

Employment in an ESOP Firm:
Deferred Compensation with an Informational Twist

John P. Bonin
Department of Economics
Wesleyan University
Middletown, CT 06459
(860) 685-2353
jbonin@wesleyan.edu

Abstract

From 2001 to 2007, the value of assets held in U.S. ESOP plans grew by an average of 15% per annum and assets per participant rose from \$45,020 to \$82,857. Does this increasingly important organizational form promote both economic efficiency and workers' welfare? Although worker compensation consists of a contractual wage plus an individual equity share in such firms, employment decisions are taken by management. According to ESOP rules, all employed workers receive company shares and no worker can cash out this individual equity stake while still employed by the firm. Hence, full labor compensation in an ESOP differs from the full wage in a profit-sharing firm due to the deferred status of the equity stake. We analyze how this difference affects employment choices by firms and workers.

Proponents of ESOPs argue that giving workers an equity stake aligns their interests with those of general shareholders. Skeptics claim that allowing workers to participate, even indirectly, in decision-making invites incumbent workers to protect their jobs and their rents for as long as they remain employed (horizon problem). Our analysis indicates that the ESOP firm in which the employment decision is taken by management and workers choose to join and leave based on their alternative options behaves as a hybrid organization with properties similar, but not equivalent, to those attributed to a profit-sharing firm.

After a selective review of the theoretical and empirical literature on U.S. ESOPs, we present a two-period model of a stylized ESOP firm. By introducing the worker's reservation wage and imposing participation constraints, we show that the ESOP firm will choose a smaller labor force than its capitalist counterpart due to the deferred nature of the equity compensation. By considering a firm-specific demand shock in the second period, we find that harmonious employment decisions depend crucially on whether the firm is growing or declining. For growing firms, the interests of incumbent workers and shareholders are aligned as proponents claim. However, for declining firms, the necessary adjustment in the labor force may require dismissing workers who wish to remain employed. We show that the willingness of workers to leave voluntarily depends crucially on incumbent workers using their informational advantage concerning the market price of a publicly traded company. To explore further the downsizing scenario, we present a mini case study of an ESOP firm that was required to reduce its workforce after a period of considerable growth.