Center for American Progress

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Inclusive Capitalism for the American Workforce

Reaping the Rewards of Economic Growth through Broad-based Employee Ownership and Profit Sharing

Richard B. Freeman, Joseph R. Blasi, and Douglas L. Kruse March 2011

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Introduction and summary

The American model of capitalism needs major institutional reforms to regain its economic health and do what it has failed to do for the past three to four decades—ensure that the benefits of economic progress reach the bulk of our citizens. Well before the recent housing and financial crises, the Great Recession of 2007-2009, and the ensuing jobless recovery, the U.S. economy was not delivering the benefits of sustained economic growth to the vast bulk of workers.

From the mid-1970s through the 2000s the earnings of most American workers increased more slowly than the rate of productivity growth. Real median earnings barely rose even as gross domestic product per employed worker grew substantially.[1] This contrasts with the nearly equal rates of real earnings growth and productivity growth from the turn of the 20th century through the early 1970s, which created a large prosperous middle class.

The disconnect between economic growth and earnings growth over the past four decades results today in the United States having an extremely high level of economic disparity. In 2008 the level of income inequality was higher in our nation than in any other advanced industrial democracy in the Organisation for Economic Cooperation and Development. Among the 135 countries with measured levels of inequality, our nation ranks 41st highest in inequality, with greater inequality than in over half of low-income developing countries, including China, where a large part of the population remain poor peasant farmers.[2]

The recent housing and financial crises, the ensuing recession, and the current jobless economic recovery exacerbate these long-term trends. Indeed, despair about the direction of the economy is overwhelming earlier hopes that the recent economic turmoil was a temporary breakdown from which our country would rapidly recover. The reason why most Americans have a pessimistic view about our economic future is clear. High unemployment will likely last through the end of the decade, which will depress wage growth for most workers and together with unemployment add to economic disparity.[3]

Even if U.S. macroeconomic policies somehow restore employment and economic growth in the next few years to the rates that preceded the implosion of Wall Street, few Americans would find satisfactory another decade in which economic growth benefited only a small proportion of Americans. But it is hard to envisage the economy attaining a sustainable growth path if most workers continue to be excluded from the benefits of growth as they have been in recent years. Flat to falling wages in real terms means less money spent in our economy by the vast majority of our workers.

So what can be done to reverse the economic disparity in our nation and restore prosperity for all? This paper lays out a policy reform that will help restore the link between economic growth and the earnings of workers so that the recovery re-establishes a prosperous middle class. The reform encourages firms to develop broad-based incentive compensation systems that link employee earnings to the performance of the firm. This reform would give employees access to the capital-related earnings of their companies comparable to that of the senior executives who run these firms.

Some of the country's leading firms, such as Wegmans Food Markets, Inc., one of the nation's top grocery chains, and technology giants Cisco Systems Inc. and Google Inc., among others, boast incentive compensation systems that our policy seeks to encourage alongside a track record of successful business performance that benefits both workers and firms. For these and other firms that practice an inclusive form of capitalism, broad-based wealth creation and business success go hand in hand, but most firms limit pay for performance to a small number of high earners or have no access to meaningful incentive pay systems at all.

Our proposal is designed to encourage the senior executives and board members of firms that do not have inclusive incentive compensation systems to adopt such systems for the good of their employees, their companies, and the broader economy. To the extent that broad-based incentive compensation systems affect these firms as they do the firms that already use such systems, it is likely that productivity will rise as well, increasing output as well as spreading the rewards of growth to more workers.

In the pages that follow, we first lay out the deep-seated problem facing our nation—the stagnation of wages for most workers over the past 30 or so years despite increases in output per worker, and the substantial growth in capital-based earnings that went to a small group at the top of the earnings distribution. We then present our proposed reform. This is to allow firms to deduct incentive-based pay as a business cost only in incentive programs that are sufficiently broad-based to cover most workers. Currently, companies can deduct incentive compensation costs from their corporate taxes no matter how few employees benefit and no matter how large the compensation.

This reform builds on longstanding regulations governing pension and health care systems, which allow tax deductions for those forms of compensation beyond regular wages and salaries only if the plan covers most workers. Specifically, our plan would give favorable tax treatment to compensation systems that link incentive pay to company performance if all of the company's full-time employees participated in them and if the value expended on the top 5 percent of employees by salary was also expended on the bottom 80 percent of employees by salary.

