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EMPLOYEE STOCK OWNERSHIP PLANS (ESOP's)

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

FIRST SESSION

PART 2

DECEMBER 12, 1975

Printed for the use of the Joint Economic Committee

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EMPLOYEE STOCK OWNERSHIP PLANS (ESOP's)

FRIDAY, DECEMBER 12, 1975

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. Gillis W. Long (member of the committee) presiding.

Present: Representative Long.

Also present: Robert D. Hamrin, professional staff member; and Micahel J. Runde, administrative assistant.

OPENING STATEMENT OF REPRESENTATIVE LONG

Representative LONG. Today the committee will hold its second day of hearings on employee stock ownership plans. Yesterday we had an interesting session which focused on the broader economic implications of widespread adoption of employee stock ownership plans.

There were widely varying viewpoints presented, making it clear that perhaps it is too early to arrive at any definitive idea as to how adoption would affect the economy.

Mr. Kelso, who has been in the forefront of presenting these plans, presented an optimistic picture of a fully employed situation experiencing a greatly increased rate of economic growth to a substantial extent due to the result of the ESOP's. The economists yesterday did not agree with his whole program, but I think they were in general agreement that broadening stock ownership in the country is a worthwhile objective with potential for fostering economic growth.

Today we are going to move away from the macropicture and focus on ESOP's as viewed at the corporate level. Obviously this is where the action has to take place before there can be any aggregate economic effects nationwide to consider.

Some action has already taken place in this regard. The important factor is that all companies that are waiting in the wings, so to speak, to see the direction of future congressional legislation—what we in the Congress might do and what types of regulations the Treasury is going to come up with with respect to those legislative actions that we have already taken.

There they also are trying to find out what it really means to turn ownership over to the employees. The crux of the matter is this: Can ESOP's be instituted? It will definitely benefit the corporations, the financing needs, and the employees through enabling them to acquire a meaningful piece of the action.

Today we have four witnesses with us who are well qualified to shed further light on both the merits and the problems associated with ESOP's.

Mr. Harry Thurmon, the vice president and treasurer of E-Systems, one of the largest firms to have an ESOP in effect, is here. His firm bore the entire expense of this program to establish a partnership that combines the long-term personal goals of each employee stockholder with the company's objectives of healthy, profitable growth. This is according to the president of the company.

We also have Mr. Robert N. Flint, vice president and comptroller of A. T. & T. So far, most ESOP's have really been quite small. A significant impact on the economy will occur only if the large corporations in our economy begin to adopt ESOP's.

The United States Railway Association was mandated by the Regional Rail Reorganization Act of 1973 to consider whether the financing of railroads—the needs of ConRail—could be met through an ESOP mechanism.

They wanted to know what would be the impact on the employees. Their final report which was quite negative concerning ESOP adoption will be highlighted for us by Mr. John Terry, the vice president for financial planning of the United States Railway Association.

Helping to present an overview on the corporate view of ESOP's is Mr. Neil Wassner, certified public accountant and partner of Main Lafrentz. He has developed an objective view on what they can accomplish and what their shortcomings might be. We also had scheduled with us Mr. Robert Tibbs, the head of the local gasworkers union in Missouri. He is a strong supporter of ESOP's, believing that they can be of great benefit to all parties concerned, the utility companies, the employees of the utility companies and the utility customers. Unfortunately, he could not be with us today.

Even with the absence of Mr. Tibbs, we have a well-balanced panel which should be able to give us a unique perspective on ESOP's—a show of support and a show of the weaknesses of ESOP's.

I am looking forward to a very informative session. If we would, why don't we start with you, Mr. Wassner, and then we will just go down the line and do the questioning afterward in a panel-type basis rather than individual questions after each of you finish.

STATEMENT OF NEIL A. WASSNER, PARTNER, MAIN LAFRENTZ, NEW YORK, N.Y.

Mr. WASSNER. Congressman Long, it is a great honor and privilege to be here today. I will be taking a pragmatic approach to the question of ESOP's, based upon my personal experience with ESOP's over the past year.

A major incentive provided for corporations that establish ESOP's, or any other qualified employee benefit plan, is a tax incentive. Tax deductions are provided for employer contributions to an ESOP and under the Tax Reform Act, a tax credit may be available for companies establishing so-called investment credit ESOP's.

It follows therefore that ESOP's will primarily appeal to profitable, tax-paying corporations, and the ESOP candidate must either have current profits sufficient to absorb the ESOP tax benefits or must have had such profits in the past 3 years. The law permits the carryback of an ESOP-generated tax loss.

New companies that have not yet attained profitable operations are thus not likely to be ESOP candidates. Nor are struggling other companies that pay taxes 1 year and get refunds the next. While other incentives such as those contained in the Trade Reform Act of 1974, are provided to ESOP-sponsoring corporations, my experience is that it is the tax incentive that has been the major impetus to companies establishing ESOP's.

Not only should an ESOP-sponsoring company have a good earnings record, but it should have bright prospects. This is true for several reasons, in addition to the above-mentioned tax motivation.

One relates to the fiduciary responsibility standards of the Employee Retirement Income Security Act—ERISA. An ESOP trustee-purchasing stock of a failing company from an insider is likely to find himself falling short of the standards of the "prudent man rule."

Further the ESOP must purchase corporate stock at fair market value. In order for the owner of a closely held business to be able to sell the stock at a price he would consider realistic he, and an independent appraiser must be able to foresee good prospects for the company several years in the future.

If outside financing is necessary to buy the stock a forecast of a bright future will be required to obtain the financing. It has sometimes been said that ESOP's can provide the owner of a company with the means of bailing out of a troubled situation.

While doubtlessly this will happen, my experience is that fiduciary responsiblity standards and the financing requirements will prevent it from becoming a widespread practice. Here again my personal experience has been that ESOP's are not being set up by clients whose prospects appear to be perilous.

My experience has been that companies that are in trouble have not been setting up ESOP's.

Closely held corporations are usually better candidates for ESOP's than are publicly held corporations for a variety of reasons. These can best be examined by observing tax, accounting, financial, and legal factors.

The tax benefits of an ESOP to an owner of a closely held corporation are not merely the tax deductiblity of the ESOP contribution to the corporation, but the ability of the owner to sell his stock to the ESOP, from time to time at capital gains rates.

Under present tax law, the sale of stock by the owner of a corporation to the corporation is usually taxed at ordinary income rates unless the owner sells all of this stock at one time, or sells a sufficiently large amount as to qualify as a "substantially disproportionate redemption."

This is particularly difficult to do, especially if other members of the owner's family are shareholders—a very common occurrence.

Very often the owners of a closely held corporation are faced with the prospect of having to sell their companies as the only means of cashing in their chips at capital gains rates. Furthermore, the pressure of having to provide some liquidity to their future estates often leads them to sell the company, when they would have preferred not to do so.

My function in my firm is director of mergers and acquisitions. A number of my clients had advised me of the desire to sell to their employees instead of having to sell to strangers. Until ESOP came along, there was really no vehicle by which they could accomplish that result.

The ESOP concept has given these owners several new alternatives. The corporation can make annual cash contributions to the ESOP and the ESOP can then buy stock from the owner with the cash.

A private ruling by the Internal Revenue Service has held that the purchase of stock by the ESOP is different from the redemption of stock by the corporation. Thus the owner will realize a capital gain on the sale. The major shareholder of a closely held company can gradually sell out his holdings to the ESOP and be taxed in the same favorable manner that he would be taxed if he sold out to another corporation.

My personal experience is that most of the owners would prefer to sell to their employees than to strangers all other tax and financial factors being equal. The ESOP concept makes these tax factors equal.

The ESOP is also able to borrow money with a corporate guarantee, in order to buy out a shareholder—I prefer the term buy out to bail out.

A buy out is an orderly transfer of the ownership of a company to those people who helped the present ownership build it up.

In this manner the shareholder can be paid out faster than he would be through the gradual redemption method discussed above. This tends to equate the financial aspects of an ESOP with those of a sale to outsiders.

Another approach that several ESOP authorities had been suggesting for the solution of the estate-planning problems of family-business owners was recently prohibited by the Internal Revenue Service.

It was felt that the owners of a closely held company could enter into a binding buy-sell agreement with an ESOP to provide for the ESOP buying the stock at the owner's death. This approch had many favorable tax incentives and was of great interest to many of my clients. However, the Internal Revenue Service has taken the position that such a buy-sell agreement would not be in the best interests of the ESOP beneficiaries, since it may require the ESOP to buy the stock at an unpropitious time to do so.

To return to the main point I have found that the single most typical situation for a company establishing an ESOP is one wherein the company is closely held, and the owner is at the age where he is concerned with estate planning considerations and perhaps has already considered the sale of his business to third parties.

In these cases, an ESOP provides an attractive alternative.

The accounting treatment required for a company establishing an ESOP also makes it more attractive to closely held than to public companies.

In brief an ESOP transaction requires a reduction in the company's reported earnings, since the contribution to the trust is an expense of the company. In a typical non-ESOP financing, the repayment of a loan does not affect the company's earnings.

Further, when a company buys back its own stock, the shares are no longer outstanding. However, when an ESOP buys the stock, the shares are usually considered outstanding. The effect is that ESOP sponsoring companies usually show lower earnings and more shares outstanding and thus lower earnings per share.

Since the stock price of a publicly held company is often a result of its reported earnings per share, many public companies have not established ESOP's. Because accounting earnings are usually of less concern to a closely held company than are tax earnings, the accounting treatment has not, in my experience, seriously affected nonpublic companies in their evaluation of the pro's and con's of ESOP.

If private companies are contemplating going public in the near term however, the earnings per share impact of ESOP does exert a strong negative force.

Closely held companies are also more likely than public companies to establish ESOP's because they have fewer alternative financing sources available to them. It was the inability of many of these companies to go public in the 1970's that has created the corporate financing and estate planning pressures that an ESOP program can alleviate. A publicly held company's owners can often sell their stock on the market to provide personal liquidity, or can have their companies sell new shares to provide corporate liquidity.

Closely held companies have seen their financing options dwindle, and many are now looking toward ESOP to provide the capital they cannot find in the more traditional manner.

Very large publicly held companies, those that employ a large percentage of the American work force—have been particularly slow to adopt ESOP programs. The main reason, in my view, is that standard financing techniques are available to these companies at a lower cost of capital than under an ESOP program.

Disregarding the employee benefit aspects, if a corporation contributes stock to an ESOP the tax deduction will provide it with cash flow equal to about one-half of the value of the stock. But the sale of that stock on the market will provide a company with the full value of the shares. A closely held company does not have that alternative.

The legal hazards of being a public company also make these corporations less likely to establish ESOP's. Public companies must justify to their many shareholders, and often to their shareholders' layers, the taking of corporate assets from the shareholders for contribution of employees. Obviously this is not a serious problem if ESOP contributions are modest, but I can say that the possibility of shareholder suits has entered into the thinking of many of the public companies with which I have counseled.

My conclusion then is that for a number of reasons ESOP's have more appeal for closely held companies than they do for publicly held companies.

The administrative costs and burdens of establishing and maintaining an ESOP dictate that the ESOP sponsoring company be above a certain size, both in earnings and in covered payroll. The figures often quoted are $100,000 per year in pretax earnings and $500,000 in covered payroll. This would mean that unless a company can save $50,000 to $75,000 per year in taxes, before ESOP expenses, it may not be worth the time and expense of establishing an ESOP.

My experience is that while this range may be reasonable in major urban areas where legal, accounting, and valuation services tend to run high, it is possible in other parts of the country to have an ESOP be cost justified at perhaps $50,000 in pretax earnings and a covered payroll of about $250,000.

A company in a labor-intensive industry is more likely to benefit from an ESOP than one that is not so situated. Since the tax deductible ESOP contribution is usually limited to 15 percent of covered payroll, it follows that those companies in which labor is an important factor will be able to shetler a greater portion of their taxable income than would a company in which labor is less signficiant. Furthermore, the employee motivation aspect of ESOP is going to be more meaningful to companies with a high labor factor.

Companies without labor unions have been more interested in ESOP's than those with unions. The reason is that some company owners view ESOP as a means of making it less likely that their workers will join a union.

They feel that, having been given a piece of the action the workers will have second thoughts about joining a union. While this view has been expressed by several of my clients, I should point out that it was always viewed as a secondary rather than as a primary reason for setting up an ESOP.

I would like to turn now to the applicability of the investment credit ESOP under the Tax Reduction Act of 1975 to companies that I have worked with. My present feeling is that very few of my clients are likely to establish this type of ESOP. This is true for a number of reasons. First is the provision's short period of applicability.

Only contributions made in 1975 and 1976 will be permitted as a credit against the Federal tax liability. Yet an ESOP, like any employee benefit plan, is meant to be permanent. Thus most companies feel while the Government is paying the first two contributions, they will be required to pay the rest.

This could be a heavy commitment for a company to make unless it can take advantage, in the future, of some of the other ESOP benefits already mentioned.

A second reason that investment credit ESOP's have been slow to take hold, in my view, is the requirements of immediate vesting and of a passthrough of voting rights. As mentioned earlier closely held companies seem to be the most likely candidates for ESOP's, since the rules allow owners to gradually sell out without relinquishing control. By requiring the passthrough of votes immediately to the workers, it becomes more difficult for an owner to retain his control and still utilize the ESOP approach.

The larger publicly held companies have taken what I would categorize as a defensive view to investment credit ESOP's.

On one hand, if they do not establish an ESOP they feel that the company can be criticized for not giving its workers a benefit that Congress has authorized. On the other hand, they feel that if they do establish an ESOP they will be starting a benefit program that will be difficult to discontinue after the Government's 2-year contribution is made.

Further, these companies are not really sure that providing one share per employee as expressed to me by one large company's treasurer, can really have any benefit from a motivational point of view.

There is little question in my mind that if the 2-year period were extended, many of the larger, capital intensive public held companies would be taking a more positive approach to the ESOP program. Mr. W. Gordon Binns, Jr., assistant treasurer of General Motors Corp., has written an enlightening article on how the major companies then look at ESOP, in the September 1975 issue of Financial Executive. I would suggest that it be read by anyone pursuing this subject.

ESOP'S IN SERVICE INDUSTRIES

An adjunct to the question of the universal applicability of ESOP's is the issue of whether ESOP's are particularly useful to the majority of participants in the labor force, who are employed in service industries. Many of these workers are employed by the Federal, State, and local governments, and as such are not candidates for ESOP participation.

Others are employed by various professions, such as medicine, accounting and law, that traditionally operate in partnership rather than corporate form.

While profit-sharing forms of arrangements are common in these industries, particularly at levels just below partner, these entities cannot benefit from the ESOP concept under present law.

Workers in such other service industries where ESOP can be adopted are more likely to find themselves as ESOP beneficiaries than are their fellow workers in manufacturing. As I already mentioned this is due to several factors. One is the fact that a company in a service industry, being more labor intensive, will be able to shelter more taxable income than one not so situated due to the 15 percent of covered payroll limitation on contributions.

Second, a service company is more people oriented and more anxious to motivate its workers and to keep its exceptional workers. Third, a service company often is less able to use traditional forms of financing, lacking as it does, the brick and mortar collateral that such financing often requires. Finally, service companies often are nonunion companies and, this tends to make ESOP's more practical.

My own experience is that our clients in such industries as engineering, architecture, insurance brokerage, and contracting have been the most interested in the ESOP concept for the reasons outlined above.

IMPACT IN FINANCIAL MARKETS

You have requested that I address myself to the issue of the possible impact of ESOP's, if they were to become widely adopted, on the stock market and the financial markets in general.

As a certified public accountant rather than an economist or investment banker, I do not feel that my personal views would be of great interest to the committee. I therefore spoke to several of my associates in the investment banking community as well as to the New York Stock Exchange. My conclusion from these discussions is that the present expectation is that ESOP's will not be so widely adopted as to have any impact on the financial markets. Thus I have not been able to uncover any informed opinion on what the impact will be should the unforeseen occur.

I would expect that should the widespread interest in ESOP continue, this unresearched area will be the subject of future studies.

MOTIVATION BEHIND INTEREST IN ESOP'S

The final issue I wish to discuss is the question of whether in my experience the present widespread corporate interest in ESOP's is based mainly on the favorable tax treatment involved or by a desire to build equity ownership among corporate employees and thereby interest them in the successful performance of the company.

Let me first define widespread corporate interest as I view it. I should say that many groups are presently holding seminars and lectures on the subject of ESOP's. These include the American Management Association, the Association for the Corporate Growth, various bar associations, and others.

The financial, professional, and general press have had many ESOP articles published over the past year. A few books on ESOP have been published and many more are on the way. Even a television program has examined ESOP's briefly. At the same time accountants and lawyers have been busily educating themselves and their clients on the implications of ESOP.

Despite such a volume of activity, it would be wrong to interpret all this smoke as fire. Most of the companies I have spoken to are in a holding pattern regarding ESOP's.

They are talking to their professional advisers, their bankers, and their employees, but they are waiting for some clarification from the Internal Revenue Service on certain important technical points. These companies are in the evaluation stage regarding ESOP's; very few have actually reached the point of drafting plans and filing for determination letters.

With this as background, I think that the question can be more properly answered. My experience is that without question the overriding initial interest in ESOP's by my clients and those who have attended my lectures is in the favorable tax treatment that they have heard ESOP's provide and in the favorable financing opportunities that derive therefrom. They initially like the idea of being able to repay a loan in pretax dollars and to sell their stock to an ESOP at capital gains rates.

The initial reaction, however, is soon tempered when these people hear of the negative aspects of ESOP: That the positive cash flow which an ESOP generates in early years may turn to negative cash flow in later years if the company agrees to buy back employee stock at retirement; that the debt of the ESOP which the company guarantees will be reflected as debt on the company's balance sheet; that earnings per share will be diluted; that, perhaps, the law will change and the votes of ESOP shares will have to be passed through to the employees.

Where then does the question of employee motivation through share ownership arise? Quite frankly in my experience it arises as a hope. There is only a hope on the part of the ownership interests that the productivity of their workers will increase as a result of the establishment of an ESOP.

There is too little hard evidence available on this aspect of ESOP for any businessman to be able to rely. More research and perhaps more time is necessary before it becomes apparent to what degree an ESOP plan decreases turnover, increases productivity, and motivates workers.

While there will no doubt always be a gray area, it is at the present time too new to voice almost any opinions. Obviously the success of ESOP as a motivating tool will require proper communication to the employees and an understanding of how their individual efforts can result in the appreciation of their stock.

Beyond this, opinions vary quite extensively on this aspect of the ESOP concept.

To some extent, I have found certain geographic distinctions on this point. In Rochester, N.Y., for example, where companies such as Eastman Kodak and Xerox have had very successful stock purchase plans for many years, and local workers were familiar with individual success stories through the newspapers and through personal contacts, the owners of several companies told me they believed that ESOP could have an immediate positive impact on employee turnover. They were quite optimistic on increasing employee productivity as well. In many other cities, the view was often expressed that the workers would prefer an increase in take-home pay to anything as vague as an ESOP. Many companies felt that motivation through stock ownership would only work at the higher levels of the company, where stock ownership was clearly understood. It was considered doubtful that the rank-and-file worker could be motivated by such a plan.

In conclusion it is my view that most of the companies that will be establishing ESOP's in the near future will be doing so for the tax and the financial benefits to be derived therefrom. At the same time, I assure you that these companies will be doing all they can to see that the ESOP program is understood by their workers and is successful as a motivating tool.

At the present time, if Congress were to eliminate the tax incentives behind the ESOP program, I think it would be safe to say that the ESOP concept would fade rather quickly from the scene. Perhaps sometimes in the future, however, when ESOP-sponsoring companies have a track record of proven success through higher employee productivity, it may be possible to remove some of the tax incentive without totally destroying the ESOP idea.

Thank you.

Representative LONG. Thank you, Mr. Wassner. It was very enlightening and appeared to be a very objective analysis of the whole concept. We are appreciative to you for sharing your views with us.

Representative LONG. Mr. Thurmon, if you would, please.

STATEMENT OF HARRY L. THURMON, VICE PRESIDENT AND TREASURER, E-SYSTEMS, INC., DALLAS, TEX.

Mr. THURMON. Thank you, Congressman Long. I am vice president and treasurer of E-Systems, and I might say that in order to stay within the time limit of my presentation, it will vary slightly from my prepared statement.

E-Systems, Inc., is an electronic systems and manufacturing company headquartered in Dallas, Tex. The company's 9,000 employees are currently producing profitable sales of approximately one-quarter of a billion dollars annually. E-Systems securities are listed on the New York Stock Exchange.

In 1973, E-Systems became the first large, publicly held, listed company to establish an employee stock ownership plan—ESOP. The company adopted the ESOP concept primarily for the purpose of purchasing a sufficient amount of E-Systems stock to make all employees stockholders and thereby develop a long-term incentive program to increase productivity.

The ESOP also provides E-Systems' employees with a supplemental retirement benefit in addition to the company's existing pension plan and the Government's social security program, and provides the company with future financing flexibility to raise capital for growth.

The ESOP was adopted after 2 years of study to replace a program initiated in 1967 to purchase company stock for employees.

That 1967 program had been created to encourage employees to become shareholders with the purpose of developing their incentive to increase productivity. The 1967 program was unsuccessful in that in June 1973 less than 25 percent of the employees owned stock in the company.

The 1967 program failed primarily because the employee was required to pay two-thirds of the price of his stock purchase with his own funds. The company paid the other one-third.

For the next 2 years the company studied various ways to stimulate and maintain employee productivity. Those reviewed included profit-sharing plans, stock purchase programs, stock option plans, thrift plans, bonus programs, stock bonus programs, variations to the standard retirement and pension plans, and variations and combinations of these.

We studied specific plans currently in operation at other companies such as Sears, Honeywell, Texas Instruments, Long Island Light, Sun Oil, Chicago Bridge & Iron, Consolidated Foods, United Airlines, I. T. & T., IBM, and others.

In addition we studied plans including various ESOP alternatives and ESOP combinations with other types of incentive-oriented plans. While each of these plans had good points, we selected the basic ESOP concept, with some of our own modifications, because in our opinion it contained most of the advantages of the other plans and embodied more of the positive factors for employee motivation.

One of the primary advantages of the ESOP was its ability to borrow money for the initial purchase of the stock for the plan. We believe that purchase of most of the stock in the beginning accelerates the employee's incentive to perform more productively because a large amount of stock can be placed in the trust initially rather than the employee having to wait for the stock to build up over a long period of time through the annual purchase of smaller amounts of stock in the market.

The employee can see that the stock has already been bought and is in the ESOP trust for his benefit. Also if the company is growing, the stock can generally be bought at a lower price all at one time in the beginning; therefore, the employee can get more shares for the same company contribution.

As mentioned initially the primary objective of the ESOP was to create a long-term incentive program that would result in improved productivity for the company. Therefore the major long-term benefit expected from the ESOP was to provide employee motivation to increase productivity by linking their goals with those of the company and the shareholders.

As for our experience with the ESOP to date, it is still too early to determine its exact effectiveness. Although our ESOP was established in 1973, the stock was only purchased for the ESOP in April 1974, and the first stock allocation to employees accounts was just made 1 year ago this December.

However, to closely monitor the results of our ESOP we have established communications councils within our divisions to actively communicate the operations and actions of the company downward to the employees and for the employees to communicate upward their questions and suggestions regarding the company's operations.

These councils consist of employees from all departments, including supervision, union, and nonunion. The communication councils also allow us to measure the employees reaction and the effectiveness of our ESOP. To date the emmployee feedback has been very satisfying regarding employee acceptance.

I personally feel that we are 3 years ahead of where I expected to be on our planned employee acceptance time schedule. Our seven union locals cordially accepted the ESOP, some enthusiastically and we continue to have their support. There was no union objections to the ESOP and there have been no union complaints relative to the ESOP's operation or purpose.

There seems to be better morale and a much more cordial working relationship between supervision and other employees in that they are working together better, with a team membership feeling, seemingly for a common goal.

One of the indications of this is that our union grievances have declined. There seems to be an attitude of mutual problem solving rather than certain groups within the company taking adversary roles as has sometimes occurred in the past.

Employee turnover has declined 50 percent since 1973 and is below the national average for our type of company. Our absenteeism has declined and is now 25 percent below the national average.

Since the ESOP was established, interest and participation in the company suggestion program has improved in that suggestions submitted have increased 140 percent with a marked increase in suggestions regarding cost and waste reduction and efficiency improvements.

This was against the backdrop of an already active employee suggestion program. Through the communication councils we are seeing more creativeness from our employees in performing their jobs. There seems to be more peer group pressure to properly care for machinery, to discourage loafing, to reduce absenteeism, to provide better designs, to reduce operating supply costs and to generally work better together.

As to the company's operating results since the establishment of the ESOP, backlog and new business are up to record levels, sales in 1975 through 9 months are up over 30 percent and profits are up more than 60 percent.

Profit margins have improved, annual dividends have increased from 80 cents to $1 per share, the price of the company's stock and its price to earnings ratio have increased and as I mentioned, our union relations are excellent, our employee turnover is down and our employees seem to be extremely pleased.

Again this improvement certainly cannot be totally attributable to our ESOP but we feel that it was a significant contributor; however, the real, more significant benefits to the employees and the company are expected to occur over the long-term future of the plan as it gains momentum, because that is the purpose of ESOP.

In conclusion E-Systems really has not had any major problems with its ESOP since its establishment. The absence of problems is primarily attributable to the amount of time and effort the company spent in carefully analyzing the ESOP in relation to other plans and to the company's goals concerning incentive programs, employee benefits, employee motivation and goals, growth, cost impact, profitability, financing requirements, and capital structure.

There are, however, several areas of concern regarding the future of ESOP's, particularly pertaining to governmental administration of ESOP's by the regulatory agencies such as the SEC and IRS.

The SEC's financial statement treatment of the ESOP borrowings has been particularly disappointing to E-Systems and discouraging to other public companies interested in establishing ESOP's.

Likewise certain IRS comments regarding ESOP's have been of concern and there has been some question that ESOP's may not be allowed to flow through cash dividends on vested shares directly to the employee. E-Systems believes that the paying of cash dividends directly to employees after all trust debt obligations are satisfied is very critical to the success of the long-term employee incentive features of the ESOP.

I believe that the most important lesson learned by E-Systems in analyzing the ESOP concept again was that the plan is not necessarily good for all companies, it cannot alone save a bad company and the plans have to be custom designed for each company individually just like any good financial or benefit plan.

An ESOP poorly designed to a company's needs can do harm rather than good. They should be different to meet individual company objectives. The secret to a successful ESOP lies in carefully determining what you want to accomplish and how you can best go about it, just like any business decision.

We feel that ESOP should not necessarily be used as a sole or primary retirement plan but can contribute significantly as a supplemental retirement plan to assist our Government social security financial load.

E-Systems believes that the ESOP can contribute significantly toward helping solve the capital shortage problems of the future while supporting the capitalistic system.

Through ESOP E-Systems' employees will own 25 percent of the company's outstanding stock. We believe that the U.S. economy would benefit tremendously over the long term if this country's workers collectively received the dividend income and appreciation benefis of 25 percent of the total equity in the United States.

We believe that the U.S. economy would benefit tremendously. We believe that those employees would be more productive and more interested in the economic welfare of the United States and that the dividends and equity appreciation alone should certainly relieve some of the financial pressure on the Government's social security program.

This makes the ESOP a natural to communicate and explain the free enterprise system and the basic economics of American business to workers at all levels which I believe will make for a more unified America.

I only hope that regulatory agencies do not discourage establishment of ESOP's by shortsighted over administration and excessive regulation, while overlooking the longer term economic benefits for productivity growth in the U.S. economy.

Thank you.

Representative LONG. Thank you very much, Mr. Thurmon. Acknowledging that it is a rather limited experience, you certainly make a forceful argument for the institution of ESOP programs for companies in a similar position as yours at the time you did it.

[The prepared statement of Mr. Thurmon follows:]

PREPARED STATEMENT OF HARRY L. THURMON

E-Systems, Inc., is an electronic systems and manufacturing company headquartered in Dallas, Tex. The company's 9,000 employees are currently producing profitable sales of approximately one quarter of a billion dollars annually. E-Systems securities are listed on the New York Stock Exchange.

In 1973, E-Systems became the first large, publicly held listed company to establish an Employee Stock Ownership Plan (ESOP). The company adopted the ESOP concept primarily for the purpose of purchasing a sufficient amount of E-Systems stock to make all employees stockholders and thereby develop a long-term incentive program to increase productivity. The ESOP also provides E-Systems' employees with a supplemental retirement benefit in addition to the company's existing pension plan and the Government's Social Security program, and provides the company with future financing flexibility to raise capital for growth.

The ESOP was adopted after two years of study to replace a program initiated in 1967 to purchase company stock for employees. That program had been created to encourage employees to become shareholders with the purpose of developing their incentive to increase productivity. The program was unsuccessful in that in June 1973 less than 25 percent of the employees owned stock in the company. The program failed primarily because the employee was required to pay two-thirds of the price of his stock purchase with his own funds (the company paid the other third) and SEC trading regulations made it difficult for the program to buy sufficient shares in the stock market to meet the participating employees share purchase requirements because trading volume was low and the stock float was thin. When the market price of E-systems stock declined in 1969, the program developed negative incentive because some of the employees who had contributed to buy company stock could lose some of their money.

E-Systems management had been concerned for some time about the failure of the stock purchase program to provide the desired motivation and in 1971 began studying alternative plans which could provide for long-term employee incentive. Management was primarily interested in an incentive program to maintain a high level of employee motivation over the long-term. We believed this could best be accomplished by making all employees stockholders in the company at no cost to the employee so as to establish a commonality of interest among our employees, the company and our shareholders.

For the next two years, the company studied various ways to stimulate and maintain employee productivity. Those reviewed included profit sharing plans, stock purchase programs, stock option plans, thrift plans, bonus programs, stock bonus plans, variations to the standard retirement and pension plans and variations and combinations of these. We studied specific plans currently in operation at other companies such as Sears, Honeywell, Texas Instruments, Long Island Light, Sun Oil, Chicago Bridge and Iron, Consolidated Foods, United Airlines, ITT, IBM and others. In addition we studied plans including various ESOP alternatives and ESOP combinations with other types of incentive oriented plans. While each of these plans had good points, we selected the basic ESOP concept, with some of our own modifications, because in our opinion it contained most of the advantages of the other plans and embodied more of the positive factors for employee motivation.

One of the primary advantages of the ESOP was its ability to borrow money for the initial purchase of the stock for the plan. We believe that purchase of most of the stock in the beginning accelerates the employees' incentive to perform more productively because a large amount of stock can be placed in the Trust initially rather than the employee having to wait for the stock to build up over a long period of time through the annual purchase of smaller amounts of stock in the market. The employee can see that the stock has already been bought and is in the ESOP Trust for his benefit. Also, if the company is growing, the stock can generally be bought at a lower price all at one time in the beginning; therefore, the employee can get more shares for the same company contribution.

As mentioned initially, the primary objective of the ESOP was to create a long-term incentive program that would result in improved productivity for the company. Therefore, the major long-term benefit expected from the ESOP was to provide employee motivation to increase productivity by linking their goals with those of the company and the shareholders. From this the company expects an improvement in employee effort and attitude that will create a team effort; a feeling of employee ownership and importance; strengthened employee allegiance, loyalty and pride; increased employee interest in profitability and growth of the company and thereby increased productivity, reduced costs and improved operations resulting in increased profits and a more competitive company.

In addition to the incentive benefits for greater productivity and operating performance, E-Systems also views the ESOP as a supplemental employee benefit to its existing retirement and other employee benefit plans. However, the ESOP did not replace E-Systems' existing retirement plan and the company's annual contribution to the ESOP represents only about 5 percent of the company's annual fringe benefit cost. The ESOP was not used to terminate or replace any of E-Systems retirement benefits covering all employees.

As an additional employee benefit, the ESOP is expected to minimize employee turnover and absenteeism. Minimizing employee turnover is extremely important to E-Systems because, as a high technology systems company, we are very dependent upon retaining superior engineering talent. Therefore, we feel that we have to be more receptive to our employees' needs and desires than the average company and we believe the ESOP can help us greatly in retaining technical employees by tying their personal goals through ESOP to the goals of the company.

The ESOP also provides E-Systems with additional financing flexibility in that it provides a secondary source for raising capital in the event it is needed for company growth. This could become increasingly important considering the current problems with raising capital in the equity market, increasing restraints on bank credit and the anticipated increase in capital financing requirements over the next decade. After we selected the ESOP as our employee incentive program, in 1973 we began its establishment by preparing a plan and trust agreement with the assistance of Mr. Louis Kelso. The proper filings were made with the IRS and SEC and the Trust arranged to borrow $7 million to purchase E-Systems stock for the employees. In April of 1974, E-Systems' shareholders approved the establishment of the ESOP and a Trust which bought 500,000 shares of E-Systems stock for the employees through a public tender offer with the $7 million. Since E-Systems' ESOP bought the stock in the market place rather than directly from the company, E-Systems did not initially use the ESOT as a financing mechanism. There were several reasons for this approach to the stock purchase which pertained to E-Systems' particular financial and shareholder status at that time.

Each year for seven years the company must make a contribution to the Trust sufficient to allow the Trust to meet its expenses and make its annual paydown on the original seven year loan. As the Trust receives the tax deductible contribution from the company each year, a portion of the 500,000 shares of E-Systems stock originally purchased in the tender offer is made available for allocation into employee accounts within the Trust at that time. The amount of E-Systems stock available for allocation into employee accounts each year is equal to the percentage of the original 500,000 shares of stock originally purchased by the Trust which would be paid for with that particular contribution (i.e., the percentage of annual contribution to the original purchase price of the stock plus expenses and interest expense on the loan used to purchase the stock for the Trust). In 1974, the company contributed approximately $1.3 million (2 percent of E-Systems annual payroll costs) to the ESOP which thereby provided 75,000 shares of E-Systems stock available for allocation to employees that year. A portion of the 75,000 shares was allocated to each employee's account in the Trust last year in accordance with the percentage of his annual salary to the total annual payroll of the company.

At the company's option more shares can be added to the ESOP for allocation during the seven years or thereafter if desired. The allocated stock is held in the ESOP Trust in each employee's individual account. The allocated stock vests for the employee at 10 percent per year and the vested stock is distributed from the Trust to the employee at retiremnt, death or termination, whichever occurs first.

So, in the last four years E-Systems, a large public company listed on the New York Stock Exchange has discovered Louis Kelso's ESOP concept, analyzed it for two years, compared it with other plans, modified it to some degree to fit our goals, adopted it, obtained all the proper clearances, put it into action, arranged financing and funded it with stock and made our first allocation into our employees accounts; and it's working.

As for our experience with the ESOP to date, it is still too early to determine its exact effectiveness. Although our ESOP was established in 1973, the stock was only purchased for the ESOP in April of 1974, and the first stock allocation to employees accounts was just made a year ago this December. However, to closely monitor the results of our ESOP, we have established communications councils within our divisions to actively communicate the operations and actions of the company downward to the employees and for the employees to communicate upward their questions and suggestions regarding the company's operations. These councils consist of employees from all departments, including supervision, union and non-union. The communication councils also allow us to measure the employees reaction and the effectiveness of our ESOP. To date the employee feedback has been very satisfying regarding employee acceptance. I personally feel that we are three years ahead of where I expected to be on our planned employee acceptance time schedule.

Our 7 union locals cordially accepted the ESOP, some enthusiastically, and we continue to have their support. There was no union objection to the ESOP and there have been no union complaints relative to the ESOP's operation or purpose. There seems to be better morale and a much more cordial working relationship between supervision and other employees in that they are working together better, with a team membership feeling, seemingly for a common goal. One of the indications of this is that our union grievances have declined. There seems to be an attitude of mutual problem solving rather than certain groups within the company taking adversary roles as has sometimes occurred in the past.

Employee turnover has declined 50% since 1973 and is below the national average for our type of company. Our absenteeism has declined and is now 25 percent below the national average. Since the ESOP was established, interest and participation in the company suggestion program has improved in that suggestions submitted have increased 140 percent, with a marked increase in suggestions regarding cost and waste reduction and efficiency improvements. This was against the backdrop of an already active employee suggestion program. Through the communication councils we are seeing more creativeness from our employees in performing their jobs. There seems to be more peer group pressure to properly care for machinery, to discourage loafing, to reduce absenteeism, to provide better designs, to reduce operating supply costs and to generally work better together. Although it is very difficult to determine all of the reasons for these employee improvements, we are convinced that the ESOP's providing stock ownership to our employees has increased their interest and incentive to participate and contribute to the company.

As to the company's operating results since the establishment of the ESOP, backlog and new business are up to record levels, sales in 1975 through nine months are up over 30 percent and profits are up more than 60 percent. Profit margins have improved, annual dividends have increased from $.80 to $1.00 per share, the price of the company's stock and its price to earnings ratio have increased and as I mentioned, our union relations are excellent, our employee turnover is down and our employees seem to be extremely pleased. Again, this improvement certainly cannot be totally attributable to our ESOP but we feel that it was a significant contributor; however, the real, more significant benefits to the employees and the company are expected to occur over the long-term future of the plan as it gains momentum, because that is the purpose of ESOP.

In conclusion, E-Systems really has not had any major problems with its ESOP since its establishment. The absence of problems is primarily attributable to the amount of time and effort in carefully analyzing the ESOP in relation to other plans and to the company's goals concerning incentive programs, employee benefits, employee motivation and goals, growth, cost impact, profitability, financing requirements, and capital structure. We spent the two years studying the anticipated ESOP impact on E-Systems because the plan was so new, the concept had not really been tested and few really understood how it worked. Therefore, E-Systems had to be extremely careful in designing and adopting the ESOP, but that time and effort has paid off by minimizing errors.

There are however, several areas of concern regarding the future of ESOPs, particularly pertaining to Governmental administration of ESOPs by the regulatory agencies such as the SEC and IRS. The SEC's financial statement treatment of the ESOP borrowings has been particularly disappointing to E-Systems and discouraging to other public companies interested in establishing ESOPs. Likewise certain IRS comments regarding ESOPs have been of concern and there has been some question that ESOPs may not be allowed to flow through cash dividends on vested shares directly to the employee. E-Systems believes that the paying of cash dividends directly to employees after all Trust debt obligations are satisfied is very critical to the success of the long-term employee incentive features of the ESOP.

E-Systems finds difficulty in understanding the IRS problems with the ESOP concept particularly considering that the concept has been allowed for a number of years, and is really generally only different from normal benefit plans in that it allows for the Trust to borrow funds and buy securities earlier than normally would be allowed, which accelerates the benefit to the employee and the company. The ESOP does not increase the maximum tax deduction of 25 percent of payroll costs allowed by IRS for qualified employee benefit plans (including 15 percent for ESOP type plans); therefore, ESOPs should not have any unplanned negative impact on Treasury revenues since the 25 percent maximum deduction has been in effect for several years and should have already been considered and factored in planned tax receipts. Further, increased profits from ESOP improved productivity could generate increased tax revenue.

I believe that the most important lessons learned by E-Systems in analyzing the ESOP concept was that the plan is not necessarily good for all companies, it cannot alone save a bad company and the plans have to be custom designed for each company individually just like any good financial or benefit plan. An ESOP poorly designed to a company's needs can do harm rather than good; they should be different to meet individual company objectives. The secret to a successful ESOP lies in carefully determining what you want to accomplish and how you can best go about it, just like any business decision. We feel that ESOP should not necessarily be used as a sole or primary retirement plan but can contribute significantly as a supplemental retirement plan to assist our Government Social Security financial load. E-Systems believes that the ESOP can contribute significantly towards helping solve the capital shortage problems of the future while supporting the capitalistic system.

Through ESOP, E-Systems' employees will own 25 percent of the company's outstanding stock. We believe that the U.S. economy would benefit tremendously over the long-term if this country's workers collectively received the dividend income and appreciation benefits of 25 percent of the total equity in the United States. We believe that those employees would be more productive and more interested in the economic welfare of the United States and that the dividends and equity appreciation alone should certainly relieve some of the financial pressure on the Government's Social Security program. This makes the ESOP a natural to communicate and explain the free enterprise system and the basic economics of American business (costs, budgets, schedules, profits, investment, etc.) to workers at all levels which I believe will make for a more unified America. I only hope that regulatory agencies do not discourage establishment of ESOPs by short-sighted over administration and excessive regulation, while overlooking the longer-term economic benefits for productivity growth in the U.S. economy.

Representative LONG. Mr. Flint, please proceed.

STATEMENT OF ROBERT N. FLINT, VICE PRESIDENT AND COMPTROLLER, A.T. & T. CO., NEW YORK, N.Y.

Mr. FLINT. Yes sir. I have a prepared statement and I would like to take 10 minutes to summarize some of the high points.

Representative LONG. We will incorporate your prepared statement into the record.

Mr. FLINT. I appreciate this opportunity to express the Bell System's views concerning plans under which employees may acquire shares of their employer. As the employer of almost 1 million people, we strongly favor expanding employee stock ownership and we are convinced that a properly designed program will provide substantial benefits to employees, their employers and to the Nation.

I would like to summarize the environment in which these conclusions are reached. First, looking at the big picture, our national economy, we have seen unemployment increase over the past 10 years from about 4½ percent to almost double that figure.

In addition, the labor force is increasing at a rate of about 2 million new workers a year. As a nation we need additional jobs and this requires capital, tremendous amounts of new capital, estimated by some to be about $4½ trillion during the next 10 years.

To the extent that there is a shortfall in the amount of savings available for the desired new capital investments, our national goals must suffer. Unfortunately during the past 10 years American business has placed heavy reliance on debt financing with the result that debt equity ratios generally exceed prudent levels.

Major segments of American business have had their credit rating reduced or placed in jeopardy. What is needed are some good, solid doses of equity capital.

Turning from the national scene to the Bell System, during the past 10 years, our debt ratio has increased from about 33 percent to about 50 percent. Too high. Our post-tax interest coverage has declined from about 6 times to about $2\frac{1}{2}$ times. Too low. We must finance an annual construction program of about $10 billion a year to provide communications services for our customers. In the process, we will require large amounts of new equity money each year to preserve the soundness of our capital structure. For this, we must look to our present and future shareholders.

Presently over half of our 3 million shareholders are small investors, holding 60 shares of stock or less. About a third of our almost 1 million employees are share owners today.

Many of our employees have expressed an interest in a stock purchase plan. In this environment, we have examined a wide array of features which would produce an effective employee stockownership program to meet the mutual interests of the employees—who are interested in acquiring A. T. & T. shares—and the company—which needs new equity capital.

In this analysis, we have concluded that employees would participate in stockownership programs which offer inducement in four general areas. First, an attractive purchase price; for example a purchase at some discount below market.

Second, favorable tax treatment such as capital gain treatment or perhaps a deduction or a credit by the individual for shares which he did purchase.

Third, they seek convenience. For example, payroll deductions in amounts tailored to meet the employee's personal circumstances and without transaction costs or expenses. Fourth, their general view is that they would like early acquisition of the shares and the dividend income.

My prepared statement contains the outline of an ESOP which we feel is an appropriate balance of the interests of employees, employers and the Government. Its principal feature includes a payroll deduction plan under which shares are purchased by the ESOP from the employer at a discount.

The dividends are reinvested tax-free, and the employee is allowed a limited tax credit on his income tax return for amounts contributed to the trust. We feel that an ESOP essentially along these lines would be successful. In our view the single most important feature for a successful ESOP is attractive tax treatment of the employees' investment. We believe a plan of this nature would be attractive from the Government's viewpoint, because it creates new equity capital which increases the job opportunities and thus increases the tax base.

From the employer's standpoint, starved for equity capital, the additional equity would help redress the increasingly critical problems in their capital structure.

Looking at both employers and employees who are shareholders, each should benefit from a closer identification of their interests.

And, of course, employees benefit from participating in financially attractive savings programs through which they can increase their ownership in American business.

For these reasons, we agree that employee stockownership plans are desirable vehicles to provide stock for employees. In the process of our analysis, we have reviewed the Kelso form of ESOP and, of course, have studied carefully the ESOP funded by the 1 percent investment tax credit.

The 1 percent investment tax credit plan is discussed in my prepared statement, including several areas which unless modified by the next tax bill pose serious problems that I am sure will deter utilities and other large corporations from adopting the ESOP with the 1 percent credit.

With respect to the Kelso form, we have more questions than answers. I would like to pose some of these questions and observations for your consideration.

As I understand the Kelso plan, a plan is established which would function as an employee-owned, tax-exempt trust. A bank lends money to the ESOP. The ESOP turns these funds over to the corporation in exchange for new shares issued at market value.

The shares are pledged as collateral for the bank loan. The corporation guarantees the bank loan. The corporation makes annual tax deductible contributions to the ESOP and when the bank loan is paid off, the employees become full beneficial owners of the stock.

I also understand that the fully implemented ESOP contemplates, in the future, major tax revisions in the laws regarding corporations and federally subsidized low-cost interest and insurance for the loans and the investments in the ESOP.

As discussed in some detail in my prepared statement, the Kelso proposal for ESOP gives us concern. We are concerned that if fully implemented, as proposed, the plan could have a highly inflationary potential.

This is particularly true, if the plan must be treated as additional compensation, which is to be recovered through price increases. Also the introduction of subsidized low-cost Federal credit and guaranteed insurance plans could well inflame the economy.

If the plan is viewed as a substitute for other forms of compensation, it does represent something in the nature of forced savings by employees which could change the nature of collective bargaining processes. I don't know what that would be, but it is something which should be looked at carefully.

In either instance, whether it is additional compensation or a substitute for current compensation, as we see it, there is no additional tax advantage which would accrue to the corporation which is not otherwise currently available through the deduction for payments for traditional forms of compensation such as wages, fringe benefits and/or pensions.

Of particular concern to us is the fact that the viability of the plan is based on the creation of additional debt through employer guarantee of the bank loan. Particularly now at a time when corporate financial structures are topheavy with debt, we raise the question whether the burden of additional debt should be encouraged at this time.

Notwithstanding these questions of broad application of the Kelso plan, I understand that it has been adopted and utilized in creating a market for privately owned business, for assisting the finance of small firms or establishing pension plans where none existed before. We believe other large corporations probably do not have that kind of an impetus to adopt a plan.

In summary, the Bell System finds itself in broad agreement with Mr. Kelso's objective of encouraging expanded employee stockownership. The vehicles he has developed for achieving these objectives give us some grounds for some serious questions.

As outlined in my prepared statement, we believe that there may well be better ways of accomplishing the objective of employee stockownership and we suggest what our views in this area would be.

Since the Kelso plan does involve some fairly basic and fundamental changes in our economic system, we do hope that these questions will be subject to very careful investigating by your committee.

If the Bell System can be of any assistance to the committee, we will be happy to do so. Thank you.

Representative LONG. Thank you, Mr. Flint. You have already been helpful to the committee. I think the prepared statement you have submitted is going to be helpful to us. I have a specific question I would like to ask you, but I will wait until we get back over and go down the line.

[The prepared statement, with attachments, of Mr. Flint follows:]

PREPARED STATEMENT OF ROBERT N. FLINT

I. INTRODUCTION

This statement is submitted on behalf of the Bell System, which is comprised of American Telephone and Telegraph Company and its associated companies. The focus of my comments will be to share with you the Bell System's concerns about the need for adequate capital formation on a national basis to provide sufficient jobs for the rapidly growing work force. Our concerns in this area extend to the availability of sufficient equity capital—estimated at about $250 billion over the next decade—to meet the new capital needs of industry in general and, at the same time, to offset the excessive usage of debt financing in recent years.

The Bell System, because of its capital-intensive nature and because of the heavy capital requirements of current technologies in the communications business, is expected to need large amounts of new capital annually over the next decade. As a result we are constantly searching for new and innovative ways to improve the capital formation process. This has led us to a review of ways to encourage capital formation through plans under which employees may acquire shares of their employers. We have a strong conviction based on our own experience that broadly-based stock ownership, and particularly employee stock ownership, has tremendous advantages to the nation and to individual companies.

In the process of our review of various plans, we reviewed the Louis Kelso form of Employee Stock Ownership Plan (ESOP). Our review has raised some serious questions in our minds as to whether the Kelso Plan has inherent conceptual problems which will prevent it from achieving the admirable objective of broadening employee stock ownership without serious inflationary impact on the National economy. Also, we feel there may be alternatives to the Kelso Plan which might work toward the same objective without requiring such a drastic change in our economic system.

I am not an economist and have not developed definitive answers to the questions raised by our review of the Kelso Plan. My purpose is to summarize for you our concerns, to describe the nature of these concerns in some detail and to outline the characteristics of potential alternatives to the Kelso Plan. Finally, I would urge strongly that this Committee study these issues in depth before reaching any conclusions regarding the legislative thrust which would be most effective in improving the capital formation process in the United States.

Let me now develop my review in more detail.

II. THE CAPITAL FORMATION CHALLENGE

An adequate supply of new capital has always been the touchstone of progress in the American economy. According to our economists, additional capital investment is essential to the process of translating breakthroughs in research and development into new products or into more efficient processes, all of which produces a steady increase in the American standard of living. In addition, new capital is needed every year to provide jobs for the 2 million people entering the labor force. It is currently estimated that, on average, investors must provide $30,000 of capital investment to provide a job for each worker in American business today.

The requirements for new capital to fund technological progress and expand job opportunities are with us year in and year out. Our problems in the coming decade will be heightened by additional forces which will increase the need for investment funds at the same time as special constraints on capital formation exist which will make it difficult to achieve an adequate supply of new capital.

On the demand side, increases in plant and equipment spending can be expected as the economy moves from recession to recovery. While significant amounts of excess capacity appear to exist at the moment, some of it is already obsolete. Some also exists in companies and industries which will not participate immediately or fully in the recovery, and some capacity will be made obsolete by new technologies now waiting in the wings to be implemented. By the time the economy returns to normal, we will have experienced two or three years of minimal growth in national productive capacity. As a result, we face a catch-up period ahead if the current unacceptably high level of unemployment is to be reduced significantly, without regenerating inflationary pressures.

A second area leading to unusually large demands for new capital results from the shift in our national priorities in the last few years toward objectives which absorb significant amounts of new capital. These include the increased emphasis on ecological considerations, safety in our products and the processes of production, as well as the national goal of achieving self-sufficiency in meeting our energy needs.

Many studies have been made of demand for new capital in the next decade. All have concluded that business investment will represent a larger than usual proportion of national output. To cite one—namely, that of Data Resources Inc.—it appears that the need for capital funds by business, government and consumers from 1975–85 will total about $4.5 trillion in contrast to $1.5 trillion in the preceding decade and $760 billion in the decade prior thereto.

On the supply side, we also see constraints on the economy's ability to achieve a balance to national demand for capital. Several factors contribute to these constraints.

1. Demography

The 47 million persons born during the post-World War II baby boom are now marrying and producing children of their own. Combined with the low birth rate of the 30's and the tendencies toward longer life, we face some demographic mismatches. The age groups which will show the biggest growth during he next decade—namely, the 20–34 group and the over-65 group—have traditionally been "dissavers." The 45–64 year age group, which traditionally are the "savers", will show virtually no growth.

2. Government Deficits

Economists generally recognize a government surplus will be necessary to achieve a ready balance between the supply and demand for capital during the next 10 years. Several studies made recently of the coming "capital shortage" have differed in their conclusions to a large extent because of differing assumptions as to the outlook for government deficits in the decade ahead.

Given the fact that governments have absorbed 20% of the available credit during the 1965–74 period and account for almost half of 1975's, most studies project a continuing government drain on available credit in the next decade.

3. Inflation

Rapid, chronic inflation tends to erode the whole process of productive capital formation and to direct funds into speculation. Ready evidence of this is provided by the capital formation problems of the South American nations. Our own experience with inflation during the last few years has highlighted the inadequacy of traditional depreciation methods, the distortions introduced by price controls and the regulatory lag problems of the utilities. Moreover, uncertainties as to our ability to bring inflation under control add to the risk premium investors require before committing their funds.

4. Financial Structure

Complicating the overall capital supply problem is a serious financial problem which arises from the illiquidity of American business. Corporate balance sheets have moved from 24% debt in 1950 to 36% debt in 1974, with utilities on average carrying well over 50% debt. The increasing burden of debt during this period of rising interest rates can be illustrated by the fact that in 1950 corporations distributed $7.50 in dividends for every dollar of interest they paid. In 1974, it was dollar for dollar between interest and dividends. The heavy dependence on debt financing and the accompanying decline in coverage of debt charges has resulted in numerous downgradings of corporate debt securities by the rating agencies. In the 1971–73 period an average of 20 companies a year had their debt securities downgraded, and in 1974 the total climbed to 63. In short, debt is at a dangerous level today.

Thus the solution to our capital supply problem would appear to lie in encouraging large infusions of new equity capital into American business. But, this will not be easy at the present time: new stock issues are not attractive, since the common stock of many companies is selling below book value; today's tax laws have a decided bias against equity investment; and the Employee Retirement Income Security Act (ERISA) may well impact on the investment decision of pension fund money managers in a way which will encourage a shift toward fixed income securities rather than equity. Finally, there is the fact that the individual investor has been a net seller of equity securities for many years, with the result that equities as a percent of the financial assets of individuals have fallen from a peak of about 40% to a recent level of about 23%.

The New York Stock Exchange has estimated business needs some $250 billion of equity capital in the 1975–85 period. This equates to about $1,000 for each person in the United States. If the equity assets held by individuals as a percent of their total financial assets could be increased by 10 percentage points, some $200 billion of new equity capital could be generated from this source alone. On balance, it seems to us that any program to stimulate capital formation must be designed to attract individual investors to equity investment.

III. THE BELL SYSTEM AND THE NATIONAL CAPITAL FORMATION CHALLENGE

The importance to the Bell System of an adequate supply of new capital cannot be emphasized too strongly. There are several ways to illustrate the heavy capital intensity of the telecommunication business. I mentioned earlier that it takes $30,000 of capital investment to provide a single job for each worker in American industry. For the Bell System about $75,000 of capital investment is required. Another way to look at the relative importance of capital to a business operation is in terms of the investment required per dollar of revenue. For the Bell System it takes about $2.40 of investment to generate $1 of revenue; in contrast, manufacturing businesses require only about 50 cents, and a large retail food distributing company needs only about 10 cents of investment per $1 of sales.

Along with most of American industry, our debt ratio has been increasing in recent years. It has risen from about 33% ten years ago to about 50% today. When combined with rising interest rates, this has led to a serious decline in our interest coverage. As a result, we will need to attract large amounts of new equity capital every year to reduce our debt ratio and at the same time to finance our annual construction expenditures of more than $10 billion.

As a result we are continually searching for innovative measures which will aid us in meeting our financing requirements. We have taken several steps in just the last year to improve our ability to raise new equity. We made our dividend reinvestment plan more attractive by offering new shares, purchased with reinvested dividends, at a 5% discount below the market price. In addition, our shareowners buy shares at market price directly from the company. Also, at this year's annual meeting our shareowners upon management's recommendation, voted to eliminate preemptive rights, thereby increasing the Bell System's financing flexibility considerably.

The Bell System has always been interested in achieving as broadly-held ownership of its stock as possible. Our almost 3 million share owners, more than half of whom are small investors holding 60 shares or less, provide dramatic illustration of that fact. Moreover, about ⅓ of our Bell System employees are also share owners. Over the years we have tried to encourage this by offering a variety of employee stock purchase plans. At present, management employees are eligible to participate in a Bell System Savings Plan in which one of the optional investment vehicles is the purchase of AT&T stock.

In this environment, we have examined a wide array of features which would produce an effective employee stock ownership program to meet the mutual interests of employees (who are interested in acquiring AT&T shares under attractive terms) and the company (which needs new equity capital).

In this analysis, we have concluded that employees would participate in an employee stock ownership plan which offers sufficient inducement in four general areas:

First—an attractive purchase price (for example, a purchase at some discount below market)

Second—favorable tax treatment (tax-free reinvestment of dividends, favorable capital gains treatment and/or a tax incentive to purchase, such as a special tax credit or deduction)

Third—convenience (payroll deductions in amounts tailored to meet the employee's personal circumstances without transaction costs or expenses)

Fourth—early acquisition of shares and dividend income

The combination of our continuing search for new approaches to raising equity capital, and our interest in broadened stock ownership, led us to examine the proposal which has been advocated for many years by Louis Kelso, and I will try to summarize for you the results of our review.

IV. KELSO FINANCING AS A SOURCE OF EQUITY CAPITAL

Louis Kelso has proposed a financing procedure designed to increase the employee-ownership base of capital assets in the country. It involves the establishment of Employee Stock Ownership Plans by individual companies which would in turn guarantee bank loans to a trust administering the ESOP in order to finance employee purchase of common stock from the company. I will refer to this procedure as the "Kelso Plan" in my remarks in order to distinguish it from the 1% Investment Tax Credit option in the 1975 Tax Reform Act which is tied to the formation of an ESOP. I will refer to this latter proposal as an ITC-ESOP. While related, the Kelso Plan and the ITC-ESOP have some different characteristics and thus need to be considered separately. (A capsule description of each is included as an attachment, summarizing our understanding of the basic structure of the two proposals.)

A. The Investment Tax Credit—Employee Stock Ownership Plan (ITC-ESOP)

The Investment Tax Credit—Employee Stock Ownership Plan provided by the 1975 Tax Reduction Act is understood to be currently under consideration by a broad range of companies, as well as by the Bell System. The availability of an additional one percent of tax credit offers added equity capital in a period when external capital is difficult and expensive to obtain. The provision is likely to prove of most interest to the more capital-intensive segments of the economy. Regulated utilities, in particular, may be interested since they have large needs for additional common equity. Utilities may also be encouraged in this by regulatory authorities.

There appear, however, to be four areas which pose serious obstacles to the adoption of an ITC-ESOP.

1. Normalization for Regulatory Purposes

For unregulated industry new capital from the election of the additional 1% investment credit is essentially equivalent to ordinary equity financing. Essentially, the only difference is the source of the equity funds. In the case of the 1% portion of the credit going to ESOP, equity ownership interest goes to the employees, with the funding received by the company being provided through the auspices of the Federal government.

For many regulated public utilities, including the Bell System, if the 1% ESOP provision is treated the same way for regulatory purposes as the 10% ITC portion, it would be "normalized," or amortized to net income over the life of the associated plant. The credit in effect would be returned to ratepayers by way of lower revenue requirements. While this is reasonable for a regular tax credit, it should not apply to a situation wherein capital stock has been issued for the credit. In effect, the Federal government has purchased the stock from the utility with tax dollars and then given it to employees. Thus, there is no further benefit to flow through.

If regulatory authorities require flow-through, a utility would find itself, at some future time, in the position of having issued stock for which no permanent capital was received. This situation would be most injurious to existing shareholders. Their interests would be diluted because no permanent capital was retained to support the new shares.

We have recommended that legislation be enacted to provide specifically that the portion of the tax credit going to the ESOP be treated as equity capital with flow-through prohibited.

2. Recapture of the Investment Tax Credit

When plant is removed from service prior to the expiration of its expected life, a portion of the ITC that was originally claimed on that plant may be subject to recapture. The terms of the 1975 Tax Reduction Act require that amounts transferred to the ESOP shall remain in the plan and continue to be allocated to employees. In the event of recapture of a part of the ITC, a company would be in the position of having issued stock for which no funds were actually made available. This would of course be discriminatory to the interests of existing shareholders. We have recommended a legislative change which would prohibit the recapture of any portion of the 1% credit contributed to the ESOP, unless bad faith on the part of the taxpayer can be demonstrated.

3. Redetermination of the Investment Tax Credit

At the time it is taken, the investment tax credit represents an estimate which cannot be fully evaluated by the Internal Revenue Service until well after the fact. By the time this process is completed, several years may elapse before final determination of the actual investment tax credit for a given year. The effect of any disallowance is essentially the same as the recapture situation; the company would have issued more stock than it received in funds available for capital investment. In this case we have recommended a change in the existing law so that ESOP contributions can be adjusted to reflect amounts subject to redetermination.

4. Administrative Costs

The expenses of managing the ESOP trust for seven years should be charged to the trust rather than to shareowners. This should insure that administrative costs are kept in line with the attendant benefits.

The problem areas we have identified may deter utilities (particularly with regard to the flow-through) and other large corporations from adopting ITC-ESOP provisions.

B. The Kelso Plan

The ultimate Kelso Plan, as Mr. Kelso is understood to envision it, is quite complex, and its full implementation wouid include Federally subsidized, low cost interest and insurance for ESOPs, requiring substantial and far-reaching changes in our banking and monetary system, as well as major tax legislation, including elimination of the corporate income tax.

In the basic Kelso Plan, however, stock is purchased through a trust for employees. The trust obtains its funds through bank loans supported by the corporation's credit and the loan is repaid by tax-deductible contributions from the corporation. The tax savings to a corporation in using an ESOP for financing are equivalent to straight debt financing by the corporation, coupled with the issuance of stock to its employees as a bonus or compensation. Thus, the initial effect of a Kelso Plan is to increase the debt burden of the firm.

The stated objectives of the plan, favoring a broad base of equity ownership, long-term investment rather than speculation, and employee participation in the ownership of the businesn, are generally consistent with business positions. The thrust of the plan (after the payback of the original borrowings) would also be in the direction most corporations are trying to move their capital structure—namely, toward increased equity and a lower debt ratio. It also appears that the Kelso Plan has demonstrated some value in such areas as creating a market for privately owned businesses, assisting the financing of small firms in trouble, and establishing pension benefits where none had existed before.

In a broad way, therefore, the Bell System finds itself in general agreement with Mr. Kelso's objective of stimulating employee stock ownership. The vehicle he has developed for achieving these objectives, however, gives rise to some serious concerns on our part. Since the Kelso Plan involves some fairly basic changes in our economic system, we urge that these questions be the subject of careful investigation by this committee as part of its evaluation of the complex issues in the Kelso financing plan and as it considers other alternatives for stimulating capital formation and equity ownership on an expanded basis by all citizens.

V. BASIC QUESTIONS RAISED BY THE KELSO PLAN

A. Can the implementation of Kelso's ultimate proposals for ESOP increase the amount of new capital available to the economy without generating significant inflationary pressures?

