COVID-19: Government Aid that also promotes Employee Ownership

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Abstract

The premise of this paper is that state aid to distressed companies should benefit not only the current owners but also the employees, who are the ones taking personal risks to continue or restart companies. Government aid during 2008 Great Recession was aimed primarily at restoring the status quo. In the current deeper crisis, aid should be designed to create a fairer, more inclusive, and more socially responsible economy by promoting employee ownership as both an incentive and a reward. We show how the Employee Stock Ownership Plan (ESOP), which has been pioneered in the US for 40 years and can be adapted to the European legal context, can be used as the vehicle for structuring this aid.

1. Introduction

It has become a common cultural reference to observe that Chinese character for “crisis” combines the characters for “danger” and “opportunity.” While the dangers of the ongoing crisis are increasingly clear, the opportunities have not been sufficiently explored yet. Our paper focuses on how to utilize the ‘opportunity’ *while* saving the economy from the ‘danger’.

Around Europe governments and central banks are currently considering different fiscal and monetary instruments to help the liquidity-constrained private and state-owned enterprises. This includes direct government assistance in form of subsidies, tax breaks, factoring or buying of receivables, and forgiving of debts, and indirect aid through national or developmental bank loans.

Governments should ensure that the aid is inclusive and equitable. One option currently being weighted in Europe is nationalization. A return to state ownership is sensible when it comes to strategic infrastructure or public goods and services such as healthcare, education, and so forth. However, when talking about more standardized economic goods, and especially when dealing with the structure of ownership in SME sector, state ownership is not likely to be desirable.

An alternative to nationalization with conventional enterprises is establishing broad-based employee ownership by using government assistance (Mathieu 2020; Mitarbeiterbeteiligung 2020a, 2020b). This paper proposes concrete, practical, and bi-partisan policy addendums for governments to use aid packages to establish (partial) employee ownership both for private and state-owned enterprises.

The paper is structured as follows. In the second section, we suggest that the American *Employee Stock Ownership Plan* or ESOP model may be the most relevant example for our purpose. We explain how government help can be translated into employee ownership (EO). In the third section we outline the most relevant public policy rationales that support the general case for implementing employee ownership on the EU and individual state level. The concluding section summarizes the proposal and its most relevant points.

2. Government interventions and the ESOP model

Different forms of government assistance packages may partly be channeled through dedicated legal entities to establish partial employee ownership. We propose that employee ownership be structured according to the American Employee Stock Ownership Plan model (ESOP). ESOPs are probably the most successful existing practice of employee ownership with around 14 million employees included in the plans, roughly 10% of the private workforce in the US, in several thousand companies of all sizes and sectors.[1]

In a nutshell, ESOP is ownership based on a dedicated trust-like entity associated with a company, which functions as an internal market for shares (and percentages in LLCs). These trust-like entities maintain ownership among the current employees even through generational transitions of workers in a company.

The ESOP model can be recreated in a European legal context. At the Institute for Economic Democracy, we have designed a model for Slovenia, but the same principles should apply to other European countries. The idea is that the legal entity, which would function as an ESOP trust, is recognized as a legally constituted cooperative (where a cooperative law applies). The reason for making use of the cooperative legal structure is practical not ideological. As membership institutions, cooperatives are relatively easy to use to organize employee-members with little to no red-tape involved. Historical in Europe, cooperatives have for ages offered an alternative way of organizing production. We call ESOP cooperatives a ‘Co-Op-ESOP’.

2.1 Structuring aid to establish EO in private enterprises

To know how this proposal would be part of the intervention legislation, we need to understand principles of legislation. The general principle is when a company is getting a grant out of public money, the help (or a part of it) should be shared between the existing owners and the employees by making them part owners.