By offering tax deductions to plans that cover all workers, this reform should induce firms to adopt such plans. By linking the earnings of all workers to company performance, our reform will help re-establish the historic relation in which the earnings of all workers increase with economic growth.

We next review the evidence on the economic performance of firms with broad-based incentive systems and on the performance of firms with incentive systems limited to few top earners. There are over one hundred studies that compare firms with and without broad-based incentive systems and/or compare firms before and after they introduce such systems. And there are a small number of field or laboratory experiments on broad-based incentive systems. These studies find that broad-based incentive compensation systems are generally associated with higher economic performance for firms and better labor market outcomes for workers. This evidence contrasts with growing evidence that incentive systems that allocate incentive pay to only a few workers do not work well for the firms or the economy.

Since our proposal calls for a change in tax policy, we examine the magnitude of tax deductions that currently go to equity compensation plans and profit-sharing plans under current U.S. tax law. The law does not allow firms to deduct as a cost of business salaries for executives beyond $1 million, but allows tax deductibility of incentive pay of any amount regardless of how many persons are covered by the plan. Recently-released data from the U.S. Internal Revenue Service show the deduction for stock options alone amounted to $86 billion from July 2007 to June 2008. The tax deduction effectively subsidizes the incentive pay of a few top executives and other high paid employees.

Finally, we consider how firms and workers might respond to our reform. We examine the impact of our proposal on a few Fortune 500 firms. Our analysis shows that firms with current broad-based systems will likely not be meaningfully affected by the change since they already practice the brand of inclusive capitalism that the policy seeks to encourage. Firms with narrowly-defined compensation systems will, however, have to re-evaluate their plans and either expand them to cover more workers or pay taxes on their narrowly based plans. Firms without any incentive pay plans will hopefully be spurred by the reform to examine the potential that such forms of broad-based compensation have for improving their economic performance and the well-being of their workers.

On the workers' side we examine ways in which firms can give workers incentive pay while keeping the risk manageable and consistent with diversification of employee assets. It is important that our reform does not place employee pay and wealth unduly at risk due to the vagaries of the performance of their firm, as has happened to many workers in their 401k retirement plans. This problem can be addressed by limiting the amount of company stock in a company or individual employee's 401k plan financed by that worker's savings to 10 percent.

The net outcome of our proposed reform should be that more firms will adopt broad-based incentive systems that will spread and deepen incentive pay systems to their workers, which should improve economic performance and help restore the relation between worker incomes and economic growth. Such inclusive capitalism would do wonders to restore faith in the American Dream.

The problem and the reform

The problem

Over the past three to four decades the U.S. economy grew while the real earnings of most workers did not. Where did the gains from economic growth go if not to regular workers? Analysis of the statistics on the distribution of labor earnings show that much of the gains in productivity growth went to those at the very top of the earnings pyramid.

Following the lead of University of California Berkeley economist Emanuel Saez and Thomas Picketty of the Paris School of Economics, many analysts highlight the fact that the growth of earnings and income have a fractal quality in which the bulk of economic growth primarily benefits those in the upper 10 percent of earnings, that the bulk of earnings growth in the upper 10 percent goes primarily to those in the upper one percent, and so on.[4]

Much of the growth of earnings at the top is not in the form of normal wages and salaries. It takes the form of incentive pay linked to capital income, or income derived from company stock options, and other incentive plans. The amounts and proportion of executive compensation in stock options and related incentive plans increased massively in the first decade of the 21st century.[5] The Treasury's Office of Tax Analysis estimates that profit from options exercised hit $126 billion in 2000, from less than $50 billion in 1997, and amounted to $78 billion even after the 2000 stock market crash. From 2001 to 2007, the most recent year that full data are available, estimates based on Standard & Poor's Execucomp show that profit from all stock options averaged about $58 billion per year.[6]

Is this form of compensation labor income or capital income? Standard statistical accounts treat it as labor income but it is a peculiar kind of labor income since it is derived from and varies with capital income.

The Internal Revenue Service treats all earnings for paid employees as labor income, including earnings from stock options or other capital-related pay. The National Income and Product Accounts, which the U.S. Bureau of Economic Analysis creates as a comprehensive measure of economic activity, also treat the capital-related part of earnings as labor earnings. But both the IRS and national income account statisticians recognize the fuzzy boundary between capital and labor income.