Ultimately Kelso proposes a broad revision in Federal tax policy and banking laws to facilitate the functioning of ESOP. He advocates the introduction of low-cost credit through the Federal Reserve, including discount of ESOP loans through the Federal Reserve, the creation of a Federal agency to insure both the bank loan to the ESOP and the trust investments of the ESOP and, finally, elimination of corporate income taxes to accelerate the flow of funds directly into the ESOP.

As stated recently by Dr. Tilford Gaines, Senior Vice President and Economist of Manufacturers Hanover Trust Company: "The fact that excessive use of credit contributes to the inflation process is broadly accepted . . . whether one looks at the influence of credit upon inflation as enabling users to spend more than they earn or whether one looks at it through its indirect influence upon money supply growth."

Economists in general agree that "real" capital formation cannot be increased beyond the rate of savings, once the economy is at full employment. Beyond the point of full employment, the prices of scarce resources will be bid up an inflation will result. The attempt to stimulate investment beyond the capacity of the economy to absorb it would therefore result in inflation and also in economic instability as an overheating of the economy would likely be followed by a resulting slowdown. An ESOP with these characteristics will tend to alter the form in which capital is raised rather than generate a net increase.

Without the broad monetary and tax changes envisioned by Mr. Kelso, corporate cash dividends flowing to a trust would be insufficient to pay interest and principal. Thus, the burden of interest and loan repayment would fall squarely upon existing shareowners, having a dilutive effect on their earnings and book value. Alternatively, if the corporation attempts to fund the plan by increasing the pirce of its products, inflationary pressures would result.

In addressing the matter of inflation, advocates of the Kelso Plan believe it has offsetting anti-inflation effects. In this they depend very heavily on the elimination of wage demands which presumably will be accomplished when workers become shareowners. However, during the postwar period, the relative shares of national income accounted for by labor compensation and corporate pre-tax profits were about 71% and 12%, respectively. Given the large proportion of income already going to labor, it seems unlikely that shifting to labor some portion of the 12% share now going to shareowners would create a significant increase in their income and, consequently, it is unlikely to eliminate new wage demands.

B. Does the Kelso plan create new capital or merely change the processes of obtaining it?

It seems to us no new capital is created by the Kelso Plan. "Real" capital formation results only from the aggregate savings in the economy. The plan merely changes the flow of savings without changing the amount of savings.

Funds for financing the Kelso Plan must come from one of three sources: employees, shareowners or customers.

If an ESOP replaces other forms of compensation to employees, it will in effect represent "forced savings" by the employees. At the same time it would change the nature of the collective bargaining process, since in effect part of the negotiated compensation package would be determined by the capital spending plans of the firm.

Alternatively, if the ESOP does not replace other forms of compensation to employees and the corporation raises prices to fund the plan, the burden falls upon consumers. Also, if it becomes a form of additional compensation, the Kelso Plan would tend to introduce imbalance into National wage patterns because the amount of additional compensation will depend on the capital intensity and rate of growth of particular firms.

As mentioned earlier, if corporate cash dividends are insufficient to pay interest and principal of the ESOP loan, the burden falls upon existing shareowners.

C. Can Kelso Plans adequately substitute for pension systems and other retirement programs?

There are several aspects of this proposal which trouble us:

1. It seems doubtful that an equity fund consisting of stock of the employing corporation should be the major source of retirement income, since this would expose employees to the risks inherent in a single business.

2. As already mentioned, the new investment income that would go to employees out of the 12% share of the National income represented by profits would not be significant and could not, therefore, provide an adequate source of retirement security.

3. The Kelso literature stresses that the ESOP investments in new equities would yield a higher income than existing pension funds do from their purchase of securities already outstanding. However the risks to the ESOP would be greater than in the case of the typical pension fund, which diversifies its holdings.

D. Will a change in the distribution of equity ownership generate the very large increases in productivity claimed by the proponents of the Kelso Plan?

While it is true that capital investment is vitally important to the process of translating technological developments into productivity improvements, it does not necessarily follow that changes in the distribution of equity ownership will speed up the process. It could even be argued that the Kelso theory does not take sufficient account of the risks involved in innovation and investment planning. A great deal of innovation, leading to the development of new industries and processes, has come from small beginnings or from individual inventors, motivated by the hope of a profit. Thus, the Kelso plan could conceivably limit the availability of credit to such entrepreneurs, and therefore interfere with the process of innovation.

It is possible hat workers might work harder or more conscientiously due to their ownership of capital, but productivity gains from this source are likely to be small, based on the evidence gathered in empirical studies which have been made of the sources of productivity improvement.

As mentioned earlier, given the large proportion of income already going to labor, it seems unlikely that shifting to labor some portion of the 12% share now going to shareowners would have sufficient impact or leverage to provide the extra incentive needed to achieve dramatic productivity improvements.

E. Is there a danger that widespread implementation of Kelso Plans would seriously reduce the role of "voluntarism" in our economic system?

This is a difficult question to articulate in any specific sense, but there are several aspects of the Kelso Plan that could affect the traditionally voluntary nature of our economic decision-making. Perhaps I can illustrate it best by citing a few examples of what I have in mind.

In effect, a Kelso Plan codld become a form of forced employee saving if employers tend to regard it as a substitution for other forms of compensation. The employee's freedom of choice between consumption and saving would thereby be reduced.

The Kelso Plan calls ultimately for total pay-out of corporate earnings. This reduces the areas of choice open to both corporations and shareowners with regard to the financing of expansion.

VI. ALTERNATIVES TO KELSO FINANCING DESIGNED TO ACHIEVE THE SAME BROAD OBJECTIVES

Extensions or modifications of the tax code are possible which would stimulate equity capital formation and broaden the stock-ownership base. For example, it would be desirable for the employee to be able to contribute to the ESOP plan with his own savings if he so desires. On a broader base, better tax treatment for dividend reinvestment or an equity incentive extended to taxpayers at large rather than just the employee body would be useful alternatives. I believe all of the practical possibilities for insuring the availability of an adequate supply of capital should be explored. Conceptually, the objectives should be to:

1. Broaden the base of equity ownership while fully protecting the rights of existing shareowners.
2. Build in a "leverage" factor so that the equity created is larger than the tax dollars involved. This means that in general the tax incentive should make it attractive to invest from personal savings rather than a pure "gift" of the entire amount from the government.
3. Provide tax incentives to permit more adequate earnings.
4. Reduce inflation as an absolutely essential precursor to adequate capital formation.

Let me illustrate with a few examples the sort of alternative plans that could achieve the objectives of increased capital formation and broadened stock ownership.

1. Permit the employee the option of taking shares as currently provided under ITC-ESOP, or permit the 1% ITC-ESOP to be used to further reduce the amount which an employee must pay for the shares (perhaps at discount from market) under a tax-qualified Employees Stock Purchase Plan. Employee participation in the Plan should be based on a percent of the employee's salary, but a limit as to the number of shares which each employee could acquire might be required.

An employer could offer payroll deductions and since the employee in this option is contributing his own savings, a loosening of the 7-year holding period would seem in order. Something on the order of 1–2 years should be sufficient. These modifications to the present ITC-ESOP would offer the following benefits:

The employee who can afford no out-of-pocket contribution still receives some stock.

The employee who devotes some of his income to savings is encouraged to direct his dollars toward much needed equity investment.

The base-broadening process is speeded up as the relative importance of employee investment is increased.

The modification provides a multiplier effect, wherein the government generates several dollars of new equity investment for each tax dollar foregone.

2. Another alternative would be Employee Ownership Incentive Plans, based on the principle of tax incentives to employees, made available to all corporations—not just those which are capital intensive—which would significantly improve the flow of new equity capital from employees particularly if the employer were to offer its stock at a discount. The tax incentive could take the form of either a deduction from income or a tax credit, with the choice between them as well as the size of the incentive tailored to meet investment and revenue considerations. As with dividend reinvestment, the employee incentive could be made even more attractive if capital gains treatment was afforded the reduced cost basis of the stock when sold by the employee. The particular advantages of this plan would be:

It is neutral with regard to the capital intensity of the firm.

The stimulus costs the government tax revenue only to the extent that it is successful in bringing in new equity.

3. Capital Formation Proposals

There are a number of proposals which have already been made that are aimed specifically at increasing the availability of capital. Some of these proposals are:

(a) Integration of corporate and individual taxes to eliminate the "double tax" on dividends.

(b) A corporate income tax rate reduction.

(c) Increased authorization ranges under the asset depreciation range system.

(d) The retention of accelerated depreciation.

(e) Further acceleration through the use of shorter asset lives.

(f) Tax changes designed to stimulate individual savings.

I hope that the material presented in these comments has given you a sense of the Bell System's concern about the availability of an adequate supply of capital in this country during the next decade; the reasons why an adequate supply, particularly of equity capital, is important to us; our willingness to investigate all feasible new approaches to encouraging new capital formation; the serious questions raised by our examination of Kelso financing as one of those new approaches; and some suggestions of alternatives to Kelso financing which will tend to satisfy the admirable objective of broadening the base of stock ownership in this country.

Thank you for giving me the opportunity to meet with you today.

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The ITC-ESOP

Pursuant to the Tax Reduction Act of 1975 a taxpayer may elect an additional one percent investment credit for investment in qualified property during the year if an amount equal to the 1% is contributed to an Employee Stock Option Plan. To qualify for this purpose, the ESP must meet the following requirements:

1. The plan must be established in writing and:

(a) Be a stock bonus plan, a combination stock bonus and money purchase pension plan, or a profit-sharing plan;

(b) Be designed to invest primarily in "employer Securities" (described below); and

(c) An election made on or before the due date for filing the corporate income tax return.

2. The "employer securities" must be:

(a) Common stock of the employer or a corporation in control of the employer, with voting and dividend rights at least equivalent to that of the other common stock.

3. The employer must transfer eligible employer securities or cash to the plan in an amount equal to one percent of the qualified investment for the taxable year. Any cash so transferred must be used to purchase eligible employer securities. This transfer must be made on or before the 30th day following the due date.

4. All employer securities transferred to or purchased by the plan must be allocated as of the close of the plan year to each participants account substantially in proportion to his annual compensation, disregarding compensation in excess of $100,000. A participant receives an allocation whether or not he is a participant at the close of the plan year.

5. Each participant must be 100 percent vested in the amounts allocated to his account, but he cannot receive any distribution until at least 84 months from the month of allocation, except in the event of separation from service, death, or disability.

6. Each participant must be entitled to direct the vote of the employer securities allocated to his account.

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The "Kelso Plan"

As proposed by Mr. Louis O. Kelso, the workings of his plan are understood to be as follows:

1. An Employee Stock Ownership Plan (ESOP) is established. The ESOP would function as an employee-owned trust. It would qualify under the IRS regulations as exempt from all federal and most state taxes.

2. A bank lends funds to the ESOP for the purpose of making an equity investment in the company. The ESOP turns the cash from the bank over to the corporation in exchange for new shares issued at market value.

3. The shares are pledged as collateral for the bank loan. The corporation guarantees that the ESOP will have sufficient cash flow to repay the bank loan principal and interest.

4. The corporation makes annual tax-deductible contributions to the ESOP (not to exceed 15 percent of payroll under IRS rules). When the debt is paid off, the employees, through the ESOP, become full beneficial owners of the stock.

5. The corporate dividends paid to the trust are credited toward the loan obligation. After the stock is paid for, dividends paid can be flowed through the trust to the employee, providing him with a second source of income if desired. Allocation of stock is on the basis of salary or wages. The individual employees pay income tax on the stock's cost to the trust when they take actual possession, typically at retirement.

6. Ultimately, Mr. Kelso would envision a broad revision of our Federal tax policy and banking laws to facilitate the functioning of ESOPs. Among the major requirements he foresees are: introduction of low-cost credit through the Federal Reserve, including discount of such loans with a Federal Reserve Bank, the creation of a Federal agency to insure ESOP investments; and the modification of tax policy to eliminate corporate income taxes. In addition, he envisions 100% payout of corporate earnings in the form of dividends. With these changes, Kelso believes a corporation, could flow 100% of its earnings, tax-free, to an ESOP, thereby paying off the loan in three to five years.

Representative LONG. Our next witness is Mr. John J. Terry. Mr. Terry.

STATEMENT OF JOHN J. TERRY, VICE PRESIDENT FOR FINANCIAL PLANNING, UNITED STATES RAILWAY ASSOCIATION, WASHINGTON, D.C.

Mr. TERRY. Thank you, Congressman Long, I, too, will summarize my prepared statement in the interests of time.

Representative LONG. We will also make your prepared statement part of the record.

Mr. TERRY. I am vice president for financial planning of the United States Railway Association. Seated behind me are consultants retained by the association to study the plan. They are Mr. Saul Gellerman, a nationally known specialist in employee motivation, Paul Bagley, vice president of E. F. Hutton & Co., a leading investment banking firm, and John Fisher, vice president of Towers Perrin, Forster & Crosby, recognized consultants on employee compensation.

I am pleased to be able to appear before this distinguished committee today and present to you the thinking of the United States Railway Association in deciding that the use of an employee stock ownership plan would be inappropriate at this time in the instance of ConRail and provide our views concerning the appropriateness of ESOP's for large corporations in general.

I would like to note at the outset that our decision not to utilize an ESOP for ConRail was not a judgment in general on the value of an ESOP. In fact, we feel that employees stock ownership plans may have merit in other instances. Rather, our decision reflects solely the serious problems which we have determined would exist in seeking to implement an ESOP in this instance.

The association staff found six serious problems which mitigate against the use of an ESOP by ConRail, at least until the railroad becomes a financially viable entity.

First, ConRail could not raise the necessary funding through an ESOP under existing rules. Second, ESOP would increase the requirement for Government funding of ConRail. Third, and ESOP would not strengthen ConRail's financial position.

Fourth, ConRail would not derive any tax benefits from the ESOP for the foreseeable future. Fifth, there is little evidence that an ESOP, in the instance of ConRail would improve employee motivation.

Sixth, the issuance of common shares to an ESOP trust could make the Government vulnerable to an expensive settlement in litigation with the creditors.

Now, to go back to the first problem, ConRail could not raise the necessary funding through an ESOP under existing regulations. And, an ESOP would require the issuance of ConRail common shares to the trust. The proceeds of the issuance would finance ConRail. The trust would obtain the funds to purchase the common shares through issuance to the Government of securities with terms and conditions similar to the terms and conditions of the securities described in the United States Railway Association's final system plan for ConRail. The trust would issue these securities to the Government, but ConRail, of course, would be liable for the repayment.

The fundamental problem is that ConRail's need for funds far exceeds the current value of the securities it could issue into the trust. The terms of an ESOP demand that the securities be purchased by the trust at their then fair market value. ConRail needs the Government to provide nearly $700 million in its first year alone. The total value of the ConRail capitalization at the end of the first year will be considerably less than the $700 million needed. During the years after conveyance when Federal funding is required—the first 5 years of ConRail's existence—the fair market value of ConRail common stock available for purchase would be substantially less than the $1.85 billion of new funding needed by ConRail.

Thus, an ESOP would not insure that ConRail would receive financing in the amount required. Moreover, the issuance to the trust at fair market value of large amounts of securities which are senior to the common stock would reduce the value of any junior securities held by the estates. This creates other problems which I will discuss later.

Second, an ESOP would increase ConRail's requirement for government financing. If the requirement to purchase ConRail securities at fair market value were waived. ConRail common stock could be purchased at a stated or artificial value. The annual contributions to the ESOP trust would be required of ConRail. The trust would use the annual contributions to service its financing and to repurchase shares from retiring employees.

Moreover, additional financing may be needed because private sector financing is unavailable. The annual contributions would lower ConRail's net income and consequently inhibit ConRail's ability to obtain private sector financing. Without the Constraints necessarily imposed by an ESOP, ConRail would be able to raise $1.25 million of new private sector financing for revenue equipment. This, in turn, reduces the requirements for Government financing of ConRail.

Furthermore, annual contributions lessens the likelihood of ConRail meeting the results projected for it. Government financing would increase if ConRail were not financially viable and, in the event ConRail required reorganization, the Government might be in a position of having to compensate disillusioned employees for the loss of value.

The use of the ESOP will not strengthen ConRail's financial position. Under the "Final system plan" financing proposal, interest and dividend payments are made in the form of additional securities rather than cash, until ConRail has achieved an adequate level of cash for these purposes, at least. With an ESOP, the burden of annual contributions—principal and interest—from the beginning would seriously jeopardize ConRail's prospects for achieving self-sustainability through a reduction in net income and would probably reduce the value of ConRail's securities.

For the foreseeable future, there would be no tax benefits. The tax advantages of the ESOP method of financing over alternative methods stem primarily from the corporation's right to deduct contributions to the plan from income.

That is, the primary objective from a financial standpoint is the ability to deduct both principal and interest from pretax income. ConRail will be in a position to eleiminate or defer income taxes for at least the 10-year planning horizon, 1975 through 1985, because of other tax shelters available to the railroad. Absent the tax advantage, traditional debt financing would provide an equivalent amount of capital without the higher charges to earnings brought about by the ESOP.

There is little evidence that an ESOP, in the instance of ConRail, would improve employee motivation. Studies prepared for the association showed three reasons why motivation would not be materially enhanced.

One, in such a large corporation as ConRail, employees do not see the impact of the results of their own efforts on net income. Two, an individual's share of the trust accumulation is not expected to reach a value high enough to alter employee behavior. And, three, the existence of large numbers of older employees, in the instance of ConRail, dampens the impact of stock ownership because there are fewer years of employment available to accumulate stock and less meaningful expectations of dividends. We have forecast that no dividends will be paid by ConRail on its common or preferred stock until at least 1986. At the present time, about one-half of the employees of the railroads are age 50 or older.

Finally, under the terms of the Act, the exchange of rail properties owned by the bankrupt estates for ConRail securities and other benefits must be "fair and equitable and in the public interest." ConRail cannot issue securities with a face value equal to the claims of the estates in order to provide the estates with fair and equitable compensation. The securities given the estates must have the prospect of achieving a fair market value equivalent to their face value and must have the prospect of paying a return while held by the estates. Anv ESOP would assign to the employees value in ConRail which the final system plan assigns either to the estates of the predecessor railroads or to the Government. If the estates receive a securities package which is not considered adequate compensation for the properties conveyed, they can bring suit against the United States under the Tucker Act for deficiencies resulting from any constitutional inadequacy of the securities and benefits. Such a suit could make the Government vulnerable to the expensive settlement in the Court of Claims.

Ownership by the estates of the common stock is necessary if the estates are to receive fair and equitable compensation for the rail properties conveyed to ConRail. The common stock represents the right to participate in the future growth of ConRail. A proposal to require that the common stock of ConRail be issued to ESOP trust rather than to the bankrupt estates could adversely affect the Government's position in litigation. The bankrupt estates would be able to argue with considerable force that preventing them from ever receiving the normal benefits of equity ownership in ConRail destroys the character of the final system plan as a reorganization process.

In responding to the question concerning the appropriateness of ESOP's for large corporations, I have submitted with my prepared statement the findings of the three consultants who studied ESOP in general in order to complete their work for the association.

The association considered the implementation of an ESOP only for ConRail and did not study the applicability for ESOP's to other large corporations. Thus, the United States Railway Association does not take a position on this issue. However, in view of the committee's request, the association is making available the views of the consultants. Further details are provided in the letters from the consultants which are attached to the prepared statement. I have brought for the committee's use the full text of the reports of the three consultants. We believe these represent the most comprehensive independent study of ESOP's in existence.

I will not go through the individual comments of the consultants on the applicability of ESOP's to large corporations, but they are here and available to answer your questions if you should have any on that point. Thank you.

Representative LONG. Thank you. Did I understand that you would make the report of your consultants available to the committee?

Mr. TERRY. Yes, sir. We have them here. I believe a number of copies have been delivered.

Representative LONG. If you would, we would be most appreciative and they shall be made a part of the record.

[The prepared statement, with attachments, of Mr. Terry and the report referred to above follow:]

PREPARED STATEMENT OF JOHN J. TERRY

My name is John Terry. I am the Vice President for Financial Planning of the United States Railway Association. Seated with me are representatives of the three independent consulting firms retained by the Association to study the use of an Employee Stock Ownership Plan in ConRail. They are Saul Gellerman, a nationally known specialist in employee motivation, representing his own firm; Paul Bagley, Vice Prenident of E. F. Hutton and Company, a leading investment banking firm; and John Fisher, Vice President of Towers, Perrin, Forster and Crosby, recognized international consultants on employee compensation.

I am pleased to be able to appear before the distinguished members of this Committee today and present to you the thinking of the United States Railway Association in deciding that the use of an Employee Stock Ownership Plan would be inappropriate at this time in the instance of ConRail and provide our views concerning the appropriateness of ESOP's for large corporations in general.

I would like to note at the outset that our decision not to utilize an ESOP for ConRail was not a judgment in general on the value of an ESOP. In fact, we feel that the Employee Stock Ownership Plan has considerable merit in many instances. Rather, our decision reflects solely the serious problems which we have determined would exist in seeking to implement an ESOP in the specific case of ConRail.

I will not review the mechanics of how an ESOP works, but go directly to our findings concerning an ESOP in relation to ConRail.

In the specific case of ConRail, the Associations staff has found six serious problems which mitigate against the use of an ESOP by ConRail at least until the railroad becomes an established and financially viable entity. Discussion of these six areas follows.

1. An ESOP would require issuance of ConRail common shares to a trust. The proceeds of the issuance would finance ConRail. The trust would obtain the funds to purchase the common shares through issuance to the government of securities with terms and conditions similar to the terms and conditions of the securities described in the Final System Plan. The trust would issue these securities to the government, but ConRail, of course, would be liable for repayment.

The fundamental problem is that ConRail's need for funds far exceeds the current value of the securities it could issue into the trust. The terms of an ESOP demand that securities be purchased by the trust at their then fair market value. ConRail needs the government to supply nearly $700 million in the first year alone. The total value of the ConRail capitalization at the end of the first year will be considerably less than the $700 million needed. During the years after conveyance when federal funding is required, the fair market value of ConRail common stock available for purchase would be substantially less than the $1.85 billion needed by ConRail. Thus, an ESOP would not assure that ConRail would receive financing in the amount that it requires.

Moreover, issuance to the trust at fair market value of large amounts of securities which are senior to the common stock would greatly reduce the value of any junior securities held by the estates.

2. An ESOP would increase ConRail's requirement for government financing. If the requirement to purchase ConRail securities at fair market value were waived, ConRail common stock could be purchased at a stated or artificial value. However, annual contributions to the ESOP trust would be required of ConRail. The trust would use the annual contributions to service its financing and to repurchase ConRail shares from retiring employees. While ConRails need for government financing would be significantly increased because of these necessary annual contributions, the governments net cash outflow would not increase as much since the trust would use the contributions primarily to meet its own principal and interest payments to the government.

Moreover, additional government financing may be needed because private sector financing is unavailable. The annual contributions lower ConRails net income and consequently inhibit ConRails ability to obtain private sector equipment financing.

Furthermore, the annual contributions may lessen the likelihood of ConRail meeting the results projected for it. The government financing would, of course, increase if ConRail were not to become financially viable. And, in the event that ConRail required reorganization, the government might have to compensate disillusioned employees for their loss of value in ConRail securities.

3. Use of an ESOP will not strengthen ConRail's financial position. Under the Final System Plan financing proposal, interest and dividend payments are made in the form of additional securities until ConRail has achieved an adequate level of cash available for these purposes. Redemption payments are likewise delayed. But, with ESOP, the burden of annual contributions (principal and interest) from the beginning would seriously jeopardize ConRail's prospects for achieving financial self-sustainability through a reduction in the corporation's net income, and probably would reduce the value of ConRail's securities.

4. For the foreseeable future, an ESOP would not provide ConRail with any tax benefits. The tax advantages of the ESOP method of financing over alternative methods stem primarily from the corporation's right to deduct contributions to the plan from income. That is, the primary incentive from a financial standpoint for adoption of an ESOP is the ability to deduct both principal and interest, of the trust's financing, from pre-tax income. ConRail will be in a position to eliminate or defer income taxes for at least the 10-year planning horizon (1975–1985). Absent the tax advantage, traditional debt financing would provide an equivalent amount of capital without the concomitant dilution and higher charges to earnings brought about by the ESOP.

5. There was little evidence that an ESOP, in the instance of ConRail, would improve employee motivation. Studies prepared for the Association showed three reasons why motivation would not be materially enhanced: a) in such a large organization as ConRail, employees do not see the impact of the results of their own efforts on net income; b) an individual's share of the trust accumulation is not expected to reach a value high enough to alter employee behavior; and c) the existence of large numbers of older employees, in the instance of ConRail, dampens the potential motivational impact of stock ownership because there are fewer years to accumulate stock and less meaningful expectations of dividends.

6. Under the terms of the Act, the exchange of rail properties owned by the bankrupt estates for ConRail securities and other benefits must be "fair and equitable and in the public interest." ConRail cannot merely issue securities with a face value equal to the claims of the estates in order to provide the estates with fair and equitable compensation. The securities given the estates must have the prospect of achieving a fair market value equivalent to their face value and must have the prospect of paying a return while held by the estates. Any ESOP would assign to the employees value in ConRail which the Final System Plan assigns to either the estates of the predecessor railroads or the government or both. If the estates receive a securities package which is not considered adequate compensation for properties conveyed to ConRail, they can bring suit against the United States under the Tucker Act for deficiencies resulting from any constitutional inadequacy of the securities and benefits. Such a suit could make the government vulnerable to an expensive settlement in the Court of Claims.

Ownership by the estates of the common stock is necessary if the estates are to receive fair and equitable compensation for the rail properties conveyed to ConRail. The common stock represents the right to participate in the future growth of ConRail. A proposal to require that the common stock of ConRail be issued to an ESOP trust rather than to the bankrupt estates could adversely affect the government's position in litigation. The bankrupt estates would be able to argue with considerable force that preventing them from ever receiving the normal benefits of the equity ownership in ConRail destroys the character of the Final System Plan as a reorganization process.

* * * * * * *

In responding to the question concerning the appropriateness of ESOP's for large corporations, I would like to pass along the findings of the three outside consultants who had to study ESOP's in general in order to complete their work for the Association. The Association considered the implementation of an ESOP only for ConRail, and did not study the applicability of ESOP's to other large corporations. Thus, the United States Railway Association does not take a position on this issue. However, in view of the Committee's request, the Association is making available the views of our consultants, which I will now discuss in summary form. Further details are provided in the letters from the consultants attached to this presentation.

May I first present, in summary, the views of Dr. Gellerman on the motivational implications of ESOP's in large corporations:

ESOP's are unlikely to produce significant motivational effects in companies with more than a few hundred employees, with the principal exception being that employee turnover might be reduced, and there is also some evidence that such plans may enable nonunionized companies to resist unionization. The principal reason for making this assertion is the difficulty most employees of large companies have in seeing any direct or significant connection between their work and their compensation, on the one hand, and corporate profits, on the other hand.

Motivational improvements that are relevant to productivity are best stimulated by non-financial methods, such as enlightened supervision and job enrichment. To the extent that financial methods of motivation can stimulate productivity, perhaps legislative attention could more profitably be given to stimulating employee stock *purchase* plans, rather than ESOP's.

ESOP's can be motivationally effective under certain circumstances, especially in smaller companies that are already profitable and where there are relatively few older employees. It also would be desirable that current pay levels in such companies not exceed industry or regional averages. A great many companies, encompassing a great many employees, fall into this category.

If it were to become national policy to encourage ESOP's in large companies, it would be desirable from a motivational viewpoint to revise the laws so that companies undergoing such a change of ownership would simultaneously be broken into a group of loosely-linked small companies, each having their own stock and their own profit-and-loss statement.

Apart from ESOP's, legislative consideration could also be given to granting more favorable tax treatment to that part of employee income which might be directly tied to the reduction of employee-influenced costs.

Mr. Bagley and E. F. Hutton & Company examined the ESOP from the standpoint of corporate financing. Mr. Bagley found that ESOP's for large, publicly-held business concerns would have the following adverse consequences:

1. *Dilution.*—Earnings per share and book value per share are reduced by the ESOP shares sold.
2. *Reduced Earnings.*—The principal amortization becomes a charge against earnings.
3. *Leverage.*—The ESOP loan must be reflected on the balance sheet if guaranteed by the employer.
4. *Cash Flow.*—Positive cash flow effects results in early years; however, if the corporation plans to redeem ESOP issued shares, this could result in substantial cash requirements as the plan vests.
5. *Reduced Market Liquidity.*—If shares of a public corporation are purchased on the open market or through tender offers, then the liquidity of the trading markets can be substantially impaired.

However, Mr. Bagley wishes to note that every financial transaction must be analyzed under the specific circumstances involved, and ESOP's can present significant financial benefits to certain companies and their large shareholders under the proper conditions.

Finally, Mr. Fisher of Towers, Perrin, Forster & Crosby examined ESOP in relation to the total employee compensation package. His findings indicated that, since an ESOP represents a substantial employee benefit, it must be viewed in conjunction with other benefits and overall pay levels. If a corporation is already highly competitive in this regard (and most major corporations are), an ESOP would be logical only if accompanied by reductions in pay or in other benefits. Conversely, a company which has fallen behind in overall compensation could utilize an ESOP to restore total compensation to higher levels. Here, again, the presence of a labor union would be an important factor since establishment of an ESOP would impact the overall bargaining situation. In this event, improvements in personnel management techniques might represent a better approach than the addition of an ESOP since financial incentives would already be competitive.

Mr. Fisher has noted that the corporation most likely to benefit from an ESOP would be one with the following characteristics:

Need for additional capital.
Good earnings record.
Need to improve cash flow.
Good shareholder relations.
Young employee group.
No labor union present.
Good employee communications.
Below average total compensation.

One of the primary objectives in an Employee Stock Ownership Plan is to encourage employee ownership of company stock. It should be emphasized in this regard that there are a number of alternatives to ESOP which accomplish the same objective and have already gained wide acceptance in the business community. Among these are profit sharing plans, thirft and savings plans, and stock purchase plans. All of these are usually broad-based plans covering a wide range of employees. If the Congress wishes to encourage employee stock ownership in the private sector, broad-based legislation might well be more effective than legislation directed solely at ESOP's. In this regard, such measures as liberalized employer contribution limits, more generous tax treatment of plan distributions and special dividend exclusion allowances would all have the desired effect. They would serve to encourage employee stock ownership in the private sector without seeming to dictate which form is best suited to any given corporation.

Attachments.

SAUL GELLERMAN/CONSULTING, INC.,
Ho-Ho-Kus, N.J., November 25, 1975.

Mr. W. J. ANDERSON,
Manager, Securities Financing,
United States Railway Association,
Washington, D.C.

DEAR ANDY: This is in reply to your letter of November 24th.

1. I enclose a brief resume of my professional career and accomplishments. The most pertinent aspects, as far as my qualifications to investigate and recommend on the uses of ESOPs for ConRail are concerned, are:

The McKinsey Foundation Award given to my book on motivation. It has become a standard work on the subject in many corporate libraries and is widely used as a textbook in graduate schools of business administration.

Diplomate status in industrial and organizational psychology granted by the American Board of Professional Psychology. This is the highest level of professional recognition granted by the American Psychological Association. It is based on an examination of professional accomplishments at the post-doctoral level.

I have been retained as a consultant on motivational matters by many organizations, including (private sector) IBM, Eastman Kodak, General Foods, New Jersey Bell Telephone; and (public sector) Internal Revenue Service, Department of Agriculture, Department of the Army.

The only "public relations" material I have consists of advertisements for some of my films and tapes. These are enclosed.

2. My recommendation against the adoption of an ESOP for ConRail was based primarily on these considerations:

There is no evidence to support the motivational claims that have been made for ESOPs. Neither do those claims stand up under rigorous analysis.

Foreseeable "second incomes" under an ESOP in ConRail are likely to be inadequate to stimulate significant motivational improvements for at least ten years.

The basic motivational premise for applying ESOPs in ConRail—specifically, that ConRail employees will consider it to their advantage to play in a game in which both the payoff and the losses may be very high, but where the probability of either outcome is indeterminate—is highly unlikely, to say the least.

The specific conditions that obtain in ConRail—very large, unprofitable companies with many older employees and a long history of difficult relationships between management and unions—are inappropriate for ESOPs and would probably militate against their effectiveness.

3. As you know, my views on ESOPs are restricted to their motivational implications. With that in mind, my views on the applicability of ESOPs to other large business concerns are as follows:

ESOPs are unlikely to produce significant motivational effects in companies with more than a few hundred employees. (The principal exception would probably be with regard to employee turnover, which might be reduced. There is also some evidence that such plans can aid companies that are not unionized to resist unionization.)

The principal reason for this assertion is the difficulty that most employees of large companies have in seeing any direct or significant connection between their work or their compensation, on the one hand, and corporate profits, on the other hand.

Motivational improvements that are relevant to productivity are best stimulated by non-financial methods, such as enlightened supervision and job enrichment. To the extent that financial methods of motivation can stimulate productivity, I would suggest that legislative attention could more profitably be given to stimulating employee stock purchase plans than to ESOPs.

ESOPs can be motivationally effective under certain circumstances, especially in smaller companies that are already profitable and where are relatively few older employees. It would also be desirable that current pay levels in such companies not exceed industry or regional averages. Please note that a great many companies, encompassing a great many employees, fit this definition.

If it were to become national policy to encourage ESOPs in large companies, it would be desirable from a motivational viewpoint to so revise the laws that companies undergoing such a change of ownership would simultaneously be broken into a group of loosely-linked small companies, each with their own stock and their own profit-and-loss statement.

Apart from ESOPs, legislative consideration should also be given to granting more favorable tax treatment to that part of employee income that might be directly tied to the reduction of employee-influenced costs.

Cordially,

SAUL W. GELLERMAN.

E. F. HUTTON & COMPANY INC.,
New York, N.Y., December 3, 1975.

Mr. W. J. ANDERSON,
Manager, Securities Financing,
U.S. Railway Association,
Washington, D.C.

DEAR MR. ANDERSON: In response to your request of November 24, I have enclosed a brief resume of myself. As you know, I was one of a group here at E. F. Hutton that worked on our evaluation.

I have also drafted responses to the questions posed, although this is somewhat duplicative of the excellent summary contained on page 116 of Volume I of the Final System Plan.

I look forward to seeing you and Mr. Terry on the eleventh.

Very Truly Yours,

PAUL BAGLEY,
Vice President.

Enclosures.

Question 1.

What were the major reasons why the U.S.R.A. recommended against the adoption of an E.S.O.P. for ConRail?

Addressing ourselves solely to the financial impact of an E.S.O.P. for ConRail we found that this financing technique was not appropriate under the specific circumstances of the ConRail situation. From a financial standpoint the use of an E.S.O.P. must be objectively determined just as one would evaluate other financial transactions such as the use of convertible debentures or an initial public offering.

The principal financial benefit of leveraged E.S.O.P.s to private taxpaying corporations arises from the tax deductibility of the principal repayments used to purchase employer stock. Since ConRail's projections did not show ConRail to be a taxpaying entity for at least 10 years, this benefit was lost. We were not engaged to critically analyze the projections and thus are not in a position to answer assertions that the E.S.O.P. would make ConRail profitable sooner.

As a capital raising vehicle the E.S.O.P. was also found to be inappropriate under the ConRail circumstances. In a typical private leveraged E.S.O.P. the employer guarantees the loan made to purchase employer stock. Since ConRail must use government guaranteed financing in its initial phase there is no increase in capital available through an E.S.O.P. The money raised in an E.S.O.P. is not "equity" since ConRail (the Federal Government) would have an equal, offsetting, debt or guarantee obligation.

From an accounting standpoint an E.S.O.P. has very significant drawbacks for a corporation that is publicly held or contemplates an initial public offering. The contributions to the E.S.O.P. must be recorded as a charge to earnings, thus the principal amortization reduces reported earnings. At the same time the company has the dilutive effects of having the shares outstanding again reducing earnings per share and the value of the shares held by others. The debt obligation must be carried on the balance sheet giving a leveraged appearance to the balance sheet. For ConRail this would mean that it would achieve profitable operations at a later date, that the value of any shares gives to other creditors was reduced, and that the balance sheet would reflect the E.S.O.P. debt.

A final disadvantage is that the employer stock must be purchased at "fair market value." Not only does this create immėdiate problems vis a vis the issuance of stock to present creditors, but subsequent annual valuations are required. Since the existence of the E.S.O.P. itself reduces the value subsequent valuations can well be lower than the original, an obvious problem.

Question 2.

Why might not ESOPs be appropriate for other large business concerns?

Assuming a public company these would be in brief:

1. Dilution. Earnings per share and book value per share are reduced by the ESOP shares sold.

2. Reduced Earnings. The principal amortization becomes a charge against earnings.

3. Leverage. The ESOP loan must be reflected on the balance sheet if guaranteed by the employer.

4. Cash Flow. While positive cash flow effects result in early years, if the Corporation plans to redeem ESOP issued shares this could result in substantial cash requirements as the plan vests.

5. Reduced Market Liquidity. If shares of a public corporation are purchased on the open market or through tender offers then the liquidity of the trading markets can be substantially impaired.

Every financial transaction must be analyzed under the specific circumstances involved. ESOPs can present significant potential financial benefits to certain companies and their large shareholders under the proper conditions.

TOWERS, PERRIN, FORSTER & CROSBY, INC.,
Washington, D.C., December 3, 1975.

Mr. W. J. ANDERSON,
Manager of Securities Financing,
U.S. Railway Association,
Washington, D.C.

DEAR ANDY: Enclosed is our draft response to the second of the two questions posed by Senator Humphrey in his November 14 letter to John Terry. We have not drafted a response to the first question because we believe that it has been answered fully both in the final System Plan and in John Terry's initial draft response.

If you would like to discuss our response further, please let me know.

Sincerely,

JOHN K. DIRLAM,
Consultant.

Enclosure.

USRA Testimony Before Joint Economic Committee

RESPONSE TO QUESTION NO. 2

In determining whether an ESOP would be advantageous to a particular corporation, the concept must be evaluated on the basis of its merits in each of the following three areas:

(1) Corporate Financing.
(2) Employee Motivation.
(3) Relationship to Total Compensation.

This breakdown is important because there are various alternatives to an ESOP in terms of both corporate financing and employee motivation and because an ESOP represents a substantial employee benefit which must be viewed as part of the overall compensation provided by the corporation. If an ESOP does not provide advantages in each of these three areas, a corporation should explore alternative solutions.

The following are among the primary criteria which may indicate the potential application of an ESOP in each of the three major areas noted above.

(1) *Corporate Financing.*—To utilize an ESOP for capital formation purposes, a corporation should first be in a tax-paying status in order to take advantage of the tax deductibility of its contributions to the plan. The corporation must also be willing to trade a reduction in reportable earnings and some dilution of shareholders' equity for an improvement in its cash flow. The prospect of dilution also requires at least reasonably good shareholder relations. If cash flow is not a primary concern and/or if earnings are low, a corporation would usually be better advised to tilize one of the more traditional approaches to capital formation (i.e., debt or equity financing). If a regular equity issue is impossible under the circumstances, an ESOP may have the added advantage of creating a market for the corporation's equity which would not otherwise exist. This would generally be less applicable, however, to a major corporation.

(2) *Employee Motivation.*—The corporation most likely to achieve motivational benefits from an ESOP is one in which there is a preponderance of younger, non-union employees. Older employees tend to be less enthusiastic about stock ownership because they have fewer years in which to accumulate meaningful accounts and to receive dividends. The presence of a union may also be a negative factor, since unions have traditionally been unenthusiastic about stock ownership plans in general. ESOP's are also most effective in situations where employees perceive a direct relationship between their own efforts and the success of the corporation. This would most often be the case at a smaller corporation or one in which different components were semi-autonomous. An effective employee relations program is also an important factor. Where these conditions do not exist, other forms of compensation or improved personnel management techniques may have a greater motivational impact.

(3) *Relationship to Total Compensation.*—Since an ESOP represents a substantial employee benefit, it must be viewed in conjunction with other benefits and overall pay levels. If a corporation is already highly competitive in this regard (and most major corporations are) an ESOP would be logical only if accompanied by reductions in pay or in other benefits. Conversely, a company which has fallen behind in overall compensation could utilize an ESOP to restore total compensation to higher levels. Here again, the presence of a labor union would be an important factor, since establishment of an ESOP would impact on the overall bargaining situation. In this event, improvements in personnel management techniques might represent a better approach than the addition of an ESOP, since financial incentives would already be competitive.

In conclusion, then, the corporation most likely to benefit from an ESOP would be one with the following characteristics:

(1) Need for additional capital.
(2) Good earnings record.
(3) Need to improve cash flow.
(4) Good shareholder relations.
(5) Young employee group.
(6) No labor union present.
(7) Good employee communications.
(8) Below average total compensation.

Unless all or most of these conditions apply, a corporation would generally be better advised to explore the alternative solutions in each of the three areas discussed above.

One of the primary objectives of an ESOP is to encourage employee ownership of company stock. It should be emphasized in this regard that there are a number of alternatives to ESOP which accomplish the same objective and have already gained wide acceptance in the business community. Among these are profit sharing plans, thrift and savings plans, and stock purchase plans. All of these are usually broad-based plans covering a wide range of employees. If the Congress wishes to encourage employee stock ownership in the private sector, broad-based legislation might well be more effective than legislation directed solely at ESOP's. In this regard, such measures as liberalized employer contribution limits, more generous tax treatment of plan distributions and special dividend exclusion allowances would all have the desired effect. They would serve to encourage employee stock ownership in the private sector without seeming to dictate which form is best suited to any given corporation.

UNITED STATES RAILWAY ASSOCIATION

An Evaluation of The Employee Stock Ownership Plan As Applied to ConRail

May 12, 1975

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Section I

BACKGROUND

INTRODUCTION

The Regional Rail Reorganization Act of 1973 created the United States Railway Association (USRA) as the agency responsible for developing a plan for the reorganization of the six bankrupt railroads initially covered by the Act. Among the areas which the plan for reorganization must specifically address are motivation of railroad employees and capitalization of the new Consolidated Rail Corporation (ConRail). In this regard, the Act states that the Final System Plan shall outline the manner in which an Employee Stock Ownership Plan may "to the extent practicable" be utilized for the dual purpose of capitalization and employee motivation. USRA must determine whether such an approach is feasible and desirable under the circumstances.

To assist USRA in addressing this question, three outside consultants were retained. E. F. Hutton was retained to address the specific questions related to corporate finance; Dr. Saul Gellerman was retained to address the broad questions relating to employee motivation; and TPF&C was retained to address the associated questions relating to employee benefits and to serve as the project coordinator.

OBJECTIVES AND APPROACH

The overall objective of the work of the three consultants was to evaluate the Employee Stock Ownership Plan as applied to ConRail. In this context, it was necessary:

- To understand other techniques available for meeting corporate financing and employee motivation needs,
- To compare these alternatives with ESOP as they would apply to ConRail, and
- To suggest alternative courses of action if the ESOP technique did not appear either feasible or desirable.

Each consulting organization conducted separate examinations of its assigned part of the overall study. Contact was maintained to assure sharing of basic background information and adherence to the tight timetable.

On April 23 a conference was held to discuss the separate conclusions and recommendations of each of the three consultants. Based on this conference, on the separate studies conducted, and on our own research, TPF&C has prepared this final report. E. F. Hutton and Dr. Gellerman have prepared their own separate reports. The full E. F. Hutton report appears in the Appendix to this study, along with the executive summary of the Gellerman report. A copy of the full Gellerman report is available at USRA.

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All three consulting organizations will be present at the USRA Board of Directors' meeting on May 21 to answer any questions with respect to the conclusions and recommendations contained in this report.

DEFINITION OF ESOP

It is important at the outset to define an Employee Stock Ownership Plan, as a proper understanding of its operation is critical to an understanding of our conclusions and recommendations. The Regional Rail Reorganization Act of 1973 includes the following definition (Section 102(5)):

> "'employee stock ownership plan' means a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under section 401(a) of the Internal Revenue Code of 1954 (26 U.S.C. 401(a)) in connection with the financing of corporate improvements, transfers in the ownership of corporate assets, and other capital requirements of a corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees;"

TPF&C defines the ESOP as an arrangement to place employer stock in the hands of employees, while at the same time providing the corporation with a source of investment capital. These goals are accomplished at the outset by the establishment of an employee stock bonus and/or money purchase pension plan "qualified" in accordance with Sections 401(a) and 501(a) of the Internal Revenue Code. Under the terms of the plan, the employer agrees to make annual contributions (according to a predetermined formula) for the express purpose of transferring ownership of company stock to eligible employees. The contributions for this purpose represent a tax deduction to the corporation and are not taxable to employees until actually distributed from the plan in the form of employer stock. All income and appreciation are also tax-sheltered until the time of distribution.

The corporate financing objective is accomplished through a loan negotiated by the trust with an appropriate lending institution. The trust applies the loan to the purchase of employer stock and pledges the stock as collateral for the loan. This places capital in the hands of the employer, who then amortizes the loan (through the trust) with his annual contributions to the plan. As the loan is retired, an amount of stock equal to each year's payment of principal is allocated to the accounts of all eligible employees. A special amortization schedule is adopted to avoid the usual imbalance between debt service and principal payments in the early years.

As an initial phase of this study, TPF&C prepared a Technical Summary which was presented to representatives of USRA on February 24, 1975. The Summary contains greater detail with respect to the technical aspects of an ESOP and is included in the Appendix to this report.

PREVALENCE OF ESOP's

Although the ESOP has been legally possible for over 30 years, it has only recently attracted attention, largely through the efforts of Louis J. Kelso, a San Francisco attorney. Most ESOP's have therefore been in existence for less than five years, and many of them are in California.

Because of the relative newness of this type of program and the way the Internal Revenue Service normally classifies the different types of "qualified" plans, it is difficult to get an accurate picture of exactly how many ESOP's are in existence today. There appear to be a maximum of 500, while 200 is probably a more reliable estimate. Exhibit I (in the Appendix) lists the names of companies with ESOP's which came to light in the course of this study. We understand that the Internal Revenue Service is currently reviewing its files in order to develop a more comprehensive list of such companies.

Generally speaking, the companies which have adopted ESOP's are very small in comparison to ConRail. The principal reasons for adoption of these plans have been capital needs, inability to fund conventional pension plans, and estate planning for the original shareholders.

Certain basic tests should be met before a corporation considers the adoption of an ESOP. The most important of these are the following:

- The company should have an eligible payroll of at least $500,000 and be in the maximum corporate income tax bracket.
- The company should have a good credit rating.

- The prospects for future earnings should be well above average.
- The company should be fairly closely held, whether publicly or privately owned.
- There should be a real desire to place substantial ownership in the hands of employees.

These criteria (explained in the Technical Summary) substantially limit the number of corporations to which an ESOP might otherwise apply.

OBJECTIVES OF ESOP FOR CONRAIL

The ESOP technique is referred to in three separate sections of the Regional Rail Reorganization Act of 1973. For convenience, these statements are shown in Exhibit II. The definition of ESOP in Section 102(5) of the Act outlines two primary objectives. The first is to provide a source of corporate financing for ConRail. The second is to create substantial employee ownership in the new corporation.

Furthermore, Section 205(e)(3) of the Act specifically lists the following items that must be considered when evaluating an ESOP as a technique for meeting the capitalization requirements of ConRail:

- Relative cost savings compared to conventional methods of corporate finance.
- Labor cost savings.

- Potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management.
- The projected employee dividend incomes.
- The impact on the quality of services and prices to railway users.
- The promotion of objectives of the Act of creating a financially self-sustaining railway system in the region.

The above goals have been a major consideration in the course of this study.

Section II

EVALUATION OF EMPLOYEE STOCK OWNERSHIP PLAN

INTRODUCTION

In this Section we have attempted to evaluate the ESOP on the basis of its application in each of four basic areas:

1) Corporate Financing

2) Equity Ownership

3) Employee Motivation

4) Relationship to Total Compensation

It is important to note at the outset that the ESOP must be evaluated on its own merits in each separate area in order to obtain a good overall picture. Within each of these areas we have first examined how the ESOP operates. We have then examined alternative approaches, where appropriate, and compared their advantages and disadvantages with those of the ESOP, with special emphasis on the actual circumstances which exist at the bankrupt railroads. We have thus not limited the scope of our inquiry to the pros and cons of the ESOP itself.

A. ESOP AS A VEHICLE FOR CORPORATE FINANCING

The information presented in this Section draws heavily on the research done by E. F. Hutton in connection with their report (included in the Appendix).

HOW ESOP OPERATES

From the corporate financing standpoint, the primary advantage of an ESOP, and the one most often cited by proponents, is that the corporation is able to repay both interest and principal on the loan to the trust with pre-tax dollars. This differs from traditional debt financing, in which only the interest is deductible. Another primary advantage of the ESOP is that it provides a "captive market" for the sale of company securities. This may be particularly important at a time like the present when conditions in the equity securities market are such that only major corporations can sell their securities through the traditional underwriting channels. Under these circumstances an ESOP may be the only available means of making an equity issue for a smaller or less attractive corporation.

Two special situations in which an ESOP can be useful are where large shareholders desire liquidity and where a corporation wishes to "go private". In both these cases, the shares purchased by the ESOP are previously issued shares. While this approach has thus far rarely been used for "going private", estate planning for large shareholders appears to have been a primary reason for the adoption of many ESOP's.

POSSIBLE APPLICATION TO CONRAIL

The tax status of any corporation considering an ESOP is of paramount importance. Concerning the probable situation at ConRail, the Preliminary System Plan projects no earnings before 1978 and rather uncertain earnings through 1985. Moreover, because of increased depreciation allowances, it appears unlikely that ConRail will be in a tax-paying status at any time prior to 1985. For this reason, whatever tax advantages an ESOP provides have no initial application. This undermines one of the primary arguments of ESOP proponents.

Another special consideration at ConRail is the existence of the creditors of the bankrupt railroads. The Regional Rail Reorganization Act of 1973 provides that these creditors are to be compensated for their interest in the bankrupt railroads through the issuance of ConRail securities. Not only will the creditors have first claim on ConRail securities, but more importantly, they are also entitled under the terms of the Tucker Act to file suit if they feel that they have not been duly compensated. This is an important consideration because any stock allocated to employees under an ESOP would be allocated at the same "fair market value" as that established for the creditors. If such a value were later lowered through litigation, an adjustment would have to be made in the allocation formula under the ESOP to avoid distribution of overvalued stock. This could result in the loss of the ESOP's "qualified" status in the eyes of the IRS, since there would be some question as to whether the plan had operated for the "exclusive benefit" of employees, as the IRS requires.

Another problem with the existing creditors may be the dilution of their equity inherent in the establishment of an ESOP. While the funds raised through the ESOP can theoretically be invested in such a way as to ensure the same earnings per share, there is a special form of dilution which can occur under an ESOP. Since the market value of the stock under an ESOP is established at the time the trust is created and is allocated in the future at that same value, any increase in the value of ConRail stock will result in an immediate gain to participants since stock will be allocated to their accounts on the basis of the original (lower) value. This will be dilutionary to other shareholders and could result in a challenge to the adoption of an ESOP.

Another special factor present at ConRail is the Federal Government's guarantee of ConRail debt. The Regional Rail Reorganization Act provides up to one billion dollars of Federal backing for ConRail debt securities.

This was considered essential in view of the recent inability of many railroads to obtain capital through the traditional money markets. Equipment obligations have become the primary source of railroad capital. The government guarantees are significant because under an ESOP the corporation is required to co-sign the loan with the trust. Because of the uncertain earnings position of ConRail, it is unlikely that any lending institution will underwrite a ConRail ESOP without government guarantees. While it is possible that the Congress would be willing to provide such guarantees, there is little difference between the ESOP and debt financing with regard to the necessity of Federal backing. A related concern is that if Federal guarantees are provided for a ConRail ESOP, and if ConRail stock appreciates substantially in the future, participants in the plan will have reaped a benefit subsidized in effect by government guarantees. Questions may well be raised as to the propriety of this use of Federal funds.

One final concern in this area is that the IRS has traditionally been reluctant to approve an ESOP if the corporation is unable to raise funds in the traditional money markets. From the IRS' standpoint, this inability raises a further question as to whether such a plan is indeed being established for the "exclusive benefit" of plan participants. While IRS objections could be overcome by legislation, it is nonetheless important to note that ConRail may not meet the usual criteria for "qualification".

A further problem associated with an ESOP at ConRail involves the timing of a public issue of ConRail stock. Under any stock bonus plan, like that under an ESOP, all distributions to employees must be in the form of company stock. While the trust generally has a "right of first refusal" to repurchase the stock from the employee, the employee cannot be required to sell the stock as a condition of participation. Section 12(g) of the Securities and Exchange Act of 1934 provides that a company will be considered to have made a public issue once it has more than 500 shareholders. While this problem may be avoided for a while with respect to the creditors, as soon as 500 ConRail employees received distributions from the ESOP, a public issue would be deemed to have occurred. This early creation of a public market might be undesirable from ConRail's point of view if it occurred prior to the establishment of a reasonable earnings record. It would also be undesirable if it adversely affected the valuation of ConRail stock for the purpose of repayment of the creditors. This problem is not peculiar to the ESOP, however, and would result from any arrangement which placed ConRail stock in the hands of employees.

ANALYSIS OF ALTERNATIVES

There is some disagreement in the financial community over whether an ESOP should properly be regarded as an equity or debt issue. The ESOP is in essence a hybrid of both debt and equity financing. While equity securities are sold to the trust under an ESOP, this sale does not provide the advantages of traditional equity financing because the corporation at the same time incurs fixed charge obligations equal to those it would have had under traditional debt financing. The ESOP differs from traditional debt financing in that both the interest and the principal on the loan are repayable through the trust with pre-tax dollars. Since the corporation must always co-sign the loan, in the event of a default by the trust the lending institution would have a claim on the corporation.

The ESOP differs from traditional equity financing primarily in that the corporation does not have unrestricted use of the capital raised because it must make annual contributions to the trust.

Exhibit III illustrates the difference between ESOP financing, debt financing, and equity financing with regard to corporate income, cash flow, capitalization and dilution. The Exhibit assumes the same pre-tax return on the investment of the proceeds from each of the three methods of financing. The terms of the loan under both the ESOP and the debt financing are also identical. Thus, the differences which appear are strictly a function of the variables inherent in each of the three financing alternatives.

With regard to the effect on income, the most important point is that under an ESOP the entire contribution to the trust is a charge to pre-tax earnings, while under traditional debt financing only the interest is similarly charged. Thus the ESOP results in lower net income to the corporation than debt financing, but also results in lower payment of taxes. Under equity financing, there is no reduction in pre-tax income since no loan is involved. Both income and taxes are therefore higher under the equity financing approach.

The ESOP's impact on income may be especially important to ConRail in light of the limited earnings projections through 1985. Estimated earnings for ConRail in 1985 are shown as $381,736,000 in the Preliminary System Plan. If an ESOP were implemented at ConRail with annual contributions equal to the maximum 15% of payroll allowed under a stock bonus plan, this would result in a charge to earnings of $210,000,000 (based on current payroll of approximately $1.4 billion). Assuming no changes in ConRail payroll, this amount would be sufficient to prevent ConRail from attaining a profit position until 1981. This clearly indicates that ESOP is by no means a "no cost" item to ConRail, as some proponents have suggested.

Concerning the cash flow effect of the three alternate forms of financing, Exhibit III demonstrates that the ESOP has advantages over traditional debt financing in the area of cash flow before dividends. However, if dividends are payable on the newly issued stock under the ESOP, it is possible that cash flow after payment of dividends will be higher with traditional debt financing since the additional dividend burden is not present. Under equity financing cash flow both before and after payment of dividends is higher than under either ESOP or traditional debt financing. The primary reason for this is that there are no financing costs associated with the loan. The importance of the dividend payments on cash flow has often been understated by proponents of the ESOP who focus on the cash flow situation before dividends and underestimate the effect of the newly issued stock. This would be a legitimate approach only in a situation where no dividends were payable, which is inconsistent with the "second income" concept.

Exhibit III shows the effects of capitalization under an ESOP as an additional debt obligation to the corporation equal to the amount of the loan rather than an increase in the equity value. In this respect the ESOP is treated exactly like traditional debt financing and just the opposite of equity financing. To include the loan proceeds in the equity section of the balance sheet would ignore the fixed obligation of the corporation to repay the loan through its annual contributions. It should also be noted that because the ESOP is treated essentially like debt financing in this regard, the corporation's borrowing capacity is further limited. Under traditional equity financing on the other hand, existing borrowing capacity probably would be increased by the issue of new stock.

The dilution of existing shareholders' equity under an ESOP has already been discussed above. While some dilution derives from allocation of shares to participants in an ESOP at less than current market value, there is also another potential for dilution inherent in the ESOP. Under traditional equity financing there is no dilution if the return on the capital received from the equity issue maintains earnings per share at their previous level. This is also true under an ESOP. It should be noted, however, that the rate of return on the capital raised through the ESOP would have to be proportionately higher than through a traditional equity issue because of the increased charges to earnings caused by contributions to the trust.

SUMMARY

In conclusion, there does not appear to be any financial advantage to ConRail in the establishment of an ESOP at this time. No enhancement of capital formation would result because ConRail is unlikely to pay taxes prior to 1985. Moreover, because of ConRail's projected earnings position through 1985, the additional charges to earnings imposed by an

ESOP might well postpone attainment of profitability. Even after ConRail becomes a tax-paying entity, the use of an ESOP would be questionable. The involvement of the creditors of the bankrupt railroads and the possibility of litigation over the valuation of ConRail stock add additional uncertainties to the establishment of an ESOP. The dilutionary impact could also be quite important in this regard. Finally, an ESOP might also have the effect of creating a public market for ConRail stock prior to the time that ConRail might otherwise wish to go public.

It must also be emphasized that because ConRail will be unable to raise capital in the traditional money markets until an earnings record has been established, any form of corporate financing (other than equipment obligations) will have to be backed by the Federal Government for the foreseeable future.

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B. ESOP AS A TECHNIQUE FOR EMPLOYEE STOCK OWNERSHIP

HOW ESOP OPERATES

As discussed previously, a primary objective of an ESOP is to place employer stock in the hands of employees. The goal is to increase the employee's estate and at the same time provide him with a "second income" in the form of stock dividends. While the ESOP has received a great deal of attention recently as a vehicle for creating employee stock ownership, it is essential to recognize that there are other methods of achieving the same objective. The purpose of this Section is to evaluate these alternatives in more detail and to compare their operation with that of an ESOP.

ANALYSIS OF ALTERNATIVES

Over the years corporations have encouraged employee stock ownership in a variety of ways. While all of these require many years for the creation of substantial equity (as shown in Exhibit IV), this has not dampened the appeal of the concept of employee stock ownership. The ESOP is the latest of the various vehicles available for transferring company stock to employees. Other approaches have been in existence for many years and have gained general acceptance in the business community. The most important of these are evaluated below in comparison with ESOP. Further details are provided in Exhibit V.

Profit Sharing Plans

There are currently more than 100,000 Profit Sharing Plans in the United States, some of which have been in existence for 40 or 50 years. Some provide investments exclusively in employer stock; others restrict investments to more general equity or fixed income portfolios; still others provide a combination of employer stock and other investments. Profit Sharing Plans with 100% investment in employer stock are often confused with ESOP's. While there are certain parallels between the two, Profit Sharing involves no capital formation and is strictly an employee benefit plan. No employee contributions are required under either approach, and vesting is company contributions is usually fairly rapid.

The IRS requires that Profit Sharing contributions be made out of either current or retained earnings. The annual contribution can be determined either in accordance with a strict profit-related formula or can be determined each year without a formula. Most companies make them out of current earnings, with the result that no contributions are made in a loss year. This differs from the practice under an ESOP, where contributions do not depend on profits and annual payments are fixed in order to retire the loan on schedule.

On the average, Profit Sharing Plans tend to provide 5% to 10% of covered payroll as the annual contribution. This level varies, depending on the profitability of the company. Profit-sharing contributions to an IRS "qualified" plan are fully tax-deductible, but represent a charge against earnings.

Thrift & Savings Plans

A Thrift and Savings Plan is similar to a Profit Sharing plan except that employee contributions are required as a condition of participation. Employee contributions usually range from 1% - 6% of employee earnings, with a company match ranging from 25% to 100% on the dollar. The cost to the employer ranges from about 2% to 3% of covered payroll depending on the match and the level of participation. Participation in these plans is generally from 80% to 90% of those eligible. As with a Profit Sharing Plan, contributions to a "qualified" Thrift and Savings Plan must be made from current or retained earnings and are tax-deductible and charged against earnings. Sometimes the company will offer a basic match which is made from retained earnings and also a supplemental match on the basis of current earnings. This approach eliminates one disadvantage of a Profit Sharing Plan to employees, since contributions can be made even in a loss year.

Thrift and Savings Plans are especially popular in larger companies. A 1973 survey of the 100 largest corporations in the United States revealed that over half had such a plan, at least for salaried employees. Many of these are invested heavily in company stock. Thrift and Savings Plans differ most notably from ESOP's in that company contributions may vary and employee contributions are a condition of participation. Vesting in company contributions is fairly rapid.

Stock Option Plans

A Stock Option Plan is another popular method of placing company stock in employee hands. Stock Option Plans encourage employee stock ownership by establishing a price equal to 100% of the fair market value of the stock on the date of grant and allowing employees to purchase stock at that price within a fixed number of years in the future. The advantage of such an arrangement is that in the period of a rising stock market, this plan enables employees to purchase company stock at a substantial discount from the current market price. In a falling market, of course, the option becomes essentially worthless.

These plans are generally restricted to a small group of employees because the amount of the discount in a rising market can be quite substantial. The cost to existing shareholders in terms of dilution would be prohibitive in the case of a broad-based plan, since a large number of shares would be sold to employees below market value. This is similar to the dilution which can occur under an ESOP. Stock Option Plans can either be "qualified" under the provisions of Section 422 of the Internal Revenue Code or established on a "non-qualified" basis.

Qualified Stock Option Plans - Plans which are qualified must restrict the period in which the option can be exercised to a maximum of 5 years and must exclude employees who own 5% or more of the company's stock. The plan must also be approved by stockholders and the number of shares must be specified.