The Slovenian Government is considering buying receivables (factoring) from private companies with liquidity difficulties through a special state-trust. So, let’s think first of this idea. A creditor company has a receivable from a debtor company which the debtor company probably cannot pay off. The Govt comes in through this legislation and buys the receivable from the creditor company perhaps at some discount. What does the Govt do with it? If the Govt then 'swallows' the receivable, then it is a wealth transfer to the debtor company which got their debt erased. Hence, debtor companies could be required to agree to the transfer of equal-valued or some portion of shares to the Co-Op-ESOP in return for the Govt eating the receivable. Is the creditor company also getting a gift? It depends on the 'actual' value of the receivable. If it was really worthless and they got it purchased for some price, then that was

[1] https://www.nceo.org/articles/employee-ownership-by-the-numbers#2

also a wealth transfer since the government 'purchased' a worthless asset for a positive price--so some transfer to an Co-Op-ESOP might be appropriate for them too. The principles of translating other forms of direct and indirect grants into employee ownership are the same. The general idea is that the value of state help should be matched by newly issued shares or treasury shares, which are transferred to Co-Op-ESOP trusts.

In the situation where the aid is a liquidity loan rather than an indirect grant (or wealth transfer), the general principle is that part or the whole loan is channeled through an Co-Op-ESOP, which then transfers the money to the company in return for new issues or treasury shares. This shares the ownership by diluting the existing owners and has no cash cost to the company. Then as the loan is paid off with payments put through the ESOP (with principal portion also deductible from taxable income in the US case), then the workers get shares equal to their portion of the principal payment into their individual share accounts in the ESOP. The split between workers is usually according to salary. Below we briefly explain how loan would be channeled through Co-Op-ESOP and repaid to the developmental or state-bank using companies retained earnings.

In Step 1 (Diagram 1 below), a Government agency makes part (or all) of a loan package through an ESOP that is guaranteed by the Company just like any standard commercial loan. The Company could be either a private company or a state-owned company awaiting future privatization. In Steps 2 and 3, the Co-Op-ESOP passes the loan money through to the Company in return for newly issued or treasury shares of the Company. In accordance with the loan agreement, the Company will pay back the loan in installments over a period of years. But as indicated in Step 4, those loan payments will be legally packaged as a contribution to the Co-Op-ESOP (which should be made deductible from taxable income as is the practice followed in the US). Then the Co-Op-ESOP passes the money through to the Government in Step 5.

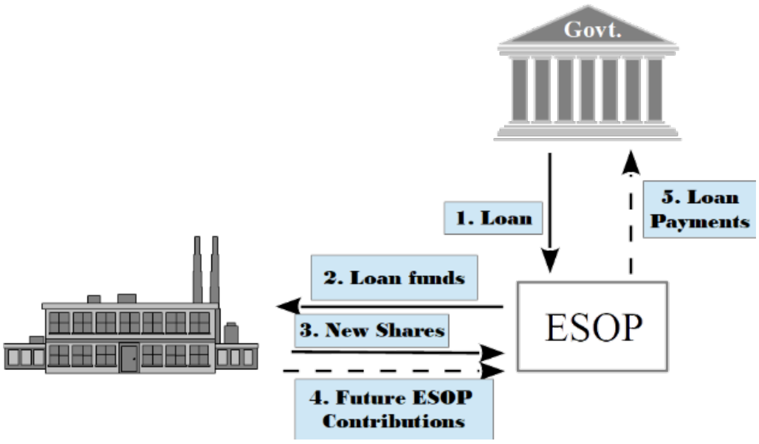

Diagram 1: Part of Govt. Loan Channeled Through an ESOP

The relief loans or subsidies may be made well before an Co-Op-ESOP can be established, but the same net effects can still be obtained. Then the loan would be made directly to the company but each loan payment would be accompanied by a *tax-incentivized* contribution of newly issued or treasury shares to the later-established Co-Op-ESOP (e.g., with a tax-deductible value equal to the principal portion of the loan payment) as illustrated in the following Diagram 2.