The IRS applies a "reasonableness" criterion to the earnings paid top earners in a closely-held corporation, and has rules for determining whether modes of pay that exceed $1 million in public corporations are deductible as a labor cost of business under tax law. National income statisticians apportion the income of the self-employed between labor and capital compensation in estimating labor's share of national income. Economic analysts, of course, recognize pay that depends on capital income differs in important ways from wages and salaries paid to regular employees.[7] The whole point of linking pay to capital income in the business world is to differentiate that form of pay from normal wages and salaries in order to provide incentives to improve the performance of companies.

But back to the data. With stock options and capital-related forms of pay counted as part of labor income, the share of national income going to labor has either fallen modestly or dropped fairly sharply depending on whether one uses the Bureau of Labor Statistics or Bureau of Economic Analysis estimates of labor's share. International agencies also show divergent estimates of the change in labor's share of income in the United States. The OECD estimates a huge drop in U.S. labor's share of national income, while the International Labor Organization estimates a modest decline comparable to the Bureau of Economic Analysis's estimates.

We do not attempt here to reconcile these divergent estimates of how labor's share, inclusive of earnings associated with capital income, changed over the past several decades. Instead, we estimate the magnitude of labor earnings due to capital income using Standard and Poor's Execucomp data files for the top five executives of public corporations with SEC filings and the value of one part of that pay, stock options, to the upper 5 percent of earners within those companies. The data show that pay based on capital income is large and rising over time. The value of compensation apart from basic salary paid to only the top five executives of public companies rose to $29.3 billion in 2006, the last year for which complete data are available, from $4.9 billion in 1992, or a total of $238.3 billion across the whole period.

This compensation pay packet for senior corporate executives includes bonuses, restricted stock grants, values realized on stock options exercised, cash and long-term incentives, and other payments that more closely correspond to capital income than to labor income. Counting only stock options exercised, which are concentrated among the top five percent of employees by pay, the value hit $65.1 billion in 2006, up from $10.8 billion in 1992, or a total of $806.7 billion across the whole period for the top five percent of employees. This figure would be larger if it included the value of all forms of performance-based pay for the top five percent of employees by pay, such as various cash incentive and equity plans like restricted stock plans which themselves are growing in importance.[8]

If we treat the capital-related income as capital income, then labor's share would fall in all of the different data series. Whether we assign this form of pay to labor's share (since it is taxed as such) or to capital's share (since it gives workers an ownership claim on the performance of the firm), the key fact for our purposes is that it is a rising part of income from which most workers have been excluded.

The reform

As noted in the introduction, our proposal seeks to return the economy to one in which worker earnings rise with productivity by encouraging the inclusion of more workers in these forms of capital-related pay. To accomplish this we propose that the country give favorable tax treatment solely to incentive compensation systems that provide incentives broadly to all workers while withholding favorable tax treatment from systems that provide incentives to small numbers of executives and other highly paid workers. Corporations that sought the favorable tax treatment would decide about how to design the broad-based equity and profit sharing plans based on their unique circumstances and business strategies.

Currently, the U.S. Tax Code does not allow the deduction of salaries beyond $1 million as a business expense, but it does allow firms to deduct as a cost of business any amount of money paid as incentive pay under Section 162(m) of the Internal Revenue Code. We would limit the deduction as an expense to broad-based incentive systems.

Broad-based incentive compensation systems are expanding in the United States as increasing numbers of firms recognize that broad-based profit sharing, employee stock ownership, and stock options motivate workers to perform better. In 2006, 48.6 percent of workers in the private sector had one of more of the following:

Cash profit sharing, in which worker pay is linked to overall company performance; **gain sharing,** in which pay is linked to work group or department performance; **employee stock ownership,** in which employees own company stock either directly or through a retirement plan; or **company stock options,** in which employees are able to profit from increased stock prices by buying stock at a set exercise price and selling it at the increased price.

Approximately 63 percent of workers in corporations organized as joint-stock companies have one or more of these inclusive capitalist practices. Taking all private-sector workers, 30 percent received profit sharing, 21 percent received gain sharing, 18 percent owned stock in the company where they work, and 11 percent had company stock options, while 7 percent received a grant of stock options in 2006.