The incentive to qualify a Stock Option Plan with the IRS lies in the favorable tax treatment granted a participant in the plan. Under a qualified Stock Option Plan the employee incurs no tax obligation at the time he purchases the stock. If he then holds the stock for a minimum of three years before selling it, he is subsequently taxed at the long-term capital gains rate on the value of the option (i.e., the difference between the price he paid for the stock and the market value on the date he purchased it) and on additional appreciation.

From the employer's standpoint, a qualified plan involves no charge against earnings for the value of the option. However, there is no tax deduction allowed, either. Existing shareholders suffer some dilution of their equity, just as they do under an ESOP.

Non-Qualified Stock Option Plans - Under a non-qualified Stock Option Plan, there are no restrictions imposed by the IRS. As a result, the period in which the option may be exercised is usually longer (often 10 years), and there is no favorable tax treatment to the employee. He is taxed at the time he purchases the stock on the difference between the option price and the current market value of the stock. If he then holds the stock for six months before selling it, any further appreciation is taxed as a long-term capital gain.

The company may take a tax deduction under a non-qualified plan for the difference between the option price and the current market value at date of exercise; there is no charge against earnings unless the option price is discounted at the outset. Existing shareholders suffer approximately the same dilution of their equity as under a qualified plan.

Both qualified and non-qualified Stock Option Plans must be registered with the Securities and Exchange Commission using Form S-8. A prospectus must be given to all eligible employees at the time the plan is implemented.

Stock Purchase Plans

Stock Purchase Plans are also a popular means of placing employer stock in employee hands. A 1974 survey of 233 industrial companies by Edward N. Hay & Associates revealed that 102 had Stock Purchase Plans for at least some employees. Stock Purchase Plans encourage stock ownership either through a limited price discount (similar to a stock option) or through a matching company contribution. Unlike Stock Option Plans, however, they are generally extended to all employees. These plans are sometimes incorrectly identified as ESOP's.

Like Stock Option Plans, Stock Purchase Plans may be either qualified or non-qualified under the Internal Revenue Code.

Qualified Stock Purchase Plan - Under a qualified Stock Purchase Plan, all employees with two or more years of service must be eligible, and those owning 5% or more of of the company's stock must be excluded. The incentive to participate is generally a price reduction equal to a maximum of 15% of the fair market value of the stock on the date the option is granted or on the date it is exercised. The amount of stock available must be in direct proportion to compensation and is subject to an annual maximum of $25,000 per employee.

The tax treatment for employees under the qualified plan is less generous than that under the qualified Stock Option Plan, and the required holding period is slightly shorter. The tax treatment for the company is exactly the same as under a qualified Stock Option Plan, and there is no charge against earnings. Dilution of shareholders' equity is also the same.

Non-Qualified Stock Purchase Plan - Under the non-qualified Stock Purchase Plan, the employer has full discretion as to the eligible group of employees, and there are no restrictions on the amount of stock price discounts. The option price may be either more or less than the 85% allowed under the qualified plan. In practice, employer support of non-qualified plans generally takes the form of payment of brokerage fees, administrative costs, and/or a match of employer contributions (usually 10% - 20% but sometimes as high as 50%). A payroll deduction is usually established to make stock purchase less burdensome to employees.

The non-qualified plan provides no favorable tax treatment to the employee; he is taxed on the difference between the market price and the purchase price at the time he buys the stock. The tax treatment of the company is the same as under a non-qualified Stock Option Plan, but there is usually a charge against earnings. Dilution of shareholders' equity also occurs.

Both qualified and non-qualified Stock Purchase Plans must generally be registered with the Securities and Exchange Commission using Form S-8. A prospectus must be distributed to all eligible employees at the time the plan is implemented.

POSSIBLE APPLICATION TO CONRAIL

In comparing the various alternatives outlined above with an ESOP the primary consideration must be the cost to ConRail. This is especially important in light of the uncertain earnings projected for ConRail through 1985 and the already high labor/cost ratio at the bankrupt railroads.

As noted above, the cost of an ESOP may run as high as 15% (sometimes 25%) of covered payroll because of its non-contributory nature. The average annual contribution under a Profit Sharing Plan, regardless of the type of investment, is generally equal to 5% to 10% of covered payroll, although it may run as high as 15%. Under a Thrift and Savings Plan, contributions generally range from 2% to 3%, while under a Stock Purchase Plan the employer contribution is usually about 1% of covered payroll, depending on the degree of participation. The contribution may be no more than the brokerage fees and administrative expenses, if the employer chooses not to offer a financial incentive.

Another major consideration is the amount of stock accumulation under each of the various plans. This will determine the amount of employee equity and the amount of his annual dividends, or "second income". In this regard, the impact of employee contributions must also be considered. While the ESOP and the Profit Sharing Plan are both non-contributory, employee contributions range up to 6% of earnings under a Thrift and Savings Plan, and up to 10% under a Stock Purchase Plan. Thus, the overall accumulations are substantially greater than the cost to the company would indicate. Exhibit IV demonstrates the total accumulation and annual dividends at five-year intervals, assuming an overall contribution equal to 15% of earnings per year. It is important to note that no substantial equity ownership or dividend income results for a number of years, even at the liberal 15% rate.

The determination of which plan is the most effective stock ownership vehicle depends primarily on the amount of stock accumulation versus the cost to the company. Based on our calculations and on the projected earnings for ConRail, it appears that the most cost-effective approach in this instance would be some form of Stock Purchase Plan. Such a plan would involve substantially lower cost and still provide reasonable levels of ownership. The question is whether the qualified or non-qualified plan best fits the circumstances at ConRail and what the timing and degree of financial support should be.

A qualified Stock Purchase Plan has a number of important advantages. First, because there is no charge against earnings, the adoption of a qualified plan will not affect the projections of ConRail's future profitability. The cost of the plan lies entirely in the dilution of existing shareholders' equity inherent in the stock price discount. Although no tax deduction is available to ConRail, this is not a major consideration because of the improbability that ConRail will be in a tax-paying position prior to 1985. The IRS requirement that all employees with two years of service be included in a qualified plan presents no real problem either, since the intention is to include as many employees as possible. From the employee standpoint, a qualified plan offers an advantage in that taxation is deferred until he subsequently sells the stock (provided he holds it for the requisite period).

Perhaps the major obstacles to adoption of a qualified Stock Purchase Plan are the requirements of shareholder approval and the 15% limit on the amount of stock price discount. Shareholders may be reluctant to approve such a plan because of the dilution of equity involved. Because ConRail was created by an Act of Congress, however, legislative remedies may be available if this becomes a major obstacle.

The 15% limit on the option price discount could eventually pose a more serious problem to continuation of a qualified plan. Since employee participation in Stock Purchase Plans is directly related to the amount of financial incentive provided, the 15% limit will effectively restrict participation. If more generous ConRail support of the plan appears justified, this may eventually necessitate the use of the non-qualified approach. The non-qualified Stock Purchase Plan, as noted above, usually results in a charge against earnings and a corresponding (but currently meaningless) tax deduction. It does not offer any tax advantages to employees, nor does it require shareholder approval.

Concerning implementation of a Stock Purchase Plan at ConRail, the basic questions are when should a plan be offered to employees and what incentives for participation should be provided.

With regard to timing, implementation of any stock ownership at the present time would seem ill-advised. In the first place, the value of ConRail stock may not be determined for some time and may subsequently be adjusted through litigation. To offer shares to employees in the face of a possible adjustment in value could ultimately result in employee resentment. A subsequent downward adjustment might even raise questions in employees' minds as to the company's true intentions. It would therefore be better to defer adoption of a plan until the valuation question has been completely resolved.

A further consideration in this area concerns the timing of the first public offering of ConRail stock. As noted previously, Section 12(g) of the Securities and Exchange Act provides that a public offering of stock will be deemed to have occurred once there are more than 500 shareholders. Since a Stock Purchase Plan might well produce 500 shareholders at an early date, ConRail would have "gone public" sooner than it might otherwise have elected. This could impact on the valuation of the stock for purposes of repayment of creditors.

Another argument for deferring adoption of a plan concerns the earnings projections for ConRail. The Preliminary System Plan predicts that ConRail will first become profitable in 1978. Since the value of the shares of an unprofitable company are unlikely to provide much financial incentive to employees, it would appear logical, based on the projections, to defer adoption of a plan until 1979, or later.

Finally, the proportion of older employees for whom stock ownership has less appeal, will decrease with each passing year. A delay in implementation will thus ensure that the plan is more closely attuned to the needs of employees when it is first implemented.

Concerning the amount of financial support ConRail might provide, a qualified Stock Purchase Plan allows up to a 15% price discount, based on the value of the stock either on the date of the offer or on the date of the actual employee purchase. Basing the discount on the date of the actual purchase gives the company better control over the amount of dilution likely to result. The maximum 15% discount under a qualified plan is the most common and represents a reasonable initial incentive to participation. Under normal circumstances, this approach results in participation of approximately 20% of the eligible group. It is important to note, however, that this 20% would probably represent the more highly motivated individuals at ConRail and would therefore maximize the plan's impact.

If ConRail's earnings position in future years improves substantially, a more generous incentive might be in order. Under these circumstances, a non-qualified Stock Purchase Plan could replace the qualified plan, with ConRail matching employee contributions on a percentage basis. This is the more common approach under non-qualified plans, although a price discount is also sometimes used. Either approach usually results in a charge to earnings. The company match could be increased gradually as earnings increase, with 50% being the ultimate goal. An incentive of this magnitude would rank the plan among the most generous Stock Purchase Plans in existence and could result in as high as 90% employee participation.

SUMMARY

In conclusion, the ESOP represents only one of several different approaches to employee stock ownership. From a cost standpoint, it places the greatest burden on the employer because it does not require employee contributions. Because of the uncertainty of ConRail's earnings position, this poses a serious drawback to adoption of an ESOP.

The most cost-effective stock ownership plan for ConRail would be a Stock Purchase Plan. A qualified plan, with a 15% discount from market price at time of purchase would seem appropriate at the outset. This would not impact on earnings and would result in more limited dilution of shareholders' equity.

Adoption of a Stock Purchase Plan should be deferred until ConRail has attained profitability. Based on current projections, 1979 would appear to be the earliest target date.

C. ESOP AS A VEHICLE FOR EMPLOYEE MOTIVATION

The information presented in this Section draws heavily on the research done by Dr. Gellerman in connection with his report (executive summary in the Appendix).

HOW ESOP OPERATES

Four primary features of the ESOP comprise the motivational impact of this approach. The four are as follows:

1) Increased Employee Estates (the employee stock accumulations)
2) Annual Stock Dividends ("second income")
3) No Out-of-Pocket Costs to Employees (the company pays the entire cost)
4) Fact of Ownership of Company (closer harmony and identity with employer)

Proponents of the ESOP place great emphasis on the importance of building stock ownership into employees. They argue that an employee with part ownership in his company is more likely to work harder because the results of his efforts will ultimately be reflected in the value of his stock holdings. The employee is viewed as being in a position where his interests are identical to those of management. It is therefore considered unlikely that he will place unreasonable demands on the company or resort to strike action to express his grievances.

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Some proponents have gone so far as to equate the ESOP with the Homestead Acts of the latter part of the 19th Century. The Homestead Acts allowed settlers to stake out claims on the frontier which eventually became their property. These settlers presumably had a vested interest in improving their land because they had a direct ownership interest - something the 20th Century industrial worker currently lacks.

From the employee's standpoint, ESOP is defended as a means not only of increasing his estate, but also of providing him with a "second income" in the form of stock dividends. Proponents stress the importance of this "second income" as a means of redistributing wealth in America and increasing productivity through stimulated consumer demand. The "second income" is also relied upon to make the advantages of stock ownership apparent to the employee on a current basis.

Finally, the ESOP is defended on the grounds that there is no risk involved for the employee, since it is funded entirely by employer contributions. No out-of-pocket expenditure is required on the part of the employee. This is viewed as a major advantage of the ESOP and one which distinguishes it from more traditional stock purchase arrangements in which employee contributions are a condition of participation.

AVAILABLE EVIDENCE ON ESOP's

The question now is whether the available evidence supports the claims. Fifteen of the companies known to have ESOP's in existence have been surveyed in depth. As is typical of such companies, the majority of these have fewer than 400 employees and have been in effect for less than three years. Because of the newness of these plans, the motivational impact on employees is not yet entirely clear. What is clear, however, is that many of these plans were installed for other than motivational reasons. Moreover, a majority of the companies with ESOP's have no labor unions, and of those that are unionized the majority have never in their history had a strike. Absenteeism and employee turnover do not appear to have been major problems, and employee motivation was already high at most of these companies before the installation of the ESOP. The motivational value of the ESOP has therefore not been clearly demonstrated either one way or the other.

POSSIBLE APPLICATION TO CONRAIL

Since the evidence on ESOP's is inconclusive, we must analyze the arguments set forth in a more theoretical vein. It is essential to bear in mind the characteristics of the railroad employees since these are of paramount importance in the present instance.

Turning our attention first to the impact on employee estates, an increase under an ESOP would typically be dependent on the following features:

1) The number of years the employee participates in the plan
2) The employee's earnings on which the allocation of stock is based.

3) The value of the stock at the time it is allocated and the future value based on appreciation.

The employees who benefit the most from an ESOP will tend to be those who are younger and more highly paid. Conversely, the benefits will be the lowest for the older, lower paid employees who form a disproportionately large share of the railroad work force. Exhibit VI indicates that 52% of the railroad employees were age 50 or above in 1974. This is an important consideration because motivational research has shown that older employees tend to be more interested in retirement income than in capital accumulation. An ESOP (and stock ownership in general) thus appears to be rather inappropriate for the large segment of the railroad work force which is over age 50.

In evaluating the potential motivational impact of stock dividends as a "second income", we must rely heavily on existing motivational research on "incentive ratios". An incentive ratio is essentially the ratio between the income an employee receives based on his current behavior and the incremental income that would result from a change in behavior. In this case, the desired change in behavior would be an increase in employee productivity through greater personal effort. Research has shown that for employees in the middle income brackets, the minimum effective incentive ratio, excluding consideration of inflation and taxes, is somewhere between 20% and 35%. This means, in effect, that payment of annual dividends below 20% of the employee's current earnings cannot reasonably be expected to increase productivity. It does not rule out the possibility, however, that the employee may come to feel a greater sense of identity with the company, which could result in an increase in the quality of his work and an improvement in his overall attitude.

Exhibit IV indicates that even on the basis of rather liberal assumptions (15% annual employer contribution and 11% annual appreciation), the "second income" generated by the stock accumulation would not reach the minimum 20% incentive ratio for more than 25 years. Under slightly less liberal assumptions (15% annual employer contribution and 7% annual appreciation), the minimum incentive ratio would not be reached for more than 30 years. These figures indicate that while the stock accumulations under an ESOP might achieve a closer level of employee identity with ConRail, they would be insufficient to alter employee behavior to the extent of increasing productivity. This effectively refutes a primary argument of the ESOP proponents, who stress the inevitability of productivity gains.

An additional factor concerning the role of the "second income" is the importance of security to railroad employees. Since dividends are based ultimately on profits, and since profits in the railroads can be influenced by factors over which neither employees nor management have control, it is obvious that dividends cannot be guaranteed. Since the Preliminary System Plan projects no earnings for ConRail prior to 1978, and since the earnings projections through 1985 are not substantial, this is a major consideration. The employees themselves, moreover, can hardly be unaware of the uncertain profitability of a corporation which is a reorganization of bankrupt companies. Realizing this, the employees are more likely to opt for more tangible benefits, such as increases in wages and retirement income. Labor's traditional lack of enthusiasm for <u>any</u> stock ownership plan and the history of labor-management relations at the railroads will serve to reinforce this tendency.

Another argument often made on behalf of ESOP's is that the "second income" will remove pressure for inflationary wage increases. This appears rather doubtful, especially at a time when inflation is rampant and corporate earnings are down (e.g., the current period). Under these circumstances employees are unlikely to remain satisfied, and will probably demand wage increases of the same magnitude as they would without an ESOP.

A further consideration is the extent to which financial risk on the part of employees may in itself be a prime motivational factor. Studies in various companies have shown the employees tend to take a more active interest in the company when they have invested part of their own funds. Where no financial risk is involved, the employee response is more likely to be apathetic. Thus, the "no-cost" aspect of the ESOP may actually be a demotivational factor.

Concerning the importance of ESOP as a motivational device, a basic assumption among proponents is that all employees have a natural acquisitive instinct. This assumption, despite the fact that it is widely accepted, is not necessarily supported by the available evidence. Many people whose incomes are quite substantial consume all that they earn. They have an opportunity to acquire income-producing assets but they choose to spend instead. In reality, it appears that some people are by nature acquisitive while others are not. This is an important consideration in assessing the impact of stock accumulation versus increases in wages or other benefits.

The analogy of the Homestead Act raises some very basic questions. Is there, in fact, a legitimate parallel between the 19th-Century farmer and the 20th-Century industrial worker? The differences would appear substantial, to say the least. The 20th-Century industrial worker is generally involved in a large enterprise in which his particular contribution is only one very small input. The effect of his efforts upon the company's success may thus be very slight and difficult for him to perceive. It may therefore be too much to assume that he will take the same personal interest in his investment that the 19th-Century farmer took. Especially with respect to labor relations, it is unreasonable to assume that the 20th-Century worker will shed his union identity and join ranks with non-agreement employees. The gains which workers feel have been achieved through collective bargaining are too substantial to be risked lightly in a new venture. The analogy with the Homestead

Acts thus appears to ignore the recent history of labor/management relations in the United States.

Certain other aspects of the ESOP must also be analyzed to determine their impact on employee motivation. First, the existence of a trust to hold the stock may serve to dilute whatever motivational gains are derived from the fact of ownership. In particular, the trust tends to lock employees in so that shares may not be sold when market conditions might otherwise dictate. While the existence of a trust is not characteristic solely of ESOP's, this is still a primary disadvantage.

Another significant feature of ESOP's is the fact that shares of stock are generally allocated in proportion to earnings. A successful ESOP would therefore increase the impact of salary differentials. In a situation where there are a number of different unions representing the employees (29 at the bankrupt railroads), this could have the effect of increasing the competition among unions for wage increases, since these would be doubly important. It could also result in the union's bringing pressure to bear on management to restrict management salaries in order to increase short-term earnings. This pressure would ironically be more likely if the ESOP were indeed successful in encouraging employees to seek ways in which corporate costs could be reduced.

Finally, the unfamiliarity of ESOP's also tends to dilute their motivational impact. The complexity of the plan has been cited by a number of the companies which have installed ESOP's as having detracted from its initial impact. Since ESOP's are somewhat complex even to members of the financial community, it is not surprising that they should be confusing to employees. Proponents of the ESOP recognize this problem and argue that communication problems would tend to decrease the longer the plan was in effect. This argument may have some merit, but it indirectly acknowledges that whatever positive effect an ESOP may have would be deferred for some time.

The above comments make it apparent that the ideal situation for implementation of an ESOP is one in which the following conditions are present:

1) The employee group is either heavily weighted with younger employees or only lightly weighted with older employees.
2) There is a history of positive labor/management relations.
3) There has been a demonstrated ability by management to communicate effectively with employees.
4) The company is either small or decentralized so that employees can see the results of their efforts.

The evidence indicates that none of these conditions exist at the bankrupt railroads. For this reason, ESOP does not appear to be a practical approach from the employee motivation standpoint.

ANALYSIS OF ALTERNATIVES

While the ESOP is one broad-based approach to employee motivation, there are a number of other alternatives, some of which have been in existence for many years. The most important of these are discussed below.

Stock Purchase Plans

As noted previously, the plan most closely related to the ESOP is the traditional Stock Purchase Plan. Stock Purchase Plans differ from the ESOP primarily in that employee contributions are a condition of participation. The company typically encourages employee membership either through a reduction in the purchase price of the stock or by matching employee contributions (usually at a rate of 10% to 20%). Purchases are generally made on a payroll deduction basis to avoid the necessity of lump-sum payments.

The most recent major study of Stock Purchase Plans was published by the Conference Board in September, 1966, and covered over 200 large companies with plans of this type. The primary finding of this survey was that employee participation rates in these plans vary directly in proportion to how much of a "bargain" the plan offered the employees. When price discounts of 10% to 15% below market value were offered, the participation rate was as high as 30%. When the company contribution was 20% to 25%, the participation rate was around 50%. When the company contributed 50%, the participation rate jumped to 90%.

Several railroads already have Stock Purchase Plans. Among these are Southern Railway, Norfolk and Western, Seaboard Coastline, Louisville and Nashville, Union Pacific, and Burlington Northern. Perhaps the most relevant example of a Stock Purchase Plan for ConRail is the one in effect at Chicago and Northwestern Transportation Company. There have been two offerings of stock under this plan since its inception in 1972, and the total participation in the plan is now about 25% of the work force. While virtually 100% of the salaried group participates, the hourly participation rate is closer to 20%. It is interesting to note that while very few hourly employees took advantage of the first offering, a much larger number took advantage of the second offering, which occurred after the company had demonstrated reasonable profits.

It is interesting to note that the Chicago and Northwestern's labor/cost ratio has declined since the inception of the plan. It is tempting to ascribe this decline, at least in part, to the establishment of the Stock Purchase Plan. However, at approximately the same time that the plan was adopted, the Chicago and Northwestern also undertook several innovative steps to improve labor/management relations. These included hiring industrial psychologists, assigning labor relations supervisors to settle grievances, eliminating heavy-handed supervisors, and increasing labor-management contacts on the personal level. Thus, it is difficult to determine which of these efforts resulted in the decrease in the labor/cost ratio. It is certainly conceivable that the Stock Purchase Plan itself was partly responsible for the improvement. However, the importance of other innovations in the personnel management area cannot be over-emphasized and may hold the key for ConRail.

Profit Sharing Plans

Probably the most heavily researched of the alternatives to the ESOP is the Profit Sharing Plan, since many of these plans have been in existence for 40 or 50 years. Among the studies of Profit Sharing Plans are a 1971 survey by the Profit Sharing Research Foundation, an unpublished 1972 study by John Greenebaum and a 1969 study by Edgar Czarnecki. Unfortunately, none of the studies attempts to distinguish between plans which invest in company stock and those which utilize other investments.

The results of the various studies indicate that the primary advantages of Profit Sharing Plans are reduced employee turnover, ability to retain competent employees and a general identification of the employee with the company. Primary disadvantages are employee dissatisfaction when accounts decline and failure on the part of employees to perceive how their own efforts contribute to profits. One interesting conclusion of the Greenebaum study was that companies with Profit Sharing Plans open to unionized hourly employees tend to have fewer strikes than companies without such plans. In a similar vein, the Czarnecki study indicates that companies with Profit Sharing Plans in effect were more likely to be successful in avoiding unionization.

The problem in determining the impact of Profit Sharing Plans is the same as with Stock Purchase Plans. While one is tempted to ascribe the various successes outlined above to the existence of the plans themselves, it is also conceivable that enlightened management may itself be the cause. The question is whether enlightened management adopts Profit Sharing Plans, which bring about the positive results, or whether enlightened management is directly responsible for the improvements.

Thrift and Savings Plans

As noted previously, Thrift and Savings Plans are essentially a more recent variation of the Profit Sharing approach. Under these plans employees generally contribute from 1% to 6% of their earnings, with the company matching the contribution in a proportion ranging from 25% to 100%.

In 1972, Bankers Trust Company surveyed Thrift and Savings Plans covering approximately 2.4 million participants. The median participation rate in these plans was 79%. As with the Employee Stock Purchase Plans discussed above, the participation rate in the Thrift and Savings Plans was greater when the company match was greater.

The rate was 86% when company contributions were 50¢ or more on the dollar but only 63% when the company contributed less than 50¢ on the dollar. The participation rate was also affected slightly by the vesting schedule, with more rapid vesting resulting in higher participation.

The Bankers Trust survey did not attempt to make any judgments as to the motivational effect of these plans, but the evidence suggests that employees react the same to Thrift and Savings Plans as to Profit Sharing Plans.

Scanlon Plan

The Scanlon Plan, developed by the late Joseph Scanlon, is a more unusual approach to the problem of increasing employee identification with the company. Although there are numerous variations on the Scanlon Plan, generally an attempt is made to determine something comparable to a labor/cost ratio for a small group of employees. When, in any given month, the labor/cost ratio is below the historic average for the group, part of the savings is paid out to the employees responsible as a bonus. Part also goes to the company and part to a reserve pool to compensate for months in which the labor/cost ratio exceeds the historic average. The labor/cost ratio is recalculated at the end of each year. The unique feature of the Scanlon Plan lies in its attempt to tie the employee's financial reward more closely to his own personal efforts. Because there are so few Scanlon Plans in effect, and because they exist in relatively small companies, information on the degree of success they have achieved is limited.

For a Scanlon Plan to be successful in a large corporation like ConRail, extensive administrative decentralization would be necessary. Because the Plan is based on the concept of small work groups, a large organization usually does not provide a favorable environment. However, where such decentralization is possible, or already in effect, the Scanlon Plan may be successful in enabling employees to perceive more clearly the link between their own efforts and their financial rewards.

Employee Participation in Management

A much different approach to employee motivation is the concept of employee participation in management. While there have been no major efforts in this direction in the United States, this approach has received widespread attention in some European nations. In Sweden, worker representatives sit on the boards of companies above a certain size, and since 1974 management's perogative to fire employees has been sharply curtailed by the necessity of entering conferences with the unions. Proposed laws will soon give unions the primary responsibility for interpreting labor agreements and work rules. In effect, management's traditional perogatives are being sharply curtailed in this area.

In Germany, a similar system known as co-determination has been tried. By law, workers elect representatives to a supervisory board which, together with management-appointed members, reviews managerial performance. This supervisory board is separate from the regular Board of Directors and tends to be more concerned with day-to-day operations than with broad financial performance. Some thought is now being given to increasing employees' power by placing worker representatives on the Board of Directors as such. It is interesting to note in this regard that in both Sweden and Germany the issue is transfer of decision-making power to employees rather than actual company ownership. In this respect, these approaches represent the "mirror image" of the ESOP. The motivational impact of these approaches has not yet been studied in detail, and it is therefore difficult to draw a conclusion about their effectiveness. From a practical standpoint, they represent a rather dramatic step which management in the United States would be unlikely to take without more concrete evidence as to results.

SUMMARY

In conclusion, the ESOP appears inappropriate at ConRail because it is not well suited to the employee group involved. Because of the preponderance of older employees, and their heavy emphasis on security, stock accumulation would not be as attractive as increases in wages or other benefits. The dividends generated by the stock would be insufficient to motivate employees to greater productivity for a number of years, although improvements in overall attitude might result. Finally, the history of labor-management relations at the railroads will tend to dampen any motivational gains which might result. These factors apply not only to ESOP, but to any broad-based stock ownership plan.

In comparing the various alternatives to ESOP, it becomes clear that the data on motivational improvements resulting from the plans is somewhat ambivalent. No plan appears to have a clear-cut advantage in this regard, although the Scanlon Plan, where applicable, does appear to overcome the problem of the worker's failure to perceive the results of his efforts. The Stock Purchase Plan has an advantage in that employees control their shares without the intervention of a trust. The Stock Purchase Plan (along with the Thrift and Savings Plan) has the added advantage of being contributory, which generally results in greater employee interest in the plan. Moreover, it may be simpler than the ESOP and require less communication to employees.

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D. ESOP IN RELATION TO TOTAL COMPENSATION

ESOP AS AN EMPLOYEE BENEFIT

Since ESOP is a costly element of employee compensation, it is essential to consider it in the context of existing wage levels and benefit programs at the railroads. In view of the railroads' already high labor/cost ratio, the addition of another plan on top of those which already exist would not appear justified if existing benefits are competitive with those in other industries. The purpose of this Section is to determine how competitive those wages and benefits are.

EARNINGS LEVELS

With regard to wage levels for agreement employees, comprehensive data is available both for the railroads and for industry as a whole. Based on data used during the 1974 railroad negotiations, the average annual wage for agreement employees at the railroads included in the bargaining is $13,526. Based on a survey conducted by the United States Department of Commerce, the comparable figure for all industries in the country is $8,900. For major industries the figure is $9,266. The average railroad wage is thus more than $4,000 a year higher than that in other industries. This is obviously a significant difference and one which helps to account for the higher labor/cost ratios at the bankrupt railroads. While the differential may vary according to the exact job classification, the overall figure is still meaningful and must be taken into account in weighing the necessity for additional benefits.

Because of the difficulty in matching salaried job classifications with similar positions in other industries and because of the time constraints involved in this study, it was not possible to make similar comparisons for the salaried employees. Indications are, however, that the lower-echelon salaried employees probably benefit to some extent from the compression caused by the high wages for agreement employees, while the higher-echelon salaried employees appear to have earnings comparable to their counterparts in other industries.

EMPLOYEE BENEFIT PLANS

Retirement Benefits

Railroad employees are not covered under the terms of the Social Security Act, but are instead covered under the Railroad Retirement Act, which operates in many respects like Social Security. Both salaried and agreement employees are included at the same benefit levels. Creditable compensation for Railroad Retirement purposes is the same as the taxable wage base for Social Security ($14,100 in 1975).

The primary difference between the two systems is in the level of benefits and in the rate of employee and employer contributions. The employee contribution rate is the same under both Systems, but the employer contribution rate under Railroad Retirement is more than twice that under Social Security. The benefit levels are also substantially different, with Railroad Retirement benefits currently averaging approximately 50% higher than those under Social Security. For example, an employee who retires in 1975 with maximum earnings and 30 years of service under the Railroad Retirement Act will receive approximately $600 a month. His counterpart under the Social Security System will receive less than $400 a month.

In addition to the benefits provided under the Railroad Retirement Act, the bankrupt railroads also have supplemental pension plans for salaried employees. All the supplemental plans are coordinated with Railroad Retirement benefits, just as many plans in private industry are coordinated with Social Security.

Exhibit VII compares the overall pension benefits payable at the bankrupt railroads with the national average for other industries. The figures clearly indicate that the level of benefits for both salaried and agreement employees is competitive with those of other industries at all but the lowest earnings levels (i.e., $9,000 or less). It is also noteworthy that the companies surveyed for purposes of this comparison include some of the largest corporations and unions in the country. The benefits are therefore competitive not only with national averages but also with those companies which traditionally provide the highest benefits. Ancillary benefits (e.g., early retirement, disability) have not been included in the exhibit, but these are also competitive with national norms.

Group Insurance Benefits

Exhibit VIII compares the Group Life Insurance benefits available to both salaried and agreement employees with those in effect in other industries. While the average salaried coverage at the railroads of two times annual earnings compares favorably with that in other industries, the flat $6,000 agreement benefit tends to be somewhat below that commonly found in bargained plans. Once again, it should be noted that these comparisons are being made not with overall national norms, but with the average among the largest companies and unions.

Exhibit IX compares the Basic Medical benefits in effect at the railroads with the national averages, while Exhibit X does the same for the Major Medical benefits. In both instances, the coverages at the railroads are competitive with those in the other industries surveyed. In fact, under the Major Medical plans the average maximum at the railroads is somewhat in excess of that found elsewhere. Moreover, the lack of required employee contributions for both salaried and agreement employees represents a significant advantage over the large number of plans which are still contributory.

No exhibit has been prepared for Long-Term Disability Insurance because this is handled primarily through the Railroad Retirement Act, which provides substantially more generous disability benefits than Social Security. Further, supplemental pension plans generally provide long-term disability benefits after reasonable periods of service. With regard to Short-Term Disability (generally less than six months), the policy at the railroads is usually salary continuation on a schedule basis. This is also common practice in other industries. In addition, sickness benefits are provided to all railroad employees under the Railroad Unemployment Insurance Act, and in certain situations agreement employees are entitled to supplemental sickness and accident benefits.

LABOR RELATIONS CONSIDERATIONS

Labor relations is a consideration in this study because of the fact that most of the larger railroads in the country bargain with the 29 railroad unions through the National Railway Labor Conference. If an ESOP were adopted by ConRail, it might well be viewed by the unions at the other railroads as an excuse to demand either a similar program or increases in other areas. Because of labor's traditional lack of enthusiasm for any sort of stock ownership plan, it is probable that increases in either wages, retirement income, or group insurance benefits would be sought. This would obviously be detrimental to the bargaining position of the NRLC and might seriously threaten the solvency of some of the marginally profitable railroads. This is a sensitive area and one which must be weighed heavily in evaluating any new employee benefit plan.

SUMMARY

In conclusion, the question must be asked whether the adoption of a costly plan like an ESOP is justified in light of present wage and benefit levels and the high labor/cost ratio at the bankrupt railroads. With employee benefits already competitive for both salaried and agreement employees, and with wages in excess of national norms for agreement employees and perhaps for some salaried employees as well, it would seem difficult to justify the addition of a costly new benefit plan. Such a plan would only be logical in this context if agreement could be reached to reduce either wages or benefits, at least on a prospective basis. Since such an agreement is unlikely, the ESOP represents an unwarranted addition to an already generous program.

Section III

CONCLUSIONS AND RECOMMENDATIONS

INTRODUCTION

This Section presents our conclusions and recommendations, which in most cases have been suggested in earlier parts of the report. Throughout the evaluation we have separated the corporate financing, employee motivational and equity ownership aspects of ESOP, because each must be evaluated on its own merits. In our judgment, this is the most effective method of analyzing ESOP.

CONCLUSIONS

1) ESOP does not offer advantages to ConRail in terms of corporate financing.

   a. ConRail will probably not be in a tax-paying status through 1985, and thus will not be in a position to take advantage of the tax deductibility of the annual contributions to the trust. Even if ConRail were in a tax-paying status, the use of ESOP for capital formation purposes would be questionable.

   b. Because the annual contributions to the trust would be charged against earnings, adoption of an ESOP could defer attainment of profitability.

c. The dilution of shareholders' equity under an ESOP could be substantial.

d. Issuance of shares to employees could result in ConRail's "going public" at an earlier date than it might otherwise elect.

e. ConRail will not be able to raise capital in the traditional money markets in the foreseeable future, except through equipment obligations.

2) ESOP does not offer advantages to ConRail in terms of employee motivation.

a. While stock ownership may increase overall employee identification with ConRail, there is no evidence of its ability to increase the productivity of employees.

b. The existence of large numbers of older, security-conscious employees at the railroads will dampen the impact of employee stock ownership.

c. The history of labor-management relations at the railroads may cause some skepticism toward employee stock ownership.

d. Employee stock ownership will not have much impact until ConRail achieves reasonable levels of profitability.

e. While employee stock ownership is widely accepted in industry, ESOP is only one of several vehicles for placing employer stock in employees' hands.

f. ESOP is one of the most complex approaches and therefore difficult to communicate to employees.

g. ESOP is among the least cost-effective approaches for ConRail.

3) ESOP does not offer advantages to ConRail in view of the competitive overall employee compensation at the bankrupt railroads.

a. Earnings of agreement employees are substantially above those in other industries.

b. Earnings of salaried employees are competitive with those in other industries.

c. Retirement benefits for both agreement and salaried employees are competitive with national averages.

d. Group insurance benefits for both agreement and salaried employees are competitive with national averages.

c. The additional expense inherent in an ESOP (or any other additional employee benefit) is not justified in an already competitive situation.

RECOMMENDATIONS

1) Do not look to an ESOP as a source of capital formation. ConRail will probably have to rely on government-backed debt issues and equipment obligations for the foreseeable future.

2) Take positive steps to structure a Human Resources Management function at ConRail which, through some of the newer personnel management techniques, can attempt to improve employee motivation within the existing competitive compensation program.

3) Because any stock ownership plan at ConRail would at present involve substantial risks and be unlikely to provide a meaningful estate accumulation or "second income", defer the introduction of such a plan until ConRail attains a reasonable level of profitability.

4) Once ConRail achieves reasonable profit levels, consider implementation of a qualified Stock Purchase Plan with a 15% stock price discount below market value at time of purchase. (Exhibit XI outlines the provisions of such a plan.)

5) As ConRail earnings increase in future years, consider gradually increasing financial support to the Stock Purchase Plan to encourage additional employee participation. A target of 50% stock price discount or company match should be established. A non-qualified Stock Purchase Plan will have to be used once the stock price discount exceeds 15%. (Exhibit XII outlines the provisions of such a plan.)

EXHIBIT I
(Page 1 of 2)

UNITED STATES RAILWAY ASSOCIATION

Companies Known to Have ESOP's

Statesman Group, Inc.
E. Systems, Inc.
Pacific Architects & Engineers
Mulach Steel Corporation
Katz Agency, Inc.

Monolith Portland Cement
Ultra-Violet Products
Halmode Apparel, Inc.
California Insurance Management & Investment
Brooks Camera, Inc.

First California Co.
Anthony Schools of San Francisco
Behring International
The Clegg Company
Gonzalez & Oberkamper

Helix, Ltd.
Intelcom Industries
Jerell, Inc.
J&J Corrugated Box Co.
MacBeath Hardwood

Manalytics, Inc.
National Visual Research Corp.
Rockland Industries
Sacramento Valley Moulding
Sasaki, Walker & Roberts

Steiger Tractor, Inc.
United Chemical Corporation
Woodland Mobile Homes
Egan & Sons
Gulf Consolidated Services

Juice Bowl Products, Inc.
Rathbone, King & Seeley
Nahm, Turner, Vaughan & Landrum
American Mutual Underwriters, Ltd.
Bearing Specialty Co.

EXHIBIT I
(Page 2 of 2)

Companies Known to Have ESOP's (cont'd.)

American Pacific International, Inc.
Concyne Corporation
Oppenheimer & Co.
Robinson-Humphrey
Watts Manufacturing

Food World, Inc.
Jerry's Nugget
Western Bank & Trust
Northern Vermont Asbestos
American Lumber Co.

Piper Jaffray, Inc.
University Industries, Inc.
Bartle Wells Associates
Crosby Valve
Infant Specialties

NOTE:
The primary source of the above names was Bangert & Company, a firm specializing in the implementation of ESOP's.

May, 1975

EXHIBIT II

UNITED STATES RAILWAY ASSOCIATION

References to ESOP in the
Regional Rail Reorganization Act of 1973

Section 102 "Definitions"

(5) "employee stock ownership plan" means a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under section 401(a) of the Internal Revenue Code of 1954 (26 U.S.C. 401(a)) in connection with the financing of corporate improvements, transfers in the ownership of corporate assets, and other capital requirements of a corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees.

Section 206(e) "Corporation Features"

(3) the manner in which employee stock ownership plans may, to the extent practicable, be utilized for meeting the capitalization requirements of the Corporation, taking into account (A) the relative cost savings compared to conventional methods of corporate finance; (B) the labor cost savings; (C) the potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management; (D) the projected employee dividend incomes; (E) the impact on quality of service and prices to railway users; and (F) the promotion of the objectives of this Act of creating a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation.

Section 301(e) "Initial Capitalization"

In order to carry out the final system plan the Corporation is authorized to issue stock and other securities. Common stock shall be issued initially to the estates of railroads in reorganization in the region in exchange for rail properties conveyed to the Corporation pursuant to the final system plan. Nothing in this subsection shall preclude the Corporation from repurchasing the common stock initially issued through payments out of profits in order to establish an employee stock ownership plan; and nothing in this subsection shall preclude the recipients of common stock initially issued from establishing an employee stock ownership plan.

May, 1975

UNITED STATES RAILWAY ASSOCIATION

Comparative Effects of ESOP, Debt, and Equity Financing
(The following schedule traces the effects on a hypothetical corporation of a $10,000,000 financing)

(000's)	Before Financing	ESOP Financing(A)	Debt Financing(A)	Equity Financing
Income Effects				
Pre-Tax Income Before Financing Costs(B)	$ 9,000	$ 10,800	$ 10,800	$ 10,800
Financing Costs - Interest	-	(800)	(800)	-0-
- Principal	-	(690)	(not deductible)	-0-
Adjusted Pre-Tax Income	$ 9,000	$ 9,310	$ 10,000	$ 10,800
Taxes at 50%	4,500	4,655	5,000	5,400
Net Income	$ 4,500	$ 4,655	$ 5,000	$ 5,400
Pre-Tax Financing Costs Charged to Income	-	$ 1,490	$ 800	$ -0-
After-Tax Financing Costs Charged to Income(C)	-	745	400	-0-
Cash Flow Effects				
Cash Flow Before Financing Costs	$ 18,000	$ 21,600	$ 21,600	$ 21,600
Financing Costs Before Dividends				
- Interest	-	400	400	-0-
- Principal	-	345	690	-0-
Adjusted Cash Flow Before Dividends	$ 18,000	$ 20,855	$ 20,510	$ 21,600
Dividends at 5%	2,500	3,000	2,500	3,000
Cash Flow after Dividends	$ 15,500	$ 17,855	$ 18,010	$ 18,600
Cash Financing Costs(C)	$ -	$ 1,245	$ 1,090	$ 500
Capitalization Effects				
Debt	$ 50,000	$ 60,000	$ 60,000	$ 50,000
Shareholders Equity	50,000	50,000	50,000	60,000
	$100,000	$ 110,000	$ 110,000	$ 110,000
Effect on Existing Shareholders				
Shares Outstanding	1,000,000	1,200,000	1,000,000	1,200,000
Dilution in Proportionate Interest	-	16.7%	None	16.7%
Earnings Per Share	$ 4.50	$ 3.88	$ 5.00	$ 4.50
Increase (Decrease)	-	(13.8%)	11.1%	None
Book Value	$ 50.00	$ 41.67	$ 50.00	$ 50.00
Increase (Decrease)	-	(16.7%)	None	None

(See notes on Page 2 of this Exhibit)

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EXHIBIT III
(Page 2 of 2)

UNITED STATES RAILWAY ASSOCIATION

Comparative Effects of ESOP, Debt, and Equity Financing

(The schedules below show the impact to net income and cash flow - ESOP and Debt financing - over the full term of the loan. In Case 1 a 50% tax rate was assumed while in Case 2 the Corporation is assumed to pay no taxes.)

Case 1 - 50% Tax Rate

(000's)	Charge to Net Income (000's) ESOP Financing	Charge to Net Income (000's) Debt Financing	Charge to Cash Flow (000's) ESOP Financing (before dividends of $500 per annum)	Charge to Cash Flow (000's) Debt Financing
Year 1	$ 745	$ 400	$ 745	$ 1,090
2	745	372.5	745	1,117.5
3	745	342.5	745	1,147.5
4	745	310.5	745	1,179.5
5	745	275.5	745	1,214.5
6	745	238	745	1,252
7	745	197.5	745	1,292.5
8	745	153.5	745	1,336.5
9	745	106.5	745	1,383.5
10	745	55	745	1,435

Case 2 - No Taxes

(000's)	Charge to Net Income (000's) ESOP Financing	Charge to Net Income (000's) Debt Financing	Charge to Cash Flow (000's) ESOP Financing (before dividends of $500 per annum)	Charge to Cash Flow (000's) Debt Financing
Year 1	$ 1,490	$ 800	$ 1,490	$ 1,490
2	1,490	745	1,490	1,490
3	1,490	685	1,490	1,490
4	1,490	621	1,490	1,490
5	1,490	551	1,490	1,490
6	1,490	476	1,490	1,490
7	1,490	395	1,490	1,490
8	1,490	307	1,490	1,490
9	1,490	213	1,490	1,490
10	1,490	110	1,490	1,490

(A) The loans under the ESOP and Debt alternatives are made on the following terms: Term: Ten Years
Interest Rate: 8%
Amortization Schedule: 14.9% of the principal amount per annum

(B) The corporation earns an 18% pre-tax return on the investment of the proceeds from each of the financings.

(C) The charges to net income and cash flow before dividends relating to the ESOP and Debt financing over the life of the loan differ because of the varying portion of the loan payments allocated to interest. The schedules above show the impact each year.

Note: The source of this table is E. F. Hutton & Company, Inc.'s report on the corporate financing aspects of ESOP's. A copy of the report is included as Appendix B. Specifically, see notes to Table I found on pages 3 and 4.

May, 1975

UNITED STATES RAILWAY ASSOCIATION

Projected Stock Accumulations and Dividends Under an ESOP
(Employee Age 30 in 1975)

Year	$9,000 Current Earnings				$12,000 Current Earnings				$15,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$ 11,362	$ 9,365	$ 281	2.5%	$ 15,149	$ 12,487	$ 375	2.5%	$ 18,937	$ 15,608	$ 468	2.5%
1985	15,205	28,311	849	5.6	20,273	37,748	1,132	5.6	25,342	47,185	1,416	5.6
1990	20,348	64,478	1,934	9.5	27,131	85,971	2,579	9.5	33,913	107,463	3,224	9.5
1995	27,230	131,090	3,933	14.4	36,307	174,787	5,244	14.4	45,383	218,483	6,554	14.4
2000	36,440	250,927	7,528	20.7	48,587	334,569	10,037	20.7	60,733	418,212	12,546	20.7
2005	48,766	463,018	13,891	28.5	65,021	617,357	18,521	28.5	81,277	771,697	23,151	28.5
2010	65,259	833,997	25,020	38.3	87,012	1,111,996	33,360	38.3	108,765	1,389,995	41,700	38.3

Year	$20,000 Current Earnings			
			Annual Dividends	
	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$ 25,249	$ 20,811	$ 624	2.5%
1985	33,789	62,913	1,887	5.6
1990	45,218	143,284	4,299	9.5
1995	60,511	291,311	8,739	14.4
2000	80,978	557,616	16,728	20.7
2005	108,369	1,028,929	30,868	28.5
2010	145,020	1,853,327	55,600	38.3

Assumptions:

(1) Employer makes annual contribution at year-end equal to 15% of employee's earnings.

(2) Salaries increase at a compound rate of 6% per year.

(3) Stock appreciates at the rate of 11% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

(4) Dividends payable at the rate of 3% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

UNITED STATES RAILWAY ASSOCIATION

Projected Stock Accumulations and Dividends Under an ESOP
(Employee Age 40 in 1975)

	$9,000 Current Earnings				$12,000 Current Earnings				$15,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
Year	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$ 11,362	$ 9,365	$ 281	2.5%	$ 15,149	$ 12,487	$ 375	2.5%	$ 18,937	$ 15,608	$ 464	2.5%
1985	15,205	28,311	849	5.6	20,273	37,745	1,132	5.6	25,342	47,185	1,416	5.6
1990	20,348	64,478	1,934	9.5	27,131	85,971	2,579	9.5	33,913	107,463	3,224	9.5
1995	27,230	131,090	3,933	14.4	36,307	174,787	5,244	14.4	45,383	218,483	6,554	14.4
2000	36,440	250,927	7,528	20.7	48,587	334,569	10,037	20.7	60,733	418,212	12,546	20.7

	$20,000 Current Earnings				$30,000 Current Earnings			
			Annual Dividends				Annual Dividends	
Year	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$ 25,249	$ 20,811	$ 624	2.5%	$ 37,873	$ 31,217	$ 937	2.5%
1985	33,789	62,913	1,887	5.6	50,683	94,370	2,831	5.6
1990	45,218	143,284	4,299	9.5	67,827	214,927	6,448	9.5
1995	60,511	291,311	8,739	14.4	90,767	436,967	13,109	14.4
2000	80,978	557,616	16,728	20.7	121,467	836,423	25,093	20.7

Assumptions:

(1) Employer makes annual contribution at year-end equal to 15% of employee's earnings.

(2) Salaries increase at a compound rate of 6% per year.

(3) Stock appreciates at the rate of 11% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

(4) Dividends payable at the rate of 3% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

UNITED STATES RAILWAY ASSOCIATION

Projected Stock Accumulations and Dividends Under an ESOP
(Employee Age 50 in 1975)

Year	\$9,000 Current Earnings				\$12,000 Current Earnings				\$15,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	\$11,362	\$9,365	\$281	2.5%	\$15,149	\$12,487	\$375	2.5%	\$18,937	\$15,608	\$468	2.5%
1985	15,205	28,311	849	5.6	20,273	37,748	1,132	5.6	25,342	47,185	1,416	5.6
1990	20,348	64,478	1,934	9.5	27,131	85,971	2,579	9.5	33,913	107,463	3,224	9.5

Year	\$20,000 Current Earnings				\$30,000 Current Earnings				\$50,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	\$25,249	\$20,811	\$624	2.5%	\$37,873	\$31,217	\$937	2.5%	\$63,122	\$52,028	\$1,561	2.5%
1985	33,789	62,913	1,887	5.6	50,683	94,370	2,831	5.6	84,472	157,283	4,718	5.6
1990	45,218	143,284	4,299	9.5	67,827	214,927	6,448	9.5	113,044	358,211	10,744	9.5

Assumptions:

(1) Employer makes annual contribution at year-end equal to 15% of employee's earnings.

(2) Salaries increase at a compound rate of 6% per year.

(3) Stock appreciates at the rate of 11% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

(4) Dividends payable at the rate of 3% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

EXHIBIT IV
(Page 4 of 6)

UNITED STATES RAILWAY ASSOCIATION

Projected Stock Accumulations and Dividends Under an ESOP
(Employee Age 30 in 1975)

Year	$9,000 Current Earnings: Annual Earnings	$9,000 Current Earnings: Accumulation	$9,000 Current Earnings: Annual Dividends: Dollars	$9,000 Current Earnings: Annual Dividends: % of Earnings	$12,000 Current Earnings: Annual Earnings	$12,000 Current Earnings: Accumulation	$12,000 Current Earnings: Annual Dividends: Dollars	$12,000 Current Earnings: Annual Dividends: % of Earnings	$15,000 Current Earnings: Annual Earnings	$15,000 Current Earnings: Accumulation	$15,000 Current Earnings: Annual Dividends: Dollars	$15,000 Current Earnings: Annual Dividends: % of Earnings
1980	$10,528	$8,366	$ 251	2.4%	$14,037	$ 11,115	$ 333	2.4%	$17,546	$ 13,894	$ 417	2.4%
1985	12,810	21,911	657	5.1	17,080	29,215	876	5.1	21,350	36,519	1,096	5.1
1990	15,585	43,114	1,293	8.3	20,780	57,485	1,725	8.3	25,975	71,856	2,156	8.3
1995	18,961	75,535	2,266	12.0	25,281	100,713	3,022	12.0	31,601	125,891	3,777	12.0
2000	23,070	124,272	3,728	16.2	30,760	165,696	4,971	16.2	38,450	207,120	6,214	16.2
2005	28,068	196,600	5,898	21.0	37,424	262,133	7,864	21.0	46,780	327,666	9,830	21.0
2010	34,149	302,873	9,086	26.6	45,532	403,831	12,115	26.6	56,915	504,789	15,144	26.6

Year	$20,000 Current Earnings: Annual Earnings	$20,000 Current Earnings: Accumulation	$20,000 Current Earnings: Annual Dividends: Dollars	$20,000 Current Earnings: Annual Dividends: % of Earnings
1980	$23,396	$ 18,591	$ 558	2.4%
1985	28,467	48,691	1,461	5.1
1990	34,633	95,809	2,874	8.3
1995	42,136	167,856	5,036	12.0
2000	51,267	276,160	8,285	16.2
2005	62,373	436,889	13,107	21.0
2010	75,887	673,051	20,192	26.6

Assumptions:

(1) Employer makes annual contribution at year-end equal to 15% of employee's earnings.

(2) Salaries increase at a compound rate of 4% per year.

(3) Stock appreciates at the rate of 7% per year.

(4) Dividends payable at the rate of 3% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

UNITED STATES RAILWAY ASSOCIATION

Projected Stock Accumulations and Dividends Under an ESOP
(Employee Age 40 in 1975)

	$9,000 Current Earnings				$12,000 Current Earnings				$15,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
Year	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$ 10,528	$ 8,366	$ 251	2.4%	$ 14,037	$ 11,115	$ 333	2.4%	$ 17,546	$ 13,894	$ 417	2.4%
1985	12,810	21,911	657	5.1	17,050	29,215	876	5.1	21,350	36,519	1,096	5.1
1990	15,585	43,114	1,293	8.3	20,780	57,465	1,725	8.3	25,975	71,856	2,156	8.3
1995	18,961	75,535	2,266	12.0	25,281	106,713	3,022	12.0	31,601	125,891	3,777	12.0
2000	23,070	124,272	3,728	16.2	30,760	165,696	4,971	16.2	38,450	207,120	6,214	16.2

	$20,000 Current Earnings				$30,000 Current Earnings			
			Annual Dividends				Annual Dividends	
Year	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$ 23,396	$ 18,591	$ 558	2.4%	$ 35,094	$ 27,857	$ 837	2.4%
1985	28,467	48,691	1,461	5.1	42,701	73,037	2,191	5.1
1990	34,633	95,809	2,874	8.3	51,950	143,714	4,311	8.3
1995	42,136	167,856	5,036	12.0	63,204	251,784	7,554	12.0
2000	51,267	276,160	8,285	16.2	76,901	414,240	12,427	16.2

Assumptions:

(1) Employer makes annual contribution at year-end equal to 15% of employee's earnings.

(2) Salaries increase at a compound rate of 4% per year.

(3) Stock appreciates at the rate of 7% per year.

(4) Dividends payable at the rate of 3% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

UNITED STATES RAILWAY ASSOCIATION

Projected Stock Accumulations and Dividends Under an ESOP
(Employee Age 50 in 1975)

	$9,000 Current Earnings				$12,000 Current Earnings				$15,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
Year	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$10,528	$ 8,366	$ 251	2.4%	$14,037	$ 11,115	$ 333	2.4%	$17,546	$ 13,894	$ 417	2.4%
1985	12,810	21,911	657	5.1	17,080	29,215	876	5.1	21,350	36,519	1,096	5.1
1990	15,585	43,114	1,293	8.3	20,780	57,485	1,725	8.3	25,975	71,856	2,156	8.3

	$20,000 Current Earnings				$30,000 Current Earnings				$50,000 Current Earnings			
			Annual Dividends				Annual Dividends				Annual Dividends	
Year	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings	Annual Earnings	Accumulation	Dollars	% of Earnings
1980	$23,396	$18,591	$ 558	2.4%	$35,094	$28,427	$ 837	2.4%	$58,489	$46,478	$1,394	2.4%
1985	28,467	48,691	1,461	5.1	42,701	73,037	2,191	5.1	71,167	121,728	3,652	5.1
1990	34,633	95,809	2,874	8.3	51,950	143,714	4,311	8.3	86,583	239,522	7,186	8.3

Assumptions:

(1) Employer makes annual contribution at year-end equal to 15% of employee's earnings.

(2) Salaries increase at a compound rate of 4% per year.

(3) Stock appreciates at the rate of 7% per year.

(4) Dividends payable at the rate of 3% per year (based on performance of Standard and Poor's 425 Industrials during ten-year period ending in 1974).

May, 1975

1	2	3	4	5	6	7	8	9
		Employee Contributions			Purchase of Stock			[illegible]
Type of Plan	Eligibility for Participation	Rate	Administration	Company Contributions	Source	Price per Share	Number Purchasable by Employee	
Qualified Thrift or Savings Plan	Some age and/or service requirements common (maximum age 25 and 1 year) but plan may not "discriminate" in favor of executive, supervisory or highly-paid employees.	Usually from 1-6% of earnings, at employee option. Higher amounts usually not matched by employer.	Trustee receives and invests monies. Individual employee accounts usually maintained in units. Unit value fluctuates with market value of fund.	Made from current or retained profits, but usually a fixed percentage (25 to 100%) of employee contributions. May vary by years of service or level of profits. Invested by trustee, but different investments may be stipulated than for employee contributions.	Generally purchased in open market.	Market value at time purchased.	No more than 15% of covered payroll may be contributed annually by employer. No more than $25,000 worth of stock may be purchased in one year for any employee.	No direct [illegible] since [illegible] [illegible] [illegible] trustee in [illegible] stock [illegible]
Qualified Employee Stock Purchase Plan (per Section 423 of the Internal Revenue Code)	Generally all employees, but may exclude part-time or seasonal employees, those with less than 2 years' service, or executive, supervisory or highly-paid employees. Employees owning 5% or more of Company stock are ineligible.	Not prescribed, but options to purchase more than $25,000 worth of stock in one calendar year not permitted.	Single payment or payroll deductions.	Generally in form of stock price discount of up to 15%. Some administrative costs also usually assumed.	Either purchased in open market or distributed from authorized but unissued block of shares.	Not less than the lesser of: (a) 85% of fair market value on date option granted or (b) 85% of fair market value on date exercised.	Not prescribed, but must be uniformly related to employee compensation rate and may be subject to maximum. Option must be exercised within 5 years of grant if option price (by terms of plan) is not less than 85% of fair market value on date of exercise; otherwise, within 27 months of grant.	None [illegible] transferred [illegible]
Non-Qualified Employee Stock Purchase Plan	Generally all employees, but some service requirement common. No IRS restrictions, and employer has full discretion as to eligible group.	At employee's option, with minimum and maximum rates (in dollars or percent of pay) usually provided.	Varies widely. Plan may require [illegible] within stipulated period, or employee contributions may be accumulated with interest and used to purchase stock at specified dates or when sufficient funds accumulate.	May be none, but more customarily stock is sold at less than market value, or employer contributes 10-20% of cost of stock is purchased on open market, or one "free" share is given for each 4 to 5 shares purchased by employee. Some administrative costs also usually assumed.	Either purchased in open market or distributed from authorized but unissued block of shares.	Generally 80-100% of fair market value.	Based upon amount contributed by employee, but either company or employee may designate number to be purchased.	None [illegible] transferred [illegible]
Qualified Employee Stock Option Plan (per Section 422 of the Internal Revenue Code)	Generally restricted to executive group, but may be open to all employees. IRS requires that classes of eligible employees be specifically enumerated and that employees owning 5% or more of company stock be excluded.	Not prescribed.	Single payment.	Difference between fair market value on date of grant and date of exercise. Some administrative costs also usually assumed.	Either purchased in open market or distributed from authorized but unissued block of shares.	100% of fair market value on date option granted. Higher-priced options must be exercised first.	Total number of shares available must be specified at time of grant. Option must be exercised within 5 years of grant.	None [illegible] transferred employee.
Non-Qualified Employee Stock Option Plan	Generally restricted to executive group, but may be open to all employees. No IRS restrictions, and employer has full discretion as to eligible group.	Not prescribed.	Single payment.	Difference between fair market value on date of grant and date of exercise. Further, may be option price discount. Some administrative costs also usually assumed.	Either purchased in open market or distributed from authorized but unissued block of shares.	Generally 100% of fair market value on date option granted, but sometimes lower. Options can be exercised in any order.	Total number of shares specified at time of grant. Option must be exercised within period set by employer (usually 10 years).	None [illegible] transferred employee.

UNITED STATES RAILWAY ASSOCIATION

SUMMARY OF COMPANY-ASSISTED EMPLOYEE STOCK OWNERSHIP TECHNIQUES

[illegible]	13	14	15	16	17	18	19	20
Acquiring Stock by Employees		Duration of Plan	Approvals and Submissions			Nature of Company Cost	Relation of Employee Benefit to Company Profits	Extent of Employee Identification as Shareholder
...tions	Employee Tax Implications		To Stockholders	To Internal Revenue Service	To Securities & Exchange Commission			
...e stock ...uted ...e.	To extent net unrealized appreciation at distribution was not taxed in year of distribution, such amount is taxed as long-term capital gain on later sale. Excess of value at date of sale over value at date of distribution taxed as long- or short-term capital gain.	Indefinite. Plan is presumed to be permanent, but may be terminated at any time by employer.	Customarily submitted for approval or ratification.	Detailed filing required to "qualify" plan and establish tax-exempt status of associated trust fund under Sections 401(a) and 501(a) of Internal Revenue Code. Requires use of Form 4573 and Form 4575.	Plan must register under the Securities Act of 1933, [illegible] prospectus must be given to all eligible employees.	Tax-deductible expense (up to 15% of covered payroll), but direct reduction in net income. Amount of company contribution roughly determinable in advance, and may remain level as percent of payroll.	May be direct if company contribution for year is so designed. Also indirect relationship through effect of profit on dividends and market value of shares held in trust.	Limited, since stock held and voted by trustee for fixed number of years or until employee terminates service. However, plan may permit employee to instruct trustee on voting of shares held in his behalf.
...er than ...from ...transfer ...s from ...n was	If option price is at a discount from fair market value, ordinary income tax on lesser of excess of fair market value at grant over option price or excess of fair market value at disposition over price paid for share. If option price not fixed at grant, it is determined as if option were exercised at grant. Long-term capital gains tax on balance of actual profit in either case.	May be indefinite or have limited duration, at employer option.	Must be approved within 12 months before or after date plan is adopted.	Employer must report transfers of stock under the plan only if option price was less than 100% of fair market value on the date of grant.	Offering of stock under plan must generally be registered using Form S-8, and prospectus given to all participants.	Indirect cost through dilution of shareholders' equity to extent options exercised at price below market value. Magnitude of cost roughly determinable in advance. Benefit to most employees derived at greater cost to corporation than direct compensation increase.	Indirect relationship only, through effect of profit on market value of shares for which options have been granted.	None, unless or until option is exercised; then full identification since employee has stock certificate.
	Long- or short-term capital gains tax on excess of sale price over fair market value at time stock was transferred to employee.	May be indefinite or have limited duration, at employer option.	Customarily submitted for approval or ratification.	Not required.	Plan must generally be registered using Form S-8, and prospectus given to all eligible employees.	Company cost depends on extent of "discount" or "bonus" offered employees, and on price of stock. Cost to company is tax deductible but reduces net income. Amount of cost is roughly determinable in advance.	Primarily indirect relationship, but company may offer variable discount or bonus depending on profit results.	None until stock is purchased and certificates issued to participating employees. Will be greater the more often stock is distributed to employees.
...ier than ...ion transfer.	Long-term capital gains tax on difference between the price paid for share and sale price.	May be indefinite or have limited duration, at employer option.	Must be approved within 12 months before or after date plan is adopted.	Not required.	Plan must generally be registered using Form S-8, and prospectus given to all eligible employees. Purchases and sales by company officers must be separated by at least 6 months to comply with insider trading rules.	No charge against income. Indirect cost through dilution of shareholders' equity to extent options exercised at price below market value. Because no tax deduction is allowed, costs are greater than for direct compensation. Magnitude of cost roughly determinable in advance.	Indirect relationship only, through effect of profits on market value of shares for which options have been granted.	None, unless or until option is exercised; then full identification since employee has stock certificate.
	Long-term or short-term capital gains tax on excess of sale price over fair market value at time stock was transferred to employee.	May be indefinite or have limited duration, at employer option.	Customarily submitted for approval or ratification.	Not required.	Plan must generally be registered using Form S-8, and prospectus given to all eligible employees. Purchases and sales by company officers must be separated by at least 6 months to comply with insider trading rules.	No charge against income. Indirect cost through dilution of shareholders' equity to extent options exercised at price below market value. Because tax deduction is allowed, costs are comparable to direct compensation.	Indirect relationship only, through effect of profits on market value of shares for which options have been granted.	None, unless or until option is exercised; then full identification since employee has stock certificate.