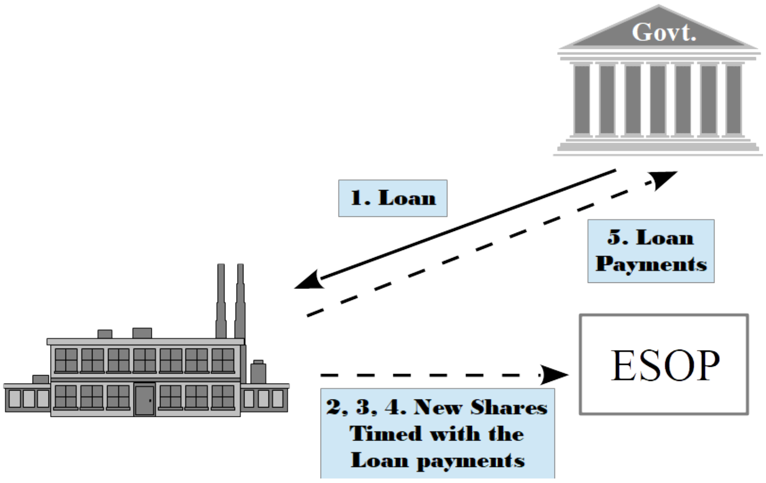

Diagram 2: Govt. Loan Directly to Company with ESOP Shares Timed with Loan Payments

It is only in Step 6 in Diagram 3 below that shares (equal-valued to the loan principal payment) are allocated to the individual employee share accounts in the Co-Op-ESOP as their reward as those loan payments are made. If the Company continues to make Co-Op-ESOP contributions after the loan is paid off, then the Co-Op-ESOP can buy back the employee shares after say X = 5 years (Step 7) and redistribute them to the share accounts of the current employees—to be rolled over again after another X = 5 years.

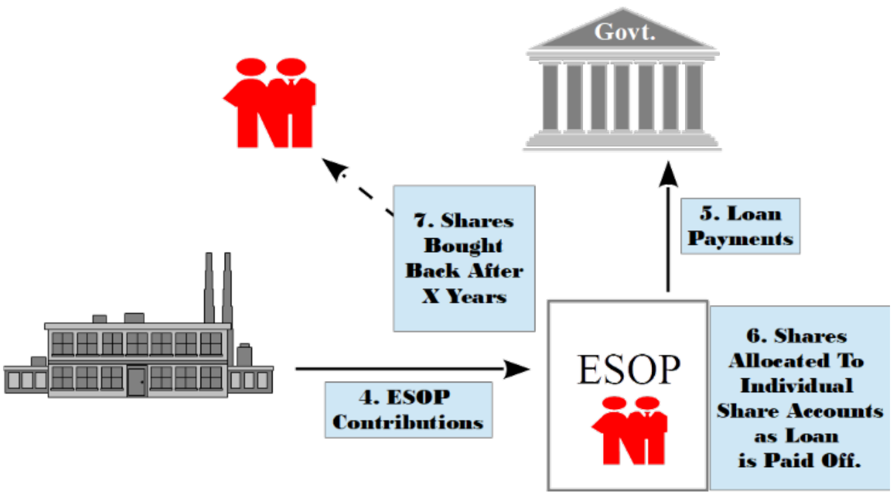

Diagram 3: Shares Allocated to Individual Share Accounts with Loan Payments

One important element of this proposal is that there should be a company evaluation for every private company that would have to match the value of government aid with the value of shares transferred to Co-Op-ESOP. For the purpose of this crisis, a universal method of evaluation could be legally determined with which all companies should apply, a method that would not be very resource consuming. We would suggest a Net Asset-Value (NAV) approach to evaluation.

2.2 Government aid for SOE that reduces state-ownership

European governments are also putting financial resources into state-owned enterprises. The principles of establishing employee ownership in those are the same. When it comes to SOE's using government aid to establish employee ownership, this can be viewed as a partial privatization in accordance with EU guidelines (where applicable, exempting the companies providing public goods and services that should remain under state-ownership).

In Slovenia and other economies where there is a high level of public ownership, many SOEs are already in line for privatization in the upcoming years. Our experience is that impulsive privatizations may turn out ugly; they are often characterized by corruption and underselling. Private investors do not always have long-term health of the enterprise in mind and may simply want to decapitalize the company.

