methodology. First, the two smallest firms in the sample had 12 and 20 employees, respectively. Some studies have indicated that independent firms with fewer than 20 employees generate 51 percent of the net new jobs. While this conclusion has been recently challenged, researchers agree that smaller firms are somewhat more prolific at creating jobs. Of the 43 firms providing employment data for this study, only 7 had fewer than 50 employees; 13 had fewer than 100; and 33, fewer than 500. The average number of employees per firm was
earlier that workers in employee-owned companies will seek firms can probably be explained by the argument made democratic, while all cooperatives are, by definition, democratic. cooperatives, as just over half of the ESOPs are nondemocratic, probably also accounts for the difference between ESOPs and faster than comparable conventional firms. This difference cratic firms create relatively fewer jobs than do nondemo- selected characteristics.

The relatively small number of responding companies makes further elaboration of the data hazardous, but with this caveat in mind we can look at the relative performance of different categories of employee-owned companies. Keep in mind that the numbers reported represent the difference between employment growth in employee-owned companies and employment growth for all firms in the parent sector. Table 1 provides a summary of the differences, by selected characteristics.

Several things are striking about the data. First, democratic firms create relatively fewer jobs than do nondemocratic firms, although they are still growing considerably faster than comparable conventional firms. This difference probably also accounts for the difference between ESOPs and cooperatives, as just over half of the ESOPs are nondemocratic, while all cooperatives are, by definition, democratic.

The difference between democratic and nondemocratic firms can probably be explained by the argument made earlier that workers in employee-owned companies will seek to keep new hiring down. When workers control the firm, they are, obviously, in a better position to do this. It could be argued that democratic firms are less successful than nondemocratic firms, but there are reasons to believe this is not the case. A 1978 study found a small, but positive, correlation between the pass through of voting rights and profitability, and, as will be discussed later, managers in democratic firms are more likely than managers in non- democratic firms to report that ownership has contributed to the company’s economic performance. Moreover, employee-owned democratic firms are doing much better than conventional firms, which are almost all undemocratic. In others words, democratic firms tend more than nondemocratic firms to hold down employment initially, but their financial success seems to “overcompensate” for this and subsequently drives employment up.

Table 1 shows that firms which cite a philosophical or incentive reason for installing their plan (respondents were given seven potential reasons) are particularly successful in generating new employment. This suggests that when companies use employee ownership as a basic part of their business strategy, they are more likely to succeed than if they use employee ownership primarily for financial or other reasons. Preliminary data from our ongoing research project generally seem to confirm this observation. Employee-owned firms that are the result of employee buyouts do less well than other firms, although still better than conventional firms, no doubt because the firms being bought were in financial difficulty when they became employee owned. The success that these firms have had (they too generate significantly more new jobs than conventional firms) suggests how effective ownership can be.

Finally, there is a large difference in the performance of employee-owned companies between sectors, with the manufacturing sectors doing especially well, and durable goods leading the others by a wide margin. Unfortunately, an explanation of this intriguing difference would be entirely speculative. There is no theoretical or empirical evidence to suggest why this difference emerges. The possibility that this is simply a random artifact of the small number of cases involved cannot be ignored—as, indeed, it cannot be ignored in any of the data in the table.

### Are managers satisfied with employee ownership?

Respondents were asked to indicate whether employee ownership was responsible for “changes in your company’s performance,” and whether company performance had improved since the change to employee ownership. Only 51 respondents answered these questions. The others indicated that their plans were too new for meaningful assessment or that they did not have reliable data on this point.

The responses were categorized as (1) positive change (those responding yes to both questions and those who did not respond yes to the second, but specifically indicated that employee ownership had helped prevent things from getting
worse), (2) a small positive change (respondents who specifically made this statement), and (3) no effect. None of the respondents indicated the plan had made things worse.

Management perceptions about employee ownership are unreliable in measuring the effectiveness of a plan. It is to be expected that respondents, almost all of whom had a hand in creating the plans, and all of whom benefit from them, would have generally positive perceptions. The purpose here, however, was to determine if respondents in certain kinds of plans were more likely to provide positive responses. The following tabulation shows managers' perception of employee-ownership plans (in percent):

<table>
<thead>
<tr>
<th>Number of responses</th>
<th>Successful</th>
<th>Somewhat successful</th>
<th>No impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total plans</td>
<td>51</td>
<td>68.6</td>
<td>23.5</td>
</tr>
<tr>
<td>Democratic</td>
<td>27</td>
<td>81.5</td>
<td>14.8</td>
</tr>
<tr>
<td>Nondemocratic</td>
<td>19</td>
<td>58.0</td>
<td>26.3</td>
</tr>
<tr>
<td>Other plans</td>
<td>5</td>
<td>40.0</td>
<td>60.0</td>
</tr>
</tbody>
</table>

While the number of respondents is too small to draw definitive conclusions, the difference between democratic and nondemocratic firms is striking. Almost all respondents indicate at least some positive gains from employee ownership, but those from democratic firms were more enthusiastic. This, at least, suggests that the reason democratic employee-owned firms tend to generate relatively fewer new jobs than nondemocratic employee-owned firms (but still more than conventional firms) is not that they are less economically proficient, but that they are more likely to hold down new hiring. It also is interesting in that our respondents were all managers. Clearly, they believed that democratic organizations can be very successful. In fact, it is apparent that democratic organizations are more successful, at least when employees are owners. Although only a speculation, it seems reasonable to argue that in some nondemocratic firms, there may be a tendency for employees who are beneficial owners to become disgruntled with their lack of input, and actually become demotivated. Our larger study of employee-owned companies will address this point in detail.

--- FOOTNOTES ---

1 For detailed arguments for and against employee ownership, see Employee Ownership: A Handbook (Arlington, Va., National Center for Employee Ownership, 1982).


4 Marsh and McAllister, "ESOP: Tables."


6 For a summary of the study, see "Employee-owned companies: is the difference measurable?" Monthly Labor Review, July 1978, pp. 23–28. For the full study see Michael Conte and Arnold Tannenbaum, Employee Ownership (Ann Arbor, University of Michigan, Institute for Social Research, 1980).

7 Marsh and McAllister, "ESOP: Tables."


10 Conte and Tannenbaum, Employee Ownership.