TOWERS, PERKIN, FORSTER & CROSBY
May, 1975

EXHIBIT VI

UNITED STATES RAILWAY ASSOCIATION

Distribution of Employees By Age and Service
(Six railroads in reorganization)

A. Non-Agreement Employees

Age in 1974	Under 1	1	2-4	5-9	10-14	15-19	20-24	25-29	30-34	35-39	40+	Total	
	Service (Years)												
Under 20	1	8	1									10	(0.2%)
20 - 24	4	54	59	36								153	(2.4%)
25 - 29	1	45	114	210	37							407	(6.5%)
30 - 34	1	12	48	221	211	20						513	(8.2%)
35 - 39	1	5	16	72	141	178	42					455	(7.2%)
40 - 44	1	8	20	51	79	214	291	72				736	(11.7%)
45 - 49		7	15	39	41	89	311	449	217			1,168	(18.6%)
50 - 54		7	16	39	27	54	150	300	861	60		1,514	(24.1%)
55 - 59		2	9	15	21	26	49	118	383	316	15	954	(15.2%)
60 - 64		2	2	5	3	15	15	35	91	97	87	352	(5.6%)
65 - 69		1		1	1		1	2	2		11	19	(0.3%)
Total	9	151	300	689	561	596	859	976	1,554	473	113	6,281	(100.0%)
	(0.1)	(2.4)	(4.8)	(10.9)	(8.9)	(9.5)	(13.7)	(15.5)	(24.8)	(7.5)	(1.8)		

B. Agreement Employees

Age in 1974	Under 1	1	2-4	5-9	10-14	15-19	20-24	25-29	30-34	35-39	40+	Total	
	Service (Years)												
Under 20	3	255	16									274	(0.3%)
20 - 24	24	2,019	2,490	703								5,236	(6.1%)
25 - 29	12	1,104	2,447	3,552	278							7,393	(8.6%)
30 - 34	8	420	1,113	2,649	1,260	93						5,543	(.6.5%)
35 - 39	2	222	589	1,402	1,030	1,302	209					4,756	(5.6%)
40 - 44	3	123	393	964	688	1,686	2,016	336				6,209	(7.3%)
45 - 49	1	94	320	876	607	1,289	2,756	3,209	1,275			10,427	(12.2%)
50 - 54	5	72	253	828	553	873	2,120	3,341	7,773	277		16,095	(18.8%)
55 - 59	2	36	202	646	366	518	1,282	2,309	7,924	2,657	452	16,394	(19.2%)
60 - 64	2	15	85	401	217	329	730	1,494	4,715	1,783	1,608	11,379	(13.3%)
65 - 69			14	107	34	50	81	169	454	126	682	1,717	(2.0%)
70+		3		3	1		11	9	21	1	20	69	(0.1%)
Total	62	4,363	7,922	12,131	5,034	6,140	9,205	10,867	22,162	4,844	2,762	85,492	(100.0%)
	(0.1)	(5.1)	(9.3)	(14.2)	(5.9)	(7.2)	(10.8)	(12.7)	(25.9)	(5.7)	(3.2)		

NOTES:
(1) Figures based on data submitted to USRA as of January 2, 1974.
(2) Figures do not include Erie Lackawanna employees.
(3) Figures in parentheses are number of employees as percentage of total.

May, 1975

EXHIBIT VII
(Page 1 of 3)

UNITED STATES RAILWAY ASSOCIATION

Illustration of Potential Annual Retirement Income Benefits
(Agreement Employees)

Final Year's Earnings	All Seven Railroads		National Average	
	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings
$ 9,000:				
Private Plan	-	-	$3,120	34.7%
RRA*	$5,100	56.7%	3,510	39.0
Total	5,100	56.7	6,630	73.7
$12,000:				
Private Plan	-	-	$3,120	26.0%
RRA*	$6,100	50.8%	3,750	31.3
Total	6,100	50.8	6,870	57.3
$15,000:				
Private Plan	-	-	$3,120	20.8%
RRA*	$7,200	48.0%	3,750	25.0
Total	7,200	48.0	6,870	45.8
$18,000:				
Private Plan	-	-	$3,120	17.3%
RRA*	$7,200	40.0%	3,750	20.8
Total	7,200	40.0	6,870	38.1

(* Social Security for National Average)

See Notes on page 3.

UNITED STATES RAILWAY ASSOCIATION

Illustration of Potential Annual Retirement Income Benefits
(Non-Agreement Employees)

	Penn Central		Ann Arbor		Central of New Jersey		Erie Lackawanna		Reading	
Final Year's Earnings	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings
$ 9,000:										
Private Plan	$ 0	0%	$ 0	0%	$ 826	9.2%	$ 569	6.3%	$ 475	5.3%
RRA*	5,100	56.7	5,100	56.7	5,100	56.7	5,100	56.7	5,100	56.7
Total	5,100	56.7	5,100	56.7	5,926	65.9	5,669	63.0	5,575	62.0
$15,000:										
Private Plan	737	4.9	737	4.9	2,105	14.0	2,028	13.5	2,111	14.1
RRA*	7,200	48.0	7,200	48.0	7,200	48.0	7,200	48.0	7,200	48.0
Total	7,937	52.9	7,937	52.9	9,305	62.0	9,228	61.5	9,311	62.1
$25,000:										
Private Plan	4,828	19.3	4,828	19.3	6,196	24.8	4,461	17.8	4,839	19.4
RRA*	7,200	28.8	7,200	28.8	7,200	28.8	7,200	28.8	7,200	28.8
Total	12,028	48.1	12,028	48.1	13,396	53.6	11,661	46.6	12,039	48.2
$50,000:										
Private Plan	15,057	30.1	15,057	30.1	16,425	32.9	10,542	21.1	11,658	23.3
RRA*	7,200	14.4	7,200	14.4	7,200	14.4	7,200	14.4	7,200	14.4
Total	22,257	44.5	22,257	44.5	23,625	47.3	17,742	35.5	18,858	37.7

(* Social Security for National Average)

Final Year's Earnings	Lehigh Valley		Lehigh & Hudson		Group Average		National Average	
	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings	Annual Benefit	Benefit as % of Final Earnings
$ 9,000:								
Private Plan	$ 569	6.3%	$ 569	6.3%	$ 430	4.8%	$2,610	29.0%
RRA*	5,100	56.7	5,100	56.7	5,100	56.7	3,510	39.0
Total	5,669	63.0	5,669	63.0	5,530	61.5	6,120	68.0
$15,000:								
Private Plan	2,028	13.5	2,028	13.5	1,682	11.2	4,800	32.0
RRA*	7,200	48.0	7,200	48.0	7,200	48.0	3,750	25.0
Total	9,228	61.5	9,228	61.5	8,882	59.2	8,550	57.0
$25,000:								
Private Plan	4,461	17.8	4,461	17.8	4,868	19.5	8,750	35.0
RRA*	7,200	28.8	7,200	28.8	7,200	28.8	3,750	15.0
Total	11,661	46.6	11,661	46.6	12,068	48.3	12,500	50.0
$50,000:								
Private Plan	10,542	21.1	10,542	21.1	12,832	25.7	19,000	38.0
RRA*	7,200	14.4	7,200	14.4	7,200	14.4	3,750	7.5
Total	17,742	35.5	17,742	35.5	20,032	40.1	22,750	45.5

(* Social Security for National Average)

Notes:

(1) National Average based on Bankers Trust "1975 Study of Corporate Pension Plans", encompassing 190 large corporations in 56 industries.
(2) Employees assumed to retire at normal retirement age in 1975 with 35 years of service.
(3) Employee earnings assumed to increase 5% per year prior to retirement.
(4) Social Security benefits estimated for a 65-year old male retiring in 1975. No consideration given to spouse benefit which might be payable.
(5) Railroad Retirement benefits estimated for a 65-year old male retiring in 1975. No consideration given to supplemental annuity or spouse benefit which might be payable. Impact of spouse benefit can be substantial for agreement employees and lower-paid non-agreement employees.
(6) Certain of the railroads (e.g., Penn Central) have provision for covering agreement employees who were hired before 1961 under private plan. These benefits, which require employee contributions, have been excluded from this comparison.

May, 1975

EXHIBIT VIII
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UNITED STATES RAILWAY ASSOCIATION

Brief Description of Employee Benefits
Group Life Insurance
(Agreement Employees)

Major Provisions	All Railroads (GA 23000)	National Average
Basic Coverage	$6,000	$11,000
Employee Contributions	None	None

NOTES:

(1) National Average based on 1975 TPF&C study of recent bargaining agreements in ten major industries.

(2) National Average based on annual earnings of $12,000.

EXHIBIT IX
(Page 1 of 2)

UNITED STATES RAILWAY ASSOCIATION

Brief Description of Employee Benefits
Basic Medical Insurance
(Agreement Employees)

Major Provisions	All Railroads (GA23000)	National Average
Hospital Room and Board	Semi-private room for 365 days	Semi-private room for 365 days
Hospital Ancillaries	$1,000 plus 80% of excess	In full
Surgical Benefits	$650 schedule maximum	Reasonable and customary
Employee Contributions	None	None

NOTES:

(1) National average based on 1975 TPF&C study of recent bargaining agreements in ten major industries.

UNITED STATES RAILWAY ASSOCIATION

Brief Description of Employee Benefits
Group Life Insurance
(Non-Agreement Employees)

Major Provisions	Penn Central	Ann Arbor	Central of New Jersey	Erie Lackawanna	Reading	Lehigh Valley	Lehigh & Hudson	National Average
Basic Coverage	2 x annual earnings	2 x annual earnings (maximum $115, 000)	2 x annual earnings (maximum $100, 000)	1 x annual earnings (maximum $10, 000), plus optional 1 x annual earnings	1 x annual earnings, plus optional 1 x annual earnings	2 x annual earnings	2 x annual earnings	2 x anhual earnings
Employee Contributions	None	None	None	None (optional requires contributions)	None (optional requires contributions)	None	None	None

NOTES

(1) National Average based on 1973 TPF&C study "Employee Benefit Plans in the Top 100 U. S. Industrial Companies".

May, 1975

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EXHIBIT IX
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UNITED STATES RAILWAY ASSOCIATION

Brief Description of Employee Benefits
Basic Medical Insurance
(Non-Agreement Employees)

Major Provisions	Penn Central	Ann Arbor	Central of New Jersey	Reading	Lehigh Valley	Lehigh & Hudson	Erie Lackawanna	National Average
Hospital Room and Board	Semi-private room for 180 days	Semi-private room for 365 days	Semi-private room for 120 days	Semi-private room for 365 days	Semi-private room for 180 days	Semi-private room for 180 days	First $1000 in full 80% of next $2000 Excess in full	Semi-private room for 365 days
Hospital Ancillaries	$1000, plus 80% of excess	$1000, plus 80% of excess	$2000	$2000, plus 80% of excess	$1000, plus 80% of excess	$1000, plus 80% of excess	80% of charges	In full
Surgical Benefits	$650 schedule maximum	$650 schedule maximum	$1000 schedule maximum	$650 schedule maximum	$650 schedule maximum	$650 schedule maximum	80% of reasonable and customary	Reasonable and customary
Employee Contributions	None	None	None	None	None	None	None	None

NOTES:

(1) National Average based on 1973 TPF&C study "Employee Benefit Plans in the Top 100 U.S. Industrial Companies".

(2) Erie Lackawanna has a comprehensive medical plan combining basic and major medical coverage.

May, 1975

EXHIBIT X
(Page 1 of 2)

UNITED STATES RAILWAY ASSOCIATION

Brief Description of Employee Benefits
Major Medical Insurance
(Agreement Employees)

Major Provisions	All Railroads (GA23000)	National Average
Maximum	$250,000 per lifetime	$100,000 per lifetime
Co-insurance (paid by plan)	80%	80%
Deductible	$100	$100
Employee Contributions	None	None

NOTES:

(1) National Average based on 1975 TPF&C study of recent bargaining agreements in ten major industries.

UNITED STATES RAILWAY ASSOCIATION

Brief Description of Employee Benefits
Major Medical Insurance
(Non-Agreement Employees)

Major Provisions	Penn Central	Ann Arbor	Central of New Jersey	Reading	Lehigh Valley	Lehigh & Hudson	Erie Lackawanna	National Average
Maximum	$250,000 per lifetime	$50,000 per lifetime $20,000 per year	$250,000 per lifetime	$2[illegible]0,000 per lifetime	$50,000 per lifetime	$50,000 per lifetime	$1[illegible],000 per lifetime	$25,000 per lifetime
Co-insurance (paid by plan)	80%	80%	80%	80%	80%	80%	80% (first $1[illegible]0 of hospital room and board and excess over $3000 paid in full)	80%
Deductible	1% of earnings (minimum $100) (maximum $250)	$100	$100	$100	1% of earnings (minimum $100) (maximum $250)	1% of earnings (minimum $100) (maximum $250)	$100	$100
Employee Contributions	None	None	None	None	None	None	None	For dependents only

NOTES:

(1) National Average based on 1973 TPF&C study "Employee Benefit Plans in the Top 100 U. S. Industrial Companies".

(2) Erie Lackawanna has a comprehensive medical plan combining basic and major medical coverages.

May, 1975

EXHIBIT XI
(Page 1 of 2)

UNITED STATES RAILWAY ASSOCIATION

Qualified Employee Stock Purchase Plan

ELIGIBILITY	On the first day of January or July, after attainment of age 21 with 2 years of service. Employees owning 5% or more of ConRail stock excluded.
EMPLOYEE CONTRIBUTIONS	From 1% to 10% of basic earnings. $25,000 annual limit per employee. Contribution rate may be changed, or contributions may be suspended, on the first day of January or July, provided notice is given 30 days in advance.
EMPLOYER CONTRIBUTIONS	No contributions as such. 15% discount in market price of stock at time of exercise.
APPLICATION OF CONTRIBUTIONS TO PURCHASE SHARES OF STOCK	All employee contributions remitted to Trustee at end of each month. Trustee then acquires shares within 30 days after receiving funds.
DISTRIBUTION OF ACCOUNT	On July 1 and January 1 Trustee distributes a certificate covering full shares then held in participant's account. Cash representing the market value of fractional shares retained in employee's account for subsequent purchase of shares.
SALE OF STOCK BY PARTICIPANTS	No taxation until sale of stock. If stock is held for required period, taxation as combination of ordinary income and long-term capital gain.

EXHIBIT XI
(Page 2 of 2)

VOTING RIGHTS OF EMPLOYEES	Full and complete upon allocation of shares to participant account.
PLAN TERM	Indefinite
PLAN ADMINISTRATION	By committee and trustee selected by ConRail

May, 1975

EXHIBIT XII
(Page 1 of 2)

UNITED STATES RAILWAY ASSOCIATION

Non-Qualified Employee Stock Purchase Plan

ELIGIBILITY	On the first day of January or July, after attainment of age 21 with 2 years of service.
EMPLOYEE CONTRIBUTIONS	From 1% to 10% of basic earnings. Contribution rate may be changed, or contributions may be suspended, on the first day of January or July, provided notice is given 30 days in advance.
EMPLOYER CONTRIBUTIONS	Ultimately 50% of employee's contributions during each pay period. This level to be reached gradually as corporate profits allow.
APPLICATION OF CONTRIBUTIONS TO PURCHASE SHARES OF STOCK	All employee and employer contributions remitted to Trustee at end of each month. Trustee then acquires shares within 30 days after receiving funds.
DISTRIBUTION OF ACCOUNT	On July 1 and January 1 Trustee distributes a certificate covering full shares then held in participant's account. Cash representing the market value of fractional shares retained in employee's account for subsequent purchase of shares.
SALE OF STOCK BY PARTICIPANTS	Value of ConRail contribution taxed to employee as ordinary income at time of purchase. At subsequent disposition, additional appreciation taxed as capital gain.

EXHIBIT XII
(Page 2 of 2)

VOTING RIGHTS OF EMPLOYEES	Full and complete upon allocation of shares to participant account.
PLAN TERM	Indefinite
PLAN ADMINISTRATION	By a committee and trustee selected by ConRail

May, 1975

UNITED STATES RAILWAY ASSOCIATION

A Technical Review of the Employee Stock Ownership Trust

February 24, 1975

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UNITED STATES RAILWAY ASSOCIATION

A Technical Review of the Employee Stock Ownership Trust

I. Introduction

The Regional Rail Reorganization Act of 1973 created USRA as the agency responsible for developing a plan for the reorganization of the six bankrupt railroads covered by the Act. Among the areas which the plan must specifically address are motivation of railroad employees and capitalization of the new Consolidated Rail Corporation (CONRAIL). In this regard, the Act states that the final system plan shall outline the manner in which an Employee Stock Ownership Trust may, "to the extent practicable", be utilized for the dual purpose of capitalization and employee motivation. USRA must determine whether such an approach is feasible under the circumstances.

TPF&C was retained for the purpose of evaluating the appropriateness of an Employee Stock Ownership Trust for CONRAIL. This report is intended to present sufficient background information to enable USRA to understand exactly how the concept operates. A more detailed study of its possible application to CONRAIL will then be conducted with assistance from outside experts in the fields of corporate finance and employee motivation. The results of this study will be presented in a final report in May of this year.

II. Basic Design of an Employee Stock Ownership Trust

The Employee Stock Ownership Trust (ESOT) has been legally possible for over thirty years, but has attracted attention only recently largely through the efforts of Louis O. Kelso, a San Francisco attorney. While the Internal Revenue Service does not keep precise figures on ESOT's, estimates of the number currently in existence range from about 200 to 500.

Essentially the ESOT is designed to place employer stock in the hands of employees, while at the same time providing the corporation with a ready source of investment capital. These goals are accomplished at the outset by the establishment of a "qualified" employee stock bonus and/or money purchase pension plan in accordance with the provisions of the Internal Revenue Code. Under the terms of the plan, the employer agrees to make annual contributions (according to a pre-determined formula) for the express purpose of transferring ownership of company stock to eligible employees. The contributions for this purpose represent a tax deduction to the corporation and are not taxable to the employees until actually distributed from the plan in the form of employer stock. All income and appreciation are also tax-sheltered until the time of distribution.

The corporate financing objective is accomplished through a loan negotiated by the trust with an appropriate lending institution. The trust applies the loan to the purchase of employer stock and pledges the stock as collateral for the loan. This places the necessary capital in the hands of the employer, who then amortizes the loan (through the trust) with his annual contributions to the plan. As the loan is retired, an amount of stock equal to each year's payment of principal is allocated to the accounts of all eligible employees. A special amortization schedule is adopted to avoid the usual imbalance between debt service and principal payments in the early years.

III. Establishment of an Employee Stock Ownership Trust

In order to establish an ESOT, the following basic steps must be performed:

1. The employer creates a stock bonus plan and trust (and/or money purchase pension plan) qualified under Sections 401(a) and 501(a) of the Internal Revenue Code with a fixed formula for determining annual contributions and a fixed formula for allocating them among employees.

2. The employer applies to the Securities and Exchange Commission for a ruling on whether the employer stock earmarked for the plan must be registered. (While the employer stock generally does not require registration

under a qualified plan, some authorities have expressed concern on this point and recommend this step as a precaution.)

3. The employer establishes the fair market value of the earmarked stock. (An outside firm may be called upon to assist in the evaluation in order to insure impartiality.)

4. The employer appoints a trustee who applies to a lending institution for a loan with the earmarked employer stock as collateral. (The employer will also be asked to co-sign the loan.)

5. The trustee applies the borrowed funds to the purchase of the earmarked employer stock.

Once an ESOT has been established, the following steps must be taken in each succeeding year:

1. The employer makes a contribution to the stock bonus and/or money purchase pension plan in accordance with the pre-determined formula (usually a percentage of eligible payroll).

2. The trustee uses the employer's contribution to make the required payment on the loan.

3. The trustee credits each participating employee's account with company stock equal to his share (based on the allocation formula) of the employer's payment of principal.

4. The employer claims the entire contribution as a tax deduction up to 15% of eligible payroll (25% if a money purchase pension plan is included).

5. The trustee (at the employer's direction) votes all shares held under the trust. (Employees may be granted voting rights for shares in which they are vested.)

IV. <u>Use of an Employee Stock Ownership Trust</u>

An ESOT is typically applicable to corporations in a rather narrow range of circumstances. A corporation contemplating the adoption of an ESOT should meet all of the following requirements:

1. The company should have an eligible payroll of at least $500,000 and be in the maximum corporate income tax bracket.

2. The company should have a good credit rating.

3. The prospects for future earnings should be well above average

4. The company should be fairly closely-held, whether publicly or privately owned.

5. There should be a preference for equity over debt financing.

6. There should be a real desire to place substantial ownership in the hands of employees.

The size of a company is important because the loan to the trust must be amortized with annual payments equal to a maximum of 25% of the payroll of eligible employees. A payroll of less than $500,000 is not adequate to produce loan payments over the customary number of years. A company which is not in the maximum corporate income tax bracket is unlikely to be in a strong earnings position and moreover would not gain the same tax advantages from an ESOT because of its lower tax bracket.

The company must have a good credit rating and good prospects for future earnings for two reasons. First, the lending institution will require that the corporation co-sign the loan with the trustee. A weak credit rating will jeopardize the plan right from the start and will also raise Internal Revenue Service questions concerning the company's true intentions. Second, and perhaps more important, an ESOT represents a major commitment to an employee benefit plan which should not be undertaken by a company in a weak earnings position. No firm should ever resort to an ESOT to raise capital when its credit position in the traditional money markets is unsound.

It is vitally important that any corporation considering an ESOT weigh carefully the pros and cons of equity versus debt financing. Since an ESOT often involves a new issue of employer stock and future allocation to participants at less than fair market value, there is bound to be some dilution of shareholders' equity. While this may be justified in management's eyes when compared to the current cost of debt financing, there is the possibility of a backlash from shareholders. Private, closely-held firms appear to be the most likely candidates for an ESOT because the employee group represents a "captive market" which makes an equity issue possible and thus presents an alternative to the usual debt financing.

Finally, the importance of a genuine management commitment to the idea of employee stock ownership cannot be over-emphasized. While the corporate financing aspect of the ESOT approach often commands the most attention, management must view employee ownership of the firm as a positive goal in itself. Because of the

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ongoing nature of a qualified stock bonus plan, employees will come to expect an opportunity to participate in company ownership beyond the time when the loan to the trustee is repaid. If this ongoing commitment is not present, an ESOT may ultimately become a source of employee dissatisfaction.

V. Internal Revenue Service Requirements

Internal Revenue Service requirements are a major factor in the consideration of an ESOT because the employee stock bonus plan must be "qualified" in order to ensure that employer contributions (and employee accounts) are exempt from taxation. The basic requirements which a stock bonus plan must meet in order to obtain "qualified" status are the following:

1. The plan must be permanent in nature (duration of the plan cannot be linked to the repayment period of the loan).

2. The plan must not discriminate in favor of officers, shareholders, or highly compensated employees.

3. The plan must be for the "exclusive benefit" of eligible employees.

4. All distributions from the plan must be in the form of employer stock, although dividends can be paid annually in cash on a

non-tax-favored basis. (Money purchase pension plan distributions can be in any form.)

5. Annual employer contributions cannot exceed 15% of eligible payroll. (25% if a money purchase pension plan is included.)

The first three of the above requirements are imposed by the Internal Revenue Service on all employee benefit plans intended to provide retirement income. The fourth is directed specifically at stock bonus plans and is the one distinguishing feature of these plans in the IRS' eyes. The fifth is applicable to stock bonus, profit sharing and thrift plans alike. Generally speaking, a stock bonus plan is viewed by the IRS as a variant of the profit-sharing approach. However, there is no requirement that employer contributions be made from corporate earnings, and the employer is thus committed to make a contribution even in a loss year.

The requirement that the plan be permanent in nature deserves emphasis in light of the tendency to view an ESOT largely in terms of corporate financing. While plans of this nature can sometimes be terminated for business reasons without dire tax consequences, they should nonetheless be viewed as a fixed commitment. As noted previously, termination of a plan after it has become established and accepted can have an adverse impact on employee morale.

The requirement that the plan not discriminate in favor of key personnel is basic to IRS qualifications. While this mandates the use of uniform eligibility, vesting, and retirement rules, it does not prevent the allocation of stock in relation to salary. As long as there is a fixed allocation formula, there is nothing to prevent an employee earning $50,000 from receiving five times the amount of stock that a $10,000 employee receives. In fact, most stock bonus plans make allocations on precisely this basis.

The "exclusive benefit" requirement poses perhaps the greatest obstacle to qualification of an ESOT. In order to meet this requirement, the Internal Revenue Service has ruled that employer stock must be valued at no more than "fair market value" at the time of purchase by the trust and that the employer must have been able to borrow an equivalent sum in the regular money markets at that time. The requirements concerning liquidity, diversification, and fair return on investments are waived for a stock bonus plan.

The difficulties with the "exclusive benefit" rule center around a situation in which the employer stock declines in value after the date of purchase by the trust. Under these circumstances, there is a legitimate question as to whether the plan is indeed operating for the "exclusive benefit" of the employees, since the trust will be allocating shares at a value higher than their current market value. Lending institutions have recognized this possibility, which explains their usual insistence that the employer co-sign the loan with the trustee. The Internal Revenue Service is increasingly concerned with this problem, and a number of District Offices around the country have declared a moratorium on the approval of new ESOT's. This policy will probably remain unchanged until the National Office issues some clear guidelines in this area. At the present time, it appears unlikely that this will happen prior to 1976.

Another potential problem concerning IRS requirements involves the definition of "unrelated business income" under an ESOT. Such income is taxable to the trust in the year earned. While there are no clear guidelines in this area either, some authorities have voiced the opinion that increases in the value of the employer stock may result in a ruling that any increase attributable to the unallocated portion of the stock is "unrelated business income" and therefore taxable. While no such ruling has come down, concern will remain until clearer guidelines are forthcoming from the National Office.

On a more positive note, IRS rules are quite clear and generally favorable with regard to distributions from an ESOT. As noted above, distributions from a qualified stock bonus plan must be in the form of employer stock, with the sole exception of annual dividend payments. At the time of distribution, the employee is taxed on the original purchase price of the stock in his account. This is considered ordinary income, subject to ten-year forward averaging. Any increase in the value of the stock above its original purchase price is taxed as a capital gain to the employee at the time he actually sells it. Since there is rarely a broad market for the stock, especially with a privately-held firm, the trustee is usually granted a "right of first refusal" to repurchase the stock from the employee. This does not violate the "exclusive benfit" rule since the employee is not required to sell and may hold the stock as long as he wishes.

VI. Impact of Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act of 1974 (ERISA) specifically recognizes the ESOT and includes it in the category of "eligible individual account plan". Such plans, if they are specifically designed for investment in employer stock, are exempt from certain requirements of the new law. Most important among these is the limitation on investment in employer stock to 10% of total plan assets. While the law thus appears to treat such plans as a separate class, there are certain specific provisions which tend to raise some doubts about their exact status.

ERISA continues the exemption of stock bonus plans from the IRS requirements concerning liquidity, diversification and fair return on investments. It clearly includes them, however, under the new "prudent man" rule and the old "exclusive benefit" rule. This raises some serious questions for plan trustees, who are now classified as "fiduciaries" under the law. As such, they are subject to civil suit by employees for failure to ensure that investments are made with the care a "prudent man" would normally exercise and are for the "exclusive benefit" of employees. What, for example, is a trustee's responsibility if he believes that investment in employer stock is not "prudent" at a given point in time? While he is technically bound by the provisions of the plan (and the loan agreement), he could be exposing himself to possible legal action by employees in the event of subsequent depreciation in the employer stock. Hopefully, this question will be resolved when regulations implementing ERISA are issued sometime in mid-1975. In the meantime, it presents at least a temporary problem, although insurance is now available to cover the potential liability of fiduciaries.

Other provisions of ERISA affect the design of qualified plans in such areas as vesting and eligibility. Under the new law, no employee may be excluded from a qualified plan once he has attained age 25 and completed one year of service. This requirement obviously serves to broaden the plan base and allows employees to participate sooner than the employer might otherwise wish.

The vesting requirements of ERISA also serve to expand the benefits of a qualified plan by limiting the number of years that may be required before an employee gains a vested right to his benefits. The new law provides three alternate minimum vesting schedules, along the following lines:

1. 100% vesting after 10 years of service

2. 50% vesting when age plus service equals 45, with 10% additional each year thereafter

3. 25% vesting after 5 years of service, with additional amounts each year until vesting is 100% after 15 years.

While all of these schedules provide more rapid vesting than is currently found in many pension plans, stock bonus plans have traditionally allowed employees to gain vested rights at an earlier date in order to reinforce the motivational aspect of these plans.

One final ERISA provision which is worthy of note authorizes the Department of Labor to act if it receives objections from the requisite number of employees concerning establishment of a qualified plan or financial transactions conducted under the plan. While this is unlikely to occur in practice, it further emphasizes the importance of viewing an ESOT as an employee benefit plan as well as a corporate financing vehicle.

VII. Employee Benefit Design Considerations

Any evaluation of the ESOT approach must attempt to place it in its proper perspective among employee benefits. When, for example, does an ESOT represent a sound benefit program, and when is it either excessive or inadequate? The answer generally lies in the attitude of the employer and in the existence of other benefit plans at the same location.

A major reason for adoption of an ESOT is to improve employee motivation by tying employee fortunes more closely to those of the employer. An ESOT should never be viewed as a traditional pension plan because it offers no guarantees of retirement security. In fact, the basic design of an ESOT precludes recognition of an employee's service prior to inception of the plan. This serves to emphasize the point that an ESOT should not be utilized as a company's sole retirement vehicle, but should rather be considered in conjunction with a bona fide pension plan.

While an ESOT may thus be inadequate in some situations, there are others in which it may be unnecessary or overly generous. For example, a firm which already has a good pension plan and well-motivated employees would appear to have little need for an ESOT. This would be doubly true if there were also some sort of bonus and/or profit-sharing plan in effect. Under these circumstances, an ESOT would clearly be superflous, unless it served to replace the existing profit-sharing plan.

Perhaps the most logical situation in which to consider an ESOT would be one in which there is an existing pension plan providing modest benefits, but employee productivity and overall motivation are low. The threat of unionization might also be a further inducement to management to take some decisive action. Under these circumstances an ESOT could be very valuable, provided, of course, that the prospects for future growth were promising. If the prospects for future growth were not promising, or if the stock were publicly traded at a low price-earnings ratio, some non-profit-related incentive would be more appropriate.

One further consideration in this regard is the determination of which employee classifications should be included. In a smaller firm, all employees would normally participate once they had fulfilled the eligibility requirements. In a larger firm, while all salaried employees would normally be eligible, some or all of the hourly workers might be represented by a bargaining unit. Labor unions have traditionally been unreceptive to any sort of profit sharing or stock bonus plan, and a union might well use the introduction of an ESOT for salaried personnel as an excuse for new wage demands at the next round of contract negotiations. This possibility would have to be weighed against the advantages of introducing the plan for salaried and non-union hourly personnel.

VIII. Summary of Advantages and Disadvantages

Advocates of the ESOT have advanced a number of arguments in its favor. A company that meets the criteria outlined earlier may gain the following advantages from an ESOT:

1. Create a market for the corporate stock which might otherwise be unavailable.

2. Preserve management voting rights in newly-issued stock.

3. Provide an alternative to debt financing that allows repayment with pre-tax dollars.

4. Improve employee motivation through closer identification with the success of the company.

In addition to the above, there are some advantages to an ESOT which apply only in special situations. For example, a company which wishes to divest itself of a division or subsidiary may utilize an ESOT to avoid the problem of finding a buyer. Large shareholders in a closely-held company may find an ESOT appealing in that it provides them with a ready market for estate planning purposes without the sale of the firm to an outside interest. It is estimated, in fact, that the majority of ESOT's now in existence were created at least in part to facilitate the estate planning of key shareholders.

Perhaps the most important advantage of an ESOT lies in providing the option of equity financing to smaller, closely-held corporations which would otherwise have no choice but traditional debt financing. While a loan is still involved, the company repays both principal and interest with pre-tax dollars and at the same time provides a significant benefit for its employees. With traditional debt financing, only the interest is tax deductible, and repayment of the loan does not improve overall employee benefits. An ESOT thus provides some of the basic advantages of equity financing to the employer who is willing to pay the price inherent in an ongoing stock bonus plan.

The primary disadvantages of the ESOT approach are the following:

1. The employer stock may depreciate in value and leave the employees dissatisfied.

2. Existing shareholders may react against the dilution of their equity.

3. Bargaining units may reject coverage and view introduction of the plan as an excuse for increased wage demands.

4. Continuation of the stock bonus plan may become a liability to the firm once the original loan is repaid.

There are also the technical problems involving IRS requirements and the new pension legislation. With regard to the new law, regulations must clarify whether fiduciaries under an ESOT are responsible for deciding whether investment in employer stock is always "prudent". More importantly, until the IRS National Office clarifies whether an ESOT is for the "exclusive benefit" of employees, the District Offices which have placed a freeze on new applications are unlikely to change their position. Thus in some areas of the country an ESOT is for the moment not a viable option.

Perhaps the most important drawback to an ESOT is the possibility of a decline in company fortunes. Not only would this reduce the value of employee accounts, and make the corporate tax advantages less significant, but it would also seriously jeopardize the company's ability to continue the stock bonus plan beyond the period of the loan. Termination of the plan with only marginal gains for employees might convince them that they had been deceived. The end result would then be the exact opposite of what was intended by the establishment of the ESOT in the first place.

Taken together, the advantages and disadvantages tend to confirm above all the importance of a company's growth potential in the consideration of an ESOT. A firm which does not have both a solid earnings record and a good opportunity for expansion should probably explore other avenues of corporate financing and employee motivation. Where these requirements are met, the ESOT offers unique opportunities for certain corporations. Where they are lacking, it can prove to be both costly and ineffective.

IX. Possible Application to CONRAIL.

Concerning the possible application of the ESOT approach to CONRAIL, there appear to be a number of potential problem areas which will be explored in depth in the final report.

Perhaps the most important question concerns the potential profitability of CONRAIL; this is significant for a number of reasons. If profits are generally low, the value of CONRAIL stock is not likely to increase substantially and may decline. With today's uncertain stock market, it is also possible that CONRAIL might show reasonable profits and still be traded publicly at a low price-earnings ratio. In either event, a stock bonus plan would be of doubtful value to employees and could result in the type of employee backlash mentioned earlier.

From the corporation's standpoint, one of the primary advantages of an ESOT lies in the fact that contributions to the qualified stock bonus plan are made with pre-tax dollars. If CONRAIL were to find itself in a non-profit situation, this advantage would disappear. Moreover, the contributions to the plan would be more burdensome than if made from profits.

Another basic question is whether there exists a need for a new benefit plan for employees of the railroads comprising CONRAIL. All their employees are covered under the Railroad Retirement Act, which provides generous benefits up to annual pay levels of about $15,000. All of the railroads provide additional retirement benefits to certain groups of employees, and health and welfare benefits are also quite generous. A stock bonus plan might thus represent an unnecessary addition to the overall benefits program.

It may be premature at this point to consider new benefits prior to the consolidation of the existing benefit plans, since the consolidation may involve some increase in benefits. On a more basic level, there may be some reluctance to provide additional benefits in view of the present financial condition of the covered railroads. CONRAIL may not wish to assume another fixed payroll cost of this magnitude, especially if additional investment capital can be raised through a regular equity issue and/or government sources.

Another potential drawback to adoption of an ESOT involves the relationship between the railroads comprising CONRAIL and the rest of the railroad industry. If an ESOT were introduced for CONRAIL employees, this would probably encourage employees at the other railroads to press for some equivalent benefit. In particular, this could have an impact on national bargaining with union employees.

With CONRAIL, as with any other corporation, the key factor in the consideration of an ESOT is the potential for growth and earnings. While other factors such as labor relations and overall benefit design are important, the primary concern must be the potential profitability of the new corporation. If the financial prospects are good, the ESOT may be a viable alternative. If they are not, other approaches to both employee motivation and corporate financing will probably be more effective.

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APPENDIX B

Evaluation of the Use of an Employee Stock Ownership Plan as a Method of Capital Formation for ConRail

Submitted By
E. F. Hutton & Company, Inc.

U. S. RAILWAY ASSOCIATION

Evaluation of the
Use of an
Employee Stock Ownership Plan
as a
Method of Capital Formation for ConRail

May 12, 1975

EF Hutton

E. F. Hutton & Company Inc.

Introduction

In conjunction with a study conducted by Towers, Perrin, Forster & Crosby ("TPF/C") for the United States Railway Association ("USRA") on "The Evaluation of the Employee Stock Ownership Plan ('ESOP') as Applied to ConRail", E. F. Hutton & Company Inc. has been engaged to evaluate an ESOP as a method of capital formation for ConRail.

This analysis is based on the information set forth in the USRA's Preliminary System Plan (the "PSP") and especially Part 3 which is entitled "Financial Assessment of the Preliminary System Plan". Inputs in the areas of employee benefit programs and employee motivation will be provided by TPF/C and Dr. Saul Gellerman, respectively.

This report reviews how an ESOP serves to provide capital to a corporation; examines the financial effects of an ESOP on the sponsoring corporation; and considers the advantages and disadvantages to a corporation and to its common shareholders of an ESOP financing as compared with other financing modes. It then considers the applicability of the ESOP method of financing to ConRail and gives E. F. Hutton's recommendations on the use of an ESOP at ConRail.

How an ESOP Operates to Provide Capital

Under an ESOP a corporation sets up a Trust established under a stock bonus plan qualified under Section 401(a) of the Internal Revenue Code. Such qualification is required in order to make the corporation's contributions deductible for tax purposes. The Trust then arranges for a loan from a bank or other lending institution, the proceeds of which are used either to purchase newly-issued stock from the corporation, or to purchase previously-issued stock from existing shareholders. The loan to the Trust is secured by the stock purchased and guaranteed by the sponsoring corporation. In establishing the ESOP the corporation undertakes to make contributions to the plan in an amount related to the size of the plan and the salary and wages of participating employees. Interest and principal payments on the loan to the Trust are made out of these contributions. The contributions, to the extent that they do not exceed 15% of the wages and salaries of the participating employees, are fully tax deductible in a qualified plan. The result of the transaction is to provide the corporation with capital in an amount equal to the loan made to the Trust, or to provide cash to selling shareholders (or their estates).

ESOP Financing - Debt or Equity

By its structure ESOP financing is a hybrid of debt and equity. While equity securities are "sold" to the Trust the ESOP financing does not provide the advantages of true equity financing because the corporation also incurs fixed charge obligations equal to those it would have under a straight debt financing. The advantage is that the debt can be retired through tax deductible contributions. For all practical purposes the loan to the Trust must be viewed as having been made directly to the corporation. The contributions are in fact interest and principal payments made directly by the corporation. The ESOP's stock is validly issued and outstanding in spite of the fact that it has not yet been allocated to the accounts of participating employees. No contributions are made by the participating employees; as the loan is retired and they achieve vesting, they receive stock essentially free of any cost to them.

Basically, the ESOP is a loan to the corporation the amortization of which creates an equity interest for the corporation's employees in the capitalization of the corporation. The reason for viewing it as a loan made directly to the corporation is the fact that any lending institution providing the funds to the Trust looks through the Trust vehicle to the source of the funds required to amortize the loan. The loan is made on the credit worthiness of the corporation and thus an ESOP does not create the opportunity to borrow in amounts significantly greater than the corporation could otherwise have borrowed. In the event of a default by the Trust the lenders could sell the stock. If the proceeds are inadequate, the corporation is obligated to repay the balance of the loan. However, this security interest is not meaningful because the Trust's default would have been occasioned by a prior default by the corporation. In the event of such a default the equity securities would have only a nominal value. This problem is further compounded by the fact that most ESOP financings are done for either private companies or companies with extremely thin trading markets, making realization upon sale of large amounts of equity difficult.

The equity interest represented by the stock held in the Trust, while not immediately vested to the accounts of participating employees, is recognized from the inception of the plan. The stock has the same rights as similar stock held by other investors including the right to vote and receive dividends, if such provisions exist. Pending vesting to the accounts of employees, the Trustee votes the stock in accordance with the provisions of the plan.

Comparison of ESOP Financing with Conventional Debt and Equity Financing

A comparison of the effects of ESOP financing, debt financing and equity financing is presented in Table I. It considers the impact of each on income, cash flow, capitalization and existing equity investors. The impact on a hypothetical corporation is demonstrated in Exhibit I. Table I and Exhibit I make the following assumptions:

1. An equal amount of money is raised under each of the alternative financings.

2. The proceeds from each of the alternatives are invested to produce an equivalent amount of revenues.

3. The contributions made by the corporation are equal to the interest and principal payments on the loan to the Trust.

4. The loan to the Trust is guaranteed by the corporation.

5. The corporation has only common stock in its equity capitalization. Therefore, the number of shares sold to the ESOP would be equivalent to the number of shares sold to investors in the equity financing.

6. "t" is the corporation's marginal tax rate.

7. No effect has been given to greater productivity resulting from the plan. See Dr. Gellerman's report for an analysis of the possibilities of such effects.

8. The corporation can avail itself of any of the three alternatives.

TABLE I

	ESOP Financing	Debt Financing	Equity Financing
Income Effects	-Pre-tax income is reduced by interest and principal payments on the loan (the contributions).	-Pre-tax income is reduced by the portion of the loan payment representing interest. Principal payments do not directly affect income.	-There is no reduction in income relating to the equity financing.
	-After-tax income is reduced by the amount of the interest and principal payments multiplied by (1-t).	-After-tax income is reduced by the amount of the interest portion multiplied by (1-t). Principal payments are not tax deductible.	-Any dividends paid on the corporation's stock are not tax deductible.
	-Any dividends paid on stock issued to the ESOP are not tax deductible.		
Cash Flow Effects	-Cash flow is reduced by the amount of interest and principal payments multiplied by (1-t).	-Cash flow is reduced by the amount of the interest portion of the loan payment multiplied by (1-t).	-Cash flow is reduced by dividend payments, if any, on the newly-issued stock.
	-Cash flow is reduced by dividend payments, if any, on the newly issued stock.	-Cash flow is reduced by the full amount of the principal portion of the loan payment.	
Capitalization Effects	-Initially the corporation would reflect the full amount of the Trust's loan as a long-term liability. As contributions are applied to repay the Trust's loan this liability would decrease.	-The loan would be reflected as a long-term liability. As the loan is amortized this liability would decrease	-Shareholders' equity would be increased by the proceeds from the sale of the stock.
	-Initially shareholders' equity would not show an increase. As the Trust's loan is repaid the decrease in the principal amount would be reflected by an increase in shareholders' equity.		-The increased income which derives from not charging income with the costs associated with the ESOP and debt financing will be added to retained earnings.
	-The number of shares outstanding would be increased by the shares sold to the ESOP.		-Retained earnings would be reduced by dividend payments, if any, on the newly issued shares.
	-Retained earnings would be reduced by dividend payments, if any, on the shares sold to the ESOP.		
Effect on Existing Shareholders	-The proportionate interest of existing shareholders in the corporation's net income and book value is diluted by the percentage relationship which the number of shares sold to the ESOP bears to the total shares outstanding after the sale to the ESOP.	-The excess of the income generated from the investment of the funds over the interest costs increases earnings and book value with no dilution in either the shareholders' proportionate interest in earnings or book value.	-The proportionate interest of existing shareholders in the corporation's net income is diluted by the percentage relationship which the number of shares sold to investors bears to the total shares outstanding after the offering.
			-The effect on the book value per share of existing shareholders depends on the relationship of the offering price per share to book value per share prior to the offering. If the offering price is greater than book value the financing increases book value; if the offering price is lower than book value the offer decreases book value.

Advantages of ESOP Financing

The ESOP method of financing can provide certain financial advantages over debt and equity financing in specialized situations. Generally, the most compelling financial advantage is that the principal on an ESOP loan is repaid with pre-tax dollars compared with after-tax dollars under conventional debt financing. This cash flow advantage in dollars is:

$$\frac{P}{(1-t)} - P$$

where "P" is the principal amount of the loan and "t" is the marginal tax rate. $P/(1-t)$ is the pre-tax income which must be generated to repay the conventional loan compared with an amount P of pre-tax income to repay the ESOP loan. If the corporation does not pay any taxes this advantage is not present. An offset to this cash flow advantage (relative to debt financing) is the dividend requirements, if any, on newly-issued shares.

The corporation is able to flow pre-tax dollars into its equity account since a portion of the contributions made to the ESOP go to repay the loan to the Trust which translates into an increase in shareholders' equity. For a tax paying corporation the fact that the principal amortization becomes a pre-tax charge rather than an after-tax charge to cash flow can improve the cash flow coverage ratios of total debt service (principal and interest) and thus increase overall debt capacity when contrasted with the debt financing.

At the present time, conditions in the equity securities markets are such that only major corporations can sell equity securities through the traditional underwriting channels. Under such conditions, for many companies the only practical equity financing is through an ESOP. As discussed above, the capital raising advantages of such a sale are limited. However, for estate planning purposes or for "going private" transactions an ESOP can be very useful, because in these cases the shares purchased by the ESOP are previously issued "secondary" shares. The debt capacity of the corporation can thus be used to provide liquidity to an estate or to increase the ownership percentage of inside shareholders.

Disadvantages of ESOP Financing

The principal financial disadvantage of the ESOP method is its impact on income and the dilution of the interests of existing shareholders. Contributions made to the plan are charged directly to income. To the extent that a part of the contribution represents principal payments on the loan to the Trust, this is an additional charge not associated with a debt financing. The reported income of a corporation using ESOP financing will be reduced by the entire contribution to the Trust whereas only interest payments are charged against earnings in a debt financing. While this charge is not important to a private corporation, it will reduce the value of any shares to be utilized to raise capital for the corporation.

In addition to the earnings impact, the shares in an ESOP will dilute overall earnings per share as they are deemed to be outstanding for computation of earnings per share. This "dilution" will also lower the per share value which could be obtained in a sale of equity to raise capital. Since the shares sold to the ESOP are valued at the same price as shares sold in the equity financing, the same dilution in existing shareholders' interest is created. However, there are no on-going charges to income. Therefore, in the equity financing the offset to the dilution of the newly-issued shares is the additional income which is generated by investment of the proceeds of the financing. If the after-tax rate of return earned on the proceeds is greater than the reciprocal of the multiple of earnings at which the common stock is valued, then the equity financing is non-dilutionary to existing shareholders' proportionate interest in the corporation's earnings. In the case of an ESOP financing the rate of return would have to be proportionately higher to compensate for the increased charges to earnings before such an offering became non-dilutionary.

The earnings generated from the productivity increases stemming from the motivational aspects of the ESOP plan must exceed the contribution costs by the pre-tax rate of return which the corporation could expect on investing the proceeds from the equity financing before the ESOP method would not adversely impact the proportionate interest of existing shareholders both in income and cash flow.

Impact on Financing Alternatives

While ESOP financing has numerous attributes of equity financing it is more properly considered debt financing for the reasons mentioned earlier in the report. There is, however, a difference of opinion as to how an ESOP should be accounted for in the accounting community. The alternatives are to either reflect the ESOP loan directly in the balance sheet, or indirectly as a contingent liability footnote. The form will not affect the analysis performed by members of the financial community. Contributions to the Trust, because of the implications of the default on its loan, should be considered a fixed charge of the corporation and, therefore, such an obligation is properly included in the liability section of the balance sheet for analytical purposes. The equity formation of an ESOP arises from a charge to income which amortizes the loan and occurs over the term of the loan. To include the loan to the Trust's proceeds in the shareholders' equity section of the corporation's balance sheet ignores the fixed obligation of the corporation to indirectly repay the loan through its contributions.

The proper capital structure of a corporation depends on a host of factors, the most important of which is the nature of its business. If a business expects an assured steady demand for its services and has the ability to cover its costs in pricing its product, its capital structure could include a substantial amount of leverage. A more speculative enterprise argues for less reliance on capital which necessitates fixed payments to avoid jeopardizing its on-going business.

As an ESOP financing is categorized as debt, it limits the borrowing capacity of a corporation. A lending institution or debt investor will consider the fixed nature of the corporation's obligations to the ESOP before lending it additional funds. One mitigating aspect is the tax subsidy on principal payments not available on a conventional loan.

The equity financing has a two-fold benefit to the corporation as it does not utilize existing borrowing capacity, but actually increases the amount a corporation can look to borrow in the debt markets.

It has been assumed that the corporation can avail itself of any of the three alternatives. If such were not the case, the decision to establish an ESOP requires additional considerations, however, the I.R.S. requires that the plan be for the exclusive benefit of the employees. Rulings on this matter require that the stock sold to the ESOP must be valued at no more than fair market value at the time of purchase by the Trust and that the corporation must have been able to borrow an equivalent sum in the regular money markets at the time.

This requirement should not be confused with the timing on the establishment of an ESOP. The maximization of the value received for the equity interest sold should be an important consideration to the corporation. If short-term uncertainties are reflected in a low valuation of the corporation's equity securities, then management should resort to debt financing, if available, to avoid a sale of equity which would unnecessarily dilute the interests of existing shareholders.

The Applicability of an ESOP as a Method of Capital Formation to ConRail

ConRail's Projected Financial Results and Funding Requirements

This analysis uses as a basis for examining the applicability of ESOP financing to ConRail the data presented in Chapter 14 of the PSP entitled "Financial Analysis of the Preliminary System Plan", and no assessment is made on the accuracy of such projections as E. F. Hutton took no part in their preparation.

The ability of ConRail to obtain capital from private sources independent of Federal guarantees depends on the credence placed by the financial community on the projections developed and in their assessment of the treatment of the creditors of the existing bankrupt railroads. It is our opinion that without a Federal guarantee ConRail as presently conceived will be precluded from raising funds (other than direct mortgage indebtedness) in the private sector until it has an operating history which demonstrates a capability of profitable operation. We believe that the USRA has reached the same conclusion as the inference drawn from a reading of Chapter 14 of the PSP, is that ConRail's ability to obtain funds from the capital markets will be quite limited. Of the $3.5 billion budgeted for external financing by 1985, approximately $3 billion is expected to consist of Federal notes. The balance is projected to consist of equipment obligations. If, in fact, ConRail will have no independent ability to achieve debt financing then the creation of an ESOP will not increase the ability of ConRail to raise capital. The necessary Federal guarantees will not be increased or decreased.

ConRail's Probable Tax Position

The advantages of the ESOP method of financing over alternative methods stem primarily from the provisions of the Internal Revenue Code which enable a corporation to deduct contributions made to the plan from taxable income. Consequently, ConRail's expected tax position is a key consideration.

The PSP indicates that based on expected results and the opportunities for favorable tax treatment, ConRail will be in a position to eliminate or defer taxes for most of the ten year planning horizon (1975-1985).

Therefore, the tax advantages to ConRail of the ESOP financing are non-existent until ConRail becomes a tax-paying entity. Traditional debt financing will provide an equivalent amount of capital at the same cost without the concomitant dilution and higher charges to earnings brought about by the ESOP.

Impact on Income

The ESOP financing, as previously indicated, requires charging to income the contributions made to the ESOP Trust. These costs exceed any of the charges related to the other financing modes. In its projections USRA does not foresee ConRail becoming profitable until 1978. The establishment of an ESOP would decrease the profit potential and possibly lengthen the time before ConRail becomes a profitable entity. The magnitude of these effects would be in direct proportion to the size of the ESOP plan utilized.

Effects on Future Capital Formation Through Sale of Equity

The establishment of an ESOP dilutes the interest of existing shareholders in earnings as shown in the forepart of this report, and it will also reduce the reported earnings. Consequently, the creation of an ESOP will reduce the ability of ConRail to obtain equity capital through the sale of equity to the public. Again, further sales to the ESOP would be limited by the debt capacity of ConRail in the absence of Government guarantees, and the I.R.S. requirement that the corporation have the ability to borrow equal amounts in the capital markets.

Structure of an ESOP

There are many conceivable alternatives that could be considered in establishing an ESOP for ConRail, most of which depend upon a prior determination of how existing, unsecured creditors are to be handled in the recapitalization. If they are to receive common stock (or common stock equivalents such as convertible debentures, convertible preferreds, or warrants) then this would preclude 100% ownership by the employees. In such a case, the sale to the ESOP, which must be at "fair market value", would have to be the same price utilized in determining the value of the shares given to the creditors. If this value were to be reduced by subsequent adjudication it would presumably have to be lowered for the ESOP. At the very least, the plan would lose its I.R.S. qualification. Distributions to the creditors, or distributions to trustees in bankruptcy which subsequently flow through to former creditors and shareholders, could presumably result in ConRail becoming a public, reporting company under Section 12G of the Securities & Exchange Act of 1934. This would occur if more than 300 shareholders resulted. This early existence of a "market" could lead to the same complications.

If no equity securities are given to creditors then all or any portion of the common shares could be placed in an ESOP. In our opinion, the loan utilized would have to be guaranteed by the U. S. Government, as previously discussed. The amount would be limited to the "fair market value" of the equity. E. F. Hutton has not been engaged to determine this value, however, it is possible to say that in view of the facts that (1) the structure of ConRail has not yet been determined, (2) currently railroad related equities sell at very low price earnings multiples, (3) the projections prepared by USRA do not show achievement of profitability before 1978, and (4) many persons, groups, corporations and even governmental agencies have questioned the attainability of these projections, any valuation arrived at would be extremely low relative to the value such equities would have when ConRail becomes a viable, profitable entity.

Since in the early years ConRail's viability will require massive Federal guarantees of debt, it is clear that the U. S. Government will have provided the means by which ConRail might ultimately achieve profitability. When profitable, the equity of ConRail could conceivably be worth many billions of dollars. For example, if ConRail were to earn the $381,736,000 it is projected to earn in 1985 [page 202 of the PSP] and have a market price of five times earnings, the value of the equity would then be $1.9 billion. This would clearly be an enormous windfall for the 70,000 to 100,000 employees of ConRail, who would never have contributed toward the purchase of the shares, even at the low price levels which would currently be required.

Conclusion

Due to the unique nature of ConRail, in our opinion, there is no present financial advantage to ConRail in the establishment of an ESOP. No enhancement of capital formation results because ConRail will not pay taxes for many years and the Federal Government will be required to guarantee all unsecured debt. Future capital formation through the sale of common stock will be made more expensive due to the higher than necessary charges to earnings and the dilutive effects of having issued common shares without a corresponding contribution. In the absence of a clearly defined ConRail structure and uncertainty over the future earnings prospects of ConRail we believe that any "sales" to an ESOP would have to be at inordinately low prices relative to what the value may prove to be after the Government's efforts at restructuring, and the Government's guaranteeing of billions of dollars of indebtedness, prove successful.

At the present time it is our opinion that the only financial reason for creation of an ESOP now would be as an experimental model, to be expanded when the Board of Directors of ConRail determined that conditions then existing make it appropriate.

EXHIBIT I - Comparative Effects of ESOP, Debt and Equity Financing

The following schedule traces the effects on a hypothetical corporation of a $10,000,000 financing within the framework of Table I (see Assumptions to Table I page 3)

(000's)	Before Financing	ESOP Financing (A)	Debt Financing (A)	Equity Financing
Income Effects				
Pre-Tax Income Before Financing Costs (B)	$ 9,000	$ 10,800	$ 10,800	$ 10,800
Financing Costs -Interest	-	(800)	(800)	-0-
-Principal	-	(690)	(not deductible)	-0-
Adjusted Pre-Tax Income	$ 9,000	$ 9,310	$ 10,000	$ 10,800
Taxes at 50%	4,500	4,655	5,000	5,400
Net Income	$ 4,500	$ 4,655	$ 5,000	$ 5,400
Pre-Tax Financing Costs Charged to Income	$ -	$ 1,490	$ 800	$ -0-
After-Tax Financing Costs Charged to Income (C)	-	745	400	-0-
Cash Flow Effects				
Cash Flow Before Financing Costs	$ 18,000	$ 21,600	$ 21,600	$ 21,600
Financing Costs Before Dividends				
-Interest	-	400	400	-0-
-Principal	-	345	690	-0-
Adjusted Cash Flow Before Dividends	$ 18,000	$ 20,855	$ 20,510	$ 21,600
Dividends-$2.50 per share (5%)	2,500	3,000	2,500	3,000
Cash Flow After Dividends	$ 15,500	$ 17,855	$ 18,010	$ 18,600
Cash Financing Costs (C)	$ -	$ 1,245	$ 1,090	$ 500
Capitalization Effects				
Debt	$ 50,000	$ 60,000	$ 60,000	$ 50,000
Shareholders' Equity	50,000	50,000	50,000	60,000
	$ 100,000	$ 110,000	$ 110,000	$ 110,000
Effect on Existing Shareholders				
Shares Outstanding	1,000,000	1,200,000	1,000,000	1,200,000
Dilution in Proportionate Interest	-	16.7%	None	16.7%
Earnings Per Share	$ 4.50	$ 3.88	$ 5.00	$ 4.50
Increase (Decrease)	-	(13.8%)	11.1%	None
Book Value	$ 50.00	$ 41.67	$ 50.00	$ 50.00
Increase (Decrease)	-	(16.7%)	None	None

(A) The loans under the ESOP and Debt alternatives are made on the following terms:
 Term: Ten years
 Interest Rate: 8%
 Amortization Schedule: 14.90% of the principal amount per annum

(B) The corporation earns an 18% pre-tax return on the investment of the proceeds from each of the financings

(C) The charges to net income and cash flow relating to the ESOP and Debt financing over the life of the loan differ because of the varying portion of the loan payments allocated to interest. The schedules below show the impact of each over the full term of the loan. In Case 1 a 50% tax rate was assumed while in Case 2 the corporation is assumed to pay no taxes.

Case 1 - 50% Tax Rate

(000's)	Charge to Net Income (000's): ESOP Financing	Charge to Net Income (000's): Debt Financing	Charge to Cash Flow (000's): ESOP Financing (before dividends of $500 per annum)	Charge to Cash Flow (000's): Debt Financing
Year 1	$745	$400	$745	$1,090
2	745	372.5	745	1,117.5
3	745	342.5	745	1,147.5
4	745	310.5	745	1,179.5
5	745	275.5	745	1,214.5
6	745	238	745	1,252
7	745	197.5	745	1,292.5
8	745	153.5	745	1,336.5
9	745	106.5	745	1,383.5
10	745	55	745	1,435

Case 2 - No Taxes

(000's)	Charge to Net Income (000's): ESOP Financing	Charge to Net Income (000's): Debt Financing	Charge to Cash Flow (000's): ESOP Financing (before dividends of $500 per annum)	Charge to Cash Flow (000's): Debt Financing
Year 1	$1,490	$800	$1,490	$1,490
2	1,490	745	1,490	1,490
3	1,490	685	1,490	1,490
4	1,490	621	1,490	1,490
5	1,490	551	1,490	1,490
6	1,490	476	1,490	1,490
7	1,490	395	1,490	1,490
8	1,490	307	1,490	1,490
9	1,490	213	1,490	1,490
10	1,490	110	1,490	1,490

APPENDIX C

Analysis of Probable Motivational Effects of Employee Stock Ownership Plans in Railways in Reorganization[1]

Submitted By
Saul Gellerman/Consulting, Inc.

[1]The full report of this title may be found in the committee room files.

Analysis of Probable Motivational Effects of Employee Stock Ownership Plans in Railways in Reorganization

Submitted to

- United States Railway Association
- Towers, Perrin, Forster & Crosby, Inc.

By Saul Gellerman/Consulting, Inc.

P. O. Box 205, HoHoKus, New Jersey 07423

EXECUTIVE SUMMARY

April 25, 1975

EXECUTIVE SUMMARY

The main conclusions of this analysis, by chapter, listed according to the sections in which the supporting reasons may be found in the main report, are as follows:
(Note: Certain sections are omitted from this summary.)

Chapter 1. - Purpose and Method.

1. This analysis deals only with the motivational aspects of ESOPs.

5. The method is to favor facts over theories, but to analyze both; and to supplement available information on ESOPs with information on similar or related plans.

Chapter 2. - Labor Relations in the Affected Railways.

1. While labor costs played a role in the railway bankruptcies, they were not the primary cause, and were insufficient in themselves, to cause the bankruptcies.

2. Labor cost ratios of the bankrupts are higher than the national average. Reduction of this ratio is necessary to achieve the purposes of the Act.

3. ESCPs are unlikely to affect union positions on manning levels or wage demands. Under favorable circumstances, ESOPs might produce small but useful improvements in local interpretations of work-rules and in employee responses to positive supervision.

4. ESOPs are no guarantee against railway strikes or strike threats.

5. In order to persuade large numbers of workers to defect from supporting their unions, ESOPs must stimulate financial needs to a far greater extent than any known incentive scheme has ever done.

6. The specific employee population in these railways will be "hard to sell" on any innovation. If in their minds, the benefits claimed for ESCPs are unlikely, or deceptive, _no_ amount of dividend income will produce needed motivational changes.

7. Most railway workers are less interested in owning the railway than in preserving it. Promises unsupported by specific guarantees are unlikely to persuade them to change.

8. Salaried employees would probably react more positively to an ESCP than hourly-paid employees.

9. The success to-date of the Chicago and North Western under employee ownership is best interpreted as showing (a) that deliberate attempts to upgrade railway personnel departments, and to improve labor relations, pay off; (b) employee stock _purchase_ opportunities produce significant motivational effects on the purchasers.