Introducing part employee-ownership to the privatization model anchors the long-term interest of the company in its employees and the local community. It raises safeguards both when enterprises are owned by the government, or by a foreign private investor. It also motivates employees in the environment of "public employment", infamous for the lack of incentive structures. Finally, employee ownership in state-owned enterprises serves another function if the government decides to sell the enterprises; it is a test for the potential buyer. If the buyer would object to minority employee ownership, then that is probably a reliable signal that the buyer is not interested in the long-term health of the company.

3. Doing better than just restoring the previous status quo

EU and the member states interested in an employee ownership approach must justify their position on practical as well as policy grounds. Employee ownership has proven to be one of the most efficient organizational models for private enterprises. It also enjoys high degrees of social and environmental responsibility. In this section we outline some of the most relevant problems addressed by employee ownership.

- Reward and motivation for employees in times of high risk

The first question for the governments providing aid should be who is justified in getting the most out of it? Frontline managers and workers in the firms who are taking the personal risks in order to get the economy going again. Employee ownership typically increases the wealth of (Blasi and Kruse 2019) and increases wages receiving employees (Kardas et al. 1998), but also improves workers' quality of life (Bryson 2016; Erdal 2014).

- Greater cooperation and co-responsibility

Government aid should also aim to empower employees in their workplaces. Empirical evidence shows that greater worker autonomy reduces worker-management conflict and leads to greater affiliation for the organization (Kruse 2016; Summers and Chillas 2019). To achieve the full potential in this area, ownership aspect should be complemented with the change in workplace culture, with the encouragement of the information flow, improved management transparency and greater employee involvement and autonomy (Fakhfakh, Pérotin, and Gago 2012; Kruse, Freeman, and Blasi 2010; 2008; Perotin 2016; Rosen, Case, and Starbus 2005).

- Higher resilience and lower employment-fluctuation in times of economic crisis

Research studies comparing employee-owned companies with conventional companies concluded that the former have 20% to 50% higher survival rates on the markets, while the difference is emphasized in times of crisis. (Blair, Kruse, and Blasi 2000; Blasi, Kruse, and Weltmann 2013; Kruse 2016).

A study from 2012 found that workers in the ESOP companies are 50 percent less likely to voluntarily seek employment in the next year (Kruse, Blasi, and Freeman 2012). During the previous crisis, employee-owned companies in the USA had between 20% and 50% lower lay-off rates, and it is estimated that during the Great Recession, US Government saved around $13 billion in unemployment and other program costs because of employee ownership (NCEO 2019).

Similar results are found outside the USA. Mondragon companies were very successful in bridging the 2009 crisis. While Spanish unemployment rose to 26%, Mondragon collectively decreased wages from 5% to 10% and allocate few redundant members among cooperatives (Tremlett 2013).

- Superior economic performance of EO enterprises

Employee owned companies are not only more successful in times of crisis, but also flourish when business is good. Relatively to comparable conventional enterprises, employee owned firms on average enjoys between 4% and 10% higher productivity (Brill 2012; Freeman 2007; Blasi, Kruse, and Weltmann 2013; Kruse 2016), 2.3% greater sales per employee growth (NCEO 2019) and 8.8% faster general growth (Kramer 2010; (Blasi, Freeman, and Kruse 2017).

- The problem of extreme economic inequality

Inequality is a pertinent problem that most governments around the world are trying to address. European Commission reports that the current levels of economic inequality are unjust, unsustainable and inefficient even in one of the most egalitarian economic regions in the world (Colonna 2018). By democratizing the source of income and wealth – capital -, employee ownership addresses this issue without imposing redistributive measures. Recent research from the US shows the average wealth or savings of low- and middle-income employees is $17.000 in conventional companies, and $165.000 in employee owned companies (Blasi and Kruse 2019).