10. Apart from whether ConRail adopts ESOP or any financial incentive plan, the purposes of the Act are more likely to be achieved if it sets out to establish a modern, sophisticated personnel department.

Chapter 3. - _Research on Monetary Motivation_.

1. "Motivation" as used here refers to objective behavior changes, not subjective attitude changes.

2. Of four kinds of behavior relevant to achieving the purposes of the act: money _can_ motivate one for which the railways need no help (attract and hold employees); can motivate another only under extraordinary conditions (employees influence their union to change its position); is most unlikely to motivate another (unions alter positions altruistically); and can enhance one that can be achieved without financial motivators (taking opportunities to increase productivity).

3. Most people do not put their financial self-interest above all other considerations.

4. When money motivates at all, it does so primarily through the ratio of additional income to be received for a change in behavior to the income that could be received without a change. Unless this ratio reaches certain minimum levels, no behavior change is likely to occur because the gain is not worth the effort.

Chapter 4. - Requirements For An Acceptable Solution.

1. Eight characteristics are necessary for any monetary approach to achieving the motivational purposes of the Act:

   a - fits the age distribution and income needs of these employees.

   b - achieves and maintains minimum incentive ratios.

   c - net effect is a significant reduction of ConRail's labor cost ratio.

   d - management is prepared to negotiate guaranteed minimum incentive payments.

   e - plan is intelligible to, and believed by, these employees.

   f - educational and communications support necessary for the plan will be provided.

   g - net infrastructure costs of such support in excess of those imposed by ERISA, are acceptable.

   h - plan maintains believability even in times of economic adversity.

2. Three characteristics are desirable for any monetary approach:

   i - frequent payout.

   j - clear link between behavior and reward.

   k - personal risk and sacrifice by employee to be motivated.

3. Five characteristics are necessary for non-monetary approaches. The first four correspond to (a) (e) (f) and (g) above. The fifth is sophistication of personnel management.

4. Certain changes are unlikely to occur regardless of the approach taken. These are: abandonment of strike threats; successful motivation when supervision is unskilled, insensitive or arbitrary.

Chapter 5. - Motivational Analysis of ESCPs.

1. The basic question here is whether these employees are willing to play a high-stakes game in which both the payoff and the loss may be high, and where the probability level of either outcome is indeterminate. Most of them probably are not willing.

   A conservative computation indicates that ConRail, under an ESCP, will not generate high enough "second incomes" to have significant motivational effects for at least five years, and probably not for ten years.

2. High motivation in ConRail under an ESCP is more likely to be an effect of, rather than a cause of, high levels of profitability.

3. The "free gift" aspect of ESCP may have some motivation-enhancing effect, although not as much as other forms of financial motivation, such as stock purchase. To the extent that ESCP requires wage restraint and fore-gone advantages by union members, it is not really free.

4. The fact of ownership in itself may cause small but appreciable behavior changes with regard to care of company property.

5. The trustee-beneficiary relationship would dilute the positive motivational effects of an ESCP.

6. Ironically, proportionality of interest in the ESCP to income would have no effect if ConRail is not successful. If ConRail is successful, this feature could wreak havoc with management-labor relations, undermine union policies of wage restraint, and possibly lead to an exodus of managerial and professional talent.

7. The unfamiliarity and complexity of ESCPs, superimposed on an already-suspicious group, will postpone any significant positive reactions for a long time. Even in much smaller companies, such reactions do not seem to occur for many years.

9. The optimal conditions for ESCPs to produce positive motivational results include twelve conditions. Ten of them clearly do not exist in this case. Two (asterisks) are at least arguable:

   a - Company already profitable.
   b - Dividends will reach and maintain minimum incentive ratios soon.
   c - Relatively small company in terms of employment.
   d - Substantial proportion of jobs have self-evident relationship to profitability*.
   e - Many younger employees, or at least few older employees.
   f - Demonstrated ability of management to communicate effectively with employees.
   g - No serious animosities or suspicions between management and employees.
   h - No union, or at most one union.
   i - Democratic unions, prepared to accept reduced membership*.
   j - Minimal past or foreseeable problems with discipline or manpower reductions.
   k - Non-regulated industry.
   l - Pay levels do not exceed industry or regional averages.

Chapter 6. - Analysis of Available Evidence on ESOP Motivational Effects.

1. Some 54 companies with ESOPs were identified in the course of this study. During available time limits, it was feasible to attempt to contact 38. Twelve replied. From other sources, information on an additional 3 companies was obtained. The unduplicated sample here is therefore 15 of 54 known ESOP companies, or 28%.

2. Most ESOPs were installed in small, motivationally healthy companies, usually for reasons unrelated to motivation. The evidence for positive motivational changes in these companies is tentative at best. Therefore claims for the motivational effectiveness of ESOPs are, at best, premature.

3. If ESOPs in fact "arouse acquisitive instincts", or "motivate people in the most powerful way", no convincing evidence has yet turned up.

5. Whether it is because ESOPs are new, or inherently difficult to explain, or simply not as stimulating as has been claimed, or for whatever reason: the evidence for positive motivational results is at best tenuous. Perhaps this will change in the future. All we know is that it hasn't changed yet.

Chapter 7. - Analysis of Theoretical Arguments for ESOPs.

1. The "extensive treatment in many books and scholarly journals" claimed for ESOPs consists exclusively of works written or co-authored by one man: Louis O. Kelso. For whatever reason, other scholars have not treated the subject.

2. Preoccupation with the role of capital in production has blinded ESOP advocates to the mutual indispensibility of capital and labor. This has resulted in their neglect

of labor and has led to a regretably sketchy and superficial analysis of the real problems of management and motivation.

3. The so-called "productivity gain" claimed for ESOPs is largely a matter of semantics, i.e., of re-defining "productivity". The assumption that capital improvements are the "only" way, or even the best way, to improve productivity has not necessarily proven to be true in actual practice.

   The assumptions about human nature underlying the motivational claims of ESOP advocates are both questionable and unsubstantiated.

   The analogy between ESOPs and the Homestead Acts, while attractive, does not hold up under scrutiny.

   ESOPs do not produce net productivity gains for the organization as a whole, except insofar as they may have greater borrowing (capital-purchasing) power than other companies.

4. The conclusion that non-ownership of assets causes worker alienation is not supported by research. The causes seem to lie in non-financial factors such as the organization of work.

   The conclusion that ESOPs will reduce resistance to technological change is, evidently, excessively optimistic.

   The diagnosis that non-ownership of assets causes workers to demand more pay for less work, which in turn is the principal cause of inflation, turns out upon analysis to be superficial and grossly over-simplified in all of its elements.

5. Should ESOPs fail, proponents would blame the employees for behaving "irrationally". However, several other

causes could lead to failure for ConRail, despite the best possible employee efforts. Further, the assurances built into ESOPs that employees will not let ConRail fail are no stronger than assurances that employees will not strike, or do other "irrational" things, without ESOPs.

6. The suspicion must arise that the lack of clear-cut employee response to ESOPs is not due to their novelty or complexity, but to a feeling on the part of many people that the motivational claims for ESOPs just don't hold water. In fact, some of them don't.

7. The unlikelihood of ESOPs being able to deliver on certain of the claims made for them -- strike immunity, inflation-immunity of capital estates, and immunity from union problems -- is probably a reason for the skepticism about ESOPs. They have been oversold, unnecessarily.

Chapter 8. - Analysis of Similar Plans.

1. Profit-sharing plans enable companies to attract and hold employees. They offer some degree of protection against union organization drives (which is interesting but inapplicable here), and some degree of protection against strikes. There is no evidence that they increase employee productivity or moderate union bargaining demands.

2. Theoretically, employee stock purchase plans are the most powerful financial motivators considered here. Their main weakness -- failure to involve a majority of employees -- can be overcome with a sufficiently generous company contribution to match the employees'. The cost of such plans is about one-third that of ESOPs, probably with better motivational results.

3. Employees are most likely to participate in a voluntary contribution plan when they are offered a bargain purchase.

It is the bargain, not the attraction of stock ownership, that does the motivating. This fact is contrary to the widely-held belief that most workers, given a free choice, will opt for "a piece of the action" in the companies for which they work.

4. Scanlon plans -- which tie a group bonus to a reduction of specific employee-influenced costs, rather than to profit -- deserve investigation for possible application to ConRail in the future. The extensive preliminary planning and administrative cumbersomeness of these plans are obvious handicaps. Even if these can be overcome, this approach could not be ready for introduction into ConRail for quite some time.

5. European experience with worker participation in management has emphasized a transfer of decision-making power, not a transfer of ownership. They are thus the mirror-image of ESOPs. In gross economic terms, these plans have done no harm to the economies in which they are practiced, at least so far.

   However, they do not produce visible motivational effects, either. These plans represent political solutions to political problems, and should not be confused with managerial solutions to motivation problems. The Europeans have not legislated their way to better motivation.

   To legislate ESOPs into ConRail and other large companies would be a political solution to a political problem -- if indeed such a problem truly exists at present in the United States. It would not offer any motivational, or productivity, advantages.

Chapter 9. - Conclusions and Recommendations.

1. While ESOPs have certain motivational advantages, in this case they are either unnecessary; or attainable

by more conventional, therefore more reliable, methods; or attainable at more favorable cost/benefit ratios by other methods; or so uncertain or so far in the future as to be without foreseeable practical significance.

2. There are many serious motivational disadvantages for ESOPs in this case, including:

   - lack of evidence of effectiveness;
   - theoretical basis oversimplified or unable to withstand analysis;
   - basic premise for effectiveness in ConRail most improbable (see summary of Chapter 5, Section 1);
   - foreseeable second incomes likely to be motivationally inadequate, even under the most favorable assumptions, for at least ten years and conceivably longer;
   - and several other disadvantages listed in the main report.

3. It is concluded that ESOPs would probably be ineffective in ConRail, and it is recommended that they not be used.

4. In the long run, non-financial motivators -- unglamorous as they are -- probably represent the most effective approach for achieving the motivational purposes of the Act.

   For this purpose, it is recommended that ConRail develop a modern, fully professional personnel department with several specific capabilities -- one that could be a model for the industry.

   Financial motivators should not be introduced for several years. If it is felt that one is necessary, the best motivational results could probably be obtained by an employee stock-purchase program, especially designed to encourage maximum participation and to offer special benefits to older and/or lower-paid participants.

Representative LONG. The committee appreciates your analysis and forthright statement with respect to your experience and analyzing its applicability in your particular situation. This whole issue of whether or not an ESOP would lead to increases in productivity or not has been raised and goes pretty much to the heart of the matter.

Is it a valid reason for the creation of an ESOP or is it not? You, Mr. Terry, cited Mr. Gellerman's findings that ESOP's are unlikely to produce significant motivational effect in companies with more than 200 employees and that things relevant to productivity are best stimulated by nonfinancial matters.

Mr. Flint said that productivity gains from this source are likely to be small. That is the two biggies, we may say. On the other hand, Mr. Thurmon speaking of E-Systems which is not small with 9,000 employees—and granted the short experience, a little over a year now, a year and a half—used such words as results giving better morale, team membership finding, union grievances have declined, attitude of mutual problem solving, and employee turnover. I thought this was particularly significant—the employee turnover declined 50 percent since you went into the ESOP plan.

Summarizing it, there seems to be more peer group pressure to properly care for machinery, discourage leaving, reduce absenteeism, to provide better designs, to reduce operating supply costs and to generally work better together.

I don't know whether these statements can be reconciled at all with the statements made by you two gentlemen. Are you saying that the types of improvements Mr. Thurmon said he set forth can't be realized in a large organization?

If so, you are a little bit forced to the conclusion that this is a sad commentary on large organizations and large corporations in my opinion. I am interested in all of your views in this regard.

As I say, Mr. Thurmon, your company is certainly no small company. With 9,000 employees, it is a substantial size organization. You are one of the concrete examples we have to rely on.

I would be interested in your views and also that of Mr. Flint and Mr. Terry. Mr. Thurmon, say your company moved within the next 2 years to 30,000 employees instead of the 9,000 you have now.

Would you see the plan you have instituted working perhaps not so effectively or substantially as effectively in the categories that you set forth as it does at the present time?

Mr. THURMON. Well, I think that ours would operate very well with 30,000, or a greater number of employees. I think that the secret to the productivity question in ESOP's or any other incentive program is communications and full understanding by the employees.

We started two-way communications programs with our division employees to make it clear that we are trying to give the employees something, we are trying to create incentive and trying to avoid the suspicion of there being something more in it for the company than the employees.

We have gone to great lengths with individual meetings, presentations and this type of thing to try to convince our employees that this is true.

This was perhaps easier for us than some companies because we had in fact had a prior program where we had tried to create incentive so our employees were more likely to believe that this was one of our major purposes.

That earlier plan did not work because the employees' own funds were required. With the ESOP, we have spent much more time in trying to develop new ideas and techniques to communicate the benefits and tie the employees to the price of our stock. We have established communications councils within the company which include employees from all levels, union and nonunion, to discuss and listen to employee questions and suggestions concerning the company's operations so that they may better understand the company.

I think this is much easier for a company our size to do, but believe that it could be accomplished in any company with sufficient management effort.

Representative LONG. Have you attempted to measure employee productivity before and after?

Mr. THURMON. That is very difficult to do except through the operating results of the company. We see many things. We have a budgeting system that is not set up on an individual basis but on a cost center or departmental basis.

We do see improvements. Some of the examples I gave here are developed on the bottom line of our company.

Representative LONG. Certainly there is no question but what if you take the bottom line of it, it has been most impressive.

Mr. THURMON. We are an employee oriented company. Our investment is more in our employees than in equipment. One of the reasons we initiated the plan is that we need to retain our engineers. We need that talent. We were looking at that, when we established the ESOP.

Representative LONG. This goes along the line of what Mr. Wassner was speaking of.

Mr. THURMON. Yes; it helps us to have a high degree of technical employees with engineering expertise who are capable of understanding these things and making calculations as to their values, because it is perhaps easier for them to understand. But I do think that if the time and effort is made to communicate there can be some productivity headway made in any company. To give you an idea of some of the things the company is doing to relate the employees' effort to the price of stock for productivity purposes, we are bringing in some outside financial consultants next week.

The consultants are to show our people how our management decisions and employees' actions directly affect the productivity of the company, the earnings and the price of the stock.

Representative LONG. Mr. Flint, do you have any comment?

Mr. FLINT. Yes, sir, I don't intend to try to go through some of the studies that we have looked at on general overall productivity because I think too often it is theory and I can't equate it to our own experience.

You need to differentiate between what an employee sees in his bottom line, if you will, waht he is going to benefit, as compared with the motivational aspects of the employee who feels like people are in fact interested in what he is doing.

Let me cite one example. I think it is cited often in motivational studies. We refer to it as a Hawthorne process. Some years ago in order to seek ways to increase productivity, we instituted some changes and measured them carefully to see what impact it had on productivity.

It improved productivity. Then we changed back pretty much to what we had done before. This was an experiment. This improved productivity. The message that we get out of this is that if the employees are satisfied that you are interested in them, you are going to increase productivity.

Now, whether that employee satisfaction is going to be equated back into a penny a share that they are going to realize or 10 cents a share, or whatever, I think is part of the overall process and that you can't necessarily put a dollar sign on it.

In our industry we are running at about two times the productivity gains of the Nation as a whole by general productivity measurements.

Representative LONG. The point of the Hawthorne experiment is that by instituting these changes and sitting down and working with them and then changing them back was evidence of the interest that you had in what they were doing?

Mr. FLINT. The fact we were showing an interest in their welfare. Perhaps it is like a smile from a pretty girl. It makes you feel that you are recognized and it is pretty hard to say what it is worth. It won't pay the rent. But as an employer, there is a great deal to be gained.

We are satisfied that an employee who in fact owns shares in the company just has to be a more interested employee in the company. Now, to measure that in terms of productivity, I have some difficulty. But I am convinced and we are devoted to the proposition.

We like to have our employees own stock. I wish every one of them did own stock. About a third of them do.

Representative LONG. Mr. Terry.

Mr. TERRY. It is difficult for me to comment about E-Systems' experience other than, in listening to Mr. Thurmon, it does sound like E-Systems has the enlightened supervision and job enrichment that Mr. Gellerman feels is so important to employee productivity. In looking at ESOP's, we would break them up into two pieces. They have corporate finance aspects and employee compensation aspects. The corporate finance aspects are very onerous in that they amount to an equity issue with all the resultant dilutions of stockholders' ownerships and dilution of earnings per share.

At the same time, they place more debt on the balance sheet, yet create both leverage and a charge against income. Corporate finance shows there are better ways of raising capital, if that is the purpose of the program.

If the purpose is employee compensation, our consultants feel again that there are better ways of achieving a cost effective compensation plan than ESOP and that these exist in the employee stock purchase plans especially, but also in profit sharing plans and stock bonus plans.

When one breaks it up into its two parts, it would seem that there are better alternatives and that, if there is a desire to broaden stock ownership, it might be directed at one or two of the alternatives, rather than at ESOP where both are merged into one.

Mr. WASSNER. I would like to make a brief comment on what I found in talking to my client about their expectation of increases in employee productivity through ESOP. One interesting fact that I noted is that in certain cities like Rochester, N.Y., where there are existing companies like Kodak and Xerox who have had a stock thrift program for years and where those programs had been well known and had done well and where the workers were familiar through their local contacts and through reading newspapers with stories of workers who had retired from those two companies with substantial nest eggs.

In those cities the presidents of companies believed that the establishment of an ESOP program would have a positive impact on the productivity of the workers. In other cities where those kinds of success stories were absent, the general feeling of my clients has been that an increase in take-home pay would be more important than something as intangible as an ESOP program.

Representative LONG. Thank you very much.

We have a number of other questions that we could ask you. I have an important vote on the House floor. I am going to ask our staff economist, Mr. Hamrin, if he would, to take over and to give me 10 minutes to get over and cast my vote and get back.

Mr. HAMRIN [presiding]. I would like to pursue a few questions concerning some statements which Mr. Kelso has made. Mr. Kelso made the statement that "if a minority of families and individuals are permitted to monopolize the means of producing wealth through caqital ownership, the economy will slowly, or not so slowly, grind to a halt."

He also said "the present concentration of corporate wealth in the hands of a very small percentage of the population jeopardizes the future of the capitalist system, especially, when this concentration coexists with large-scale poverty in the U.S. economy."

To what extent do you gentlemen see these statements as being valid in light of our system as it presently exists?

Mr. WASSNER. As I indicated in my testimony, my responsibility in my firm is primarily merger and acquisitions. I have seen over the 9 years that I have been working with our clients in that field that estate-planning pressure had created problems where the owners of closely held companies had really no alternative but to add to the concentration of corporate wealth in the United States by selling their businesses to conglomerates and to other large companies in their industry.

Until the ESOP program came along, there was no way to equate the financial and the tax sale of a business to the employees with the favorable results that came from selling the business to a third party.

I have in the last 3 months seen situations where clients of ours had actively pursued the sale of their business, had either registered the company for sale with an investment banker, or had been involved in merger negotiations with large companies who have called off those negotiations, have called the investment banker and said take my name off the list, I am not for sale anymore. They have instead pursued the ESOP program. If there had not been an ESOP program, the larger companies in America would have gotten larger through the acquisition of these companies.

Mr. HAMRIN. Do you agree with Kelso's statement that if this concentration continues, the economy will slowly or not so slowly, grind to a halt?

Mr. WASSNER. A C.P.A. measures thing more precisely and we find it hard to deal with terms like grind to a halt. I would say this, the increase in concentration of American business does have an impact on the economy and the antitrust laws are there to make sure that that impact is regulated.

I think that the ESOP program will, to some extent, prevent the major companies from developing within industries and thereby make the economy grind to a halt. Surely it would, if there were one company dominating or producing 99 percent of the goods and services in each particular industry.

Mr. FLINT. I am not an economist so if you will take that as a forerunner, I will proceed. At the present time as I mentioned, we have a lot of share owners and about one-third of our employees presently are share owners. We are also in the capital market so we see what it is like to have to go out and raise large sums of money.

In my own personal view and I think I can speak for the company on this, one of the areas that is causing difficulty in having the American economy go ahead on a forward basis is the fact that in the final analysis you are not going to have growth except to the extent that you have savings that can be put back into the economy in order to sustain that growth.

Artificially created growth really just gives you inflation. Therefore, it is extremely important that devices, methods, and procedures, be developed and pursued which will make it possible for people to want to save. I feel that at the present time, the Federal income tax law has a decided bias in favor of consumption and in fact tends to penalize saving particularly when you are talking about saving at the equity level.

For example, we have just sold a $100 million bond issue. It is triple A. You can't get a better issue than this. The interest yield to the investor is 9.3 percent. It is pretty hard to see why one would want to buy equity stocks when you have available debt at returns like that.

The reason that debt costs are so high is because the investor is going to insist that he get a return to recover the risk that he will take to cover inflation and any other problems that he sees in the economy.

Normally he would expect debt to be—if there had been zero inflation—to be perhaps selling at the rate of 3 percent to 4 percent.

When you have inflation, caused by a number of things including Federal deficits, this is going to have the impact of requiring investors to get a higher return, which has foreclosed American business investors over the last several years from wanting to invest in equities.

I saw some figures that went like this: In 1950, about 43 percent of the investments owned by individuals were equity investments. Today that is about 23 percent.

If we were to have a sufficient stimulus to where they could up that figure from 23 percent to 33 percent, that would generate about $200 billion worth of equity, which is very close to the amount of shortfall that many economists see that we are going to need.

So I think it is very important that we not continue down the line of having the American economy be funded by more and more and more debt but that if we can get savers to come in with risk capital in order to want to put it into the economy, we will find that we will reverse this trend and we will then be able to have the economy move forward.

Therefore I think that looking at the tax laws themselves and taking away the bias against equity investments, the high taxation of dividends and so forth, would be extremely helpful.

Mr. HAMRIN. Would you agree with Mr. Kelso that the real key to reversing this concentration has to come through the means of employee stock ownership plans?

Mr. FLINT. I don't think I would agree with that. The important thing is equity investment. I think the ESOP plan as contemplated tends to create more debt. I just have difficulty in seeing how this is going to create the additional productivity.

At the present time I believe the figures are something like this. Of the national income, 71 percent goes for wages, 12 percent goes for pretax corporate profits—I don't think there is enough available there for realinement to be able to have that factor alone be the thing that would turn this thing around.

Broader ownership of stock will clearly make the country grow and will continue to provide for jobs and so forth. I don't think you can say any one factor will be responsible.

I would have to have some more discussions to understand the views more, perhaps an exchange just as you are having here for an opportunity to explore this.

Mr. HAMRIN. Perhaps Mr. Kelso, who is sitting behind you, would like to pursue that after today's hearing.

Do any of the panel members want to comment?

Mr. Thurmon, sitting right behind you is Mr. Fisher who in his study for the United States Railway Association concluded that if a corporation is highly competitive in the area of both employee benefits and overall pay levels, then "an ESOP would be logical only if accompanied by reductions in pay or in other benefits."

Do you feel that E-Systems was competitive in the area of employee benefits before the adoption of their ESOP and if so, did the company feel it necessary to reduce employee benefits or pay levels once ESOP was adopted?

Mr. THURMON. We are very competitive in our employee benefits. I would only agree with Mr. Fisher in the event that you were satisfied with the status quo and did not think there was something you could do to improve your productivity and performance.

We felt that the ESOP was an additional mechanism for improving the operation of our company and our employees. It added to an already adequate pension program.

Mr. HAMRIN. You don't envision that this would lead to a reduction of employee benefits?

Mr. THURMON. Certainly not in our case. That was not the purpose. We were not trading off against our normal pension benefits in our situation.

Mr. HAMRIN. I believe your company has seven unions associated with it?

Mr. THURMON. It has four unions and seven locals.

Mr. HAMRIN. The unions were not raising this as a point of concern? This is a general point that some unions bring up—namely, that this is really going to be a cost to the employees in some way.

Mr. THURMON. In our case we had very good acceptance from the unions, no skepticism, no problems in that regard. We did not try to trade off any of the retirement benefits. We were interested in creating a program that we could maximize utilization to develop further long-term incentive.

That is an improvement, again. The opposite of being satisfied with the status quo is always trying to improve. We do that in a lot of areas of our company, and we had no problems with the unions whatsoever in this regard with the ESOP because the unions understood our purpose.

Mr. HAMRIN. Speaking of unions, Mr. Flint, in A.T. & T.'s consideration of the possible adoption of an ESOP or at least in your analysis of ESOP's, did you bring the unions into this consideration at all? Have you met with some of the union officials?

Mr. FLINT. I understand that when you are talking about the 1-percent ESOP plan, that our unions are aware of the fact that it does exist. They have not expressed the view really one way or the other.

As far as I know they do know that we have had four very basic concerns which we felt would have to be corrected before we would be able to undertake the 1-percent investment tax credit.

As far as the general concept, the broad concept ignoring the investment tax concept, they have as far as I know expressed no interest in it. We do have a savings plan which is certainly something that is subject to bargaining with the unions, but we have not had an interest expressed by the leadership for such programs.

Mr. HAMRIN. But do you plan on bringing in, or trying to ascertain, the attitude of the employees of the Bell System or A.T. & T. if you eventually plan on going ahead with some form of an ESOP?

Mr. FLINT. We would want to be awfully sure we knew where we stood before we would go out and start discussions with employees. There is nothing as bad as not knowing where you stand and engaging in conversations and holding out false or wrong hopes.

Once we have got our own thinking on the 1-percent investment tax credit resolved—as to whether or not these obstacles which we see standing in the way of being able to do it—once we resolve that, there would be discussions with the unions.

They are generally fairly competent to bring their views to us. I can't answer for what the techniques will be, but I can assure you that anything that is going to affect the employee body, they are going to be right in there having meaningful discussions with us.

Representative LONG [presiding]. Following that same line, Mr. Flint, I gather you are saying that you have not made a final determination yet as to whether or not you are going ahead with this?

Mr. FLINT. We are in the posture as to where we do have four basic concerns about our ability to be able to do it. In the event we cannot find proper resolution, I don't think it is practical for us to undertake this.

Representative LONG. I understand that some of those were something that might be corrected by legislation.

Mr. FLINT. I understand that there is a very real possibility of that. As a matter of fact, I had written to Senator Long and he had some hearings at which he indicated that this was within the realm of possibility that these could be resolved by appropriate legislative action.

If that is so it is our view that we would go ahead and adopt a 1-percent ESOP utilizing this 2-year period.

Representative LONG. Mr. Wassner, in your statement you say the accounting treatment required also makes it more practical for closely held than for public companies.

In brief, an ESOP transaction requires a reduction in the company's reported earnings since the contribution to the trust is an expense of the company. In a typical non-ESOP financing, the repayment of the loan does not affect the company's earnings?

Are you saying that there is anything more there than the difference between a general debt and equity type of financing? If so, if there is anything more there than the difference between an equity type of financing which have those characteristics as you well know, what is the additional factor?

Mr. WASSNER. There is no charge to earnings for the repayment of that principal. When an ESOP borrows the money and there is a commitment to repay, to make future contributions to the ESOP, that charge each year, whether it is a direct charge or whether it is an amortization of an intangible asset, is going to flow through the profit and loss statement as additional expense and threfore reduce the earnings of the company.

Representative LONG. There was a question we discussed yesterday of the possibility of using the establishment of an ESOP plan for a bailout. The degree to which the officers and directors of a corporation which is in poor financial shape leave themselves open for personal liability, or for utilizing an ESOP method of getting out of a bad situation, coupled with the fact that it does require an independent third party—in these instances, would not the likelihood of this being done on a broad scale not really be very great?

Mr. WASSNER. I certainly feel that way. In the situations that I have seen, the usual way that the owner of a business would sell the stock to an ESOP would be to have the ESOP borrow the money from a third party and of course that lender is going to have to be sure that he is going to be repaid.

Therefore if it is a troubled company, they are going to have trouble getting the financing from the third party. Another common way of buying out as opposed to bailing out is for the owner of the company to sell the stock to the ESOP all at once on the installment basis so that he receives notes, for example, that are repayable out of contributions to the ESOP over a 10- or 20-year period. There, too, if the company is a troubled company, then the owner of the business finds himself with a note that would be as worthless as the equity that he would have had in the first instance.

So my own experience is that it is not going to be a widespread corporate practice.

Representative LONG. I am inclined to agree with that. May I go back for a moment to a broader philosophical concept? I would like to hear the comments of all four of you gentlemen on it.

The basic motivation behind moving in this direction from a public policy point of view—that is, the redistribution of wealth in this country—seems to me to be faced with a little bit of a problem in an ESOP. Under the ESOP plan, which allocates shares based upon compensation levels, doesn't the ESOP accentuate the amount of distribution which currently exists between the high- and the low-paid workers?

I was wondering if you all felt that on an equity ground, the lower paid employees on a corporation should perhaps be given a disproportionately larger share in the allocation of the stock?

If not that, could some other criteria other than the amount of dollar compensation be used as the determining factor? For instance, the number of years of service in the particular corporation could be used. Who would like to comment on that?

Mr. Thurmon.

Mr. THURMON. We looked at this very carefully. First of all we considered tenure as a means of allocation but we did not feel that it was tied to productivity. That would have meant we give the older employees more stock when they are not necessarily more productive.

We felt it should be tied to payroll uniformly because if we gave the older or lower paid employees more stock, this would create negative incentive for the higher paid employees who are normally more productive and it could therefore be counterproductive. Additionally, we felt that by distributing by salary it gave all employees equal incentive to work harder, for greater shares in merit salary increases, to increase their participation as a percentage of payroll to get more stock through ESOP.

Representative LONG. Yours, as I understand it then, is based solely upon the compensation that the employee receives?

Mr. THURMON. That is true.

Representative LONG. Mr. Flint.

Mr. FLINT. I would respond to you in the context of the fact that I work for a regulated public utility which has an obligation to furnish services to customers at the lowest reasonable cost. If we were to take the position that lower paid people should be given something more than the market would indicate that you should be paying these people, I would certainly say that I don't think that that is a proper function to perform.

I find myself in agreement with the gentleman here on my left as a general proposition, that if we are talking about this as additional compensation beyond that that is intended to compensate for the value of the services being performed, if that is in Congress' judgment the goal they want, I guess we would have to say that is going to be up to Congress.

But as a corporation with a responsibility to see to it that our employees are properly treated for the productivity they do, this would not be one of our goals.

Representative LONG. To do it on any other grounds than just straight compensation opens up another bag of worms. It accentuates this problem that you discussed before, Mr. Flint—is it part of their compensation or is it something extra? It opens that problem up in spades when you start doing it that way.

You would really have to justify it on some other grounds because you are automatically compensating the person for what you think he is worth at this time.

Then you move to some other consideration and you start meeting yourself coming around the corner.

Mr. FLINT. Yes, sir.

Representative LONG. Again, Mr. Thurmon, I would like to benefit from your experience on this, since you have had more actual operating experience with ESOP than anyone here. Are your trustees under your agreement under any compulsion to diversify at all with respect to the holdings of the trust?

Mr. THURMON. No, sir, we have a separate plan where employees can contribute, a kind of mutual fund concept in other equities.

Representative LONG. That in turn gives you to some degree the diversification that a prudent trustee would take by not having all of his eggs in one basket?

Mr. THURMON. First of all we have the diversified portfolio within the ESOP but it is a separate trust and a separate form of the ESOP. Second, we feel that we have a sufficiently diversified fund within our pension trust, which is a completely separate plan, from ESOP, which the employees are depending upon primarily for retirement purposes. We treat the ESOP as strictly an additive to that retirement plan and it is not intended to be diversified but is intended to be in addition to our regular diversified pension fund.

Our contribution to our ESOP is only about 5 percent of the company's total annual fringe benefit plans costs, so ESOP is a rather insignificant part. We do not trade it off with other pension benefits. It is an additive.

Representative LONG. Mr. Wassner, look at the substantial tax advantage that has been built into this in these few instances that it has been put into law. What would be the attitude of a corporation that is going under and had existing corporate debt outstanding setting themselves up in an ESOP program in order to pay that loan off in just a little over half the time that it would otherwise be outstanding?

I think it would work out.

Mr. WASSNER. Let me first comment on the use of the term substantial tax benefits for an ESOP. Of course the deductibility of an ESOP does not provide any more substantial a tax benefit than a contribution to any other qualified section 401 employee benefit plan.

Now as far as a leveraged company using an ESOP to be able to pay their debt off more rapidly, that could be done through making stock contributions to the ESOP that provide a tax deduction to the company and therefore the cash flow to amortize the debt.

As far as a company taking on a new financing project and financing it through an ESOP, while I have read a great deal about that advantage, I must say in all frankness that the financial benefits of ESOP have not been utilized by my clients as much as the closely held buy out situation.

I think this is partly due to the fact that the bankers in a number of communities have been a little slow to recognize the advantages of an ESOP concept. You should recognize that a bank is interested in two things when they make a loan to a company. They are interested in the collateral—which depends on the financial strength of the company and they are interested in the future cash flow that will be utilized to amortize the debt.

When a company has an ESOP, they don't improve their collateral position at all. Therefore a company looking to ESOP to borrow money and build a plant and does not have the money, will still be out of the market.

But a company that does have a strong financial position might be able to finance a project that he would otherwise have trouble financing because of cash flow problems by establishing an ESOP and therefore paying the debt twice as quickly.

Representative LONG. So there is some. I don't want to say possibility because that involves the connotation of a danger and I don't necessarily mean it is that. I don't quite mean opportunity either because there is some probability that companies would use this method in that respect?

Mr. WASSNER. I think that is correct although as I say I have read more about that than I have actually seen it in practice.

Representative LONG. Mr. Terry, I have not had an opportunity to look at Mr. Kelso's rebuttal to your study. He said the evaluation is replete with tortured logic, gross distortions, and bias and shortsighted comments about the ESOP.

He also said the report does not consider the ESOP as a safeguard against nationalization and that this granted a bailout type of philosophy to this whole thing. Furthermore, they ignored the growing support for ESOP, they failed to consider the best case for ESOP when ESOP represented 100-percent employee ownership, they failed to survey the attitude of rank and file workers, and they found absolutely no negative evidence on the ESOP's they did study. Still, they concluded that there were serious motivational disadvantages in undertaking an ESOP.

How do you respond to these accusations Mr. Kelso made?

Mr. TERRY. We did respond formally to most of them. Let me say—let me take a few. I tried to make some notes as you were talking.

Perhaps I didn't get all the criticisms.

Representative LONG. I think you got the sense of them, didn't you? [Laughter.]

Mr. TERRY. Let me take the 100-percent ownership and, in our case, the estates of the bankrupt rails are asserting that the rail reorganization is taking their property. That is not correct. It is a reorganization and, as such, they are entitled to compensation for their assets in the form of a security in the reorganized entity.

One of the goals of the act under which we operated was to minimize the cost of the northeast rail reorganization to the taxpayers. It was not practical to give 100-percent ownership to an employee trust.

In fact, any percent we considered had some exposure attributable to it. The tortured logic question is one that I personally can answer because it was my responsibility to find the people that we were going to have to study the employee stock ownership plan as was mandated by the act. I spent a good deal of time with Mr. Kelso and with people on his staff and interviewed a large number of different consultants and firms who could do that—all aimed at trying to find an independent, objective appraisal.

Our board concluded that, to do this we had to look at all aspects of the ESOP—financial, compensation, and motivation. Because of that, we put together three different consulting firms who worked independently of each other. Their reports are negative of the ESOP concept for ConRail.

We feel that it was an independent job and that a fair job was done in appraising ESOP. It is difficult to find a situation where ESOP is applicable. They principally go to companies which are in need of capital and which tend to undercompensate in their employees. It takes some unique situations. The other individual criticisms, I did not get.

If you could reiterate them, I will try to respond one at a time.

Representative LONG. Mr. Wassner, you are a C.P.A. It seems that pretty well all of us have agreed that the tax status of any corporation considering the establishment of an ESOP is of fundamental importance, and this automatically would lead you to the question about the many corporations, particularly among the giants, that pay little or no taxes.

For example, assuming the tax advantage, what benefit would an ESOP be to a Lockheed or a Honeywell or American Electric Power or this sort of a thing? Have you been dealing with anybody that is that big or anywhere near the railroad situation or the A.T. & T. situation, and what has been their attitude toward this?

Mr. WASSNER. Well, we did talk to one substantial publicly held company about the investment credit ESOP and it turned out that the company already had an investment credit carry forward based on the fact that they had losses in prior years or the interplay of foreign tax credits. I am not sure exactly what the reason was.

But of course without the ability to use the investment credit they did not have the impetus to study the concept very much further. They had a carry forward from prior years.

Representative LONG. Gentlemen, you have been most helpful and we are most appreciative.

This is the second day of hearings. We hope to explore it because it is a rather substantial suggested change in the direction which the American economic system has been moving in the past.

I think the whole system is under serious question these days. I think it is quite well that we do explore possible remedies to the situation. You all have been very helpful. I am appreciative of your taking the time to prepare your statements you made here today.

I appreciate your coming down and being with us.

Thank you very much.

Mr. TERRY. Thank you, Mr. Chairman.

Mr. FLINT. Thank you.

Mr. THURMON. Thank you, sir.

Mr. WASSNER. Thank you.

Representative LONG. Thank you kindly, gentlemen. This hearing is adjourned, subject to the call of the Chair.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

[The following letters, containing questions and answers, were subsequently supplied for the record:]

RESPONSE OF ROBERT N. FLINT TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN HUMPHREY

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., December 19, 1975.

Mr. ROBERT N. FLINT,
Vice President and Comptroller,
A. T. & T.
New York, N.Y.

DEAR MR. FLINT: On behalf of the Joint Economic Committee, I would like to thank you for your testimony before the Committee on December 12. At that time, the Committee was not able to have addressed all of the questions it wanted to ask due to the prior commitments of its members. We would appreciate your cooperation in providing written answers to the following questions for the hearing record.

ESOP AND EMPLOYEES

1. Would you agree to the contention that a substantial proportion of a company's payrolls would have to be contributed to the ESOT in order to obtain a gain in employee motivation—for example, at least 5–10 percent of the payroll? What is your reaction to the point often raised that it will take at least five years or possibly much longer for there to be a real effect on employee motivation?

ESOPS AND THE QUESTION OF DIVERSIFICATION

2. With no diversification of the trust assets, isn't it true that there is not much scope for the fund to maximize its rate of return? In other words, the ESOT is not an agent exercising its own judgment and this type of placement constraint reduces the mobility of capital. Would you agree with this assessment?

3. Doesn't the ESOP concept violate a basic principle of financial portfolio theory, namely diversification? Is it wise for the employees to acquire financial assets in the same company where they are risking their human capital?

ADVANTAGES TO CORPORATIONS

4. Given the substantial tax advantages, why wouldn't all corporations be interested in the *re-financing of existing corporate debt* through an ESOP, particularly since the loan could be paid off in approximately half the time?

COMPANY CONTRIBUTIONS TO THE ESOT

5. Should ESOP be regarded as an equity or a debt issue? It seems to differ from traditional equity financing because corporations do not have unrestricted use of the capital raised because of their annual contributions to the ESOT. Is this a serious disadvantage from the corporate perspective?

The Committee would appreciate receiving this information within the next few weeks so that it may be used in drawing up our report on ESOPs as well as being included in the hearing record.

Sincerely,

HUBERT H. HUMPHREY,
Chairman.

AMERICAN TELEPHONE & TELEGRAPH CO.,
New York, N.Y., January 16, 1976.

Senator HUBERT H. HUMPHREY,
Chairman,
Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR SENATOR HUMPHREY: In response to the Joint Economic Committee's questions contained in your letter of December 19, we have the following comments:

ESOP AND EMPLOYEE MOTIVATION

As indicated in my Statement of December 12, 1975 to the Joint Economic Committee and in the discussions at the hearings, I strongly support broadened employee stock ownership. However, I believe employee motivation to be a tremendously complex process. Therefore, I do not believe it necessarily follows that changes in distribution of equity ownership from traditional investors to employees will increase worker motivation nor speed up the process of improvements in productivity. Quoting from my Statement to the Committee:

"It is possible that workers might work harder or more conscientiously due to their ownership of capital, but productivity gains from this source are likely to be small, based on the evidence gathered in empirical studies which have been made of the sources of productivity improvement.

. . . given the large proportion of income already going to labor, it seems unlikely that shifting to labor some portion of the 12 percent share now going to shareowners would have sufficient impact or leverage to provide the extra incentive needed to achieve dramatic productivity improvements."

The prospects for productivity gains will vary considerably among various industries. In any event, we believe that traditional employee stock purchase plans or alternative plans suggested in my Statement would provide whatever employee motivation might be generated by ESOTs at less cost, even where price discounts and company contributions are a part of such plans.

ESOPS AND THE QUESTION OF DIVERSIFICATION

We agree that without diversification of assets in an ESOT that there is not much scope to maximize rate of return. Certainly, the risks in a non-diversified fund would be greater than in a fund which diversifies its holdings.

We understand that the inherent restraints on mobility of capital and the problems of non-diversification in leveraged ESOTs can be corrected after the initial loan to the trustees is repaid. We believe, however, this process might take many years to accomplish.

As set forth in my Statement there are several aspects of any proposal to substitute ESOTs for pension systems and other retirement programs which trouble us.

"It seems doubtful that an equity fund consisting of stock of the employing corporation should be the major source of retirement income, since this would expose employees to the risks inherent in a single business.

. . . new investment income that would go to employees out of the 12 percent share of the National income represented by profits would not be significant and could not, therefore, provide an adequate source of retirement security."

ADVANTAGES TO CORPORATIONS

The essential characteristic of the ESOT concept is simply the coupling of debt financing with compensation plans for employees. The "tax advantages," therefore, arise solely because of the payment to the employees of a portion of equity ownership of the business rather than because of any unique properties of ESOT. In fact, companies could derive the same tax advantages through a variety of ways of giving compensation to employees. Basically, any tax advantages that might accompany ESOTs relate primarily to the employee beneficiaries rather than to the corporation itself.

Financing new capital or refinancing existing debt through an ESOT only substitutes one form of debt for another, since the ESOT initially creates a debt liability for the employing corporation. Repayment of the ESOT loan can come from only one of three sources, shareowners, employees or customers. Dividends on the shares issued by the corporation to the ESOT will not be sufficient to cover both interest and repayment of principal of the loan. Thus, unless the ESOT is looked upon as a substitute for other forms of compensation or unless the corporation raises prices to fund the plan, repayment of principal means the creation of an additional charge against corporate net income. This charge results in a dilutive effect on earnings per share and book value of existing shareowners.

COMPANY CONTRIBUTIONS TO THE ESOT

As indicated in response to the preceding question the initial effect of the ESOT is to increase the debt burden of a corporation. No new money is created. The process rests on the extension of credit based on the guarantee of the employing corporation. While accounting standards are not yet completely delineated, we understand accountants and the Securities Exchange Commission will require that the guarantee of a loan on an ESOT shall be fully and adequately disclosed in some manner on the corporate balance sheet to reflect liabilities of the employing corporation.

The ESOP concept does differ from traditional equity financing, but I believe that a distinction needs to be made between the use of the capital raised and the funding of the repayment. The corporation does have unrestricted use of the capital funds raised but, as I pointed out in my discussion of the preceding question, the repayment of the ESOP loan becomes a burden on the customer, the employee or the entire body of stockholders of the corporation. At the same time, the channeling of the loan through the ESOT initially requires the issuance of new shares of stock which are not supported by increased net worth of the corporation.

In my Oral Statement to the Committee on December 12, I noted that during the past 12 years American business has placed heavy reliance on debt financing with the result that debt-equity ratios generally exceed prudent levels. Debt margins have been used up. Interest coverage has dropped dramatically. Lack of liquidity has reached dangerous proportions and major segments of American business have had their credit ratings reduced or placed in jeopardy. Thus, particularly now, at a time when corporate financial structures are top heavy with debt, we question whether the burden of additional debt should be encouraged.

I appreciate the opportunity of responding to the Committee's questions on ESOTs and, if I can be of further assistance, please call upon me.

Very truly yours,

ROBERT N. FLINT.

RESPONSE OF ROBERT N. FLINT TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR JAVITS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., January 12, 1976.

Mr. ROBERT N. FLINT,
Vice President and Comptroller,
American Telephone & Telegraph Co.,
New York, N.Y.

DEAR MR. FLINT: At the hearing on Employee Stock Ownership Plans on December 12th, Senator Javits requested that the following questions be asked of you for inclusion into the record of the hearings.

1. In your prepared statement you assert, "It seems to us no new capital is created by the Kelso Plan. 'Real' capital formation results only from the aggregate savings in the economy. The plan merely changes the flow of savings without changing the amount of savings." It appears that you are saying here that the Kelso Plan does not directly assist in new net capital formation. Am I correct in this interpretation? Please explain.

2. It would be appreciated if you would clarify your statement in your prepared statement—which goes directly to the heart of Kelso financing—that unless there occurs a comprehensive alteration of our monetary and tax systems, corporate cash dividend payments flowing to a trust "would be insufficient to pay interest and principal. Thus, the burden would fall on existing shareholders." Would you clarify this?

3. One of the basic questions you raise about the Kelso Plan is that there is a danger that implementation of Kelso Plans would seriously reduce the role of "voluntarism" in our economic system. You go on to say that "a Kelso Plan could become a form of forced employee saving if employers tend to regard it as a substitution for other forms of compensation."

Would you please elaborate on this statement and explain your concern—expressed in your prepared statement—that "if an ESOP replaces other forms of compensation to employees . . . it would change the nature of the collective bargaining process."

We would appreciate receiving your reply as soon as possible in order to insert the answer into the final transcript.

With kindest regards,

Sincerely yours,

JOHN R. STARK,
Executive Director.

AMERICAN TELEPHONE & TELEGRAPH CO.,
New York, N.Y., January 30, 1976.

Mr. JOHN R. STARK,
Executive Director,
Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. STARK: In regard to the questions raised in your letter of January 12 concerning my testimony before the Joint Economic Committee, I have the following comments:

Question 1. Capital Formation

Your interpretation of my answer is correct; Kelso Plans do not directly promote new *net* capital formation within the economy. Financing new capital or refinancing existing debt through an ESOP only substitutes one form of debt for another, since the establishment of an ESOP initially creates a debt liability for the employing corporation. No new savings are formed in the process, and, for the economy as a whole, the total net capital formation remains unchanged.

The ESOP loan, like any conventional loan, must ultimately be repaid. There are only three sources of funds available—shareowners, employees, and consumers. As discussed in more detail below, shifting the burden of repayment from one group to another merely changes the flow of savings without changing the amount of savings.

Question 2. Trust Repayment

As stated above, the initial ESOP loan creates a debt liability for the employing corporation. The dividend stream of most corporations would not be adequate for the payment of interest and the repayment of principal. In 1975, for example, dividend yields for the S&P 500 stocks averaged about 4.3 percent. Mr. Kelso's ultimate solution to this impasse is to repeal the corporate income tax and to mandate 100 percent dividend payout by corporations, thus increasing the funds available to repay the loan through reduced federal tax revenue and a reduction in earnings available for reinvestment. The elimination of corporate retained earnings as a result of 100 percent payout would remove a substantial component of the existing savings base within the economy. Unless all shareowners, including non-employees, elected to save or reinvest the increased dividend flow, the economy as a whole would have less net savings at its disposal.

Mr. Kelso also envisions the discounting of ESOP Plans by the Federal Reserve System at 2–3 percent rates of interest. An early return to a level of interest rates last seen in the early 1950's seems unlikely, and the monetization of ESOP debt through the Federal Reserve System is fraught with inflationary hazards.

Hence, unless the ESOP is looked upon as a substitute for other forms of compensation (thus levying the cost of repayment against employees), or unless the corporation raises prices to fund the plan (thus further burdening consumers and adding to inflationary pressures), repayment of principal would have to mean the creation of an additional charge against corporate net income. This charge would in turn result in a dilutive effect on the earnings per share and book value of existing shareowners.

Question 3. Voluntarism

As expressed in my testimony and as indicated above, there would seem to be no effective way to provide employees with stock ownership through an ESOP without "taking" from some constituency. In this sense the traditional voluntary nature of our economic decision making process would be restricted. As indicated in answer to the preceding question, the "taking" may be from consumers via higher prices, from existing shareowners via an added claim against earnings, or from some combination thereof. It could also be a taking from employees themselves in the form of reduced benefits and other types of compensation otherwise available to them—in effect, an enforced savings program.

We firmly believe in the concept of employees having an ownership stake in the business of their employer. However, this should be a matter of voluntary choice by the employee. In my prepared statement I offered some alternatives which would stimulate voluntary participation.

Voluntarism would also be affected in the collective bargaining process. The interests of employees could diverge from those of other shareowners. The interests of capital-intensive corporations would differ from the rest of industry. Capital spending plans, or lack thereof, would be reflected in differences in the overall compensation package of various corporations. Wage patterns across industries, particularly between capital-intensive and non-capital-intensive businesses, could be seriously disrupted. A business with little growth, or a non-capital-intensive business, would be at a disadvantage in terms of attracting and holding employees. Pressure might grow, for example, to make unnecessary or wasteful capital investments—an extremely troublesome possibility if capital remains in short supply.

I hope these additional comments will aid in clarifying the record. I appreciate the opportunity of responding to your questions on my testimony, and I hope that the subject of adequate capital formation will remain at the forefront of the Committee's concerns. Please call on me if I can be of further assistance.

Yours very truly,

ROBERT N. FLINT.

RESPONSE OF JOHN J. TERRY TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN HUMPHREY

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., December 19, 1975.

Mr. JOHN J. TERRY,
Vice President for Financial Analysis,
U.S. Railway Association,
Washington, D.C.

DEAR MR. TERRY: On behalf of the Joint Economic Committee, I would like to thank you for your testimony before the Committee on December 12. At that time, the Committee was not able to have addressed all the questions it wanted to ask due to the prior commitments of its members. We would appreciate your cooperation in providing written answers to the following questions for the hearing record.

ESOP AND EMPLOYEES

1. Would you agree to the contention that a substantial proportion of a company's payrolls would have to be contributed to the ESOT in order to obtain a gain in employee motivation—for example, at least 5–10 percent of the payroll? What is your reaction to the point often raised that it will take at least five years or possibly much longer for there to be a real effect on employee motivation?

2. With no diversification of the trust assets, isn't it true that there is not much scope for the fund to maximize its rate of return? In other words, the ESOT is not an agent exercising its own judgment and this type of placement assessment?

3. Doesn't the ESOP concept violate a basic principle of financial portfolio theory, namely diversification? Is it wise for the employees to acquire financial assets in the same company where they are risking their human capital?

ADVANTAGES TO CORPORATIONS

4. Given the substantial tax advantages, why wouldn't all corporations be interested in the re-financing of existing corporate debt through an ESOP, particularly since the loan could be paid off in approximately half the time?

COMPANY CONTRIBUTIONS TO THE ESOT

5. Should ESOP be regarded as an equity or a debt issue? It seems to differ from traditional equity financing because corporations do not have unrestricted use of the capital raised because of their annual contributions to the ESOT. Is this a serious disadvantage from the corporate perspective?

U.S.R.A. REJECTION OF AN ESOP

6. In Kelso's rebuttal to the U.S.R.A. report, he cited the following indictment of Senator Long: "Workers have had no incentive to make the simple formula for profits work. In fact, our ownership was structured to lead to ever decreasing revenues and services and ever decreasing non-market discipline costs. And if our railroads fail to build substantial ownership incentives and the discipline of the profit system into its workers in the future, they will never again earn a profit."

The railroads to be included in ConRail were not able to make it in the past. Do you feel confident that just changing the organizational structure and uniting them under ConRail would do the job in the future, or might we need the fundamentally new approach of directly motivating the employees by having them become the owners, and therefore, having a unity of labor and management?

7. On page five of your final report, it was cited that the payrolls should be greater than $500,000 an ESOP to be attractive to a corporation. On page 42, it was stated that a company should be either small or decentralized. How do you reconcile these two statements? Are there any hard and fast principles concerning their advantages to firms of a given type of size?

8. C. L. Dennis, President of the Brotherhood of Railway Clerks has said: "Employee ownership, it seems to me, has much to offer in strengthening our railroad system in the areas of labor management relations and of giving the employees the opportunity to participate in a more meaningful way in the fruits of the capitalist system. Here is a new idea, a fresh approach that deserves to be tried. If it works and I believe it will, everyone—the workers, the industries and most importantly, the general public—will be the winners."

Does anyone in U.S.R.A. or ConRail share this optimistic attitude to broaden employee ownership?

The Committee would appreciate receiving this information within the next few weeks so that it may be used in drawing up our report on ESOPs as well as being included in the hearing record.

Sincerely,

HUBERT H. HUMPHREY,
Chairman.

U.S. RAILWAY ASSOCIATION,
Washington, D.C., March 8, 1976.

Hon. HUBERT H. HUMPHREY,
Chairman, Joint Economics Committee,
Dirksen Senate Office Bldg,
Washington, D.C.

DEAR SENATOR HUMPHREY: Thank you for your letter of December 19, 1975, requesting answers to several questions posed by the Committee for the hearing record concerning Employee Stock Ownership Plans. We have reviewed these questions with our consultants and have prepared responses, copies of which are enclosed.

Please let me know if we can be of any further assistance to you or your staff.

Respectfully,

JOHN J. TERRY,
Vice President for Financial Planning.

Enclosures.

ESOP AND EMPLOYEES

1. Would you agree to the contention that a substantial proportion of a company's payrolls would have to be contributed to the ESOT in order to obtain a gain in employee motivation—for example, at least 5–10 percent of the payroll? What is your reaction to the point often raised that it will take at least five years or possibly much longer for there to be a real effect on employee motivation?

Motivational research indicates that a financial consideration approximating 20 percent of pay must be provided before a change in an individual's behavior—such as increased productivity—is likely to result. In this context, a substantial annual contribution, expressed as a percentage of pay, would be required over a number of years before dividend payments on the resulting accumulated amount would produce additional compensation in the magnitude of 20 percent.

For example, assuming a 6 percent compound annual increase in salary, 11 percent appreciation on invested assets, and a 3 percent dividend payment, it would take approximately 25 years at an annual contribution of 15 percent of salary to produce a dividend payment equal to 20 percent of salary.

The length of time to produce a "real effect on employee motivation" with an ESOP depends not only on the growth rate of both the value of the stock and the dividend payout, but also on the size of the organization and the quality of labor-management relations, especially communication between them. In the case of ConRail, five years would be a very optimistic estimate. In smaller companies which already enjoy more favorable labor-management relations and where profitable growth in more assured, improvements in employee motivation might be possible in less than five years.

2. With no diversification of the trust assets, isn't it true that there is not much scope for the fund to maximize its rate of return? In other words, the ESOT is not an agent exercising its own judgment and this type of placement constraint reduces the mobility of capital. Would you agree with this assessment?

Yes. Where the trustee is required to invest exclusively in company stock, the opportunity for changing investments to reflect prevailing economic conditions is obviously eliminated and thus there is not much scope for the fund to maximize its rate of return. However, in accessing a specific ESOT, it is necessary to examine the purpose of that particular trust, as well as the configuration of the total compensation program, including other employee benefits.

3. Doesn't the ESOP concept violate a basic principle of financial portfolio theory, namely diversification? Is it wise for the employees to acquire financial assets in the same company where they are risking their human capital?

An employee stock ownership plan restricts the investment of its trust assets to a single security, namely, employer stock, thus constituting an undiversified portfolio. This also is true of other qualified plans, such as stock purchase plans, stock option plans, thrift plans, etc. Generally speaking, an ESOP is offered to employees as additional compensation and is designed primarily as a financing vehicle for the employer. On the other hand, there are also available qualified plans—such as profit sharing and pension plans—which are designed specifically as investment vehicles and offer employees diversified portfolios.

While it is clearly prudent to diversity your assets, it should also be remembered that many of the great family fortunes in this country were amassed principally through ownership of single, very successful corporations. The critical question in evaluating the merits of employees acquiring "financial assets in the same company where they are risking their human capital" is obviously the value of the stock itself. The company is selling (or, in some cases, giving) to the employees what it considers to be valuable stock, with the expectation that the employees too will find the stock of value.

Further, some believe that, if the employee acquires common stock in the company for which he works, the resulting financial involvement may be conducive to a closer employee-employer working relationship and therefore a better working environment. Studies have shown that employees tend to take a more active interest in a company when they have invested part of their own funds. Where no financial risk is involved, employee response tends to be more apathetic. Thus, if the asset is acquired on the basis of a voluntary decision by the employee to invest and risk his own capital (as in an employee stock purchase plan, as distinct from an ESOP), the motivational effect on that particular employee is likely to be both prompt and positive.

Should it become public policy to encourage employee ownership of stock in their employer's companies, and if improved motivation and productivity were a primary objective of such a policy and the diffusion of capital a secondary objective, then we would advocate legislative encouragement of employee stock purchase plans as a more realistic means to these ends than employee stock ownership plans.

ADVANTAGES TO CORPORATIONS

4. Given the substantial tax advantages, why wouldn't all corporations be interested in the re-financing of existing corporate debt through an ESOP, particularly since the loan could be paid off in approximately half the time?

A company examining the total corporate financing question must evaluate more than just the tax considerations. In looking at the various alternatives to corporate financing, including an ESOP, three areas should be explored carefully: Impact on corporate earnings, cash flow, and dilution. For example, in the case of a leveraged ESOT, the advantageous tax deductibility of principal and interest payments is enjoyed only as a consequence of the disadvantageous reduced corporate earnings stemming from the fixed charges (principal and interest payments) against income—a condition normally not present under traditional debt and equity financings.

Unless the benefits derived from an ESOT exceed the detrimental impact of an ESOT on existing stockholders, a corporation's management would be hard pressed to justify adoption of such a plan.

COMPANY CONTRIBUTIONS TO THE ESOT

5. Should ESOP be regarded as an equity or a debt issue? It seems to differ from traditional equity financing because corporations do not have unrestricted use of the capital raised because of their annual contributions to the ESOT. Is thin a serious disadvantage from the corporate perspective?

A leveraged ESOT is a hybrid of debt and equity, having features associated with both of these financing methods and thus categorization of the leveraged ESOT as one or the other is inappropriate. A corporation's access to the money markets—both equity and debt—would be reduced because of the fixed or obligatory nature of its annual ESOT contributions.

USRA REJECTION OF AN ESOP

6. In Kelso's rebuttal to the USRA report, he cited the following indictment of Senator Long: "Workers have had no incentive to make the simple formula for profits work. In fact, our ownership was structured to lead to ever decreasing revenues and services and ever increasing non-market discipline costs. And, if our railroads fail to build substantial ownership incentives and the discipline of the profit system into its workers in the future, they will never again earn a profit."

The railroads to be included in ConRail were not able to make it in the past. Do you feel confident that just changing the organizational structure and uniting them under ConRail would do the job in the future, or might we need the fundamentally new approach of directly motivating the employees by having them become the owners, and therefore, having a unity of labor and management?

It is an oversimplification to suggest tha employee motivation was a primary factor in the failure of the northeastern railroads. Public policies concerning competing carriers and low density service and the structural diseconomies of the northeastern rail system certainly played a greater role. The future profitability of ConRail will be largely dependent upon its ability to successfully deal with these and other critical problems.

In reviewing the desirability of an ESOP for ConRail, we examined both employee motivation and the corporate financing aspects. Our studies demonstrated there were significant reasons in both these areas for not adopting an ESOP, even when considering the fact that more than half of the largest 100 industrial companies have in effect "qualified" profit sharing, stock option, or thrift plans, many of this allow for investment in employer securities.

We see no basis for the premise that implementation of an ESOP at the start-up of ConRail would bring about a "unity of labor and management." If we were to impose upon the employees involuntary ownership of an antiquated and administratively burdened railroad, the employees quite correctly might perceive such action as a cruel deception. At such time as ConRail becomes profitable and competitive and is in a position to offer employees secure employment, good wages, and the prospect of comfortable retirement, employees will be more likely to feel a basic commonality of interest with management.

We therefore have suggested that positive steps be taken to improve employee motivation within the existing competitive compensation program, utilizing some of the new personnel management techniques, and implementation of a stock ownership vehicle, such as a "qualified" stock purchase plan, at an appropriate time in the future.

7. On page five of your final report, it was cited that the payrolls should be greater than $500,000 (for) an ESOP to be attractive to a corporation. On page 42, it was stated that a company should be either small or decentralized. How do you reconcile these two statements? Are there any hard and fast principles concerning their advantages to firms of a given type or size?

In the absence of a reasonable payroll (i.e., $500,000 or greater), the allowable company contribution (a maximum of 25 percent of payroll, but more typically 15 percent of payroll) would not be sufficient to service a loan of any meaningful size. This is not inconsistent with the statement that preferably the company should be small or decentralized inasmuch it would only take 50 employees, each earning $10,000 a year, to produce a $500,000 payroll. For that matter, a company with 500 employees and a $5,000,000 payroll normally would be classified as a small employer, particularly relative to employers the size of ConRail.

There are no "hard and fast" principles concerning the advantages of ESOP to firms of a given type or size. However, such conditions as reasonable payroll levels, good credit ratings, prospective for above average earnings, and a desire to place substantial ownership in the hands of employees all are conducive to the overall success of an ESOP.

8. C. L. Dennis, President of the Brotherhood of Railway Clerks, has said: "Employee ownership, it seems to me, has much to offer in strengthening our railroad system in the areas of labor management relations and of giving the employees the opportunity to participate in a more meaningful way in the fruits of the capitalist system. Here is a new idea, a fresh approach that deserves to be tried. If it works and I believe it will, everyone—the workers, the industries and most importantly, the general public—will be the winners."

Does anyone in USRA or ConRail share this optimistic attitude to broaden employee ownership?

We would agree with this statement, if . . .

Employee ownership were accomplished by a voluntary employee stock purchase program, sweetened with discounts and company contributions;

Simultaneous efforts were made to strengthen non-financial motivators, especially in communications; and

Effective action were taken simultaneously to deal with the various non-labor problems facing the railroads.

The association studied at length the concept of employee stock ownership, recognizing that it has been used in various forms throughout industry for many years. At some point in time, we feel that employee ownership will make sense for ConRail employees—initially, perhaps, in the form of a "qualified" stock purchase plan. At the present time ,however, we feel that ConRail's corporate financing and employee motivational needs can be best served by means other than the adoption of an ESOP.

SENATOR LONG

Under the Rail Services Act of 1975, the taxpayer will be spending up to $8.4 billion in direct loans, loan guarantees, and other subsidies for rehabilitating the U.S. rail system. How much of these benefits will increase the ownership stakes of the top 5 percent of U.S. families and how much new equity will be spread among railway workers?

The $8.4 billion will not directly benefit the owners or the equity of the railroad workers. These funds will be used primarily for rehabiltation purposes. However, inasmuch as a part of the funding will be allocated for payroll and in view of the new jobs which will be created by the implementation of the various rehabilitation programs, it can be said that the $8.4 billion will directly benefit not only the railroad workers, but the suppliers and the overall economy of the Region as well.

RESPONSE OF JOHN J. TERRY TO AN ADDITIONAL WRITTEN QUESTION POSED BY SENATOR JAVITS

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., January 12, 1976.

Mr. JOHN J. TERRY,
Vice President for Financial Analysis,
U.S. Railway Association,
Washington, D.C.

DEAR MR. TERRY: At the hearing on Employee Stock Ownership Plans on December 12th, Senator Javits requested that the following question be asked of you for inclusion into the record of the hearings.

1. It is apparent from your concluding remarks of your prepared statement that you object to legislation which seems "to dictate which particular form (of employee stock ownership plan) is best suited to any given corporation." You seem to prefer broader-based legislation and believe this would be more effective than legislation directed solely at ESOPs. Would you please expand your remarks on this comment?

We would appreciate receiving your reply as soon as possible in order to insert the answer into the final transcript.

With kindest regards,

Sincerely yours,

JOHN R. STARK,
Executive Director.

U.S. RAILWAY ASSOCIATION,
Washington, D.C., March 9, 1976.

Mr. JOHN R. STARK,
Executive Director,
Joint Economic Committee,
Washington, D.C.

DEAR MR. STARK: Thank you for your letter of January 12, 1976, asking that I expand upon my statement concerning broader based legislation and belief that this would be more effective than legislation directed solely at ESOP's.

At the present time, employee stock ownership can be accomplished through a variety of techniques including qualified profit sharing and thrift plans, stock purchase plans, and employee stock ownership plans. Future legislation should encourage greater use of all these techniques to provide both employees and employers maximum flexibility. To that end, three areas should be explored: Incentives to employees which would encourage greater participation in existing programs, such as qualified thrift plans or stock purchase plans; incentives to employers to make existing plans more attractive to the employees; and new approaches to further expand the overall opportunities for employee stock ownership.

With respect to incentives to employees, more favorable taxation of ultimate distributions from qualified plans (e.g., long-term capital gains on the entire employee-provided portion of the distribution) would be desirable. Other incentives which might be considered include advance distributions—that is, distributions made after some reasonable period of time, but prior to separation—of common stock to active employees without causing the employees to sacrifice the favorable tax treatment currently reserved for distributions at termination of employment, and allowing as tax deductible employee contributions made to qualified plans.

Incentives for employers would include some form of tax credit to encourage large discounts on the purchase price of employer stock under for example, a stock purchase plan; elimination of double taxation on dividend, at least with respect to employer stock held under qualified plans; and higher tax deductible limits under qualified plans which would encourage larger employer contributions.

One example of a new approach to broadening the overall opportunities for employee stock ownership would be revision of pension legislation to expand the Individual Retirement Account (IRA) concept to allow all employees, not just those who are not covered under a qualified pension plan, to contribute pre-tax dollars to an individual trust which invests its funds in specific securities, such as employer common stock.

Such changes would broaden the base for employee stock ownership and provide greater incentives for participation to both employees and employers. Further, if legislation implementing such changes were to be made applicable to existing stock ownership plans, greater progress could be made over a shorter period of time.

We hope the foregoing will be of assistance to you and your staff and, should you require additional information, please let us know.

Sincerely,

JOHN J. TERRY.

APPENDIX

ADDRESS ALL COMMUNICATIONS
TO THE COMMISSION
CALIFORNIA STATE BUILDING
SAN FRANCISCO, CALIFORNIA 94102
TELEPHONE: (415) 557-3703

Public Utilities Commission

STATE OF CALIFORNIA

January 20, 1976

FILE NO.

Mr. Robert Hamrin
Joint Economic Committee
Congress of the United States
Washington, D. C. 20510

Dear Mr. Hamrin:

My interest in the subject of ESOPs arises out of my position as a Commissioner with the California Public Utilities Commission. I am acutely aware of the financing problems facing the utility industry and am convinced that the ESOP concept represents one practical source of financing.

Traditional utility financing methods are unsatisfactory for ratepayers and utilities alike. Common stock is commonly selling below book value, so that new equity issues are disfavored by existing shareholders. High interest rates are having a spiralling effect on utility rates that is entirely independent of rising operating expenses. High interest rates result in lower interest coverage ratios which result in lower bond ratings which result in higher interest rates. In this climate there is immense pressure from the financial community to keep raising utility rates. The focus on ratemaking has shifted from rate of return on rate base to return on equity. Recently, one utility company president has proposed that the appropriate measure is that rates be based on "two times interest coverage", with whatever rate of return and return on equity may be incidental thereto.

Congress over the years has passed liberal tax legislation to assist utilities in the new capital formation required by expensive new growth. These programs include accelerated depreciation, the investment tax credit, and the proposed liberalization of the loss carry-back rule from three years to eight years. Each of these can be modified to build in the benefits of the Kelso Plan.

The investment tax credit is a federal welfare program in an amount exceeding eight billion dollars annually. I understand that corporate taxes were originally instituted so that obscene profits were not realized at the expense of the mass of society. The ITC was intended to create new capital for the purpose of expansion and to assist the economy, and while it largely succeeds, it puts the rewards primarily in the hands of big business. ITC is essentially a gift from the federal government. It makes more sense to condition that gift on the issuance of additional capital stock by the corporations to their employees. The amount of stock would be based on the value of the shares at book or market, whichever is higher, equivalent to the amount of the federal gift - ITC. The benefits are the same -- the corporation retains the money -- but instead of enhancing the value of existing shareholders' interests, the benefits go to a new class of investors. In this manner those people whose tax money is being given away in this welfare program would receive the benefits of the new capital formation and have a piece of direct ownership -- the goal of the capitalist society. Existing shareholders' interests would not be diluted.

Accelerated depreciation is an analogous situation. It suits well its intended purpose. But it again enhances the value of the shareholders' interest at the expense of the taxpayer.

Another need for Congressional action in connection with ESOPs is with regard to the proposed change in loss carry-back. This proposal is nothing more than a gift estimated at $1.7 billion to assist such companies as Chrysler, Pan Am, and TWA, apparently because of their size and influence. Why reward existing shareholders and bad management? If we decide to "save" these companies because of the number of jobs at stake, then plainly the new capital contributed should go to a new class of shareholder. Why not these same people whose jobs are to be saved? Would it create better overall performance, after all the employees would have a stake?

With regard to specific comments directed to Mr. Kelso's proposals I have the following comments:

1. Existing law should be changed to allow the issuance of shares at book or market, whichever is higher. Current shareholders would be protected from the dilution otherwise resulting from issuance of the shares at market less than book. There would be no basis for the employees to object to this formula because the stock would be a fringe benefit rather like a bonus, (but should be partially considered in union negitiations) the value of which varies with the performance of the company.

Page 3 January 20, 1976

2. I have two points to make in regard to the consequences of business failure on the failing company's ESOP. First, employees of that company would be no worse off than the employees of a failing company not having an ESOP. Indeed, the existence of the ESOP may prolong the life of or save an otherwise failing company. Second, to the extent that this is perceived to be a problem, the solution is to allow ESOPs to trade in other companies' stock, rather like a mutual fund. Some limit such as 50% could be imposed on the amount of outside stock the ESOP could own.

Thank you for the opportunity to make my views known in these proceedings, and I hope Mr. Kelso's ideas will be given a chance to breathe new thinking and results into our so-called capitalistic society.

Sincerely,

Robert Batinovich
Commissioner

cc: Senators on Joint
Economic Committee

772 12th Avenue
San Francisco, California 94118
December 23, 1975

Joint Economic Committee
Congress of the United States
Washington, D.C.

RE: THE RELATIONSHIP OF ESOPs TO FULL EMPLOYMENT

Any discussion of Employee Stock Ownership Plans (ESOPs) must include a recognition of their relation to our national goal of full employment.

The (Full) Employment Act of 1946 mandates that the Federal Government "... use all practicable means ... for the purpose of creating and maintaining ... conditions under which there will be afforded useful employment opportunities ... and to promote maximum employment, production and purchasing power."

Full Employment in the Two-Factor Context

The two-factor approach, which currently finds legislative expression through ESOPs, recognizes that "useful employment" must encompass more than the employment of human resources. Rather, if the promise of technological progress is to be realized, our employment policy must be updated to include the full employment of highly productive non-human resources as well.

The choice becomes one of whether we desire to tap our technological potential and create wealth or whether we choose to thwart our technology and, instead, perpetuate toil.

To interpret the mandate of the 1946 Act solely in mono-factor terms is to deny the existence of science, engineering and management, whose mandate it is not to create but to destroy human employment in order to maximize the nation's productive efficiency.

The way to maximize "employment, production and purchasing power" is to acknowledge this job-destruction task of our technological pioneers and aid, rather than frustrate, their search for ways by which to shift the burden of toil off of man and onto the non-human factors of production.

However, in a private property economy, this increased non-human productivity will actually be translated into purchasing power only if the ownership of the productivity is itself broadly diffused among the populace.

Therefore, with business expenditures for new plants and equipment currently exceeding $100 billion annually, the question of full employment, in the two-factor sense, rightly becomes one of "Who is going to own all that?"

The Available Alternatives

As with all questions involving economics, we are faced with a choice of alternatives and their attendant costs.

The outcome of a continuance of our present methods of financing capital creation will be to guarantee that an income-hungry populace willcontinue to demand relatively unproductive and inherently inflationary jobs - not because the work is productive or nurturing but solely because it is the only way presently available to legitimate an income.

To require that men grovel for the opportunity to toil when the means for creating wealth are readily at hand is a tragic commentary on our political willingness to institutionally reflect the economics of reality.

To frustrate the economic future of a people by requiring their t toil when what they want is freedom therefrom is to permit a nation, through its economic ignorance, to forfeit its technological potential.

And, most tragically of all, to consciously choose to tie a man's life to subsistence toil in the latter part of the twentieth century is, by far, the most unhappy commentary that could possibly be made on our nation's willingness to foster humanitarian goals.

The path we choose is a matter of will - political will. To do nothing is consciously to opt in favor of continued pinnacle ownership and its attendant redistributive bureaucracy, both of which entail dire political dangers to a freedom-loving people.

ESOP's Social Dimension

The ESOP allows a new political course to be set; it progressively builds an individualized countervailing power into a people who already feel sorely dwarfed by a seemingly all-powerful and ever-pervasive government.

Rather than continue on the politically perilous and bureaucratic-ridden road that attempts to <u>break</u> the nexus between productivity and income security, the ESOP helps to <u>make</u> this connection and, by so doing, aims to provide the individual with a measure of control over his daily subsistence so as to insulate his personal will against the winds of political change.

We need new social vectors, ones which will be growth oriented -

not only in the economic and technological sense, but in the human sense as well.

I have no doubt that there can be abuses of the ESOP technique, and perhaps abuses have already occurred of which we are unaware. However, and this is crucial, the true focus of inquiry is to consider what will happen without the expanded ownership available through the ESOP.

We can study alternative costs until the system collapses under the weight of its presently innately unproductive inertia. The ESOP promises to fulfill the mandate of the 1946 Act by applying a post- (rather than an unbelieveably pre-) industrial interpretation to its terms. The ESOP is a viable alternative and, importantly, the only alternative presently being offered to salvage the fast-sinking remnants of our democratic capitalism.

The ESOP is a contemporary approach to a full employment policy; it aims to avoid the inefficiency presently inflicted on the productive sector by a political design which intentionally attempts to maximize the employment of human power at the dawn of the atomic age.

The Full Employment Conference of December 10, 1975

Had a man from Mars sat in on the JEC-sponsored round-table discussion, he would have had absolutely no way of knowing that this nation had ever invented even so much as one labor-saving device. Rather, he could only have concluded that our national economic goal was devoted solely to the creation of human toil.

Only at one brief moment in a full day of discourse by an international panel of 33 professionals did Chairman Willard Wirtz enter into the record any question which even remotely recognized the existence of any non-human factors of production. And that question, he readily admitted, was "a point that (was) a little bit hard to fit into this discussion.

Nevertheless, Mr. Wirtz did willingly acknowledge that "perhaps the answer is that we have to turn more and more of the productivity over to the machines and find other uses for the human energy."

A Production Ethic to Replace the Job Ethic

A television interviewer once asked Dr. Milton Friedman, University of Chicago economist, "How can we improve the income of the poor?" Dr. Friedman's response: "Give them money."

Remarkably, his answer was apparently taken seriously, and now that printing press solution has become one of the nation's most pressing problems. It is clear that the error stems from treating symptoms rather than causes; the cause being the inequitable distribution of productive wealth, from which stems the unworkable distribution of income.

We must produce, not spend, our way out of this current depression. The ESOP's ingenious design not only enables us to finance the full employment of our non-human productive resources, but also allows us simultaneously to escape from our myopic emphasis on the full employment of our relatively unproductive human resources by building productivity and, thus, pruchasing power into a broadened segment of income-needy American households.

ESOP and the Living Wage

Lest life, liberty and the pursuit of happiness become but the empty platitudes of a bygone era, we need only recall that the right to life was once called forth to support the laborer's right to a 'living wage'. This sort of spirit also underlies both the minimum wage and the concept of collective bargaining as well.

If you can agree that the pursuit of happiness implies the right to whatever help organized society can offer its citizens in their attempt to create a good life for themselves, then certainly, as the technological revolution progressively discounts the value of the laborer's physical input, organized society is obliged to its citizens to bring the living wage ideal into tune with the contemporary productive context: wherein capital instruments, not laborers, account for the bulk of the productive input.

This 'contemporization' implies that the individual ought to be aided in his ability to acquire ownership in, and thereby claim the wages of, productive capital. The ESOP approach recognizes that both credit and the corporation are creatures of the state and, as such, are the ideal devices by which the government can encourage the private sector to connect individuals to independent sources of income.

Additionally, broadly diffused capital ownership fosters liberty by enabling the individual to be less dependent on the government to create for him employment which otherwise would not exist due to the ever-lessening free market demand for human input in an increasingly automated age.

And to continue to grant wage increases in the name of honoring the right to a living wage is to pervert the idea by making its promise illusory. The payment of more money for the contribution of the same amount of productive input is innately inflationary; thus, the increased income is effectively forfeited due to the inflation stimulated by its receipt. A living wage needs now to include the wages of non-human labor as represented by the ownership of working productive capital.

Recommendation

Let us please not continue to study alternative routes while we speed along a road toward certain economic dollapse - particularly when such collapse seems so likely to be attended by the perils of political entrapment.

Rather, by using common sense as the guidepost, let us recognize the basic soundness of the goals and concepts of expanded ownership and begin to utilize the ESOP as the most immediately available technique for implementation of the ideal of democratic capitalism.

An unknown scribe, writing in the Dead Sea Scrolls over 2000 years ago acknowledged our perpetual predictament: "None there be, can rehearse the whole tale."

Yet surely we cannot not go wrong by setting the course of our avowedly capitalist society so as to have the vast majority of its citizens gainfully employed through their ownership of the nation's capital resources. At this point in technological history, continued divergence from that goal promises economic disaster.

Respectfully submitted,

Jeffrey R. Gates

ESOP FINANCING TECHNIQUES SUPPORT A NECESSARY ECONOMIC SYSTEM CHANGE

James L. Green
Professor of Economics
University of Georgia

Professional economists have failed to recognize and rally to the economic system improvements advocated by Louis O. Kelso.

Why this is so is hard to understand. Most economists whose advice is sought and listened to today were trained in, and conditioned by, the doctrines expounded by Lord J.M. Keynes. To the contrary, their immersion in Keynesian economic doctrine should have made them particularly susceptible and sensitive to the basic tenets expounded by Kelso. Keyne's basic purpose was to strengthen and preserve a market-oriented capitalism with all the individual freedoms inherent in that system.

Kelso takes the economists one step beyond Keynes and provides a mechanism for implementing a market system based on self-sustaining economic flows. Kelso is not an apologist for capitalism and the market system. Kelso supports the enterprising business system based on private property and individual ownership of the means of production. His proposals are designed to promote economic viability, assure economic growth with stability, dampen inflationary pressures, and provide for full employment of economic resources while decreasing the need for government interference in economic affairs and income distribution patterns.

In 1930, Keynes addressed his hypothetical grandchildren as follows:

"If we look into the future . . . the economic problem is not the permanent problem of the human race . . . I look forward, therefore, in the days not so very remote to the greatest change which has ever occurred in the material environment of life for human beings in the aggregate . . . the course of affairs will simply be that there will be ever larger and larger classes and groups of people from whom problems of economic necessity have been practically removed. . . . The critical difference will be realized when this condition has become so general that the nature of one's duty to one's neighbor is changed. For it will remain reasonable to be economically purposive for others after it has ceased to be reasonable for oneself." (Emphasis added.) (Keynes, John M., "Economic Possibilities for our Grandchildren", 1930, Essays in Persuasion, Norton, 1963, pp. 358-373).

Keynes contemplated with equanimity a substantial redistribution of wealth and income through government auspices in the direction of greater equality. Keynes also advocated a substantial government control over consumption, investment flows, and economic growth in the interest of augmented stability, employment, and income maintenance.

Keynes advocacy of governmental redirection of income flows markedly changed the inherent characteristics of the economic system. For a large proportion of Americans, income distribution in the ensuing post-war decades, became a matter of political clout rather than market-based economic contribution.

Keynes thought this change in the economic system, enlarging government "largess" would facilitate human adjustment to a dynamic and changing economic environment encompassing high levels of technology, rapid industralization, and intensive urbanization. While there is ample evidence that human adjustment to the rapidly changing environment has been facilitated, few foresaw the deleterious effects that would accompany and stem from the politicized change in income distribution patterns.

F.A. Hayek gained early insight to the evolving mixed economy as an unstable, transitional phase which would transform the enterprising market system into a bureaucratically controlled economy.

In 1960, Hayek observed:

> "This conflict between the ideal of freedom and the desire to 'correct' the distribution of income so as to make it more 'just' is usually not recognized . . . But, the ultimate result . . . will necessarily be, not a modification of the existing order, but its complete abandonment and its replacement by an altogether different system -- the command economy." (Hayek, F.A., The Constitution of Liberty.)

Other pertinent observations support Hayek.

Raymond Aron: "We have all become intensely aware of power as the major phenomenon in all societies, and as a problem which no reforms in the property system or in the functioning of the economy can solve." (German Sociology, p. 131).

David M. Gordon: "We think it is the mainstream economists who are utopian for dreaming that our present economic system could possibly work . . . Equally important . . . is the issue of greater control over our working and political lives . . . State planning will directly involve the government in the organization of production . . . Will this involvement, combined with the abolition of private property, provide the basis for the transition toward a society in which every one is free from the bonds of subsistence and shares equally in his/her material and social relations?" (New York Times Magazine, April 27, 1975.)

Hyman Minsky: "In the sophisticated American system based on credit, financial and non-financial institutions like banks, insurance companies, savings and loan associations, major corporations, and units of government issue particularized types of liabilities. There is subsequently a vast debt structure superimposed upon production and consumer units in the economy. When these institutions get into trouble, they can pull down the real economy just as they did in the 1930's . . . Now the choice is no longer between inflation and debt deflation, with a resulting deep depression. This means that we need a wringing out of the economy without a depression. Corporations and households have to be constrained to what can be financed by internal cash flows while income is maintained by government employment policies . . . The investment tax credit should be abolished along with other investment incentives that only encourage more debt and make the economy more vulnerable to collapse . . . In other words, we should attempt to achieve full employment in the context of a low investment economy." ("The New Keynesians Have a New Prescription", Business Week, May 12, 1975.)

Paul Davidson: "Inflations are dangerous because they threaten the very functioning of the economy . . . Inflations redistribute income from the less powerful to the more powerful, especially the strong unions and the large corporations. Recessions do likewise, only the total pie shrinks. Instead of that, let's have an incomes policy that's rational." (Ibid.)

Implementation of the Employment Act of 1946 instigated two governmental policies which have led to the ongoing economic malaise: (1) the tendency to shift emphasis away from production and toward consumption, and (2) the politicization of income distribution which favors consumption at the expense of investment and production.

Measures of the extant command economy foreseen by Hayek are easily documented. As recently as 1955, federal transfer payments to persons (income received for which no current economic services are rendered) amounted to 5.8 per cent of total wage and salary income earned. In 1974, transfer payments to persons amounted to $128 billion. The proportion had grown to 17 per cent of total earned wage and salary income. In 1975, the proportion is estimated to be 22 per cent or more. The "taking by command" of this sizeable proportion of earned income from those who are working and distributing it to those who are not working is deadening to the work ethic. The motivations to excel, to strive for quality, to work more efficiently and productively lose their potency as workers turn pragmatically toward bargaining for more pay for less work and in some cases to no work at all as they become wards of government.

The tendency to redistribute income away from production and toward consumption is reflected in recent data compiled by the International Monetary Fund as reported by Tilford Gaines.

	Investment as % of GNP*	Consumption as % of GNP	Gov't. Expenditures as % of GNP
U.S.	14.96	62.85	22.15
Canada	22.70	58.05	19.59
United Kingdom	18.63	62.96	18.58
Japan (1973)	38.21	51.48	8.18
Germany	26.21	53.78	17.66
France (1973)	27.56	59.46	12.29
Italy	21.71	64.45	14.12

Economic Report, Manufacturers' Hanover Trust Company, 6/75
*Residential construction excluded.

Herman Liebling, economist, Department of the Treasury, released a report on April 1, 1975 documenting the adverse impact of the redistribution of income toward consumption and away from production. (Liebling's figures include residential construction expenditures).

The share of total national output devoted to fixed investment was lower in the United States than in any of the 11 major industrialized countries for which comparable data were developed. A ranking of countries with respect to investment ratios and real growth rates for the period, 1960-1973, placed the U.S. at the bottom.

Productivity gains as measured by real output of total goods and services per employed civilian again placed the U.S. at the bottom. Japan exceeded the U.S. by an average annual rate of 6.7 percentage points; Italy by 3.2 percentage points, and France by 2.4 percentage points.

Liebling points out that factors other than fixed capital formation contribute to productivity, particularly employee motivation and managerial skills. But, he contends, there remain large benefits to productivity resulting from a larger growth in capital stock.

AN APPRAISAL OF THE KELSONIAN ECONOMIC SYSTEM.

Louis O. Kelso seeks to make the market system work and work effectively. Given Kelso's precepts, the economy would regain its bent toward production and efficiency. His system would strengthen motivations to work by broadening the capital ownership base and by providing employees "a piece of the action." Kelso would reinstate the free market economic philosophy that "compensation received reflects the contribution rendered." Kelso's system would augment stability while promoting growth by balancing purchasing power in the market with productive power in the economy.

Mortimer Adler: "I think I know enough about this subject and I think I understand the central ideas in Mr. Kelso's theory of capitalism well enough to say, without fear of exaggerations, that his is the first clear and systematic statement of capitalism that has ever been presented to the world.

Mr. Kelso's conception of capitalism as the economically free and classless society which supports political democracy and which, above all, helps political democracy to preserve the institutions of a free society is, to my mind, the most revolutionary idea of the century." (Reported in Two-Factor News, February, 1975, Vol. II, No. 1.)

Ronald Reagan: "Over one hundred years ago, Abraham Lincoln signed the Homestead Act. There was a wide distribution of land and they didn't confiscate anyone's already owned land. They did not take from those who owned and give to others who did not own. It set the pattern for the American capitalist system. We need an Industrial Homestead Act . . . I know that plans have been suggested in the past and that all had one flaw. They were based on making present owners give up some of their ownership to non-owners. Now this isn't true of the ideas that are being talked about today. Very simply, these business leaders have come to the realization that it is time to formulate a plan to accelerate economic growth at the same time we broaden the ownership of productive capital. The American dream has always been to have a piece of the action." (Speech to Young Americans for Freedom, June, 1974.)

John D. Rockefeller, III:
"Taxation has its limitations as a method of achieving a better economic distribution since for this purpose it is essentially remedial. We must also take a positive approach by finding new ways to spread ownership of future capital growth more broadly in our society . . . Louis Kelso makes a convincing argument that many of the deficiencies of our economic system could be alleviated if ways were found to broaden the ownership of the means of production . . . Kelso proposes a 'second income plan' whereby each working person would receive wages for his labor and at the same time accumulate a share of ownership in the enterprise to which he contributes his labor . . . Successful approaches of this sort would pay dividends in terms of employee commitment and morale. And they would not deprive anyone of his present holdings since they are based on future growth." (The Second American Revolution.)

At this point basic economic theory comes to Kelso's support. About two hundred years ago Jean Babtiste Say postulated an economic law that "Supply creates its own Demand." Say propounded this law in a simple, mostly barter economy in which economic goods were scarce and universally desired. Any economic good, being scarce and possessing utility, would be demanded by someone with some other good to trade. With the advent of more highly monetized economies, however, demand did not always or necessarily equal supply. Money performing its function as a storehouse of value need not be immediately spent for the supply of goods offered.

J.M. Keynes redefined Say's law in more modern terms. "Production creates Income." That is, the creation of a given supply of goods creates for the economy an income precisely equal to the market value of that supply of goods. This means that there is in the economy sufficient income to purchase all goods produced. The problem resolves itself, then, to the subsequent distribution of income and its active flow through markets.

In a market economy, which is only one of the many ways an economic system can be organized, the private sector is assigned two primary functional responsibilities: (1) to produce those goods and services needed and desired by people as reflected by their demands in the market place, and (2) to create and distribute income which is largely accomplished through the employment process for labor and capital. In creating and distributing income (purchasing power) businesses are, in effect, creating markets for the total supply of goods brought to the market. Without adequate purchasing power no market system can be effectively functional. It is for this reason that government has interjected itself as a major force in modifying income distribution patterns. Such actions have boosted consumption. At the same time, notwithstanding the significant gains in real income in the postwar years, utilization of the nation's industrial capacity has averaged out at about 83 per cent, far below the optimal 92-94 per cent that would reflect full production.

Kelso's Two-Factor theory recognizes that two factors . . . labor and capital . . . combine to produce goods, services, and income. Ownership of the productive factor entitles the owner to income produced by that factor. In Kelso's view it is capital that underpins productivity gains and income creation. Capital is not an extension of the workers' hands, but rather is an extension of the ownership of capital. With higher levels of technology more and more of the productivity gain and the output of goods and services must be attributed to the input of the capital factor. No one, says Kelso, ever gets rich through sale of his labor services alone, and never will. As the Horatio Alger stories always evolved, the poor boy became rich only as he acquired ownership of capital and was able to claim the income derived from that capital. As we look around us today in our highly urbanized, high technology economy, what can give economic security and a continuing income flow to a person except ownership of productive capital? The answer is, of course, obvious.

About 98 per cent of corporate capital formation in the United States is financed through internally generated cash flow or borrowings paid for out of cash flow. The result is a growing concentration of ownership of productive, physical capital among American households. If a capital owner is defined as a person receiving half or more of his income from the ownership of capital (which is a reasonable standard), over 50 per cent of publicly held corporate stock is owned by less than 1 per cent of income recipients.

With each new added increment of capital growth (over $149 billion of fixed nonresidential investment in 1974) further concentration in the ownership of productive capital continues. There is no question that such increasing concentration of wealth and income jeopardizes the stability, the functioning, and even the continuing existence of the market-oriented, enterprising system. Demand deficiency has become characteristic of American economic functioning.

To further elucidate the concentration of wealth and power, I turn to Timothy Bate's analysis of a Federal Reserve Board Study, dated 1962.

This study shows 94 per cent of American households with asset holdings below $50,000 owning only 10 per cent of all publicly traded stocks and 9 per cent of all miscellaneous assets (primarily beneficial interests in assets held in trust). At the upper level, the 6 per cent of households with asset holdings of $50,000 and above own 90 per cent of publicly traded stocks and 91 per cent of miscellaneous assets. The wealth concentration is dramatized when it is noted that 1.2 per cent of households with asset holdings above $200,000 own 65 per cent of all publicly traded stocks and 83 per cent of the assets held in trust. Corporate ownership has become markedly more concentrated in the last decade and a half. (See, "The Economic Origins of Political Power in America", The Political Economy of Federal Policy, 1973).

By pushing constantly for higher levels of consumption in order to sustain higher levels of employment for an expanding labor force (One-Factor Economics in Kelso's terminology) and by funding wage and price increases across-the-board with easy credit policies and a rising money supply, we have built a massive debt structure and an unrelenting inflationary bias into the price mechanism. This bias underlies much of the recessionary and socio-economic uneasiness we are experiencing today.

If we look to Simon Kuznet, the basis for corporate ownership concentration becomes clear. In Kuznet's work, (Capital in the American Economy: Its Formation and Financing) he emphasizes that the purpose of corporate finance is to enable a business firm to acquire ownership of capital instruments before it has saved the funds to pay for them. Corporate managers borrow on credit and acquire debt to build new physical capital assets. In turn, the capital acquired produces added income and self-liquidates the debt incurred in their acquisition. That is, the capital assets pay for themselves through their own earning power. At that time the corporation owns the capital assets, the shareholders' wealth is augmented, and they have claim to the income the capital produces for the remainder of its useful life. With no action on their part, no further investment necessary, and with virtually no risk, individual investors have experienced significant gains in ownership. Concentration in ownership of capital has been a benign result of corporate financing philosophy and practice in an enterprising market economy when growth has predominated in this century.

A deviation from Simon's purpose in corporate borrowing is in part a factor in the inflationary bias which has enveloped the economy. Borrowing to acquire new productive capital,plant, machines, and tools which will produce income and self-liquidate their own debt is beneficial to the corporation and to the economy. When borrowed funds, however, are not used to build new productive capacity but rather are used in purely financial transactions that do not benefit or augment total output, the result is deleterious and inflationary. When new credit extended adds little or nothing to output and real economic income, the result is an increase in monetized debt and inflationary pressures.

The following table documents this deviation from borrowing for capital formation to an abuse of credit in the post-war period. The economic boost to growth and augmented real income became less potent as the use of credit was abused.

RELATION OF CREDIT EXPANSION TO THE GAIN IN REAL INCOME. SIMPLE STATISTICS ILLUSTRATE THE MOVE FROM CREDIT USE TO CREDIT ABUSE.

	Change in GNP 1958 Constant Dollars (In Billions)	Change in Total Bank Credit* (In Billions)	Col.2/Col.1 Bank Credit/ Real GNP
June '49/June '53	$93.9	$23.9	$0.25
June '54/June '57	51.1	17.7	0.35
March '58/March '60	52.7	18.3	0.35
Dec. '60/Dec. '65	150.7	102.7	0.68
Dec. '66/Sept. '68	56.4	74.5	1.32
June '70/Sept. '73	116.7	211.8	1.82

*All Commercial Banks, Federal Reserve Bulletins.

As the data show, 25 cents of new added credit was sufficient to add $1.00 of additional real income to the economy in the early post-war years. As the use of credit became less and less devoted to capital formation the relationship deteriorated. In the latest period shown, $1.82 of new credit was required to create a $1.00 of additional real income. This reflects the acquisition of more monetized debt for reasons other than new capital formation as well as growing federal deficits aimed at redistributing income in favor of consumption and as an absorber of savings at the expense of improving and enlarging physical productive capital capacity.

In the last decade particularly, newly created monetized debt acted primarily to push up prices as the U.S. lagged behind other nations in investment and productivity gains. The resultant inflation cut into real levels of effective demand. The buying power of the total money stock dropped 5 per cent in 1974 as price rises outpaced increases in the money supply. Weekly spendable earnings in real terms retrogressed to the 1964 level in purchasing power. Between December, 1973 and August, 1975, total new bank credit extended amounted to an additional $52.6 billion. Concurrently, real GNP fell by $50 billion. For every dollar of new credit extended real income fell by $0.90. This may be a cyclical phenomenon. It may also tell us something about the effectiveness of the massive, impending $80 billion deficit and its probable success as a means of fomenting a sustainable economic recovery.

Kelso's economic system would adopt and enforce Simon's precept that the purpose of corporate borrowing is to acquire new physical capital assets which will self-liquidate the debt incurred in their acquisition in a reasonable period, of say, 5-7 years. As I perceive Kelso's proposition, the only purpose for which new credit can be extended is the formation of new, self-liquidating capital formation. For all other purposes all economic units -- households, businesses, governments, and agencies of governments -- would be limited to the total of business and private savings in the economy. This source of savings is running currently at a $250 billion level and is adequate to meet all necessary credit needs. Such a policy would require that we, as a group or national economic unit, live within our income. Inflationary pressures would be dampened and essentially eliminated.

New credit extensions allowed for new capital formation could carry an interest rate as low as needed to provide an incentive and a rate of growth adequate to meet productivity improvement and employment needs through new job creation. While investment in new technology destroys jobs in specific companies and in specific instances, investment also creates jobs as the capital base is expanded and the economy responds to increased demands for goods and services.

Kelso's programming allows employees to gain ownership of new productive capital as corporations grow and modernize. In making investment decisions corporate professional managers incorporate into the investment decision the proprietory interests of the employees. The firm experiences augmented cash flows, an amelioration of liquidity pressures stemming from excessive debt burdens, and a method of providing for employee retirement income security that does not place added pressures on future cost/price policies of the firm. ESOP financing as postulated by Kelso largely removes inflationary pressures from the economy, stimulates investment and economic growth, while augmenting and stabilizing income flows.

Kelso's concepts make it possible for employees to become substantial owners of capital, to earn a second income, to become involved as owners of the capital tools with which they work. Because workers receive income from both factors of production -- their labor and the capital they own -- the tendency to demand wage increases for less and less work diminshes. Because workers gain a proprietary interest in the capital base, capital investment is encouraged rather than opposed "tooth and toenail" as now frequently occurs. Over the years, as capital ownership is broadened, economic stability is enhanced. As the pattern of income is modified a balance is achieved so that purchasing power in the market place is increasingly more closely equal to productive power in the economy. Market development is enhanced . . . the purchasing power is there in the market . . . firms have only to offer a product which is competitive in order to get their earned share. Investment may draw on savings, and/or, if the physical productive capital self-liquidates the debt incurred in its acquisition in 5-7 years, firms may draw on the banking system for newly created credit. Inflation is minimized and controlled by balanced market forces as increased supplies of goods offset inflationary pressures triggered by new credit extension.

CRITICS OF KELSO

A common criticism of ESOP is that it is based upon a loophole in the tax laws. When one recognizes that the institution of private property itself, the corporate form of business organization, the claims to wealth, and, if you will, faith, love, and hope are all somehow imbedded in law and regulated by government, this criticism of ESOP financing techniques becomes irrelevant.

Another criticism is that each factor of production (labor and capital) receives monetary compensation in accordance with its marginal contribution to the production process under competition. If labor receives 72-74 per cent of all earned income from production then this allegedly reflects labors' contribution. If steel workers in a highly capital intensive industry are paid more than say textile workers, the steel workers' marginal contribution is said to be greater. While we all accept this as good theory in a fully competitive economy, I submit that events have rendered the actual value of this theory of wage determination impotent in an economy calcified by institutional "power" relationships.

It is true that the combination of labor and capital in steel create more economic value than the same combination in textiles. This we attribute to market demand. Due to technical capital/labor input coefficients it is not possible to measure separately the contribution of capital nor of labor. By itself, capital produces nothing. By itself labor could produce no steel and very little textiles. It is in combination that productivity occurs and value is realized.

Institutional forces and relationships -- not encountered in the purely competitive economy -- are the potent determinants of income distribution in today's power-based economy. Louis Kelso's system would indeed modify the institution of private property by broadening the ownership base of capital. This would be accomplished without coercion using the market-based philosophy and practices of market-oriented corporate finance. No present owner would lose any of his ownership. Moreover, the use of pure economic and political power to achieve economic ends by and for particularized, special groups would be diluted.

Louis Kelso offers this nation a viable alternative to more detailed government regulation and controls. His proposals are economically sound and deserve a thorough analysis and all-out effort to preserve and enhance the market-oriented, democratically based enterprising system.

JOINT ECONOMIC COMMITTEE

EMPLOYEE STOCK OWNERSHIP PLANS

STATEMENT OF PRICE WATERHOUSE & CO.

To the extent that Employee Stock Ownership Plans can further capital formation and result in broadening stock ownership by American workers, we are in favor of additional incentives to encourage their use. In our view, however, the term ESOP should be broadly defined to include any tax-qualified employee benefit plan which invests a significant portion of its funds in employer corporation stock. Although there are circumstances in which the Kelso-type ESOP is well suited for accomplishing the objectives sought, there are numerous other situations in which some other type of ESOP - such as a thrift or savings plan, or a stock bonus or purchase plan - can be more appropriate. For reasons set forth hereinafter, we do not believe that borrowing by the ESOP trust (as in the Kelso-type ESOP) is essential in most cases for achieving the goals of capital formation and broadened stock ownership by employees.

Our views on the uses, advantages and disadvantages of ESOPs are set forth in our booklet entitled Employee Stock Ownership Plans - A Critical Analysis, a copy of which is submitted herewith for the record. To illustrate our conclusion that Kelso-type ESOPs should not be viewed as a panacea - but merely as one type of plan which should be evaluated along with others to determine which is best suited for a given employer's particular facts and circumstances, there are two points noted briefly in our booklet which should be elaborated on.

An ESOP as a "tool of corporate finance"

In situations where stock is acquired directly from the employer corporation by the ESOP, the Kelso-type plan utilizes borrowing from a financial institution by the ESOP to enable the latter to buy a large block of stock from the employer "up front." The employer guarantees the ESOP's debt, and agrees with the financial institution to make future contributions to the ESOP which will be sufficient to amortize the loan over an agreed period of time. Kelso plan proponents claim that this technique permits the loan to be paid out of pretax dollars - hence the "innovative financing technique" claim.

In fact, however, it is demonstrable that direct borrowing by the employer corporation, rather than through an ESOP, can produce essentially the same financial results if the employer additionally makes stock contributions to the ESOP.

To illustrate, assume that an ESOP borrows $1 million from a bank with an employer corporation guarantee, and uses it to purchase 100,000 shares of employer corporation stock from the employer at $10 per share. Over a five year period, the employer makes sufficient tax-deductible cash contributions to the ESOP trust to enable it to pay off the debt plus interest. At the end of the five year period, employees (through the trust) own 100,000 shares of stock and the employer retains the $1 million cash originally received for the stock, less the after-tax cost of enabling the trust to pay off the $1 million loan plus interest. The employer's outstanding stock has been increased by 100,000 shares.

Alternatively, assume that the employer borrows $1 million directly from a bank and repays it with interest over the same five year period. In addition, the employer contributes 20,000 shares of its stock to an ESOP each year during that same period. Assuming that the fair market value of the stock does not change during that period, the results of the program will be the same as under the first alternative, i.e.:

1) employees will, through the trust, own 100,000 shares of stock,

2) the employer will retain cash equal to the tax savings obtained from deducting the stock contributions, less the after tax cost of interest payments on the loan. The net cash retained will be just about the same as under the first alternative.

3) the employers' outstanding stock will have been increased by 100,000 shares.

If the value of the stock increases during the five year period, the employer's tax deductions will be larger than under the first alternative. Obtaining immediate tax benefit from such larger deductions might be constrained by the 15 percent of annual compensation limitation on contributions to the ESOP. On the other hand, the fact that interest on the loan is deductible as such - rather than under the limitation for contributions to the ESOP - might well permit immediate tax benefit from the larger deductions resulting from increases in the value of the stock.

As compared to the Kelso-type ESOP, the alternative of direct bank borrowing by the employer coupled with stock contributions could offer the following advantages:

1) The necessity of complex methods for allocating stock among participants in the ESOP - resulting from the fact that stock subject to unpaid loans is not allocable - is avoided.

2) The possibility of a prohibited transaction (if the price paid for the stock by the ESOP were considered too high by IRS upon audit) is avoided.

3) The structure of the ESOP can be more flexible, since it need not meet the definition of IRC Section 4975(e)(7) (added by ERISA).

The point of this illustration is that whatever additional legislative encouragement of the ESOP concept may be enacted should not be restricted to the Kelso-type ESOP, since it is not the only way of achieving the desired objectives.

<u>Matching plans</u>

It is our view that plans under which employees are offered an opportunity to purchase employer stock at a bargain price are an attractive means for both broadening stock ownership and raising equity capital for the employer. Types of plans under which this can be done are:

1) Tax qualified plans, under which employee contributions to a trust are matched fully or partially by the employer. Such plans are usually called "thrift" or "savings" plans. All or a portion of the contributions may be invested in employer stock. Employees may be offered a choice in the matter of how their contributions are to be invested.

2) Stock purchase plans not using a trust. Employees are permitted to purchase stock directly from the employer at a discount.

Although ESOPs are conventionally thought of as plans under which employees acquire stock at "no cost," in fact there may well be a cost in terms of, for example, the lack of a pension plan, or salary and wage increases which may be foregone. Stock purchase plans require some investment by employees, but convey an economic benefit in the form of a discount from fair market value. Such plans can be more cost effective for employers than Kelso-type ESOPs. They also can encourage a strong sense of participation on the part of employees.

We believe that the tax incentives for employee stock purchase or thrift plans could be broadened. Among the measures which could accomplish this are:

1) Permit employees a tax deduction, within Individual Retirement Account limits, for contributions to a thrift or savings plan established by the employer.

2) Liberalize the tax benefits available for stock purchase plans. For example, Section 423 of the Internal Revenue Code presently permits participants in a broad-based plan to purchase employer stock at up to a 15 percent discount, without immediate taxation.

Section 423 plans, however, have not been widely utilized in the past. Among the reasons are:

1) The discount element is limited to 15 percent.

2) The employer does not obtain a tax deduction for the discount.

3) The employee realizes ordinary income, rather than capital gain, from the discount upon ultimate sale of the stock.

4) The eligibility rules for inclusion in such a plan are more restrictive than for qualified (Section 401) plans generally.

Since a Section 423 plan can offer a simple yet effective means of accomplishing many of the same goals sought through an ESOP, we recommend that consideration be given to legislation which would ameliorate the disadvantages summarized above in order to encourage wider use of such plans.

Relation to retirement income

One basic difficulty with ESOPs is a crowding-out effect, whereby the adoption of an ESOP can prevent or at least discourage the employer from installing a pension plan for its workers. Kelso plan proponents often state that those plans are not intended to be, and should not be regarded as, retirement plans. Nevertheless, if an employer has no other type of plan which can provide retirement income for its workers, an ESOP will of necessity be relied on by the workers as their only means of supplementing social security pensions. Although an ESOP installed by an employer which thereafter grows and prospers can after a period of years be a very generous source of retirement income, stock ownership of necessity involves risk. If the employer does not prosper, employee expectations could be severely frustrated in a situation where they have no other private sector source of retirement income. Under such circumstances, it is questionable whether the goals of the Employee Retirement Income Security Act of 1974 have been well served.

Conclusion

We urge that any new legislative approaches which may be formulated should not have the effect of institutionalizing Kelso-type ESOPs to the exclusion of other plans which can have the effect of:

a) broadening stock ownership by workers

b) raising equity capital for employers

EMPLOYEE STOCK OWNERSHIP PLANS

A critical analysis

Price Waterhouse & Co.

Table of Contents

Introduction

Since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Employee Stock Ownership Plans (ESOPs) have been accorded a great deal of attention and discussion. Some have advocated ESOPs primarily as a device for closely owned corporations to raise capital, i.e., as a financing tool. A companion view is that an ESOP can be a means for stockholders of such corporations to solve liquidity or estate problems by converting all or a portion of their holdings into cash in a tax-favored manner. Others think of ESOPs principally as a technique for opening up the ownership of corporations to their employees—the "every worker a capitalist" concept. Surrounding much of the discussion is a something for nothing aura; that is, an implication that tax benefits somehow cause costs to evaporate.

In the right circumstances, an ESOP *can* contribute significantly toward the achievement of the objectives mentioned above. The tax benefits *can* be quite substantial. But it is not a something for nothing proposition. Employees participating in the ESOP will ultimately acquire either cash or employer stock which they will eventually convert into cash. In the case of a corporation whose shares are not publicly traded, a portion of that cash will come from the company—directly or indirectly. Not all of it can come from tax savings.

An ESOP represents a type of deferred compensation plan for the participating employees. At least in the case of a closely held corporation, there is an ultimate, albeit deferred, after-tax cash cost to the employer in furnishing that compensation. That cost must be viewed as part of the employer's total compensation structure. In particular, it must be balanced against other types of retirement income, such as a pension, which the employer will or otherwise might provide for his employees. Questions requiring answers, from a cost-effectiveness viewpoint, include:

1. Are the costs commensurate with the benefits which can reasonably be expected from an ESOP in terms of raising capital, or solving a major stockholder's estate or liquidity problems, or enhancing employee morale, productivity or motivation?
2. How do the benefits and costs of the ESOP compare with the benefits and costs of alternative types of retirement income plans which the employer might arrange for its employees?

Any employer contemplating installing an ESOP should evaluate its projected advantages and disadvantages analytically, on a long term basis. It should not place exclusive emphasis on up-front advantages in terms of cash flow, tax savings and benefits to substantial shareholders, as important as these features may be.

The purpose of this booklet is to assist employers in understanding the key long and short run consequences of an ESOP, which should be taken into account in making the evaluation. It is important to understand, however, that the Treasury Department has not yet promulgated the regulations which will provide detailed guidelines regarding the finer points of structuring an ESOP under ERISA. While the provisions which were acceptable to the various District Directors' Offices of the Internal Revenue Service (IRS) in issuing determination letters on ESOPs in pre-ERISA days may provide some guidance, it cannot be assumed that they will continue to be acceptable in the future. Where uncertainties exist, they are noted.

What is an ESOP?

There is really no one all purpose definition.

In its broadest sense, an ESOP can be viewed as any tax qualified individual account type of deferred compensation plan which invests a significant portion of its funds in employer stock. "Tax qualified" means that employer contributions in cash or in stock to the trust established under the plan (the Employee Stock Ownership Trust, or "ESOT") are deductible, income earned by the trust is tax exempt, and participants are not taxed on stock or other amounts credited to their accounts until withdrawn from the trust. An "individual account plan," also termed a "defined contribution plan," is one in which a participant's ultimate benefits are based on the contributions and trust fund earnings credited to his account, rather than on a guaranteed pension formula.

Under this broad concept, a typical thrift or savings plan might be regarded as an ESOP. Thrift plans, under which employee contributions are matched by a stated level of employer contributions, often provide for investing all or a portion of the contributions in employer stock on a mandatory or optional basis. But for some reason common usage of the term "ESOP" does not include thrift or savings plans, which have usually been established by publicly-owned corporations.

Under the Internal Revenue Code, every tax qualified defined contribution plan must be classified under one of three basic categories:

a profit-sharing plan
a stock bonus plan
a money purchase pension plan

These basic categories were not changed by ERISA. Thus it has always been necessary—and still is—that a plan described as an ESOP qualify technically for tax purposes under one or more of these three forms.

Similarly, a plan colloquially described as a thrift or savings plan must also qualify under one of these forms.

Although plans described as ESOPs existed before the enactment of ERISA, it is often said that ERISA for the first time specifically recognized ESOPs as a unique type of employee benefit plan. That statement is true—to a point.

A definition of the term "Employee Stock Ownership Plan" *has* been added to the Internal Revenue Code as a result of ERISA. But that definition is operative only for a narrow purpose, namely the exemption from ERISA's prohibited transaction rules which is accorded to the borrowing of money by an ESOP from a "disqualified person" or with the guarantee of a disqualified person. Thus an ESOP which is structured to acquire employer stock by using funds borrowed with a guarantee of the loan by the employer (termed a *leveraged ESOP)* must meet the ERISA statutory definition. That definition is as follows:

> The term "employee stock ownership plan" means a defined contribution plan—
>
> A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under Section 401(a), and which are designed to invest primarily in qualifying employer securities; and
>
> B) which is otherwise defined in regulations prescribed by the Secretary (of the Treasury).

A leveraged ESOP uses the borrowed funds to purchase employer corporation stock from the employer itself, or from other stockholders.

If an ESOP will not borrow money, there is no need for it to meet the ERISA statutory definition. Thus the technical structure of a *non-leveraged* ESOP can be more flexible than that of a leveraged ESOP. In particular, it might take the form of a profit-sharing plan.

A nonleveraged ESOP is one which acquires employer stock by way of annual stock contributions by the employer corporation, or by using cash contributions received from the employer to purchase stock from other stockholders or from the employer.

As a result of the Tax Reduction Act of 1975, a third type of ESOP has now been introduced—*an investment credit ESOP.* The Tax Reduction Act provides that the temporary 10% investment credit can be increased to 11% if the extra 1% is donated by the employer to an ESOP. The conditions which must be applicable to participants' accounts to which are allocated stock acquired with the 1% investment credit amount are more restrictive than those applicable to ESOPs generally. Investment credit ESOPs are discussed in greater detail beginning on page 17.

A technical discussion of the structure of an ESOP, including the relative advantages and disadvantages of the stock bonus, profit-sharing, and money purchase plan types, may be found in Appendix A.

Advantages of an ESOP

Numerous recent publications have extolled the merits of ESOPs. Often the cited advantages include considerations based on economic theory, and matters of employee motivation. No attempt is made in this booklet to evaluate considerations of that nature. Rather, the discussion is confined to analysis of the operative tax and other financial factors.

On that basis, the generally cited advantages include the following:

Nonleveraged ESOP

1. Contribution by the employer of its own stock to the ESOP will give rise to a current tax deduction equal to the fair market value of the stock at the time it is contributed. Since the deduction requires no immediate cash outlay, the employer's cash flow is enhanced by the amount of the tax saving. This positive cash flow may even be available where the deductible employer contribution gives rise to or increases a current year net operating loss if the loss can be carried back to prior years to obtain a tax refund. An employer's basic annual contribution to the plan is limited to 15% of the covered compensation of participating employees. The employer deduction rules are discussed more fully in Appendix B.
2. A major shareholder can sell a portion of his stock to an ESOP at capital gains rates, while still retaining voting control of the corporation. If the corporation had instead redeemed a portion of his stock, he would most likely have received dividend treatment. The cash outlay by the corporation for a redemption would not have been tax deductible, but its cash contribution to the ESOP to cover the cost of purchasing the stock will be tax deductible.
3. Similarly, an ESOP can purchase stock from a shareholder's estate, thus increasing the estate's liquidity.
4. An ESOP might be used to convert nondeductible key-man life insurance premiums (on insurance purchased by the employer to fund a buy-sell agreement with a principal shareholder) into tax deductible payments. The advantages and potential problems connected with use of key-man insurance are more fully discussed beginning on page 15.

5. Benefits will be provided to the employees by the ESOP upon retirement, death, or other termination of employment, with favorable tax consequences.

Leveraged ESOP

In addition to the advantages of a nonleveraged ESOP, the following advantages are claimed if the ESOP is structured to purchase a substantial block of employer stock using borrowed funds:

1. The employer immediately receives a substantial amount of cash, attributable to the loan, which will be repaid over a period of years with tax deductible contributions to the ESOP. Assuming a 50 per cent tax rate, after the loan has been completely repaid, the company will still retain one-half of the original proceeds less the after-tax interest cost.
2. An ESOP can acquire a major block of stock from a shareholder by purchasing it on an instalment basis. By reporting his gain on the instalment method, the shareholder will be taxed at capital gain rates only as the instalment payments are received.
3. Assuming that a company's stock will gradually increase in value, the unrealized appreciation accruing to the plan participants will be greater as a result of the ESOP acquiring a large block of the employer's stock "up front," and thus holding it for a longer period of time than annual stock contributions would permit.
4. A leveraged ESOP can be used to help finance corporate acquisitions by the employer, or the spin-off of a segment of its business to its employees. It might even be used to assist a publicly-owned employer in "going private."

Investment credit ESOP

To the extent stock contributed to the ESOP is attributable to the additional 1% investment credit, the employer realizes a dollar for dollar tax benefit—as opposed to the 50 per cent tax benefit usually realized on other donations of stock to an ESOP.

Disadvantages of an ESOP

ESOP proponents generally recognize the existence of several drawbacks, including:

1. *Dilution*—ESOPs can result in a dilution of the stock interests of existing shareholders of the employer corporation. In some

instances, however, dilution is discussed as if it is not really a significant factor, provided voting control of the corporation can be retained by the present shareholders. The effects of dilution can in fact be consequential in many other respects—as will be discussed hereinafter.

2. *Valuation of stock*—In the case of a closely held corporation, its stock must be valued in order to determine tax deductions and also the price at which the ESOP will buy and sell stock. Independent stock valuations are not inexpensive, moreover valuation is more of an art than a science. The Internal Revenue Service may differ with the valuation amount used, and serious adverse tax consequences can result if the Service's valuation prevails. See the discussion beginning on page 13.
3. *Securities law*—A closely held corporation which is not an SEC registrant must consider whether the manner in which an ESOP will operate could result in federal securities law problems. See the discussion beginning on page 16.

Operation of a nonleveraged ESOP

A nonleveraged ESOP usually receives annual contributions of stock from the employer. The employer, however, may also make cash contributions. The ESOP can use that cash to acquire stock of the employer from other shareholders, or to invest in other securities. Since a nonleveraged ESOP does not have to meet the ERISA definition, it is not required to invest "primarily" in employer stock. Thus a nonleveraged ESOP could provide for additional investment alternatives—for example a fixed income fund or an equity portfolio. If desired, a plan could be structured to provide participants with a full or partial choice as to the manner in which employer contributions on their behalf are to be invested—i.e., company stock or other investments. A plan could also permit voluntary contributions by participants which could be similarly invested. The funding options are quite flexible where the ERISA statutory definition of an ESOP does not have to be met.

A contribution of stock of the employer will be valued for tax deduction purposes at the fair market value of the stock at the date of contribution. Contributions whether in stock or cash will be subject to the percentage limitations discussed in Appendix B. Contributions are usually allocated to participants' accounts in proportion to the relative compensation of each participant, although in some instances it is possible to add a length of service factor to the allocation formula.

Employer stock owned by the ESOP is usually voted by the trustees, who are selected by the employer. It is possible, however, to provide that a participant can direct the trustees as to the manner in which to vote the stock allocated to his account.

Two accounts are usually established for each participant—one to accumulate the shares of employer stock allocated to him, and the second to keep track of his equity in any other assets of the plan. Dividends on employer stock are allocated among participants on the basis of the number of shares in the account of each participant. Other net investment income is allocated among participants in proportion to the balances in their other assets accounts.

If a participant terminates his employment before his accounts are fully vested under the vesting schedule contained in the plan, the forfeited portions of his account balances are generally reallocated among the other participants on the basis of the formula used to allocate employer contributions.

If the ESOP can qualify as a profit-sharing plan, there is no requirement that the benefits be distributed in the form of employer stock. Accordingly, distributions to terminated participants in the form of cash, or by purchase of an annuity contract, would be permissible. But if it is a stock bonus plan, benefits must be distributed solely in the form of employer corporation stock—either in a lump sum or in instalments.

In the case of a closely held corporation, there is normally no market for the employer stock distributed to a terminated participant other than the company itself, or the ESOP. A former participant usually wishes to convert the stock into cash, particularly in a retirement situation where he may have no other source of retirement income except social security. In the past, IRS has permitted ESOPs to provide for a "put," whereby the terminated participant can require either the company or the ESOP to purchase the stock from him at its then appraised value.

IRS has also permitted the stock to be subject to a right of first refusal, whereby the terminated participant must first offer the stock to the company or the ESOP before he can sell it to anyone else. By this means, the possibility of the stock ending up in outside hands can be precluded.

IRS has, however, refused to permit ESOPs to have a "call" provision, whereby a terminated participant could be required to sell his stock to the company or the ESOP. Thus he would be entitled to hold onto his stock if he so chose. A closely held corporation should be aware of this possibility, if it would find it in any way objectionable.

While the rules regarding the disposition of a terminated participant's stock summarized in the preceding paragraphs were generally acceptable to IRS prior to ERISA, there can be no assurance at present that different rules may not be provided when ESOP regulations under ERISA are ultimately promulgated.

If the employer purchases the stock of a terminated participant, it will make a nondeductible cash outlay. In effect, the "cashless" tax deduction which was created when the stock was first contributed to the ESOP is now counterbalanced by a nondeductible expenditure. The employer, however, will have had the use of the cash generated by the original tax deduction for a substantial period of years—a significant deferral benefit. On the other hand, assuming that the value of the stock has appreciated over this period of years, the cash outlay at the end will exceed the amount of the tax deduction which was obtained at the beginning.

If the ESOP rather than the company purchases the stock of the terminated participant, the employer will obtain a tax deduction for the cash which it contributes to enable the ESOP to make the purchase. But in this case the stock is not retired; rather it is allocated within the ESOP to the accounts of other participants. When those participants eventually terminate their employment, additional cash outlays will be required to acquire the stock from them.

Thus in net effect a plan which starts out as producer of positive cash flow through "cashless" tax deductions will eventually require cash outlays, potentially significant, to reacquire stock from terminated participants. These cash outlays will represent post-employment or retirement income to the participants, and the after-tax cost thereof will represent the employer's expense of furnishing that compensation. That is a cost of the dilution created by the ESOP.

In the case of a publicly-owned corporation, terminated participants will be able to sell their stock on the market, and thus the same cash outlay effect is not involved. A publicly-owned corporation will realize a permanent cash infusion equal to the tax deduction obtained from contributing stock to the trust—but that is only roughly half the amount it could theoretically have raised by making a public offering of newly issued shares. The dilution effect, plus the charge to earnings for the contributed stock, will be reflected in the company's earnings per share and book value per share—factors which may affect the price at which its shares trade. In evaluating the possible use of an ESOP, the publicly-owned company needs to compare these factors with the costs of other types of qualified plans which it might use to furnish retirement or post-employment income to its employees.

Operation of a leveraged ESOP

The normal ways in which leveraging can be used to permit an ESOP to acquire a large block of employer stock at the outset include:

1. The ESOP borrows funds from a financial institution to buy stock from the employer or an existing stockholder, using the acquired

stock as collateral. The employer is normally required by the lender to guarantee the loan and to give a binding commitment to make sufficient annual contributions to the ESOP to service the debt.

2. The ESOP acquires stock from a major shareholder on an instalment basis, pledging the acquired stock as collateral. Again, the seller may require a guarantee of the loan by the employer, and a commitment to make sufficient annual contributions to pay off the loan principal plus interest.

Where the ESOP uses the loan proceeds to purchase stock from the employer, the effect is a large immediate cash infusion into the company. The company's tax-deductible contributions to the ESOP sufficient to pay off the loan and the interest thereon will require cash outlays over a future period. Upon full repayment, the company will retain cash equal to the excess of the original loan proceeds over the after-tax cost of the contributions used to repay the loan amount plus interest.

Where the ESOP uses leveraging to acquire a block of stock from a shareholder, there is of course no direct infusion of cash into the company. But if the alternative were for the company to redeem that stock, the expenditure required for the redemption would be nondeductible and thus a greater amount than the after-tax cost of the contributions required to permit the ESOP to repay the principal amount of its debt.

Since a leveraged ESOP must meet the ERISA definition, it must be "designed to invest primarily" in employer securities. A leveraged ESOP's ability to invest in other assets is therefore restricted. It will be necessary to await regulations in order to determine the precise limits within which a leveraged ESOP may be able to own assets other than employer stock.

Under ERISA, the loan to the ESOP from a disqualified person, or with the guarantee of a disqualified person, must meet the following criteria:

1. The loan is primarily for the benefit of participants and beneficiaries of the plan.

2. The loan is at an interest rate which is not in excess of a reasonable rate, and

3. If collateral is given to a disqualified person, it can consist only of employer stock.

The advantages of leveraging to the employer corporation or to a selling stockholder are obvious. But it will be necessary to await regulations to determine what tests if any must be met to demonstrate that the loan is "primarily" for the benefit of participants and beneficiaries.

For example, it is claimed that participants benefit because the ESOP is assured of receiving a fixed number of shares at the outset, for which the employer commits itself to pay. Conversely, if annual contributions of stock were to be made, the employer would not have the same fixed commitment and could cut back its contributions if it so chose.

Further, if the stock appreciates in value, the "up front" purchase produces a greater tax advantage for participants when they ultimately receive stock from the ESOP in qualifying lump sum distributions—see Appendix C.

But if it is assumed that over the debt repayment period the employer would contribute the same annual dollar amounts to the ESOP in stock as it contributes for debt service, then it is arguable that participants benefit from the leveraging only if appreciation in the value of the stock, plus dividends if any, exceeds the interest paid on the loan.

Allocations of stock to participants' accounts are made somewhat differently when leveraging is used. Stock purchased by the ESOP with borrowed money is initially held in a suspense account, and then allocated to participants' accounts on a pro rata basis over the period of the loan. In the past, IRS has approved determining the number of shares to be allocated with respect to each debt payment on the ratio which that payment (principal and interest combined) bears to the total amount of principal and interest estimated to be payable over the full term of the loan. Where level payment financing is used, the principal portion of the early loan payments is of course proportionately less than it is of the later payments. As a result, the number of shares released for allocation with respect to the early debt payments is proportionately greater than the principal reduction of the loan would support. This practice produces an anomaly in that the dollar value of the total balances in participants' accounts in the early years could exceed the total net assets of the ESOP.

It is claimed, however, that this allocation procedure produces a fairer result to the employees who are participants in the ESOP in the early years than would releasing shares on the basis of principal payments on the debt. But as in the case of other pre-ERISA practices relating to ESOPs, it remains to be seen whether the regulations or other IRS guidelines eventually promulgated under ERISA may require a different procedure.