- Achieving responsibility by anchoring the capital with local communities

The current crisis teaches about the importance of local ownership. Small and medium sized enterprises (SMEs) are generally considered as locally responsible, which has to do with high degrees of community interconnectedness between the owners of local business and community members. There is a natural incentive not to foul their "own nest." A sustainable form of employee ownership anchors the local interest with the ownership interest and achieves more socially and environmentally responsible business operation (Denton 1999; Stranahan and Kelly 2019; Fifty by Fifty 2019; Gehman, Grimes, and Cao 2019).

- Decapitalization problem

The European Commission, the World Bank, and the IMF have, in the last decades, pushed for violent privatization policies in the South and the South-West Balkans that often resulted in value-destruction, wealth expropriation and deepening the economic gap between the workers and corrupt individuals with political connections. Foreign and absentee ownership have their downfalls, and governments should reconsider their privatization policies.

Overcoming the decapitalization problem for larger foreign or absentee owned firms can be addressed by establishing part employee ownership that would guarantee to workers say and oversight, both *de jure* and *de facto*. Again, employee interest is the interest for long-term sustainability and success of business enterprise, but also for locally responsible operation.

- Ownership succession

The last but not the least of the problems addressed by employee ownership is the so called 'ownership succession problem' for SMEs (Močnik et al. 2019; Duh 2012; Malinen 2001; Hnátek 2013). Employee ownership through ESOP trusts is a time-tested mechanism for (gradual) employee-buyouts without depending on the employees mortgaging or risking their personal assets. Most of the companies with ESOPs in the US arose out of family succession problems in privately-held SMEs, therefore ESOP is often cited as a desirable succession tool in the business literature (Frisch 2002; Brill 2017; Flesher 1994).

4. Concluding remarks

Our proposal points out that the frontline people whose efforts will be needed to save their companies should be supported not simply by their paychecks but also by the incentive of an ownership reward. We have argued that government aid to companies in need can be channeled so that an inclusive and sustainable model of EO is established.

There is no shortage of reasons why governments and EU should consider EO as the additional goal in addressing the current crisis. Let us briefly summarize the main points on how to establish employee ownership in times of the ongoing crisis, what model to use, and what pertinent social problems are addressed by the proposal:

- It is important to make use of the government financial help (partly financed by EU money) so that when the crisis is over, employees do not return to the same precarious, uncertain, and unequal status-quo.
- Employee ownership is a structural alternative that resides between absentee ownership and economic hyper-globalization on the one hand, and state-ownership on the other. In this respect, it is a "radical-centrist" idea.
- The best model for employee ownership, according to 40 years of experience, seems to be the American ESOP. ESOP's. By explicit design, ESOP's include all the employees in a company. They do not require employees to sacrifice their own savings, and have proven to be sustainable over generations of employees so not simply a windfall for one group of workers.
- ESOPs can be adapted to European legislation. At the Institute for Economic Democracy we have developed a model for Slovenia that is based on a cooperative

legislation. We believe this model can be generalized, with slight adjustments, to other European countries.

- Government grants and loans can all be used, at least part of them, to establish employee ownership, if financial resources (or tax breaks and debt abatements) are channeled through an ESOP-like entity.
- It is not difficult to justify government help in establishing EO. EO is about rewarding employees, who are saving the economy by working in times of crisis. They build more resilient and efficient enterprises, they anchor capital in local communities, and they provides a model for ownership continuation with SMEs. Moreover, ESOP's provide a socially and environmentally responsible economic model that helps with youth emigration problem for peripheral Europe. Finally, for state-owned companies awaiting privatization, EO reduces the state-owned component and serves as a check on buyers not interested in the long-term health of the companies and their surrounding communities.

Instead of resurrecting the established status-quo, governmental assistance should use this opportunity to include ordinary employees, the men and women throughout organizations whose combined efforts will be required to restore economic health in response to the ongoing pandemic and in years to come.

Employee ownership ensures that governmental assistance is not targeted primarily to existing shareholders, who might not even work in the company. In the face of a crisis that hits wage-earning workers harder than any other single group, employee ownership provides ordinary employees who (re-)start their companies with responsibility, respect, and co-ownership, not simply a continuation of their status as hired hands.

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