Once sufficient contributions have been made to a leveraged ESOP to enable its debt to be completely repaid, it could either enter into another borrowing transaction, or it could operate thereafter as a non-leveraged ESOP. If the latter alternative were chosen, it would no longer be necessary for the ESOP to meet the ERISA definition and accordingly it would be free to acquire other investments in addition to employer stock.

Example

The example on page 12 illustrates the long term financial effects on the employer corporation which an ESOP could have under the facts assumed. The significant assumptions are:

1. ESOP borrows $1,000,000 from an outside lender repayable over a five-year period with annual level payments of $250,000 (thus aggregate interest cost is $250,000). XYZ Company agrees to make annual tax deductible cash contributions of $250,000 in each of the years 1976 through 1980, sufficient to enable the ESOP to make the required loan payments.
2. ESOP purchases 100,000 shares of stock from XYZ Co. for $1,000,000 on January 1, 1976.
3. Participants' accounts are subject to graduated vesting over a four to ten year period.
4. Terminated employees sell XYZ Co. stock back to the ESOP the same year it is distributed to them, with XYZ Co. making sufficient annual cash contributions to cover the repurchase price. Shares distributed and repurchased are shown in column 7.
5. After 1980, contributions of $300,000 per year are made to the ESOP, in cash to the extent necessary to fund stock purchased from terminated participants, the balance in stock. After 1990, stock purchase needs require cash contributions of more than $300,000 per year.
6. XYZ Company stock pays no dividends.
7. XYZ Company per share stock value increases annually as shown in column 5.

The example shows the ESOP producing a significant cumulative cash infusion for the company through the 15th year, but thereafter cumulative cash flow turns negative. Of course, a continued positive cash flow could be induced if it were assumed that the employer would make additional stock contributions in the later years. Presumably, growth in payrolls of a prosperous company would support additional deductible contributions. But those contributions would in turn increase the ESOP's stock holdings, and thus create additional future claims on cash when that stock is in turn distributed to participants. As it is, the per share stock value assumed for 1995 creates a potential value of approximately $5,620,000 for the ESOP's stock holdings—compared to the original $1 million of stock placed in the ESOP. In the event of a sale of the company, the portion of the sales proceeds attributable to the stock held by the ESOP would of course go to the participants.

Example of operation of leveraged ESOP

	XYZ COMPANY				ESOP TRUST			
	Tax deduction		Cash flow			Stock holdings		
	Cash (1)	Stock (2)	Current year after tax (3)	Cumulative (4)	Stock value per share (5)	Purchased or contributed (6)	Distributed and repurchased (7)	Cumulative number held (8)
*			$1,000,000	$1,000,000	$10.00	100,000		100,000
1976	$250,000		(125,000)	875,000	11.00			100,000
1977	250,000		(125,000)	750,000	12.00			100,000
1978	250,000		(125,000)	625,000	13.25			100,000
1979	250,000		(125,000)	500,000	14.50			100,000
1980	314,000		(157,000)	343,000	16.00		4,000	100,000
1981	81,250	$218,750	68,750	411,750	17.50	12,500	4,500	112,500
1982	95,250	204,750	54,750	466,500	19.50	10,500	5,000	123,000
1983	110,000	190,000	40,000	506,500	20.00	9,500	5,500	132,500
1984	127,800	172,200	22,200	528,700	21.00	8,200	6,000	140,700
1985	147,000	153,000	3,000	531,700	22.50	6,800	6,500	147,500
1986	163,700	136,300	(13,700)	518,000	23.50	5,800	7,000	153,300
1987	200,000	100,000	(50,000)	468,000	25.00	4,000	8,000	157,300
1988	235,000	65,000	(85,000)	383,000	26.00	2,500	9,000	159,800
1989	277,600	22,400	(127,600)	255,400	28.00	800	10,000	160,600
1990	300,000		(150,000)	105,400	30.00		10,000	160,600
1991	310,000		(155,000)	(49,600)	31.00		10,000	160,600
1992	320,000		(160,000)	(209,600)	32.00		10,000	160,600
1993	330,000		(165,000)	(374,600)	33.00		10,000	160,600
1994	340,000		(170,000)	(544,600)	34.00		10,000	160,600
1995	350,000		(175,000)	(719,600)	35.00		10,000	160,600

*Initial stock purchased using borrowed funds.

Total cash payments by the ESOP to terminated participants in exchange for their stock: $3,451,600.

The example shows total cash payments to terminated participants for the 20-year period of $3,451,600 (for purchase of their stock), compared to a cumulative net after-tax outlay by the employer of $719,600. That is a 21% ratio of the employer's net cost to gross benefit payments. In a conventional unfunded deferred compensation program, the employer's net after-tax cost would be more like 50% of gross benefit payments. The difference here is the cumulative tax saving produced by contributions of stock to the ESOP—the deferral benefit which was discussed previously. Of course, this cost to benefits ratio will increase in future years as additional stock is purchased by the ESOP from terminated participants—unless additional stock is contributed to the ESOP by the employer to create further tax savings.

Miscellaneous considerations

Valuation of stock

Knowing the fair market value of employer corporation stock is critical in three respects:

1. If stock is contributed by the employer to an ESOP, its tax deduction is equal to the fair market value of the stock.
2. If stock is distributed by the ESOP to a participant or beneficiary in other than a qualifying lump sum distribution (see Appendix C), the recipient is taxed based on the fair market value of the stock at that time.
3. If stock is purchased by an ESOP from a disqualified person (such as the employer corporation or a major stockholder) for more than "adequate consideration," a prohibited transaction occurs which will result in an excise tax being imposed on the seller.

ERISA defines "adequate consideration" as being the quoted market price of a security or, in the case of an asset for which there is no generally recognized market, the fair market value as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and according to regulations—which have yet to be issued. In the case of a closely held corporation, it is usually considered prudent for the plan administrator to retain a qualified independent expert to provide annual valuations of the stock.

Independent stock appraisers usually employ recognized techniques similar to those conventionally used for estate and gift tax valuation purposes. Nevertheless, there can be no assurance that IRS will accept

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the fair market value determination made by the appraiser. An IRS challenge on valuation can be particularly troublesome if it would result in stock being considered to have been purchased for more than adequate consideration—a prohibited transaction. Under ERISA, a plan will not be disqualified for engaging in a prohibited transaction. But the disqualified person involved is subject to a five per cent per annum excise tax based on the amount involved in the transaction. Moreover, if the transaction has not been corrected within a limited period of time after notification by IRS, a 100% excise tax can be assessed. These potential excise tax liabilities can pose a significant threat for employers or shareholders who sell stock to an ESOP even on the basis of a good faith fair market value determination.

In the past, it is understood that IRS has refused to accept stock valuation formulas being written into the terms of a plan. Hopefully, future regulations on the valuation question may provide some sort of "safe haven" whereby a degree of advance assurance might be obtained on valuation questions. The absence of safe haven provisions in the case of closely held corporations could significantly impede the Congressional intent of facilitating the establishment of ESOPs.

Conversion of an existing profit-sharing plan

The question is often posed whether an existing profit-sharing plan—i.e., one not predominantly invested in employer stock—can be converted into an ESOP.

Motivation for seeking conversion can be twofold. First, the employer may want to cause the profit-sharing plan's existing investment portfolio to be liquidated and the proceeds invested in employer stock. Secondly, it may be possible to make initial tax-deductible contributions to the converted plan substantially in excess of the usual 15 per cent of compensation—if contributions to the profit-sharing plan in prior years were less than the 15 per cent limitation in those years. See Appendix B.

It is reported that, prior to ERISA, IRS requirements for obtaining permission for conversion of an existing plan to an ESOP were not consistent. In some instances, the existing investment portfolio was permitted to be liquidated and the proceeds reinvested in employer stock. But it is understood that in other instances, it was required that the existing portfolio had to be separately retained as such.

Just what view IRS will take on this question under ERISA remains to be determined. In addition to IRS, the reaction of plan participants must be considered. Under ERISA, participants have rights to intervene in plan determination letter proceedings. It is conceivable that some participants, particularly those nearing retirement age, might object to a conversion which would result in their profit-sharing balances, which they have been relying on for retirement income, being converted into employer stock.

Estate planning opportunities and the use of key-man life insurance

A typical problem faced by closely-held corporations is the necessity of providing for a buy-out of the stock of majority or major shareholders at their death. Management is generally concerned with the detrimental effect a buyout can have on the working capital of the company, while a major shareholder must be concerned also with providing liquidity for his estate.

A major shareholder's estate often is able to have at least a portion of a closely held corporation's stock redeemed, without the redemption being treated as a dividend. But an ESOP can also acquire shares from an estate thus deferring the necessity for nondeductible cash outlays for redemption purposes. The cash required by the ESOP can be raised in the usual ways, through tax-deductible cash contributions from the employer, or through borrowing. Another possibility might be the purchase of key-man life insurance by the ESOP.

It may be possible for an ESOP to enter into a buy-sell agreement with a principal shareholder, and to fund the agreement with life insurance. The insurance proceeds could then be used to buy stock from the shareholder's estate.

If an employer purchases key-man life insurance, the premiums which it pays are not tax deductible. But if the insurance were owned by an ESOP, the funds used to pay the premiums would come from tax deductible employer contributions to the ESOP.

An important consideration would be that an ESOP's acquisition of key-man life insurance and the allocation of premium costs and insurance proceeds be equitable and fair to all plan participants. It has been suggested that life insurance proceeds when collected should be allocated to the accounts of participants in proportion to the premium costs which have been charged against each participant's account over the years. This allocation method would appear to result in equity as among those employees who are participants at the time the proceeds are received. But an obvious concern would be the employee who was a participant for several years while premiums were being paid but who terminates his employment prior to receipt of the life insurance proceeds by the ESOP, and therefore is never allocated any stock purchased with those proceeds.

There have been no published pronouncements by IRS dealing with the propriety of key-man insurance purchases by an ESOP. It is reported that in fact such purchases have been allowed in the past. It remains to be seen, however, whether under ERISA key-man insurance through an ESOP will continue to be acceptable and, if so, to what extent.

This technique, if acceptable, can in net effect result in tax deductions for paying insurance premiums. But as in the case of any ESOP, the stock acquired with the insurance proceeds must eventually be distributed to participants. At that point, the necessity of cash outlays to reacquire those shares will probably have to be faced. If the employer had owned the insurance, the stock redeemed with the insurance proceeds would simply have been retired.

Corporate acquisitions and divestitures

An ESOP can be used to help finance a corporate acquisition, by means of several techniques. For example, assume that Smith Co. contemplates acquiring Jones Co. for $1,000,000. Smith Co.'s ESOP might borrow $1,000,000 from a bank with Smith Co. guaranteeing the loan and also agreeing to make annual contributions sufficient to amortize the $1,000,000 principal amount plus interest. The ESOP could then purchase $1,000,000 of newly issued stock from Smith Co., which could use the cash to purchase all of the stock or assets of Jones Co.

An alternative technique would be for Jones Co., prior to the acquisition, to organize an ESOP which would use borrowed funds to acquire the major portion of the Jones Co. stock. Thereupon Smith Co. could purchase the remainder of the Jones Co. outstanding stock for a substantially reduced outlay. A final step in the transaction could be for the ESOP to exchange its Jones Co. stock for Smith Co. stock.

On the divestiture side, an ESOP might be used to enable employees to acquire a division which a corporation desires or is obligated to sell. Initially the corporation might transfer the assets of the division to a newly-formed subsidiary which then establishes an ESOP. The ESOP borrows sufficient funds from a lending institution to enable it to acquire the stock of the subsidiary from the parent corporation. The principal and interest on the bank loan to the ESOP is eventually repaid by means of tax-deductible employer contributions.

Once again, it must be borne in mind that all of these arrangements will ultimately require that stock be distributed by the ESOP to participants, whereupon the necessity for cash outlays to reacquire the stock may have to be faced.

Securities law implications

An employer contemplating the establishment of an ESOP is strongly urged to consult legal counsel regarding federal and state securities law implications. That is particularly true in the case of a closely held corporation which is not an SEC registrant.

Questions which need to be resolved include whether registration is required with respect to the various contributions, distributions and sales of employer corporation stock which the operation of an ESOP usually entails. A further question is whether offering participation in an ESOP to employees is in itself a securities offering requiring registration.

Financial statement implications

There have been no pronouncements to date by the Financial Accounting Standards Board or other authoritative bodies as to the appropriate accounting by an employer for certain transactions entered into with an ESOP. However, in a case where a newly-organized ESOP purchases stock using borrowed funds, and the employer guarantees the loan or commits itself to make sufficient future contributions to the ESOP to repay the debt plus interest, many accountants believe that the debt should be shown on the employer's balance sheet as representing in substance its own debt. The contra to the recorded obligation would be reflected as a reduction of stockholders' equity. It is understood that the SEC has in fact insisted on inclusion of the debt on the employer's balance sheet in recent financial statement filings with the Commission.

Difficult questions are also presented as to the determination of earnings per share, and the measurement and timing of compensation expense to be recorded by the employer. The accounting treatment of these ESOP related transactions is still in the formative stage, and future pronouncements by the authoritative bodies may be expected.

Investment credit ESOP

The Tax Reduction Act of 1975 (TRA) enables a corporation, by election, to increase its maximum allowable investment credit from 10% to 11% of qualified investment if it contributes an amount equivalent to the additional 1% to an ESOP. Unless subsequently extended, this special provision is available only for the investment credit attributable to qualifying property additions during the period January 22, 1975 through December 31, 1976.

An investment credit ESOP must be a defined contribution plan which:

1. is a stock bonus plan, a stock bonus and a money purchase pension plan, or a profit-sharing plan;
2. is designed to invest primarily in employer securities, and
3. meets other requirements (similar to those applicable to ESOPs under ERISA) under regulations yet to be promulgated by the Treasury.

Specific requirements imposed on an investment credit ESOP which are more restrictive than those applicable to a conventional ESOP include:

1. Only common stock, or securities convertible into common stock, of the employer or a corporation in control of the employer can be contributed to or acquired by an investment credit ESOP. The stock must have voting and dividend rights at least equivalent to those of other issued common stock.
2. A cash contribution by the employer in lieu of stock is permitted, but the cash must be used to purchase employer securities.
3. Stock contributed to or acquired by an investment credit ESOP must be allocated annually to participants' accounts substantially in proportion to compensation paid to such participants, disregarding any compensation in excess of $100,000.
4. Participants are to be immediately vested in the full amount of employer stock allocated to their accounts, but the stock may not be distributed by the ESOP to participants prior to seven years after it is allocated—except upon termination of employment, death, or disability.
5. Participants must be permitted to direct the plan as to the manner in which the stock allocated to their accounts is to be voted.
6. Even though (as discussed below) an investment credit ESOP need not be a tax qualified plan, it must meet the participation and nondiscrimination requirements discussed in Appendix A, and is subject to the contribution limitations discussed in Appendix B.

Although the requirements relating to an investment credit ESOP are more restrictive than those applicable to ESOPs generally, there are greater inherent tax advantages for the employer. Since the employer receives a tax credit instead of a tax deduction for qualifying contributions to an investment credit ESOP, the tax benefit of the contribution is effectively doubled.

In the case of a publicly-owned company, this tax advantage may be utilized in one of two ways:

1. If the employer contributes cash to the ESOP which it uses to purchase employer stock on the market, the effect is to provide a stock ownership benefit for the plan participants at a zero cost to the employer, except for administrative expenses.
2. If the employer contributes newly issued or treasury stock to the ESOP, the result is a capital infusion plus a stock ownership benefit for participants. The effect on the employer would be substantially the same as a public offering of its stock would produce as far as earnings and book value per share are concerned.

By contributing stock to the ESOP, a closely held corporation can also obtain a capital infusion equal to the fair market value of the contributed stock. Alternatively, by contributing cash to the ESOP, funds are provided which the ESOP could use to purchase stock from a major shareholder.

In both cases, it is important that the 1% investment credit amount be a sufficient sum to permit meaningful stock allocations to participants, and to justify the administrative costs involved.

Pending issuance of regulations, the manner of implementing an investment credit ESOP is not entirely clear. It would appear that an employer corporation could make the qualifying cash or stock contributions to an existing nonleveraged or leveraged ESOP, by making certain plan amendments. For example, a separate stock account could be added for each participant to which only his pro rata share of employer stock contributed to or purchased by the ESOP under the investment credit provision would be credited. This account would be subject to the special limitations summarized above, whereas his regular accounts with the plan would not be thus restricted.

Alternatively, the employer could establish an investment credit ESOP as a separate plan. But in view of the temporary nature of the additional investment credit (presently scheduled to expire on December 31, 1976) a separate plan established only for that purpose might be construed as not meeting the usual permanency requirement applicable to qualified plans. Thus it is possible that a separate plan could not be tax qualified. On the other hand, it is not even entirely clear that "piggybacking" an investment credit ESOP onto an existing plan definitely solves the permanency problem.

Although an investment credit ESOP is not required to be a qualified plan, participants would not be entitled to all of the usual tax advantages where a nonqualified ESOP is utilized. The tax advantages which would be lost include the exclusion from taxable income of unrealized appreciation attributable to employer stock received in a qualifying lump sum distribution, the other special taxation benefits afforded to lump sum distributions (discussed in Appendix C), and the estate tax exclusion for amounts paid from qualified plans to named beneficiaries of a deceased participant.

The TRA does provide that employer stock and dividends thereon allocated to participants' accounts in a nonqualified investment credit ESOP will not be considered income to the participant until the stock is distributed or made available to him. But there is no provision which would exempt the trust from taxation on its dividend income.

There are a number of uncertainties regarding the implementation of investment credit ESOPs, which future regulations probably will clarify.

These include:

1. *Participation*—although neither the law nor the committee reports imply that the participation, coverage and discrimination rules for an investment credit ESOP are any more restrictive than for any other type of qualified plan (see Appendix A), there remains an undercurrent of concern that regulations may require that "all" employees be covered.
2. *Consolidated returns*—where consolidated returns are filed and therefore the investment credit is determined on a consolidated basis, the extent to which the 1% investment credit generated by each company in the consolidated group must be correlated with allocations to that company's employees is unclear.
3. *Allocations*—where maximum extensions of time for filing a return are obtained, the 1% investment credit amount for one year may not actually be paid into the trust until nine months into the following year. Although stock must be allocated among participants in proportion to compensation, it is not entirely clear that it is compensation for the year in which the credit is generated which is to be used, rather than compensation for the year of payment into the trust.
4. *Administrative expenses*—where cash equivalent to the 1% credit is paid into the trust, it is not clear that any of that cash could be used to pay plan administrative expenses in lieu of purchasing stock.

Legislative developments

In addition to the recognition given ESOPs in ERISA and in the Tax Reduction Act of 1975, Congress has provided legislative encouragement of the ESOP concept in two non-tax laws—the Trade Act of 1974 and the Regional Rail Reorganization Act of 1973.

The Trade Act of 1974 provides that corporations which agree to flow 25% of certain government guaranteed financing through an ESOP will receive preference in considering their applications for the loan guarantees. This loan guarantee program is for the purpose of providing relief to communities where local industry is adversely affected by competition from imports. The Regional Rail Reorganization Act of 1973 provides that consideration be given to the use of an ESOP in connection with governmental assistance for certain railroads in financial difficulty.

Although ultimately deleted by the House-Senate Conference Committee, the Senate version of the Tax Reduction Act of 1975 contained a net operating loss provision which would have allowed the three year carryback period to be extended to eight years. If, however, a corporation received a tax benefit under this change of more than $10 million, 25% of the benefit would have to be contributed to an ESOP, over a ten-year period.

Even though this provision was deleted from the 1975 Act, future proposals to extend the loss carryback period could well resurrect the concept that a portion of any tax savings thereby derived should be "shared with the workers" through an ESOP.

A bill introduced in the House with relatively broad support, the Capital Formation Act of 1975 (H.R. 462), would both extend and broaden the concept of ESOPs. Several of the more important provisions would:

1. Remove the present percentage of compensation limitations on the deductibility of employer contributions used by an ESOP to service debt incurred to purchase employer stock.
2. Permit the employer a tax deduction for dividends paid on its stock held by an ESOP, provided the dividends are passed through to participants or used by the ESOP to repay debt.
3. Treat an ESOP like an exempt charitable organization in certain respects, thus allowing tax deductions under estate, gift and income tax provisions for contributions by individuals to an ESOP.

It is clear that the ESOP concept has the support of important members of Congress, and it is therefore likely that ESOP provisions will be attached to future legislative proposals. That seems particularly true wherever any new or expanded tax incentives for corporations are proposed, especially where capital formation is the objective.

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Structure of plan — Technical considerations

A plan described as an ESOP (but not necessarily meeting the ERISA definition thereof) might take the form of a profit-sharing plan, a stock bonus plan, a money purchase pension plan, or a combination of any of these forms.

A profit-sharing plan is one which provides for contributions by the employer out of its current or accumulated profits. The contributions out of profits need not be based an any predetermined formula, but there must be a definite formula for allocating the total contributions among the individual accounts of plan participants, and for distributing the account balances to participants after a fixed number of years, upon the attainment of a stated age, or on the occurrence of certain other events.

A stock bonus plan is similar to a profit-sharing plan, except that:

i) benefits under the plan must be distributable to participants in the form of employer corporation stock, and

ii) employer contributions to the plan are not necessarily dependent upon profits.

A money purchase pension plan is also similar to a profit-sharing plan in many respects. The more significant differences are:

i) employer contributions are based on a percentage of pay or some other fixed formula, and are not dependent on profits.

ii) distributions to participants must be deferred until retirement or other termination of employment.

iii) forfeitures of account balances of terminated participants must be used to reduce employer contributions under the plan, and may not be reallocated among the accounts of remaining participants.

Investments in employer stock

ERISA establishes a general rule that no plan may acquire or hold employer corporation stock having a value in excess of 10 per cent of the total fair market value of all plan assets. But an "eligible individual account plan," is exempted from this 10 percent limitation. An eligible individual account plan is defined as including any stock bonus plan, profit-sharing plan, or ESOP, provided that the plan by its terms explicitly permits the acquisition or holding of the employer stock. A plan in existence on January 1, 1974 is given until January 1, 1976 to incorporate the necessary language in the plan documents.

A money purchase pension plan operated in tandem with a stock bonus plan as part of an ESOP meeting the ERISA statutory definition thereof is regarded as an eligible individual account plan. But no other money purchase pension plan can be so regarded unless it was in existence on September 2, 1974 and on that date was primarily invested in employer stock or other qualifying employer securities.

Under ERISA, a purchase of stock by a plan from a disqualified person (such as the employer corporation or a major shareholder) would normally be a prohibited transaction. But an exemption is provided for purchases of qualifying employer securities by an eligible individual account plan, provided the purchase is for adequate consideration and no commission is charged.

The fiduciary rules of ERISA also normally require that a fiduciary diversify the investments of a plan. But an exemption from this requirement is also provided for any eligible individual account plan, with respect to holdings of qualifying employer securities.

Thus it is clear that, under ERISA, a profit-sharing plan has the same flexibility with respect to investments in employer stock that a stock bonus plan has. But some pre-ERISA restrictions established by IRS with respect to investments by plans in employer stock need to be considered as well.

Although prior to ERISA it was technically possible to structure an ESOP to qualify as a profit-sharing plan, it was usual in the case of closely held corporations to utilize a stock bonus plan. IRS has long taken the position that it has the right to regulate plan investments in employer corporation stock, under the requirement that a qualified plan be operated for the exclusive benefit of employees and their beneficiaries. It has established four criteria which plan investments must meet in order to satisfy the exclusive benefit test (see Pub. 778, Part 2(k)). One of these is a "fair return" requirement, i.e., that a reasonable dividend be paid on the stock.

In Rev. Rul. 69-65, however, IRS ruled that a stock bonus plan was not in violation of the exclusive benefit requirement where it makes obligatory investments in a non-dividend paying stock of the employer. By implication, certain of the other investment requisites seemed to be eased as well. On the other hand, money purchase pension plans and profit-sharing plans of closely held corporations often were effectively precluded from investing heavily in the employer's stock, as a result of the investment requisites which had to be met under the exclusive benefit test.

Since the requirement that a qualified plan be for the exclusive benefit of employees or their beneficiaries continues under ERISA, it is difficult to see how a money purchase pension plan could be operated as part of an ESOP and thus be primarily invested in stock of a closely held corporation. But the inclusion of a money purchase plan (operated in tandem with a stock bonus plan) under the ESOP definition in ERISA may perhaps constitute a Congressional mandate for IRS to make it possible. Until such time as regulations or other guidelines on the point are published by IRS, the matter must be regarded as uncertain.

The primary advantage of operating a stock bonus plan and a money purchase pension plan in tandem as an ESOP would be to permit deductible contributions up to 25 per cent of covered compensation—see Appendix B.

Differing classes of stock

ERISA places no specific restrictions on the type or class of employer stock which an ESOP may own. The question is sometimes asked whether a special class of nonvoting stock could be created for the purpose of contribution or sale to an ESOP. While there is no specific statutory prohibition against this practice (except in the case of an investment credit ESOP, as discussed beginning on page 17), it is questionable whether nonvoting stock is consistent with the expressed Congressional intent of fostering the development of ESOPs as a vehicle for employee participation in the ownership of employer corporations. It will be necessary to await regulations for a clear answer on this point.

In situations where dividends are not normally paid on a closely held corporation's stock, the question has been raised whether a special class of dividend paying stock—perhaps a preferred—could be created for contribution or sale to an ESOP. While it is unlikely that IRS would object to the practice per se, it is questionable whether it would be advisable when considered in a broader context—for example, if the corporation has any accumulated earnings tax exposure. Since dividends are not deductible, channeling employer funds into an ESOP through deductible contributions rather than dividends would seem preferable.

The question is sometimes posed in reverse—that is, if dividends are normally paid on a company's stock, would creation of a class of nondividend stock for contribution or sale to an ESOP be acceptable? While again there is no clear authority on point, it seems most unlikely that IRS would permit such an arrangement.

Participation and vesting

The general participation and vesting rules prescribed under ERISA apply to ESOPs as well as to other types of employee benefit plans. Thus an ESOP may not (because of age or service) exclude from participation any employee who has reached age 25 and has completed one year of service, except that plans providing immediate vesting may require a three years of service waiting period instead of one year.

In determining whether any qualified plan covers a sufficiently broad classification of employees—that is, does not discriminate in favor of the highly paid—ERISA permits unionized employees to be excluded from consideration if there is evidence that retirement benefits were the subject of good faith bargaining. Thus in appropriate cases unionized employees might be excluded from participation in an ESOP, if that result is desired.

An ESOP may utilize any of the three vesting rules permitted under ERISA for plans generally, i.e.:

1. no vesting until ten years of service have been completed, and full vesting thereafter.
2. graduated vesting beginning after five years of service, with full vesting after 15 years.
3. vesting under the Rule of 45.

If, however, IRS believes that more rapid vesting than under any of these three schedules is necessary to prevent discrimination—for example, where there is a high turnover rate among lower paid employees—it has the authority to require it. But the Congressional committee reports under ERISA "direct" that, except in abuse cases, IRS shall not require vesting more rapid than 40 per cent after four years of service, an additional 5 per cent for each of the next two years, and an additional ten per cent for each of the next five years.

In the case of ESOPs newly established by closely held corporations, there is a likelihood—depending on the composition of the covered employee group—that this more rapid vesting schedule may be required.

Limitations on tax deductions for employer contributions to ESOPs

The deductible amount of employer contributions to stock bonus or profit sharing plans is limited to 15% of the nondeferred compensation paid or accrued during a year to all employees covered by the plan. If in any year an amount in excess of 15% of compensation is paid or contributed to the plan, the excess or "contribution carryforward" will be deductible in succeeding taxable years. In each subsequent year, however, the total amount deductible (current contribution plus the contribution carryforward) cannot exceed 15% of the covered compensation in that year.

If in any year the employer contributes less than 15% of covered compensation, the unused limitation or "credit carryforward" will support additional deductions in any later year in which more than 15% of compensation is contributed to the plan. Under these circumstances, for years after 1975, the deductible contribution including the amount deductible under the credit carryforward will be limited in total to 25% of covered compensation.

If an ESOP consists of a combination of a stock bonus and a money purchase pension plan, the aggregate allowable annual contribution to both plans is 25% of covered compensation.

If an existing profit-sharing plan is converted into an ESOP, any existing credit carryforward of the profit-sharing plan may be utilized by the ESOP to increase the allowable annual contribution from 15% to 25% until the credit carryforward has been fully utilized. The credit carryforward would represent the excess of the maximum deductible contributions during all prior years in which the profit-sharing plan was in effect, over the employer's actual contributions during those years.

Limitation on contributions for individual participants

In addition to these limitations based on aggregate covered compensation, limitations have been added by ERISA which relate to the amounts which may be credited to any individual participants' account. These individual limitations take effect in years beginning after 1975.

In the case of any defined contribution plan, the "annual addition" to any participant's account is limited to the lesser of 25 percent of his compensation for that year, or $25,000. The term "annual addition" includes not only his share of employer contributions, but also his share of forfeitures plus, under certain circumstances, a portion of any employee contributions he may make to the plan. An employee's own contributions are included in his "annual addition" to the extent of the lesser of: (a) the excess of his contributions over 6 percent of his compensation or (b) one-half of his contributions. The $25,000 amount will be adjusted upward annually for cost of living increases under regulations to be prescribed.

If an individual is a participant in more than one qualified defined contribution plan of his employer or a related employer, the limitations are applied on an aggregate basis. If he is a participant in a defined benefit pension plan as well as a defined contribution plan, an overall maximum limitation must be determined. This overall limitation is computed under a complex formula based on allowing up to an aggregate 140% of the maximum benefit under either type of plan standing alone.

If a plan provides benefits for any participant which exceed these limitations, it will be disqualified.

APPENDIX C

Taxation of distributions to participants

Employer contributions to qualified plans and earnings on trust investments are not taxable to participants until distributed or made available to them.

Distributions of employer stock from an ESOP may be made in instalments, or as a lump-sum distribution. Instalment distributions over a period covering more than one taxable year of the recipient are taxable as ordinary income when received and are reported at the fair market value of the stock at the time of distribution. Any employee contributions to the plan may of course be recovered tax free.

If any employee takes his benefits as a qualifying lump-sum distribution, he reports taxable income in an amount equal to the trust's cost for the shares if less than their fair market value. Thus the unrealized appreciation element at the date of distribution (equal to the excess of the fair market value of the stock distributed over its cost to the trust) is deferred, and thereafter taxed at long-term capital gain rates only when the employee subsequently sells the stock. Additional appreciation that may occur after the date of distribution is taxable at short-term or long-term capital gain rates depending upon the distributee's holding period following receipt of the stock from the trust.

A qualifying lump-sum distribution means the distribution in a single taxable year of the recipient of the entire balance in an employee's account or accounts with the plan, but only if the distribution is made because of the employee's termination of employment or death, or is made after he attains age 59½.

If the employee was an active participant in the plan prior to 1974, the taxable amount of the distribution (from which unrealized appreciation in employer stock is excluded) must be divided into its capital gain and ordinary income portions. That division is made by a simple arithmetical proration, based on the employee's number of years of active plan participation before and after December 31, 1973.

The capital gain portion is included as a long-term capital gain in determining the participant's income tax for the year in which the distribution is received. Provided that the employee was a participant in the plan for at least five taxable years before the year of the distribution, and an appropriate election is made, the ordinary income portion is excluded from taxable income. Instead, an entirely separate tax is computed on the ordinary income portion by using ten-year averaging and the tax tables applicable to single persons. To make this computation, a tax is determined at single person rates on one-tenth of the *total* taxable amount of the distribution. The result is multiplied by ten, and then further multiplied by the ratio which the ordinary income portion represents of the total taxable amount of the distribution. If the total lump sum distribution is less than $70,000, a special minimum distribution allowance can be taken into account which has the effect of reducing the tax.

If the employee was not an active participant in the plan before 1974, the entire taxable amount of a qualifying lump-sum distribution is ordinary income subject to this ten-year averaging provision. Except in the case of unusually large distributions, the tax determined under this method usually compares favorably with capital gains treatment.

In the event more than one qualifying lump-sum distribution is received during a six-year consecutive period, special computational rules apply.

A lump-sum distribution to a beneficiary because of a participant's death qualifies for the special tax treatment summarized above. But in proposed regulations IRS has taken the position that if the benefit is payable to more than one individual recipient, the special tax treatment is not available.

Provided that the distribution on account of death is paid to a beneficiary other than the estate of the deceased participant, it is exempted from federal estate tax except to the extent that any portion thereof is attributable to employee contributions to the plan.

Statement of

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Professor of Law

University of Pennsylvania, Law School

* * *

Submitted to the

Joint Economic Committee

of the

Congress of the United States

Washington, D. C.

December 11, 1975

Statement of

Professor Daniel I. Halperin

I do not feel qualified to comment on what I assume to be the prime issue considered at these hearings, namely whether the state of the economy is sufficiently aided by employee ownership of business so as to justify a large expenditure of federal funds to encourage such ownership. However, as an individual specializing in federal taxation, with many years of experience both with the Treasury Department and in private practice in the area of employee benefits, I wish to point out what seems to be a clear conflict between Congressional favoritism toward ESOP's and the goals expressed in federal regulation of private retirement programs.

ESOP's appear in the tax law in at least two connections. The Tax Reduction Act of 1975 provides for an extra 1% Investment Credit to the extent the employer contributes to a trust to benefit his employees if the trust is invested in voting common stock of the employer. In effect, the federal government makes a transfer of funds for the benefit of the participating employees. Obviously, in evaluating this program, one must consider alternative federal expenditures, or if expenditures are not decreased, the effect of the increased deficit or the effect of the extra tax burden imposed on others to finance this expenditure.

Employer stock is also a permissible investment for so-called "qualified" pension and profit sharing plans which receive favorable tax treatment under section 401 of the Internal Revenue Code. While ownership of employer stock by retirement trusts was restricted to some extent by the Employee Retirement Income Security Act of 1974 (ERISA), Congress made significant efforts in that Act to encourage the formation of ESOP's by continuing to hold out the favorable tax benefits despite their ownership of employer stock.

Permanancy of Ownership

It is not clear to me whether the economic benefits claimed to result from establishment of ESOP's depend to any extent upon permanency in the capital acquired by employees and their descendents. If it does, it is well to point out that the employee's interest in the business is almost certain to terminate upon retirement or other separation from service. In some cases, the employee will never obtain ownership of employer stock, but rather will receive a cash distribution based upon the value of the stock at the time of his retirement.

In other situations where the tax law requires a distribution in stock, the employer will go as far as permitted to make certain that the stock will be redeemed as soon as possible. The employee will be given the right to sell the stock to the employer or the ESOP. While it may not be possible to force the employee to exercise this right, circumstances may make it the only viable choice.

Thus, in many circumstances, the ESOP will not enable the employer to permanently conserve cash, by paying compensation in stock. The stock distribution will be only temporary, to be replaced upon retirement with cash of equivalent value. As the appendix to this paper will explain in detail, in these circumstances, in the absence of the tax deferral to employers provided by qualified plans or under the Tax Reduction Act, an ESOP does not offer a cash advantage as compared to mere deferral of cash compensation.

ESOP vs. ERISA and Qualified Plans

As explained in the appendix, the tax deferral benefits of qualified plans are available only if the employer currently contributes to the plan and not when the employer commitment is deferred until the employee retires. ERISA significantly strengthened this funding requirement and is replete with provisions designed to insure that the assets of the plan will not be dissipated. The apparent reason for these provisions is to protect the employee against the risk of financial failure of the employer which exists in an unfunded arrangement.

It is clear that "employer" stock ownership by "qualified" retirement plans is inconsistent with Congressional insistence that such plans be funded and prudently invested. As described in the appendix, investment in employer stock permits the employer to meet the cost of retirement income out of earnings during the employee's retirement. Moreover, since the employer gets a tax deduction at the time of the contribution and not when stock is redeemed, redemption of stock distributed by a qualified plan requires greater earnings during the employee's retirement year than an equal deductible deferred compensation payment. Finally, stock ownership in the employer is even less protection to the employee than the creditor status of an unfunded plan because the employee as stockholder comes after all creditors. If the company fails, the employee not only loses his job, but also his nest egg for retirement. If "retirement security" requires funding, surely that funding should not be in the stock of the employer.

Nature of Employees' Interest

The provisions of the Tax Reduction Act of 1975, which grant an extra 1% Investment Credit, specifically require investment in common stock which the employee will have an opportunity to vote. If ownership of an interest which is extremely sensitive to changes in the value of the business and some say in the overall direction of that business is important to the aims of an ESOP, it should be noted that the tax benefits of a qualified plan may well be available even for an investment in non-voting preferred stock, and there is certainly no requirement that the vote, if it exists, be passed through to the beneficiaries of the trust.

Use of an ESOP by the Principal Shareholder to Save Tax

It has been suggested that ESOP's can be used as a vehicle to redeem a portion of the stock of the principal shareholder. Since as described above, the employee ownership is transitory, the shareholder is not really selling to the employees. Rather, the ultimate result is a sale by the shareholder to the corporation with the ESOP acting as a conduit. If such a sale were made directly to the corporation, the tax impact would often be ordinary income for the full amount of the corporate distribution. It is hoped that the sale to the ESOP will limit taxable income to the appreciation on the redeemed shares, which income would be taxed at the reduced rates applicable to capital gains. If this maneuver succeeds, it could result in a loss of tax revenue. This subsidy to major shareholders of closely held corporations, should be weighed against the supposed economic benefit of the ESOP.

APPENDIX

Employee Compensation and ESOP's

The amount an employee earns for services performed in the current year can be paid currently or deferred until after retirement. If it is deferred, it can be financed either by the corporation setting aside a portion of its current income or out of cash to be generated during the employee's retirement.

While current cash compensation obviously has to be funded at present, current compensation paid in stock, like deferred compensation, can be funded out of income during the period such stock is to be redeemed. However, unless the special benefits of a qualified plan are available, stock distribution with a promise of redemption at retirement, is not more advantageous than a deferred retirement benefit, measured by the performance of the stock, but paid directly in cash.

A qualified plan, by delaying taxation until actual distribution to the employee, enables the employee to retain more of the income from his investment. However, this advantage is only available if the corporation makes a current contribution to the trust, thus presumably financing the retirement benefit out of current income. However, if the contribution is made in stock (or the plan purchases stock from the employer), the source of financing can be deferred until a later year, thus obtaining the tax advantage without the employer commitment. In fact, since he is relying upon the employer's ability to make a nondeductible outlay to redeem his stock, the employee is even more dependent upon the employer's continued success, than he would be if the plan were unfunded. This result is inconsistent with ERISA and the Internal Revenue Code, both of which require funding.

The results outlined above will be explained in more detail in the material that follows.

Case I - CURRENT CASH Compensation

Compensation to employees is, of course, generally deductible as a business expense by the employer. Thus, if a corporation, subject to the general corporate tax rate of approximately 50%,* pays $1000 in salary to an employee, its taxes would be reduced by $500 and the net cost of the salary payment is $500.

Of course, the salary is taxable to the recipient. Therefore, the amount the employee can retain after tax depends upon the employee's marginal tax bracket. If the employee is paying taxes at a 50% rate, he will retain just $500 of the $1000 salary, the equivalent of the corporation's out-of-pocket cost. If the employee's tax bracket is lower than the corporation's, then the

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* The Internal Revenue Code imposes a tax of 48% on corporate income in excess of $50,000 annually. In addition, most corporations will be subject to state taxes on income.

employee can retain an amount in excess of the corporation's cost. The difference arises because the corporation's tax saving exceeds the tax imposed on the employee.

Case II - DEFERRED CASH Compensation

If the employee and the corporation agree that the payment should be deferred until after the employee's separation from service, the corporation is generally denied the tax deduction until payment is made. Thus the cash saving from deferral is not the full $1000 of compensation but only the $500 after tax cost.

In some situations, there would be no cash savings, since the corporation may be required to set aside a fund to support its obligation. Since this set aside would not be deductible, the corporation, presumably, would be unwilling to set aside $1000 for the employee but would limit the set aside to $500, the out-of-pocket cost of a tax deductible payment. This $500 is, of course, the same amount that the employee in the 50% marginal tax bracket would have to invest after tax if he had received $1000 currently, as in Case I.

Case III - CASH Compensation - Qualified Plans

Retirement plans that benefit a cross-section of the employees of a corporation, or at least do not discriminate to an unacceptable extent in favor of higher paid employees, are given special treatment under section 401 of the Internal Revenue Code. The most important of the tax benefits granted to these so-called "qualified" plans is the waiver of the general rule, set forth in Cases I and II, requiring mutuality of the timing of the employer deduction for compensation payments and the employee's incurrence of taxable income. Thus, employer contributions to qualified plans are currently deductible while taxation of the employee is delayed until actual distribution from the plan, most often after retirement.

Thus, a contribution of $1000 to a qualified plan will have the same after-tax cost as cash compensation of $1000, namely $500. However, since there is no current tax on the employee, the entire $1000 can be invested for his benefit.

In order to achieve this result, it is necessary for the employer to make a current contribution to the qualified plan. An unfunded plan, even one with the same coverage of employees, would be denied an immediate employer deduction and thus would not provide similar tax benefits. Therefore, the employer's share cannot generally be financed out of earnings at the time of the employee's retirement. Unlike Case II, the current $500 out-of-pocket outlay would be required.

Case IV - CURRENT STOCK Compensation - Fund for Redemption

If current compensation is paid in the form of employer stock with the expectation that the corporation will redeem the stock at its then current market value at the time of the employee's retirement, the employee, even though he does not receive any cash, would have to pay tax on the value of the stock distributed to him. If the employee's marginal tax bracket is 50%, the tax on $1000 of compensation would be $500. Based on the assumption that the employee has no cash available to pay this tax, he would presumably insist upon cash of $500 to use to pay the tax, with only $500 payable in stock. This situation is then identical as far as the employee is concerned to Cases I and II except that the $500 investment by or on behalf of the employee is in employer stock.

The corporation does not, however, have any out-of-pocket cash cost as the cash payment of $500 is offset by the tax savings from the deduction of $1000 in compensation. The shareholders, however, suffer a dilution of their ownership to the extent of the $500 stock distribution. This case then is very close to Case II. Unless there is a set aside, neither situation involves an immediate cash outlay but both create a charge on the interest of the existing shareholders. In Case II, this arises from the $500 corporate liability, in Case III from the $500 stock distribution.

The discussion so far has ignored the corporation's obligation to redeem the stock at retirement. Assuming no change in value, the corporation will need $500 at that time to redeem the stock. Here then is the out-of-pocket cost to the corporation which was avoided at the time of the original distribution. If this obligation is to be financed out of funds generated during the period in which the employee earns the compensation, the employer would have to put something aside at the time the stock is distributed in order to build a fund to finance the redemption. If this fund can be expected to grow at the same rate as employer stock, an initial set aside of $500, equivalent to the value of the stock distribution, would be required. Thus, the corporation would have the same cash requirements as if salary were paid in cash or if there were a set aside as described in Case II.

Case V - CURRENT STOCK Compensation - No Redemption Fund

On the other hand, the cost of redemption could be financed out of cash generated during the period the employee retires. In this case, no immediate set aside is required. However, if this is a possibility, then, as described above, immediate cash is similarly not required in Case II when cash compensation is deferred until retirement.

For example, suppose stock is selling at $100 a share and the employer either distributes 5 shares of stock or agrees to make a deferred compensation payment so as to provide the employee after tax with an amount measured by the value of 5 shares at the time the employee retires. At such time, if the stock is selling at $400 the amount needed to redeem the 5 shares is $2000. If there is no set aside, the employer would need to generate this amount at the time of retirement to finance the redemption.

If stock had not been distributed, a cash payment to the employee would be taxable as compensation. Therefore to give an employee in the 50% marginal tax bracket $2000 after tax (the amount he would retain from the redemption*), a cash payment of $4000 is required. However, since this $4000 would be deductible to the employer, it would similarly involve only a net outlay of $2000.

In summary, therefore, in the absence of a qualified plan, payment of compensation in stock in fact does not represent any cash saving as opposed to a deferred compensation arrangement. Either can be funded currently or only out of income following the employee's retirement.

Case VI - Qualified Plans Funded by Employer Securities

As noted in Case III, the advantage of a qualified plan is the opportunity of investing $1000 on behalf of an employee with a net cash outlay from the corporation of only $500. The potential disadvantage is that the corporation must

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* The example ignores the impact of the capital gain incurred by the employee if his stock is redeemed.

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December 30, 1975

STATEMENT OF

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submitted to the

JOINT ECONOMIC COMMITTEE,

CONGRESS OF THE UNITED STATES

in connection with its hearings of Dec. 11-12, 1975 on

ESOP (EMPLOYEE STOCK OWNERSHIP PLANS)

I am an attorney-author, and have spent the greater part of 1975 researching various forms of employee share ownership for a book which I am now completing on that subject. I submit this statement at the invitation of Mr. Robert Hamrin, JEC Staff Economist. I attended the JEC hearings of Dec. 11-12, and have read all of the statements and written materials submitted to JEC thus far on this subject.

NEED FOR A NEW NATIONAL POLICY

I believe that the JEC hearings of Dec. 11-12 can perform the vital function of alerting the Congress and the Nation to the need for serious consideration of employee share ownership, and other forms of wealth diffusion, as a NEW NATIONAL POLICY. On the other hand, if the JEC merely makes a cursory clinical study of "ESOP's" -- the one form of wealth diffusion which Senator Long has been able to institute through the tax laws -- the opportunity to develop a broad new national policy capable of curing many of our economic ills may be lost.

Perhaps it was necessary to focus the Dec. 11-12 hearings on ESOPs, since ESOPs are working in hundreds of corporations, and there are few people available as JEC witnesses who have read any further into Kelso than ESOP. However, it should be clear to JEC now that ESOP is merely the tip of the Kelso iceberg; that Kelso himself does not claim that ESOP alone will cure the major ills of our economy; and that the more advanced phases of what Kelso calls "Two-Factor Economics" must be studied in great detail to determine their potential for effecting such cure.

It would be most disappointing to see a JEC report which dwelt upon the known limitations of ESOP, without going on to make provision for further detailed study of "pure credit", "Capital Diffusion Insurance Corporation", and other more advanced and more universal Kelso concepts which are not based solely upon tax-deductible contributions to employee benefit programs.

The important issue before the JEC is not the usefulness of ESOP in its present form. Rather, it is respectfully suggested that the JEC address itself to these issues: WHAT CAN THE U. S. A. ACCOMPLISH BY ADOPTING AS NATIONAL POLICIES THE BROADENING OF EMPLOYEE SHARE OWNERSHIP AND THE DIFFUSION OF NEWLY CREATED WEALTH; AND WHAT ARE THE BEST INSTRUMENTS FOR ACHIEVING SUCH NATIONAL POLICY?

BIPARTISAN SUPPORT FOR KELSO'S WEALTH DIFFUSION GOALS

From the statements of Senators, Congressmen, staff members and witnesses at the JEC hearings, it is clear that there is strong bipartisan support for the goal of broadening ownership of wealth. The only point in dispute is the means used to achieve this goal.

Louis Kelso has suggested (and in some cases has implemented) a number of methods of attaining broader diffusion of newly created wealth. Most of the witnesses who opposed Kelso criticized ESOP; were unfamiliar with Kelso's more advanced concepts; and did not put forward any new ideas for attaining diffusion of wealth. The paucity of new ideas, even at the top rung of academic economists, is dramatized in an article which appeared on the front page of the Business Section of the New York Sunday Times on December 28, 1975. "Candidates in Search of Economic Wisdom" discusses ideas of the economic advisors and consultants to twelve presidential aspirants, and reaches this conclusion:

> "The economy will be the biggest issue in 1976, strategists say, and the candidates are seeking wisdom. Still, they've yet to come up with a single new, imaginative idea."

Given this shortage of ideas, and adding to it the public pronouncements by Federal Reserve Board Chairman Dr. Arthur Burns that the American economy is in need of basic structural change, it would be a terrible waste of scarce resources if the JEC did not follow through to determine the potential of employee share ownership and diffusion of newly created wealth. This determination cannot be made without the use of the nation's best minds and strongest resources, which up to now have not been directed toward such a determination. It is clear that the JEC has the opportunity to focus and direct our best minds and resources to this determination, and that it is in the national interest that the JEC do so.

SUGGESTED CONCLUSIONS FOR JEC REPORT

Accordingly, I respectfully suggest that the JEC consider incorporating into its report the following conclusions:

1. The great majority of Americans do not own substantial capital, and therefore American capitalism is open to the charge that it has too few capitalists.

2. The survival of American democratic capitalism cannot be assured if it does not produce broader diffusion of newly created wealth. In short, we need many more capitalists if capitalism, democracy and freedom are to survive in the U. S. A.

3. The present economic system has a strong tendency to perpetuate the overconcentration of capital and wealth in the hands of a small minority.

4. Among the very few potentially viable ideas for diffusion of wealth (without confiscation of present holdings) are broader employee share ownership, as suggested by Kelso and others; and the use of such instruments as "pure credit" and the "Capital Diffusion Insurance Corporation", as suggested by Kelso.

5. The history of use of ESOPs in such projects as South Bend Lathe Co. indicates that they (and other schemes for employee share ownership) have potential for reducing unemployment and increasing capital formation, both of which are goals of the JEC.

6. The Administration position on ESOP, as presented to the JEC by the Assistant Secretary of the Treasury, makes it clear that ESOP is not a tax loophole, but rather a device to achieve the desirable goal of broadened stock ownership.

7. It is clear that a national economic policy based upon broader employee share ownership and broader diffusion of wealth would gain strong bipartisan political support, and would be attractive both to management and labor.

8. At present, the JEC is unable to determine whether the ideas put forward by Kelso and others are capable of fulfilling such a national economic policy. However, there is enough experience with these ideas to demonstrate that they have such potential.

9. In view of such demonstrated potential, and in view of the paucity of other new ideas which might form the basis for beneficial structural changes in national economic policy, the JEC determines that it should give the highest priority to further detailed study of the proposals of Kelso and others, in an effort to fashion instruments which are capable of achieving much broader employee share ownership and much broader diffusion of newly created wealth at the earliest possible date. The JEC believes that the nation's best minds and strongest fact-finding resources should be brought into the search for workable methods of achieving such a national economic policy.

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Respectfully submitted,

Stuart M. Speiser

We are at war in energy, and Washington gives little indication of understanding that fact.

Nothing is a greater challenge to us - and indeed, in policy, there is no greater opportuntiy, for the Ford Administration goes from one wrong approach to another.

I would like to outline what I see as some basic principles of a sound energy policy.

First and foremost, energy is not just something for us to have only if a private company makes money selling it to us. Energy is <u>infrastructure</u>, just like roads and railroads. It's one of the things that's got to be there for our society to function.

The second principle relates to where we are at the moment: we must get unhooked from our petroleum addiction! The Shah of Iran says that oil is too precious to burn, and he's right! Oil has got to be saved for the things we can only do with oil - the petrochemical industry won't run on sand.

The next principle of a sound energy policy logically follows: we must husband <u>all</u> our exhaustible resources for the generations yet to come and that means natural gas and coal just as oil. If we continue to be prisoners of an energy policy that seems to feel that you've got to burn something in order to get energy, we will commit the crime of depriving our posterity of needed resources.

Therefore, the next principle: our energy infrastructure must provide energy from <u>renewable</u> sources. These are, of course, the solar sources: solar heating and cooling; solar cells for direct generation of electricity; harnessing the winds for generating electric power and through electrolysis, producing hydrogen to use for generating power when the winds do not blow; bioconversion; and the most limitless solar source of all, the use of the greatest solar collector in the world, the sea, through the process known as sea thermal gradient.

A further principle: energy conservation does NOT mean lowering of standards of living, but the creation of jobs in the installation of energy saving technology, and thereby the saving of enough money (from the energy not used) to pay for the installations.

It is an obvious corollary of such an energy policy that the creation of new energy from renewable sources, and the substitution of energy by conservation, enable us to get and to save energy by creating jobs right here in our state and our nation. A proper energy policy can be what will turn this country around!

Using solar and energy conservation technology, another principle of an energy policy emerges: we should strive, as a national policy, for the maximum energy independence at the lowest consumer level possible. This is not the same sort of energy independence Messrs. Ford and Rockefeller have in mind, with their 100 billion dollar program designed to enrich and strengthen highly centralized energy organizations. Energy independence means that if you can capture enough solar energy in your home, in your school, or your factory, to provide your electricity and your heating and cooling, that's great!

Tremendous energy independence at the level of individual units is possible - and we can significantly diminish demand - but we shall still need considerable amounts of energy produced at centralized points.

What form shall it take?

Messrs. Ford and Rockefeller propose to achieve energy independence by building 200 new nuclear power plants, carelessly overlooking the fact that even now we begin to depend on foreign uranium. Energy independence going the nuclear route could only be achieved with the breeder reactor, and no one knows if this can be built successfully, safely, and economically. In effect, our breeder program is like buying a pig in a poke - but it may not be a pig, it may turn out to be a lemon! The breeder that had been operating - in Moscow - is now shut down; the reason? An accidental explosion!

In 1969, it was proposed to build the first experiemental breeder reactor in this country near my home town of Waddington, up north on the St. Lawrence River. It went away to Tennessee, but I have been studying the nuclear approach to energy ever since.

As a result, I introduced last February the first nuclear moratorium bill to be presented in New York State. The following are some of my reasons.

Utilities have advertized that nuclear plants are no more dangerous than chocolate factories. But those can be built right in the middle of large cities. Then why cannot nuclear plants be built in large cities? Because the site selection criteria for nuclear plants looks for places where the population is sparse and can be easily evacuated. I believe that the laws of this state and of this nation should say that nuclear plants can be built <u>when</u> they are safe enough to be built at the locations where the power is needed, and not just where the population is sparce and can be easily evacuated.

Utilities say that nuclear plants are safe. Then I also propose that the laws of this state require no nuclear plant be built unless the sponsors agree to waive the limitations on liability provided by the federal Price-Anderson Act. That act is up for renewal. Since the utilities tell us that nuclear plants are so safe, then let the Congress NOT renew the Price-Anderson Act, the nuclear No-Fault bill, which prohibits lawsuits for over 560 million dollars for damages caused by a nuclear accident. Since nuclear plants are supposed to be so safe, let us require them to obtain <u>private</u> insurance for all damages that an accident might cause. Coal-fired plants need no such No-Fault, nor would solar power generation. Why a Nuclear No-Fault??

The Price-Anderson Act should not be renewed except for existing plants or those nearly finished (to protect our populace, for private insurance is not available), and then the renewal should include protection against the present estimated costs of a nuclear accident: the 560 million figure was from 1957 when the Act was first passed; the recent Rasmussen Report, considered very conservative, puts the figure at 6.2 billion dollars!

If these plants are safe as chocolate factories, the atomic industry should certainly not worry about the cancellation of the Price Anderson Act for future nuclear plants.

In most fields, you can't say "I'm going to make this investment, because you're going to pay for it", but you can in electric utilities, for the investment, once made, is recovered from the consumer. Now let's look at what the utilities want to commit us to with their so-called "cheap" nuclear power. In one of its least noticed parts, Project Independence estimated that the costs of nuclear fuel "burn-up" would go from its present 2 mills to between 11 and 13 mills per kilowatt hour by 1983. The cost of nuclear "burn-up" is the cost of the nuclear fuel as a factor of the cost per kilowatt hour, and it includes the cost of replacing the absorbed fuel, and the cost of reprocessing. Of course, Project Independence presupposed those 200 new nuclear plants in their projections, and such proliferation is what would push up fuel costs. So it logically follows that the only way to keep nuclear power costs from rising drastically is by building no more of them!

Utility investment is the only place where the consumer must pay for an error in investment judgment. Therefore, in view of the Project Independence projection, let us guard against our power consumers being charged for such errors of judgment by requiring in our state laws that when the cost of nuclear "burn-up" exceeds 3 mills per kilowatt hour, such excess must not be passed on to the consumer in higher rates, but charged against utility profits.

One last word on nuclear plants. When we build a coal plant, we have no doubt that we shall have enough fuel for the economic life of the plant; and the question obviously would not arise from a solar plant. We have plenty of doubts on oil, of course.

Therefore, it seems logical that state law, and federal regulations should require that before a nuclear plant is built, it be able to show that it has an assured supply of fuel for the life of the plant. The recent denunciation by Westinghouse of 10-year contracts for supplying uranium to nuclear plants it had built makes the point: Westinghouse could foresee as much as a billion dollars in extra costs.

It is obvious, then, that one of the imponderables in the nuclear energy situation is the cost and supply of fuel. Therefore, it is logical that plants should not be built unless a guaranteed supply of fuel is assured, and at firm prices, so that the public knows what it is committed to pay for. Solar power plants can meet this requirement. If nuclear plants are to compete successfully with solar, then they should also.

What about oil, and gas, and coal?

Some changes must be made.

First, full, total reporting of fossil fuel reserves. Do we really have a natural gas shortage. Nobody knows, although the gas companies say we do, and say its's because they need more profits. They have not yet explained why the 15% they are guaranteed under present rules is not enough.

Second, we must break up the energy conglomerates on two bases:

A: If you own one kind of energy, you can't own another, i.e., if you own oil, you can't own coal, natural gas, or uranium, etc., and no holding companies may own both.

B: If you are in the production of one of these fuels, you are absolutely forbidden to be in the retailing of it.

Third, until some competition can be injected into the fossil fuel field by the first two measures, price controls must be maintained on oil and natural gas. They also should be extended to coal, since 60% of the coal is owned by oil companies, who have grossly raised coal prices. There is no reason for OPEC prices to be transferred to American domestic oil, natural gas, or coal producation.

Fourth, coal is our only abundant fossil fuel, and we may have to lean on it somewhat for the next 5 to 10 years while we are bringing on solar energy. During that time, the price of coal, while not needing to reflect OPEC ideas on prices, must include the cost of restoring the mined land.

Where shall we get the capital for our new energy investments?

An Energy Trust Fund, if done similarly to the Highway Trust Fund, would mean taxes, perhaps on gas, perhaps someplace else. Fortunately, there is a better way.

Vice President Rockefeller has sold President Ford on a 100 billion dollar energy program. God help the nation if it does its energy investments the Rockefeller way, with more tax-free bonds cluttering up the financial market, chasing accumulated savings, leading the nation down the same primrose path he led New York State.

The better way to finance the new energy infrastructure is the way designed by master economist Louis Kelso. In his plan, the Federal Reserve Bank would be directed to rediscount loans (i.e., create money to buy the loans) by financial institutions to Employee Stock Ownership Trusts of companies constructing installations or technology for obtaining energy, and, I would stress, that should be energy from renewable sources. Kelso's plan would thus draw on pure credit, rather than on accumulated savings. The Kelso plan would avoid another problem with the Rockefeller plan, which would loan money, in effect, to the existing owners of energy companies, thereby further concentrating the extremes of capital ownership in this country, and very cleverly, doing so at the public trough. Even the Vice President's brother, John D. Rockefeller III, in his

"Second American Revolution" calls for spreading out of ownership of new capital, and cites the concepts of Louis Kelso as a desirable pattern. But there is not a word of that in the Rockefeller-Ford plan.

Under the Kelso way to finance our energy infrastructure, the new productive capital created would have new owners, instead of enriching the existing ones, and thus would spread out the prosperity deriving from the new wealth thus created. The Federal Reserve would in effect use pure credit to create the capital we need; the use of pure credit rather than accumulated savings would not be inflationary when creating new productive capital. Japan maintained a 15% growth rate for 10 years in this way.

Instead of the Rockefeller plan where tax-exempt bonds would create another 100 billion dollars worth of tax shelter for the very rich, the Kelso plan would suck no money out of the system, leaving accumulated savings available for other investments.

Were Kelso's concept of the Federal Reserve rediscounting loans to Employee Stock Ownership Trusts now the law of this land, it is easy to see that the accumulated savings in financial institutions would be far more available for sound municipal bonds.

The Rockefeller-Ford plan is pernicious in its propensity for sucking up accumulated savings and thus further distorting the financial market, and doubly pernicious in its tendency to provide the 5% of American families who already own the vast preponderance of our capital with another 100 billion of capital ownership through loans to the companies which that 5% already owns.

Mr. Rockefeller has always been noted for thinking big, and he is right with his figure: 100 billion. He is perhaps even righter in his original figure; 200 billion, but he is wrong in his concept. Surely Congress will have the wisdom to change to the far healthier concept designed by Mr. Kelso, thus ensuring that the new capital formed will belong to new owners. As Mr. Kelso is fond of saying: "If capitalism is good enough for the Rockefellers, it's good enough for everybody!"

That is how we get the capital for our new energy infrastructure, and it is equally vital that Congress have the wisdom to direct that capital formation toward the creation of an infrastructure that will deliver us energy from renewable sources, and that means solar. The greatest feature of solar energy is that once the capital infrastructure is installed, the fuel is free, and thus the costs of energy are simply the costs of transmission and delivery.

Can we get the technology? One thing is obvious: the Federal ERDA, that is, the Energy Research and Develop nt Administration, is going to take as long to bring on Solar energy - as they can get away with!! Somebody who's calling the shots knows damed well that when you're got abundant solar energy, you won't be buying so much oil, or gas, or uranium. This is why there's going to be so much push for the Rockfeller-Ford plan, which is aimed at getting us even more hooked to energy sources where we're consuming fuel owned by the energy industries.

While solar energy for the consumer is essentially a low technology field, 98% of the government grants are geared to researching highly sophisticated theories and systems. Above all, the ERDA money goes for studies and more studies. As long as they can get away with studying instead of building, they're going to do it.

That's why during the last session of the Legislature we in New York State set up our own ERDA, We're in a hurry in New York State - and we should be, for we're 50% more dependent on oil than the nation as a whole. So we turned our existing Atomic and Space Development Authority (ASDA) into the New York State Energy Research and Development Authority (NYSERDA), with authority to spend ten million dollars a year to bring into the marketplace renewable energy technology and energy conservation technology.

That may not seem like much money, but by doing joint projects with other governments that are also in a hurry, and even getting some money from the federal ERDA, I predict that within two years, New York State's ERDA can bring to the marketplace: 1) wind generation technology with the capacity of supplying vast amounts of power to New York City from the wind fields offshore in the Atlantic - and thus holding up the prospect of eventually lowering the City's power costs, as an inducement for industry to return, or not to leave; similar quantities of power from this source can be supplied to the upstate area from the wind fields in Lake Ontario; 2) inertial storage systems (often called superflywheels) which would permit a utility to store power generated from its most efficient plants operating at night when demand is low, and to draw from such stored power the following day when peak demand develops; 3) the solar cell, through purchases for use on governmental building. This will enable its manufacturers to put it into mass production so its price will diminish to a point to entice the marketplace, just as transistors fell from $5.00 to 5 cents in short order, once mass produced; 4) solar collectors, which would permit a sizeable decrease in fossil fuel consumption.

These technologies require neither splitting nor fusing atoms, nor even flying to the moon. They are not even very complicated, but added together, they spell energy in abundance and energy independence to an extraordinary degree at the consumer level.

This is what New York State is now positioned to do and determined to do. Let those shaken by the momentary problems of this state remember that only five nations in the world, plus California, have a larger production of goods and services than New York State. It was not called "the seat of empire" by George Washington for nothing.

Because of this capacity, I am convinced that this state can nudge solar technology into reality.

Our recent lessons should teach us, however, that financing the vast new energy infrastructure needed is beyond even this state's means. For that, the Federal government should provide, as I have described, for the use of pure credit by the Federal Reserve to finance the new solar energy infrastructure, and in such a way that the new capital formed is spread out into new hands.

This is a challenge for a generation: to build the infrastructure that will capture and deliver abundant, clean solar energy. "MAKE NO SMALL PLANS - THEY HAVE NO MAGIC TO STIR OUR SOULS!", said architect Burnham. This is a big enough challenge to excite the imagination of America - and to give us a sense that we're on target again. A solar energy infrastructure to leave as a legacy for posterity! A drive to achieve the solarization of America! That has the magic to stir us, and a grandeur worthy of our Bicentennial!

THE ASSEMBLY
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ENERGY SUB-COMMITTEE CHAIRMAN
EDUCATION COMMITTEE
AGRICULTURE COMMITTEE
ENVIRONMENTAL CONSERVATION COMMITTEE
LEGISLATIVE COMMISSION ON ENERGY POLICY

October 21, 1975

The Editor
The New York Times
229 West 43rd Street
New York, New York

Dear Sir:

Sometimes adversity brings a silver lining by forcing people to look at new ideas.

In the general malaise over the fiscal situations of New York City, perhaps at last some attention will be given to the ideas of master-economist Louis Kelso, author of "The Capitalist Manifesto" and "Two-Factor Theory". Kelso's ideas for Employee Stock Ownership Trusts (ESOT's) have been widely publicized recently, for instance, in Barron's this past July.

Kelso proposes that projects for new productive capital should be financed through pure credit, and not from accumulated savings; if this were our national financial policy, then available capital from savings would be looking for investments, instead of vice versa. We have recently heard from the commercial banks that the financial market is glutted with municipal bonds. This is because under our present financial system all kinds of new investments - government as well as private - are financed out of accumulated savings. There are more projects than there is available money, hence our difficulty in marketing more municipal bonds.

Kelso proposed in "Two Factor Theory" that the Federal Reserve rediscount all loans to Employee Stock Ownership Trusts for new productive capital. This would enable creation of money for the Fed to be linked very directly to the formation of new productive capacity, and would ensure that the new capital so created went to new owners, rather than further enriching existing owners of capital, as does our present capital formation system.

New York State should throw all of its forces into prodding Congress to pass legislation providing for rediscounting by the Federal Reserve of loans to ESOT's for new productive capital. In this way, pure credit provided by the Federal Reserve would provide the enormous amounts of new capital needed. By way of contrast, under our present system, where the Federal Reserve creates money in part by buying Treasury bonds, a good deal of our new money supply is thus going to pay for more government, and not to finance new productive capital. Were this change in our financial structure to occur, this country would enjoy an enormous spurt of capital investment. Money thus created for new production would not be inflationary. Let us recall that Japan did very much this sort of thing for the past 20 years, enjoying growth rates as high as 15%, and even 20% - without inflation, since the Bank of Japan's credit was extended above all for financing productive capital.

The impetus of New York State's overall prosperity by such expansion is obvious; unemployment would decrease; revenues would increase.

The other effect, and the reason why such legislation has application to our immediate crisis, is that the financial market funded by accumulated savings would be relieved of the necessity to finance great new industrial expansion since such would be financed by the Federal Reserve in the manner mentioned. The result would be that accumulated savings would then be looking for investments, instead of vice versa. Municipal bonds would again become saleable, and interest rates would drop.

The consequences of such a plan for New York State merit its immediate attention by this state's leaders. It will obviously not be adopted overnight, but it won't get adopted at all if we don't get moving. Failure to move in the Kelso direction, to my mind, will only mean that things will get worse.

Sincerely,

Daniel Haley

DANIEL HALEY
Member of Assembly

DH/sla

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KELSO'S ESOPs in REAL LIFE

Charles D. Hobbs

November 1975

This report was prepared for the Institute for Liberty and Community by Charles D. Hobbs, Inc., 1480 Wentworth Avenue Sacramento, California 95822, (916) 452-4675.

INTRODUCTION

For over twenty years Louis O. Kelso, a San Francisco attorney, has ceaselessly promoted a host of plans for creating a more widespread distribution of capital ownership.[1] Achieving that goal, he believes, would do much toward solving a number of problems, among them unemployment, inflation, lagging economic growth, and the preservation of democracy itself.

After years of neglect from all but a few devotees, and almost a conspiracy of contempt from academic economists,[2] Kelso seems to have suddenly come into his own. He has been widely written about in leading national newspapers and magazines.[3] Former California Governor Ronald Reagan has spoken kind words for the approach.[4] Nineteen members of Congress have sponsored a bill to liberalize Kelso's favorite capital-financing device.[5] Senator Russell Long, powerful Chairman of the Senate Finance Committee, has successfully incorporated Kelso inspired provisions into three major pieces of legislation in the past two years.[6] The press treats Kelso with the reverence accorded to a "fashionable thinker".[7]

Of the many proposals advanced by Kelso over the years, the one now most talked about is the Employee Stock Ownership Plan - the "fabulous ESOP".[8] An ESOP permits a company to issue stock to an Employee Stock Ownership Trust (ESOT), which pays for it from the proceeds of a bank loan secured by the company's promise to pay to the ESOT each year a specified amount up to 15% of the annual compensation of all the employees eligible to benefit. This payment is tax-deductible; hence the company is in effect repaying the principal of the loan with pre-tax dollars. rather than after-tax dollars. When the bank loan is retired, the beneficiaries of the ESOT - the employees of the company - have acquired beneficial ownership of stock in their company, without having to invest any personal savings. An example will make this clear.

The Viable Corporation, a small firm whose 120 employees manufacture widgets, determines that a growing widget market is ahead and that there is a good possibility that investment in new productive capacity will bring increased profits. The planned expansion is estimated to require $1 million in capital, above and beyond available retained earnings.

Viable Corporation has several alternatives in raising this new capital. It could sell shares of stock to the public; unfortunately, the market for new issues is weak and in any case a sale would dilute ownership by placing stock in the hands of persons not directly involved in the company. The company could also seek a bank loan: that would avoid the dilution problem. But the principal portion of the bank loan must be repaid with after-tax dollars, nearly twice as valuable as pre-tax dollars for all but the smallest corporations.[9]

Furthermore, the owners of Viable Corporation believe that their employees should have a stake in the company they work for above and beyond their wages for labor. This is not necessarily an altruistic concern. The company owners think that workers who own a stake in the company will prove to be more productive than mere wage laborers; they will be loyal, hardworking, reliable and enthusiastic. (They may also be less prone to engage in labor disputes).

The Board of Viable Corporation thus creates an Employee Stock Ownership Trust, naming the employees as beneficiaries, and qualifies it under the Internal Revenue Code. The trustees of the ESOT are appointed by the Board of the company.

The financial officers of the company and the ESOT trustees then go to the local commercial bank. They propose a loan to the ESOT of the required $1 million. The company agrees to make a tax-deductible payment each year to the trust of 15% of the payroll of all covered employees. The company also pledges its own corporate credit to the repayment of the loan. With this security the bank makes a loan of $1,000,000 for a period of 7 years at a rate of 12%. The company pledges to pay to the ESOT each year at least $219,118, the amount required to amortize the loan over seven years, and the ESOT pledges to repay a like amount to the bank.

With the proceeds of this loan, the ESOT purchases $1 million of new Viable Corporation stock, valued at the current market price on the day of the transaction. As the total value of outstanding Viable Corporation shares now becomes $3,125,000, the ESOT is now the owner of 32% of the company on behalf of the employees. In accordance with the ESOT agreement, this stock is voted by the ESOT trustees who are, in effect, a part of the Viable Corporation management. Thus control is retained in the company rather than shared with outsiders.

The new manufacturing facility proves, as expected, to be profitable. Indeed, the before tax profits attributable to it are sufficient to cover the annual payment of $219,118 required to be made to the trust by the company's agreement with the bank. This payment is conveyed to the bank by the trust. At the end of seven years the bank loan is fully repaid and the ESOT is the sole owner of 32% of the common stock of the company. In accordance with the original vesting provisions, employees who have served throughout the seven years then become 70% vested, with an additional 10% vesting in each of the ensuing three years. An employee's share of this capital is paid to him either in a lump sum, or as annuity, upon his retirement, death, or disability. The nonvested portion of the accounts of employees who terminate for other reasons are redistributed to the accounts of the other participants.

In choosing this method of financing corporate expansion, Viable Corporation has obtained a tax deduction of $219,118 each year for seven years, resulting in an annual tax savings of $105,177 as compared to a straight bank loan to the company repayable out of after tax profits.[10] Of course, had Viable Corporation sold stock to outside investors, it would have had $219,118 more each year with which to pay the $105,177 in additional taxes, but had that course been feasible at the beginning, 32% of the company would then be owned by outsiders, and the employees would have acquired no stock ownership in their own company.

There are, of course, countless variations on this basic plan. The key, of course, is the federal tax deduction for payments made to the ESOT as "deferred compensation" on behalf of employees. The payoff, as Kelso points out, is a "second income" for the worker:[11]

> "We want to get that second income into him as quickly as possible, so that gradually, by building ownership into him, we will make him, using his acquisitive instinct,

temper his demands for more and more pay in return for less and less work, which only adds fuel to the fires of inflation and makes his company and the economy less competitive."

The number of companies adopting ESOPs in recent years surely number in the hundreds, and the pace seems to be accelerating. Accounting and law firms are rapidly moving to offer their services in establishing ESOPs, using a host of sales pitches to corporate executives.[12] Since a number of companies have had ESOPs in operation for several years, it is worthwhile to examine how the results in practice square with Kelso's claims for them. Who benefits? Is worker productivity increased? Are ESOPs the beginning of a new era of worker capitalism? Do they herald a turning away from socialist income redistribution toward creating a second income from capital ownership by American workers?

Or do ESOPs serve mainly as a device for retaining close control of corporations or bailing out minority shareholders who otherwise would have no market for their shares? Are they, as presently constituted, little more than disguised pension plans which, unlike ordinary pension plans, do not require diversification of assets for the protection of worker beneficiaries?

Finding Real ESOPs

There is, of course, no national index to ESOPs, and no way in a study of this magnitude to find them all, much less to do a systematic review of their success and failures. Contact with Kelso's investment banking firm in San Francisco-- Kelso

Bangert & Co. -- elicited a promise of a list of Northern California companies willing to talk about their ESOPs, but the list was never received. Several companies with ESOPs have been mentioned in the press, and these provided two of the three ESOPs reviewed here. The third was taken from a May, 1975 list of 50 companies with ESOPs prepared for the United States Railway Association, which relied primarily on information from Kelso Bangert & Co. (then called Bangert & Co.). [13]

The list was checked against five standard corporate reference sources.[14] Twenty-three corporations could be positively identified with names on the list; four of the names on the list appeared to be variations of the names of corporations in the sources; and 23 of the names on the list could not be located at all in the sources. Of those which could be identified, most were small to medium-sized, closely-held companies. One of the companies not listed in the standard sources -- Woodland Mobile Homes-- was found through other sources, and turned out to be a small, owner-managed firm, leading to the supposition that the companies not identifiable in the sources were probably smaller and more closely-held than those which could be identified.[15]

The three case studies which follow, then, are more the result of a distillation from existing sources about ESOPs than a scientific selection. On the other hand, there was no attempt to find ESOPs which fitted any preconceived notion of company size or of plan design, longevity, success, or failure. The three cases are probably reasonably typical, except that a greater number of ESOPs have been formed in the past two years than in the preceeding 18.

Principal contacts at the three companies studied were, in two cases, the Presidents and, in one case, the Chief Financial Officer. Willingness to discuss company and ESOP affairs varied, but enough information was gained at each company to make the similarities of the ESOPs clearly visible, and to answer the major questions about employee participation in ownership. In addition to in-depth interviews with the principal contacts, informal conversations were held with a few employees to ascertain the degree to which ESOPs were regarded differently from other employee benefit plans.

The presentation of the case studies follows generally the structure of the questionnaire used for the interviews. Topics covered were:

- Company history, size, and products
- ESOP history and structure
- ESOP features
  - Owner benefits
  - Employee benefits
- Employee attitudes

Peninsula Newspapers

Peninsula Newspapers Incorporated is a 55 year old newspaper publishing firm in Palo Alto, California. Among its publications are three daily papers, including the Palo Alto Times. The company employs 400-450 people. The founders of Peninsula Newspapers apparently believed in employee stock ownership from the beginning, and one of their first acts was to establish an employee stock program for key employees. No one but the founders and the employees have ever owned Peninsula Newspapers stock. In 1954, when the employee stock trust was set up, the three principal owners (two of the founders and one of the original employees) owned three-quarters of the stock, and the remaining one-quarter was spread among key employees.

Kelso helped design and put into operation Peninsula Newspapers' Employee Profit Sharing and Trust Plan 20 years ago. The Plan is now credited with being the first ESOP. The stated purposes of the ESOP are to share profits with employees, keep ownership in the hands of working members, and guarantee continuation of company policies. The first task of the ESOP was to purchase from the principal owners, beginning in 1957, 72% of the corporate stock. The purchase was completed in eight years putting control of the company in the hands of the ESOT in 1965. The ESOT is administered by the American Trust Company under the direction of a five-member Profit Sharing Committee appointed by the Peninsula Newspapers board of directors.

The company annually contributes to the ESOT a tax-deductible portion of its net profits, after deducting a 3% "working capital supplement" and contributions to pension and retirement plans. The portion contributed is 85% of the first $100,000, 75% of the second $100,000, 45% of the third $100,000, 25% of the fourth $100,000, and 10% of the remainder. As of 1974, the company had contributed $4,721,892, at a fairly constant average, over the preceding ten years, of about $250,000 per year. Dividends and interest earned by the ESOT, in the same ten year period, fluctuated between $121,852 and $290,534, with a 21 year total of $2, 439,470. The total value of the ESOT in 1974 was $6,329,714.25, up from just over $4 million in 1965. At the same time the number of participating employees had dropped from 433 in 1965 to 408 in 1974.

As might be expected from the rise in value of the ESOT, the per-share value of the stock has risen over the past ten years, from $36.33 in 1965 to $50.96 in 1974. Dividends were $2.00 per share in 1974. The value of the company stock in the ESOT is determined annually by one or more outside appraisers selected by the Trustee upon instructions from the Profit Sharing Committee. The value of the non-company securities in the ESOT and the total value of the ESOT are determined by the Trustee.

Allocations of the company's contributions to the employees in the ESOP are based half upon proportionate wages and half upon length of service. However, allocation is not tantamount to vesting. An employee who retires, becomes disabled, or dies is entitled to 100% of the value of his account, but one who resigns or is fired or laid off is subject to a 20 year vesting requirement. No benefits are paid if termination occurs in the first five years. At five years the employee is vested 25%, and 5% for every year thereafter until, at the end of 20 years, he is fully vested. Because of the vesting provisions in the 1974 Pension Reform Act,[16] Peninsula Newspapers is now considering changes to the 20 year vesting policy.

The method of benefit payment, in all cases, is determined by the Profit Sharing Committee. It may pay the value of the accumulated stock, dividends, and other securities allocated to the retiring employee's account as a lump sum, in monthly installments, or as a life annuity insurance contract. The employee who terminates for reason other than retirement, disability, or death may, at the discretion of the Profit Sharing Committee, be paid when he terminates, within five years, or not until he reaches age 65, and in a lump sum or installments. The terminated employee forfeits any non-vested portion of his account.

Under no condition does an active employee actually receive any portion of what has been credited to his account. Thus he does not realize a "second income" from the ESOP. A glance at the 1974 Annual Report of the ESOP shows that the past ten years worth of dividends have exceeded the total growth of the ESOT. If dividends were distributed to employees, the net worth of the ESOT would fall every year.

On top of receiving no "second income" from dividends, the employees exercise no control of the company through the ESOT. Although the ESOT stock is voting stock, it is voted by the Profit Sharing Committee which is appointed by Peninsula Newspapers' board of directors. The Profit Sharing Committee votes the stock without instructions from the employees. The current chairman of the Committee is Peninsula Newspapers' President.

Peninsula Newspapers is a successful enterprise in a volatile industry. It appears to offer better than average working conditions and draw employees who are more than normally interested in doing a good job. They also seem to be impressed that there is an average of roughly $15,000 for each of them in the ESOT. While it continues to grow, the ESOT may therefore be a slight deterrent to personnel turnover. However, the employees do not consider themselves owners, unless they happen to have company stock independent of the ESOP. Because they directly receive none of the dividends going to the ESOT and have no voting power through it, their interest in the perquisites and opportunities of ownership is virtually nonexistent.

Woodland Mobile Homes

Woodland Mobile Homes is a small mobile home sales company with its headquarters in Mountain View, California. At its seven branches it sells and services most of the major brands of house trailers. It was founded in 1943 and incorporated in 1956. Until 1971 it was owned completely by the founder, who is still its president.

The owner set up an ESOP in 1971 to prepare for his retirement. His goals were to sell out without disrupting the operation of the company, to get his desired price for his stock, and to retain employee status--as president-- until he wished to retire. He also thought that an employee stock plan would reduce the high personnel turnover in his company, which is typical of the industry. He transferred all of the stock to the ESOT, which contracted to purchase it on time. The owner holds a lien on stock which has yet to be paid for by the ESOT.

The ESOP takes the place of a profit sharing plan, and is complemented by an annuity-type pension program to which the company annually contributes 10% of salaries and wages. Company contribution to the ESOT is 15%. Annual wages are about $500,000. The ESOT is administered by a three man committee consisting of the President, the Vice-President, and the company attorney or Secretary. The committee votes the stock and completely controls its allocation and the distribution of benefits. In fact, the committee controls both the company and the ESOT, as a three man extension of the owner-President.

Since 1971 the stock has fluctuated significantly in value, matching fairly closely the performance of the economy.

In 1971 its per-share value was $10.67; that dropped to $6.67 and then rose to a mid-1975 value of $8.57.

Employees receive payouts from the ESOT only upon termination. There is a seven year vesting requirement-- no vesting for the first two years and 20% per year thereafter. An employee who resigns, is fired or laid off, or who enters normal retirement before he is fully vested forfeits to the ESOT the unvested portion of his account. Forfeitures are distributed to the accounts of all other employees. However, death or retirement because of disability cancels the vesting requirement. In the past year the Vice-President and one of the senior secretaries have retired because of disability.

The difference between normal retirement and retirement on disability is not insignificant, since a vested employee also collects his share of the forfeitures. In one case, an employee who had been with the company in 1971, when the ESOP started, retired because of disability in 1975. The total value of the employee's account was $4,000 plus $1,300 in forfeitures from other employees who had terminated. If the employee had resigned or entered normal retirement, he would have received only 40% of the value of his account, not counting forfeitures, or $1,600. Retiring because of disability, the employee collected $5,300.

Although one of the motives of the owner in starting the ESOP was to reduce the high turnover rate, it is obvious that the structure of the ESOP benefits provides an incentive for senior employees to encourage the rapid turnover of unvested employees since forteitures from unvested terminating accounts accrue to the other accounts.

Aside from a possibly unusual interest in disability, Woodland Mobile Homes employees seem little affected by the existence of the ESOP. By the owner-President's own admission, key employees have a mild interest in the value of their accounts; others, none at all. This hardly seems surprising, given that the value of the stock has fallen since the ESOP was started, and the further fact that no one is yet fully vested. There is no sense on ownership on the parts of the employees. This, too, is hardly surprising, since the ESOP provides them neither with a "second income" nor with any control of the company.

Sutro & Co.

Sutro & Co. is a San Francisco brokerage firm with eight branches in California and an operations office in New York. It offers a full range of brokerage services, except that it does not sell commodities or government bonds and notes. It claims to be oriented to "retail trade": that is, to individual rather than institutional investors. It was founded in 1858 and currently employs about 400 people.

The principal contact at Sutro & Co. was the Chief Financial Officer, who was reluctant to discuss certain aspects of the company and its ESOP. He refused to discuss dollars at all, whether in regard to wages, company business levels, stock values, or ESOP benefits. He was also hesitant in discussing features of the ESOP, pleading ignorance in many instances. This attitude is not uncommon, as was proven in a later telephone check of selected companies to find out whether or not they had ESOPs. Some refused to go beyond "Well, we have such a plan, but that's all I can say."

Before 1970 Sutro & Co. was a partnership. When it was incorporated, the owners investigated the idea of an ESOP, but rejected it because of what they considered an unacceptable dilution of their interest. In 1974, Kelso Bangert & Co. (then Bangert & Co.) helped Sutro design an ESOP which could replace an existing profit sharing plan. Although the ESOP began operation in December, 1974, Sutro & Co. claimed that they were not motivated to set it up by the 1974 Pension Reform Act signed just three months earlier. The stated purposes were to upgrade the fringe benefit program, in order to decrease the personnel turnover rate, and to instill in the employees a sense of ownership. Expansion capital was not sought in connection with the establishment of the ESOT, and Sutro & Co. has no plans to use the ESOT for that purpose.

To establish the ESOT, the profit sharing plan was phased out and its assets were used to purchase a combination of treasury stock and new stock, previously authorized but not issued, which together represent 40% of the company's stock. The ESOT stock is all non-voting stock. The remaining 60% of the stock is owned by the directors and key employees. New York Stock Exchange rules govern the ownership of voting and non-voting stock. The Chief Financial Officer of Sutro & Co. was of the opinion that, under those rules, directors had to own voting stock, but he knew of no rule that would require the ESOT to hold only non-voting stock.

Besides the ESOP, Sutro & Co. has a standard annuity-type pension plan. Company guidelines call for a combined annual contribution of 15% of salaries and wages to the two plans.

Contributions to the pension plan are actuarially determined, so that the actual amounts available for ESOT allocation are sensitive to pension plan performance. The formula for allocation of stock purchased by the ESOT from company contributions is weighted in favor of lower-paid employees by means of limits on the amounts of salary to which ESOT stock can be credited.

The ESOT trustee is a bank, which operates the ESOT under the direction of a three-man ESOT Administrative Committee elected by the Sutro & Co. Board of Directors. The per-share value of the stock, which was unusually low when the ESOP was started, has risen approximately 25% since then. Since 1970 the stock, as might be expected, has followed closely the fluctuations of the national economy. The ESOT is authorized to purchase other securities than just Sutro & Co. stock, but to September, 1975 had not done so.

The ESOT pays off to employees only on termination of employment, for whatever reason. There is a ten year vesting requirement. Information concerning percentage of vesting each year and exceptions to the vesting requirement were unavailable. When an unvested employee terminates, the unvested portion of his account is forfeited and allocated to the other employees. Upon termination the employee gets his benefits in the form of stock, which he must then sell back to the ESOP, if it can afford to buy it, or to the company. There are no accumulated stock dividends. Sutro & Co. has never issued a dividend and is unlikely to in the future.

Sutro & Co. has seen no noticeable effect on employee performance or turnover because of the ESOP, but feels it is too early to judge. It should be noted, however, that the forfeiture requirements combined with a low stock value could have the effect of an incentive to senior employees to encourage unvested employees to terminate.

The Sutro & Co. ESOP provides neither a "second income" nor any corporate control to the participating employees. The general attitude of the employees is one of interest in the ESOP as a termination or retirement benefit, which of course is all it is. The employees do not consider themselves owners because of their interest in the ESOT, and of course they are not.

While it is theoretically possible for ESOPs to become the basis for a form of worker capitalism, the three ESOPs examined here offer little support for Kelso's claim. The ESOP, evolving as it did from a plan to facilitate the retirement of owner managers of closely held companies, is undoubtedly a valuable device from management's standpoint in many cases but the present operation of ESOPs holds little promise of a future of worker capitalism.

It is possible that an ESOP could give workers both the sense and substance of genuine capital ownership, although some tricky legal problems might have to be surmounted. If the three ESOPs studied are in any way representative -- and there is no reason to believe they are not -- then the "ownership" conferred upon employees is little more than the right to benefit from an ordinary pension plan.

Genuine owners of common stock are entitled to vote their shares in the American corporate system. Indeed, about half of the qualified profit sharing plans in existence today permit beneficiarie to exercise some degree of instruction to the plan trustees for voting the company stock. This provision is notably absent in the three ESOPs examined, and although no comprehensive guide to ESOPs exists, experts in the field seem to believe that few if any ESOPs exhibit such a provision. ESOP stock is, in most if not all cases, voted by the company management. This is not surprising, as most ESOPs are established by the management in the first place for reasons which do not include increasing employee control of the company.

Genuine owners are also entitled to receive the dividends from corporate shares, if any. ESOP beneficiaries in the three plans studied do not receive any periodic distribution of dividends from stock held in trust for their accounts. There is no "second income" during a worker's employment life. The only "second income" is a retirement, death, or disability benefit on top of social security or other pension payments.[17]

Genuine owners are free to sell their shares whenever they can find a willing buyer. ESOP beneficiaries cannot, of course, sell any part of the trust corpus in their accounts. It is not theirs to sell. It becomes theirs only upon separation from the company, and then only vested. They have in fact an estate in trust distributions, but it may be realized only at some distant date, barring calamity. About one third of existing qualified profit sharing plans (not ESOPs) include provisions for loans to employees using vested profit sharing accounts for collateral. In some cases such loans may be as much of 100% of the vested amount in the account, usually repayable through payroll deductions. Typically such loans are made for home purchase, college expenses of children emergency medical bills, support in time of prolonged layoff, etc. but not for ordinary consumer purchases, travel, or investment. None of the ESOPs examined had such a provision, however, and the author knows of no ESOP that does.

Finally, workers at the three ESOPs studied did not exhibit any significant sense of being company owners. They did seem to believe that the "fringe benefits" afforded by employment were satisfactory, and most were quite satisfied with their jobs. But this result could as easily have been obtained by a number of company benefits and practices other than the creation of the ESOP. Indeed, many companies exhibit similar characteristics with no "employee ownership" provisions of any kind.

It is possible to construct an ESOP that would facilitate a genuine worker ownership. It might be created by management, but the worker-beneficiaries would elect the trustees and instruct them in voting company stock. It would pass through dividends to beneficiaries on an annual basis to produce a "second income". It would arrange loans to employees for their own capital investments, in addition to home purchase, health expenses, college education, layoff subsistence, and the like.

Such an ESOP could be constructed now to qualify under the Internal Revenue Code, at least according to one expert in the field. The author is almost certain, however, that no ESOP exists today that contains these features.

It cannot be denied that the ESOP has numerous advantages, particularly for the small or medium closely-held corporation. It is hard to avoid the conclusion, however, that from the standpoint of creating a worker-owned capitalist democracy, the ESOP as presently used is little more than an ordinary pension plan.

FOOTNOTES

1. Kelso and various co-authors have made numerous statements setting forth their economic theory and legislative proposals. Chief among them are:

Kelso, Louis O. and Mortimer J. Adler, The Capitalist Manifesto (New York: Random House, 1958)

__________ and Mortimer J. Adler, The New Capitalists (New York: Random House, 1961)

__________ and Patricia Hetter, Two Factor Theory: The Economics of Reality (New York: Random House, 1967)

__________ and Patricia Hetter, "Eliminating the Purchasing Power Gap Through Two Factor Theory and the Second Income Plan", Hearings before the Joint Economic Committee on "Income Maintenance Programs", 90th Congress, 2nd Session (1968), Vol. II, pp. 633-652.

__________ and Norman Kurland, "The Federal Tax Policy to Create Full Employment by Broadening the Ownership of Productive Capital", Hearings before the Committee on Finance, U.S. Senate, on the "Tax Reform Act of 1969". 91st Congress, 1st Session, Vol. II, pp. 1937 ff.

__________, Statement, Hearings before the Subcommittee on Financial Markets, Committee on Finace, U.S. Senate, on "Financial Markets", 93rd Congress, 1st Session, (1973) Vol. II, pp. 13-87.

__________ and Norman G. Kurland, Statement, Hearings before the Committee on Finance, U.S. Senate, on "Anti-recession Tax Cut", 94th Congress, 1st Session (1975), pp. 205-233.

These works present a far reaching economic theory which Kelso claims is essential to all proposals for creating a worker-owned capitalist democracy. The validity of this "two factor theory" is not dealt with in the present paper, which is limited to the examination of the Employee Stock Ownership Plan as a device for producing worker capitalism. For a discussion of Kelso techniques (as opposed to economic theory), see Expanded Ownership (Fond du Lac, Wisconsin: Sabre Foundation, 1972) pp. 41-49. It is interesting that even this balanced and generally favorable review of Kelso's proposals produced a frantic letter from Kelso to the White House (which had supposedly commissioned the Sabre report).

2. Professional economists have treated lawyer Kelso's economic theories with utter contempt, without, so far as the author knows, having ever afforded them the usual academic discussion. For some reason Kelso's ideas have been placed in the same category as Velikovsky's worlds in collision theory and Charles Fort's

hollow earth hypothesis. Nobel Prize winner Paul Samuelson has dismissed Kelsonomics as "an amateurish and crankish fad". (San Juan, P.R. Star, April 27, 1972) So far as can be gathered, orthodox economists scoff principally at Kelso's assertion that there are two independently productive factors of production, labor and capital; and that investment in new productive capacity can occur without savings, i.e. out of "pure credit". On the latter point, see the observation of Dr. Norman Ture in "Financial Markets" op. cit. note 1, at 42. If Kelso's economics are as zany as the economic profession would have us believe, it is surprising that no one in that profession has authored a systematic demolition of them to settle the matter once and for all. In any case, the author believes that proposals for creating a worker based capitalism do not rest upon the validity of Kelso economic theories.

3. Recent articles about Kelso are numerous. Among them are

"Getting Employees to Put Up The Capital" Business Week November 20, 1971.

Nicholas Van Hoffman "What Will Save Us From Poverty?" Esquire, December 1973.

Milton Moskowitz, "Lawyer Labors to Turn Workers into Owners" New York Times, January 3, 1974.

James C. Hyatt, "Worker's Capitalism", Wall Street Journal April 29, 1975.

Dana L. Thomas, "Mighty Kelso" Barron's July 21, 1975.

4. Quoted in Hyatt, ibid. "Could there be a better answer to the stupidity of Karl Marx?" Also see Governor Reagan's address to Young Americans for Freedom, San Francisco, July 20, 1974.

5. H.R. 462, the "Accelerated Capital Formation Act of 1975", introduced January 14, 1975 by Rep. William Frenzel and others. For text and remarks, see "Antirecession Tax Cut" Hearings, note 1, pp. 221-226.

6. The Regional Rail Reorganization Act of 1973 (P.L. 93-236), §206 (e) (3), requires the newly established U.S. Railway Association to study the feasibility of incorporating ESOP financing into the eventual Consolidated Rail Corporation financial structure. The Trade Act of 1974 (P.L. 93-618), §273(f), requires the Secretary of Commerce to give preference in making loans to companies establishing facilities in trade-impacted areas to firms which have ESOPs. The Tax Reduction Act of 1975 (P.L. 94-12) §§ 301(a)(1), (d) allow an employer to claim a tax credit of 11% instead of 10%, if the employer contributes the extra percent to the ESOP.

7. For example, the Mike Wallace interview on CBS "60 Minutes", March 16, 1975.

8. ESOPs are authorized by §401 of the Internal Revenue Code. The Employee Retirement Income Security Act of 1974 (P.L. 93-406) § 2003(a) defines an ESOP as " a defined contribution plan (A) which is a stock bonus plan which is qualified. or a stock bonus plan and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and (B) which is otherwise defined in regulations prescribed by the Secretary or his delegate." For an excellent description of the workings of an ESOP, see Charles Pillsbury, "Employee Stock Ownership Plans: A Step Toward Democratic Capitalism (Note), 55 Boston University Law Review 195 (1975).

9. The Federal corporate income tax rate is now 22% of all taxable income, plus a surtax of 26% on all taxable income in excess of $25,000. For all but the smallest corporations, the effective tax rate is thus almost 48% (State corporate income taxes usually add another six percentage points to this).

10. The tax saving in this example is calculated as follows: An overall pretax return of 18% on invested capital of $3,125,000 is assumed, yielding taxable income of $562,500. The Federal corporate income tax on this is $263,500. With an additional deduction of $219,118, the taxable income is reduced to $343,382 and the tax liability to $158,323. The difference is a tax savings of $105,177.

11. Kelso, "Antirecession Tax Cut" (note 1) p. 209.

12. See, for example, Robert A. Frisch, The Magic of ESOT: The Fabulous New Instrument of Corporate Finance. A sample chapter heading: "The Frisch Plan: A Way to Fund an ESOT/Stockholder Buy-Sell Agreement or Acquire ESOT Keyman Insurance With No Net After-Tax Cash Outlay". (Ch. 12). Significantly, the benefits of an ESOP to employees are passed over rather lightly in favor of benefits to management, and the Kelso ideals of "worker capitalism are not mentioned.

13. Towers, Perrin, Forster, and Crosby, "An Evaluation of the Employee Stock Ownership Plam as Applied to Conrail", Report to the U.S. Railway Association, May 12, 1975. The report concludes, incidentally, that ESOP offers no advantages to Conrail in terms of corporate financing or of employee motivation. Instead, the consultants recomment a qualified stock purchase plan at such time as Conrail reached "reasonable profit levels".

14. Standard & Poor's Register of Corporations, Directors, and Executives (New York, 1975); F& S Index of Corporations and

Industries (Cleveland, 1975); Dun & Bradstreet's Middle Market Directory (New York, 1975); Dun & Bradstreet's Million Dollar Directory (New York, 1975) and Polk's World Bank Directory (Nashville, 1974).

15. For an early and enthusiastic account, see Norman Kurland 'Some Examples of the Use of Second Income Financing Techniques to Broaden Capital Ownership", (Institute for Study of Economic Systems, 1969). In addition to Peninsula Newspapers, the paper cites First California Corporation, now out of business, as an example of a "Second Income Plan Trust to Turn Employees into Owners of Mature, Well Managed Corporations." Of the two examples of SIP trusts to make employees of new businesses into owners, one (the Albina Corporation) is long defunct. The Valley Nitrogen Company of Helm, California, an early Kelso project, is offered as an example of a "Second Income Plan cooperative". This firm has never had an employee ownership plan of any kind, however. One of the companies named on the list provided to the U.S. Railway Association's consultants by Bangert & Company as examples of ESOPs in action- "Northern Vermont Asbestos", apparently refers to the Vermont Asbestos Group Inc.. This worker-owned company at no time considered the installation of an ESOP, however. The employees simply used their savings to buy shares of stock in the company, which was formed to acquire the GAF asbestos mine in Lowell, Vermont when that national corporation decided to close it.

16. P.L. 93-406, technically known as the Employee Retirement Income Security Act of 1975. See Pension Reform Act of 1974: Law and Explanation, (Commerce Clearing House, 1975).

17. At least one corporation had a funded profit sharing plan - not an ESOP - which provided for annual distribution of dividends, interest and other income except capital gains to plan beneficiaries: the Waukesha Foundry Company, Inc. , a subsidiary of IC Industries. This plan has, however, recently been terminated. The only other similar plan known to the author is the Bank of America's profit sharing plan, which allows participants after 25 years of membership to make a one time only election to receive future dividends in cash.

HISTORICAL PERSPECTIVE ON ESOP: THE HOMESTEAD DEBATE

By Larry Good

Louis Kelso's Employee Stock Ownership Plan (ESOP) is an innovative technique of corporate finance that provides wage-earners with access to productive capital in the companies where they work. Legislation to encourage ESOP has been referred to as the Industrial Homestead Act, recalling legislation for the widespread availability of land in the latter half of the 1800's in this country. The Homestead Act of 1862[1] enabled those Americans by birth and naturalization whose savings were insufficient to buy productive land, to settle and develop 160 acres of public land as their own. Kelso, the father of ESOP, and proponents such as Senator Russell Long (D., La.) are offering ESOP as the twentieth century answer to the Homestead Act, in that ESOP diffuses the ownership of capital by offering widespread access to productive capital.

In the nineteenth century land was the principal standard of property. The corporate enterprise is today's standard of productive property, responsible for producing most of the country's goods and services. The certificate of stock ownership replaces the deed. Though representing something less tangible -- you can't build a homestead on a corporation -- its revenue in dividends, together with wages from labor, can provide a household with enough income to purchase all its needs and wants. This analogy is most easily understood if one compares the productivity of large manufacturing machines with that of farm tools, and the factory as a whole to the farm. The larger scale of the factory makes it necessary for many people to share in its ownership, as well as its larger profits

Access to productive capital was in the 1800's and still is today the key which enables people to become more productive. This, the essence of Kelso's two-factor economics, the underlying theory of ESOP, was approximately expressed in a speech by Indiana Congressman Dunham in 1852, more than 100 years before Kelso published his more developed theory. Arguing for free access for settlers to public lands, Dunham pointed out that the non-wealthy -- those without income-producing capital and thus accumulated savings -- who wanted to settle and develop land in the West must first "lay aside the little pittance they earn" while the land they wanted remained unproductive, as waste capital. He continued with an illustration:

> "One mechanic starts out in the world to make his fortune by his own unaided toil; another starts out with a capital or material of his own to work upon. The one receives an income derived from his labor alone, while the other receives the income derived from his labor and capital combined (the two factors of production in Kelso's theory). I submit, then, ... would it not be better that the unemployed, or the unprofitably employed, labor of the country should be applied to this unemployed material, and it developed, improved, and made to yield, than that it should remain unproductive, and the labor but partially occupied, and partially renumerated? As a question of

> political economy, would it not be better that this capital of the country should be brought into a state of productiveness. Here are millions upon millions of capital lying idle, while you have the labor to make it productive, and which, if applied to it, would add to the wealth, the comfort, and the happiness of the people of the nation. But you say you will not allow this labor to be applied to this material unless the laborer will pay for the privilege of thus adding to the wealth and welfare of your country. And this you call statesmanship; and this policy of mine, which would bring the toil of the country to add to its wealth and happiness, you call demagogism! Yours is statesmanship, though you are deriving no benefit from the immense amount of material. Mine is demagogism, because I desire to employ the means to improve the material -- to develop it and make it productive to the country and to the world. ... But you will not allow your citizens to toil to add to your wealth, your power, and your greatness, unless they pay you tribute."[2]

Implicit in the latter half of this speech is the conflict -- a dominant one in the U.S. Congress in the 1850's -- between the advocates and opponents to free access to public lands, complete with impassioned accusations and counter-accusations. The public lands consisted at first of the Northwest Territory and later the vast tracts of land acquired through the Louisiana Purchase, the Mexican Cession, and the Oregon Treaty. Disposal of these public lands was long the subject of intense national debate. Federal lands were sold in the early 1800's. Sales revenues were used to cover surveying and administrative costs, with profits used to pay off national and state debts. Ironically, it was the prospect of a Treasury surplus in the late 1820's that opened the door to dissension among interest groups and states as to the distribution of public lands or revenues from their sale. The old states, the new territories and states, railroads and other corporations, public institutions such as colleges, and welfare interests all clashed in competing for these resources.

Sectional interests were primary in the arguments concerning the disposal of Western lands, as the resolution would determine which peculiar sectional interests were to be furthered, and which threatened. Southerners attempted to protect the precarious balance of power in Congress in order to preserve the institution of slavery. Small, privately owned tracts of land would nourish the growing abolitionist cause in new territories. Politically, it would mean a tilted anti-South alignment in Congress, with new Western states siding with the Northeastern states. Other Southern economic interests, such as low tariffs, were also at stake. Southern newspapers candidly editorialized on this threat once the Homestead legislation battle was brought into the open:

> "Better for us that these territories should remain a waste, a howling wilderness, trod only by the red hunter, than be so settled (by Northerners) and governed (as free territories). We prefer the neighborhood of the wild Commanche to that of the black hearted abolitionist. This, we know, is a sectional view of the subject but we are compelled in self defense to look upon it in that light."[3]

Southerners even feared that cheap or free lands would attract settlers from the South. The drain of labor talent, mostly small entrepreneurs and farmers, wasn't compensated for by immigrants, as in the North.

Immigration was another major issue of the period which, like slavery, was intertwined with the fight over Homestead legislation. The availability of cheap or free land would relieve crowded conditions in Eastern cities, burdened by an influx of immigrants. But Homestead legislation proponents were sharply divided over the question of whether immigrants, even when naturalized, should be entitled to the same access to public lands as citizens born in the United States.

The effect of these issues -- immigration, slavery, and sectional interests -- on Homestead legislation has no bearing on the current debate concerning ESOP. It is important, however, to note the diversity of issues that complicate any economic reform, and that each issue could be used to divide support for such reform, as the opponents of Homestead legislation were keenly aware. Southerners adroitly exploited the division of Homestead supporters by seeking clarification of, and offering amendments to, several provisions of Homestead bills, such as the eligibility of immigrants to settle on public lands.

Moreover, vested interest in these ancillary issues dominated the Homestead debate before proponents grew strong enough to force the articulation of more specific reasons for and against Homestead legislation. Early proponents were fighting for respectability before they were able to effectively argue for free access to public lands. Until the Homestead movement established firm roots, its advocates were scorned as radicals with an unsound new-fangled notion. What's more, the Homestead measure had to emerge from a large array of proposals -- many backed by strong special interest lobbies -- relating to the disposition of public lands. In 1850, Congress was beset by 65 bills proposing to divide the public lands among canals, corporations, lunatic asylums, colleges, etc.[4]

Similarly, ESOP proponents have had to fight for respectability. It is thirty years since Kelso first wrote a manuscript containing his economic theory that was revised and published eighteen years ago (co-authored by Mortimer Adler) as The Capitalist Manifesto. Two more books and numerous articles were published on the underlying theory of ESOP. But only since a strong supporter was found in Senator Long and ESOP provisions were written into four Acts of Congress has ESOP become an issue of national debate. Still, there are economists and politicians who ask for evidence of public demand for ESOP legislation encouraging widespread access to capital ownership.

Changes in conditions and attitudes in the past 100 years complicate the comparison here of ESOP to Homestead measures. These changes might help to explain why the public demand for ESOP legislation hasn't been as great as public demand for the Homestead Act by the 1860's. First, leaders in politics and in the press aren't as effective at stirring and shaping public opinion with a speech or an article. Second, the public lands were available capital waiting to be developed, while Kelso advocates financing techniques to bring new capital into existence. Third, there was more emphasis on ownership of property in the 1800's. In the early history of America, property was even a prerequisite for political participation. Ownership is not as vital in today's more mobile society. While this increases freedom to some extent, it also contributes to the loss of appreciation of economic productivity and responsibility. Modern workers derive nearly all their income from their labor productivity, supplemented by the productivity of capital. Wage increases are justified by the myth of the rising productivity of labor, though rising productivity more often reflects greater input from capital technology owned by others. This abrogates the moral and legal rights of owners to enjoy their property and all it produces. Still, it appears necessary, but only because workers have no ownership stake and income from the capital of industrial society, as was afforded Americans in agricultural society in the nineteenth century by the Homestead Act.

Horace Greely, newspaper editor and Congressman, appreciated all this. In 1848, he introduced a bill (though not the first) "authorizing each landless citizen of the United States to occupy and appropriate a small allotment of the Public Domain free of charges." Asked about the surprising interest of a New Yorker in the generous disposal of Western lands, Greely replied, "... my interest in the matter was stimulated by the fact that I represented more landless men than any other member on the floor."[5] Andrew Johnson, then a Senator, explained further: "Just in proportion as men become interested in property, they will become reconciled to all the institutions of property."[6]

While they were united on the need for legislation that would make land available to all Americans, Homestead supporters differed on several key provisions. Eligibility of immigrants, as noted earlier, was one. Other disagreements on eligibility focussed on age, sex and family status -- some said this should be only for heads of households. The total amount of public lands set aside for settlers was also argued, mostly for political reasons. To allay the jealousy of powerful special interest lobbies, some Homestead supporters wanted to reserve some of the lands for other purposes. Most controversial, however, was the argument over a selling price, if any, for the land. In 1853, the Commissioner of the General Land Office issued a report that estimated the cost to the government of purchasing, surveying, managing, and selling the public lands at just under 22¢ per acre.[7] Those who agreed the public lands should be available to settlers argued over whether to donate the land, let the settlers buy on credit, or sell the land on a graduated scale, depending on time it had been on the market and the land's quality. Only by compromising on such so-called graduation measures were Homestead supporters able to pass any of their principles through Congress until the hard-core opposition disappeared with the secession of the Southern states. Finally, with the support of President Lincoln, the Homestead Act was passed and signed into law in 1862. It provided for entitlement of any head of family, or person over 21 years old, who was a citizen or declared his intention to become one, to 160 acres of public land for settlement and cultivation, non-transferable for five years, upon payment of $10.[8] It is this measure, which embodied the principle and fulfillment of the Homestead movement, that I shall compare to ESOP.

Opponents to the Homestead Act raised several specific objections which have been closely repeated as objections to ESOP, in that they focus on the distribution of productive wealth, then land and now capital. These objections can be categorized as: (1) economic implications for the federal government; (2) economic implications for the private sector; and (3) moral implications; and (4) practical implications.

(1) Economic Implications for the Federal Government: the free distribution of public lands would necessitate the transfer of the revenue burden to another class through taxation, since the lands had been an expense to the government and would otherwise produce revenues, from their sale.

This same argument has been applied to tax benefits for companies using ESOP's; the Treasury Department and others have complained of the potential loss to the Treasury. Kelso has responded that the tax base would be enlarged by broadened stock ownership, and that the stimulation of private sector expansion through tax breaks would lessen the burden of the federal government to provide transfer payments, thus more than compensating for temporarily reduced revenues. Critics of the Homestead legislation had been similarly answered. Ironically the same Committee on Public Lands in the Senate which warned of a revenue loss[9] had four years earlier -- under different leadership -- reported a response:

> "Had they (the public lands) all been given away on condition of settlement and cultivation, such would have been the increase of consumers of dutiable articles, and such their increased ability to buy them, the general coffers would have been full to repletion. Instead of broad and fertile plains, unfurrowed by the plough, and the forest wilderness yielding no products for the sustenance of man, or for markets, to swell, by their avails, the receipts of customs, there would have been seen at this day, high cultivation, a dense, hardy, and industrious population, possessed of all the means of enjoyment, contented and happy, and contributing, by their numbers and power, to the grandeur and stability of our political and social system."[10]

(2) Economic implications for the private sector: Value depreciation of lands. No one would invest in lands when they're free; those who wanted the land and would work it either could buy it or would find the means to do so.

This argument placed a premium on the use of past savings to develop the economy and sustain real estate value. It assumed people who were or could be productive possessed such savings, thus favoring those people who were fortunate enough to possess enough wealth to make more. Homestead proponents countered that the economy would be developed more rapidly, and thus its value enhanced, by encouraging settlers to cultivate public lands. In reality, many would-be settlers could not afford the purchase price of land. What scant savings they might have had were needed to stock and improve their farms. The influx of millions of permanent settlers to the Western lands eventually proved the point.

Similarly, very few people today can afford to buy significant amounts of income-producing capital, although if they could it would increase the value of individual and national wealth without hurting the investors who have already accumulated wealth. Recent qualitative analysis of stock ownership shows that only 5% of Americans own over 67% of such capital.[11] Yet current U.S. Administration policy, while sanctioning the ideal of broadened capital ownership, expects this to be accomplished through individual savings. This policy is simply unrealistic; perhaps it reflects the Administration's sincerity.

(3) Moral implications: national wealth should not be used to help able-bodied men rather than the needy -- widows, the sick, the handicapped -- especially since "what is lightly won is lightly prized."

Inherent in this argument is the notion of a trade-off, between giving away public lands to settlers and using revenues from sales of land for other purposes -- namely, welfare. This attitude invited endless moral debate on use of resources, then as now, and ignored the potential of vastly expanded resources. In vetoing the Indigent Insane Bill in 1854, President Pierce expressed the principle that there was no difference between distribution of public lands and distribution of revenues derived from their sale. And then, "The whole field of public beneficence is thrown open to the care and culture of the federal government."[12]

But as Homestead advocates pointed out, the lands were capital that needed to be made more productive. Free access for settlers to land would avoid land remaining idle, including prime land purchased by speculators that interfered -- by virtue of strategic location -- with the development of many communities. (The land speculators' lobby was a powerful, corruptive force in delaying Homestead legislation.) Such idle, unproductive land was comparable to hoarding capital, or hiding savings, thus holding back the economy. As noted above, productive lands would bring rewards, in tax revenues, to the government, and increase national wealth, to be applied to a diminished "field of public beneficence." Thus the widespread, productive use of public lands was not just another alternative but a solution for creating wealth needed for moral and other non-productive purposes.

ESOP has also been placed in the category of a government give-away, since workers acquire capital ownership at the immediate expense of the Treasury, as a result of favorable corporate tax treatment. Again, however, the idea is to encourage productive use of capital by as many people as possible, to augment national resources and purchasing power. Access to productive capital is the main obstacle to this policy. ESOP is proposed as a solution just as the Homestead Act was a solution to the problem of would-be settlers acquiring otherwise unproductive land. What's more, workers acquiring capital through an ESOP effectively pay for its cost out of the profits their capital produces, besides contributing more to the national economy and Treasury once the capital has been paid for, usually in five to seven years. The Homestead Act didn't require the settlers to pay for their land out of profits from their productive cultivation, not even to the extent of the cost to the government. Yet the economic success of that land policy, which provided millions of Americans the opportunity to acquire and develop vast amounts of capital, is clearly evidenced by the development of the West and the enormous agricultural output of American farmers.

The saying "What is lightly won is lightly prized" obviously does not apply to the opportunity to be productive. Its implications of the undermining of individualism, and encouraging socialism, were later denied even by Homestead critics; individual ownership of property is, in fact, a hedge against communism. Frederick J. Turner, chronicler of the American West, noted that after the settling of free lands, America faced a vital struggle against communism and socialism.[13] Yet many ESOP opponents have cried "socialism" at the idea of expanding individual capital ownership as a logical extension of the Homestead policy of expanding individual land ownership. Louis Kelso has pointed out that while land is finite, the amount of capital we can bring into existence is limited only by our institutional barriers, such as conventional techniques of financing capital. Rather than monetize welfare, as we now do, Kelso suggests we monetize new capital formation by making loan paper for ESOPs directly discountable with the Federal Reserve System.[14]

The Fed, in a tone reminiscent of President Pierce's warning of throwing open the 'whole field of public beneficence,' responds to this credit-financing proposal by saying the selective use of discounted credit would invite similar demands from others for "socially desirable lending activities."[15] Evidently, the difference between (1) productive use of capital and (2) less productive special interests and needs, in terms of government encouragement, wasn't permanently settled by the Homestead Act. Kelso calls this difference the Law of the Urgent and the Important: first build productive power into households so they can obtain life's necessities (the Urgent), then attend to the Important things, using the increased wealth to obtain them.[16] Debate on moral or other non-economic priorities misses the point of increasing national wealth,, which lessens the need of, and pressure on, centrally decided social priorities.

(4) Practical implications: Not everyone is suited for cultivating a farm in the new territories.

The above statement was true, but ignored the enormous overall benefits of the Homestead measure. Included among these benefits were the secondary opportunities opened up by the Homestead Act --

the increase in trade and demand for new services provided opportunities to many people who weren't suited for, or disposed to, cultivating the new lands.

This secondary impact and general benefit to the economy apply as well to ESOP, though the argument of discriminatory benefits has again been used to oppose government encouragement of ESOP through favorable tax treatment. Until recently, the Treasury Department argued that OPs benefitted only those people who work for companies that choose to use the plan, so the favorable tax treatment is unfairly discriminatory.[17] Lately, Treasury has taken the more positive approach of advocating supplemental Individual Stock Ownership Plans for people who don't work for companies using ESOP.[18] These so-called ISOPs, however, would be similar in effect to the Graduation Act of 1854 that scaled land prices so that settlers paid less than others, in that the credit mechanism is not used. The Graduation Act was a compromise that did not satisfy those who sincerely wanted a measure that would bring vast amounts of Western land under cultivation.

Kelso has proposed a policy designed to encourage the formation of capital on a vast scale, with ownership of new capital going to those it most directly concerns: the workers who build it, the workers who manage and operate it, and the consumers it serves. Then, other individuals could apply for loans from banks to purchase additional shares of stock -- ownership of capital -- in eligible companies. This solution answers another aspect of the "not everyone is suited for cultivating a farm" criticism as well. Namely, not everyone is suited to manage. Kelso emphasizes the importance of widespread ownership of capital, leaving management to the professionals, who are then accountable to a broad-based constituency of owners.

This approach could not have applied so well to the Homestead situation. Horace Greely in 1854 proposed a provision offering settlers 80 acres rather than 160 acres, since nobody cultivates 160 acres -- few even 40 -- except by the hired or stolen labor of others.[19] The modern corporation avoids this situation through its organization of delegated responsibilities. Kelso, though, has suggested a statutory limit on the amount of capital any individual can accumulate through an ESOP, so as not to infringe on the opportunities of others to become economically self-sufficient.

In all, the Congressional debate on the Homestead issue was marked by eloquent speeches and arguments. But the issue was not won just by eloquent oratory on convincing positions. Many members of Congress and their constituents had pre-conceived ideas; the tide was turned more by political pressure than by skilled debate. Martin Van Buren, as a Presidential contender in 1848, supported Homestead legislation in general, but eluded the issue of free lands to settlers, fearing the espousal of a radical policy would have lost him conservative support. In 1850, Congressman Andrew

Johnson, sensing the hostility of the House Committee on Public Lands to the several Homestead bills introduced in the House of Representatives, changed the title of his bill to "A bill Encouraging Agriculture" to have it referred to the more friendly Committee on Agriculture.[20]

By 1852, few Western politicians could oppose a Homestead measure and expect to be reelected. Popular opinion in the North, with the help of a supportive press, embraced the Homestead principle and made itself felt in Congress. The House, despite disagreements over some provisions, passed a homestead bill by a two to one margin in 1852. But in the Senate, less sensitive to the momentum of public opinion and with greater proportionate representation of the South, Homestead supporters were frustrated even in their attempts to have a bill considered. As in the House, an unfriendly Committee on Public Lands delayed consideration. Through parliamentary manoeuvers, Southern politicians were able to prevent a Homestead bill similar to the one passed by the House from being voted on. For several years there was a stalemate between the two bodies of Congress. When a compromise bill was passed finally in 1860, President Buchanan vetoed it, succumbing to Southern influence. After the secession of the Southern states, the opposition was easily overcome and President Lincoln, who had included a Homestead plank in his 1860 campaign platform, signed the Homestead Act in 1862.

The struggle to pass the Homestead Act was long and arduous; the same is true for any economic reform, especially one so sweeping. Popular demand was a main ingrediant of the successful vote. Today some economists (e.g. Arthur Okun, Senior Fellow at Brookings Institute) and politicians (especially labor-backed liberals) are asking for signs of popular demand for ESOP to demonstrate that it is truly a popular solution to economic problems. Provisions on ESOP in four Acts of Congress[21] and extensive media coverage notwithstanding, ESOP as an economic policy has yet to attract a large constituency. Some of the reasons for this are similar to those which were obstacles to Homestead legislation: the time it takes for a new idea to be accepted; fear of espousing an idea outside of the mainstream of current thought; the perceived threat to special interests; and stubborn resistance to change in general. However, a recent national poll showed that by a 66% to 25% margin, Americans favor employees owning most of their company's stock.[22]

There are obstacles to winning public support for ESOP not faced by Homestead proponents. For one, Americans are not as responsive to a vital need to own productive capital. Another is the complexity of issues and solutions, whose number saturate the average citizen to the point where he grows skeptical of all of them. Also, there is less leadership and faith in leadership to shape public opinion. The growing paternalism of big government cannot be discounted; many people expect the bureaucracy to take care of them. Having lost sight of individualism, many would-be ESOP proponents are devoting their attention and efforts to ideas and causes which, in reacting to pressing problems, seek only to amelicrate the situation. This was true in a limited sense in the 1850's, when Homestead advocates opposed agricultural subsidies as temporary expediants which detracted from more basic problems. And recent public opinion surveys have shown there is a general distrust of the business community among many Americans.

On the other hand, a very basic obstacle to the Homestead measure is not faced by ESOP advocates. Free land was a government resource; the government had to decide how it should be used. ESOP is based on the creation and diffusion of private sector resources, using corporate credit. Private companies are encouraged to use ESOP by availing themselves of a tax law that has been on the books since 1920. Expanding the tax advantages and other favorable government actions depend somewhat on greater public support for ESOP. But the progress of ESOP is not as obligated to national political debate as was the Homestead measure. Successful examples of ESOPs, with the help of media and personal communication, can build the necessary popular support.

A fundamental difference in perceptions of Homestead legislation and ESOPs lies at the heart of the analogy: the former fostered individual ownership of individual units of capital (land) and the latter fosters individual ownership of collective units of capital (the corporation). Though the Homestead Act was feared as a socialist measure, ESOP is regarded by some people as being socialist in form -- that is, many people own a stake in the same property. This kind of ownership, however, relates more to the nature of the corporation in that it is due to, and benefits from, corporate efficiency in managing technology and resources. Ownership through ESOP is in individual accounts so that the worker feels he directly owns a piece of the action, which he can pass on to his heirs. That differs significantly not only from collective ownership through the state, as in most socialist countries, but also from the Yugoslavian, Peruvian, and Algerian socialist models of worker-ownership. In these models, workers share in some of the company's profits, but the government owns the company and the right -- which in each of these cases it exercises -- to take some of the profits and distribute them elsewhere in the economy. The worker is awarded for the company's capital productivity, but has no personal responsibility based on a personal stake in the property. The argument of collective vs. individual responsibility and rewards is too extensive to discuss here. (However, the export of enormous amounts of American grain to Russia is suggestive of the implications for economic productivity.)

History, for those who care to study it, offers instructive precedents. The last Czar of Russia, Nicholas II, deposed by the 1917 Revolution, was one of those who cared to study history, though he was not quick enough to act on what he had learned:

> "General Nelson A. Miles said that when he represented the United States at the coronation of the present Czar of Russia he asked His Majesty what he intended to do with the lands of Siberia when the great railroad, then under construction, had been completed. 'We intend,' replied His Majesty, 'to do with it what your great statesman, Mr. (Congressman Galusha) Grow, did with the public domain in the United States. In due time we shall give it to the people, because we are convinced that the Homestead Law is the most useful enactment ever placed on the statute book of nations.'"[23]

Homestead proponents themselves had sought historical perspective:

> "The principle involved in this bill is one that has divided free democratic principles and aristocratic government for all past time. ... Those agrarians (a term then synonymous with radical) who for thousands of years have been denounced as foes of property and of popular right and social order were in fact the only friends of conservative popular liberty that the Republic of Rome ever saw, and all on earth they contended for was a fair and equal distribution of the public lands."[24]

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FOOTNOTES

1. Stautes at Large, May 20, 1862, Vol.XIV, p. 392.
2. Congressional Globe, April 6, 1852, 32 Cong., 1 Sess., Ap. 407-8.
3. Columbus (Miss.) Democrat, July 22, 1854.
4. Speech by Andrew Johnson, Jan. 23, 1851, Congressional Globe, 31 Cong., 2 Sess. p. 312.
5. Greely, Horace, Recollections of a Busy Life, p. 217.
6. Speech in the Senate, Mar. 20, 1858, Congressional Globe, 35 Cong., 1 Sess., p. 2265.
7. Senate Executive Documents, 33 Cong., 1 Sess., Doc. #1, pp. 110-112.
8. See footnote 1.
9. Senate Reports, July 16, 1850, 31 Cong., 1 Sess., Doc. #167.
10. Report of the Senate Committee on Public Lands, Senate Documents, Feb. 24, 1846, 29 Cong., 1 Sess., Doc. #152.
11. Survey of Current Business of the U.S. Department of Commerce, Nov. '74, Vol. 54, p. 27.
12. As quoted in Stephenson, George M., The Political History of the Public Lands, p. 179.
13. Turner, Frederick J. Social Forces in American History, p. 223.
14. Kelso, Louis, and Hetter, Patricia, Two-Factor Theory, p. 95.
15. From an interview with Norman Bernard, spokesman for Chairman Arthur Burns of the Federal Reserve Board, Sept. 3, 1975.
16. Kelso and Hetter, op. cit., pp. 111-119.
17. Letter to Senator Russell Long from Treasury Department Assistant Secretary Frederick Hickman, April 30, 1974, re S. 1370.
18. Testimony of Charles Walker, Assistant Secretary of the Treasury for Tax Policy, before Joint Economic Committee, Dec. 11, 1975.
19. Stephenson, op. cit., p. 144.
20. Ibid., p. 142.
21. Regional Rail Reorganization Act of 1973, Pension Reform Act of 1974, Trade Act of 1974, and Tax Reduction Act of 1975.
22. Peter Hart Survey, as quoted in The Wall Street Journal, Aug. 22, 1975.
23. Dubois, James T., and Matthews, Gertrude S., Galusha A. Grow, p. 289.
24. Ibid., p. 198.