These inclusive plans link the compensation of workers to company or work-group performance. They are usually associated with management practices that devolve some decisions to workers so that workers can respond to incentives to improve performance. Presidents of different ideologies from Ronald Reagan to Barack Obama have expressed broad support for a wider dissemination of these types of systems.[9]

In the box on page 9 we highlight two firms that use broad-based incentive systems for their workers, Wegmans Grocery chain and the high tech giant Cisco. Wegmans and Cisco differ in the composition of their workforces as well as in the industries in which they operate. Wegmans boasts a less-educated and lower-paid work force. Cisco hires many computer engineers and scientists, giving it a highly educated and high-paid work force. But both are among America's most successful and admired firms and both make use of broad-based incentive systems for their workers. That Wegmans does this with a less-skilled and lower-paid workforce gainsays the often-heard belief that incentive pay is not for ordinary workers.

While profit-sharing, employee stock ownership, and broad-based stock options became increasingly widespread over the past three decades, the vast majority of workers receive only modest amounts of income from them.[14] Over half of

A tale of two companies

Shared capitalism works at Wegmans and Cisco

Grocers at Wegmans and techies at Cisco profit from inclusive compensation systems and the higher profits these programs deliver. Wegmans Food Markets, Inc. is a family-owned, U.S. regional supermarket chain with about 37,000 employees in 75 stores in New York, Pennsylvania, New Jersey, Virginia, and Maryland. In 2009 Consumer Reports ranked it the nation's best large grocery chain. It was ranked 3rd on Fortune's "100 Best Companies to Work For" in 2010. Wegmans has profit-sharing for full-time employees and a host of benefits for part-timers as well as full-timers.[10] According to Fortune Magazine:

All that means Wegmans' labor costs run between 15 percent and 17 percent of sales, [industry guru Bill] Bishop estimates, compared with 12 percent for most supermarkets (the company declines to comment). But its annual turnover rate for full-time employees is just 6 percent, a fraction of the 19 percent figure for grocery chains with a similar number of stores, according to the Food Marketing Institute. Almost 6,000 Wegmans employees—about 20 percent—have ten or more years of service, and 806 have a quarter-century under their belts. The supermarket industry's annual turnover costs can exceed its entire profits by more than 40 percent, according to a study conducted by the Coca-Cola Retailing Research Council. When you understand that, you begin to see the truth in Robert Wegman's words: "I have never given away more than I got back."[11]

Cisco Systems, Inc, is one of the world's leading consumer electronics, networking, and communications technology and service firms, with over 65,000 employees. It is an archetype Silicon Valley high-tech multinational corporation, which at the height of the dot com boom had the highest market capitalization of any corporation in the world. It has been awarded "for the exemplary quality of their relationships with employees and communities," and appears regularly on the Fortune "100 Best Companies to Work For" list, ranking 16th in 2010. Its CEO, John Chambers, has spoken publicly about the importance of Cisco's broad-based incentive systems:

…On employee ownership…there's not been a single successful company in the history of high tech in the last two decades that has done that without broad-based stock option plans. When I originally heard about that in school, I would have called it socialism, when in fact it is the ultimate form of capitalism. It is a very effective way to align interests.[12] *I find it ironic that the United States invented the sharing of the success of the company with its employees very broadly, and now we have other countries around the world that beat us not only in education and infrastructure, but also in terms of employee ownership.*[13]

workers receive no incentive pay. By giving tax-favored treatment only to firms that award at least as much to the bottom 80 percent of their full-time workforce as they award to their top 5 percent, our plan seeks to increase the amounts of income made available to regular workers in incentive pay.

The widespread use of different forms of broad-based incentive pay tells us that many managers are familiar with such practices. They have in place the administrative machinery to extend them to more workers. Our proposal can thus be implemented by many businesses at minimum administrative cost. Moreover, most American workers are favorable to having a stake in the firm just as their bosses do.[15] So they are likely to react positively as well.

We chose the criterion of allowing tax deductions for plans in which all of the company's full-time employees participated and where the value expended on the top 5 percent of employees by salary was also expended on the bottom 80 percent of employees by salary in the plans for two reasons.[16] First, U.S. corporate and regulatory experience with similar types of rules governing pension and health care systems means these types of regulations are familiar to all. Second, because our analysis of compensation data for Fortune 500 firms shows that the bulk of the benefits of most narrow-based programs are concentrated in this top layer of earners rather than going almost exclusively to the top executives, whose earnings are reported in SEC filings. We examined publicly available information on equity and profit-sharing plans approved by corporate compensation committees and made available to shareholders in Securities and Exchange Commission filings for a random sample of the Fortune 100. Based on these data, most plans appear to apply to less than the top 5 percent of earners.

Our proposal would include the following typical forms of pay in the incentive compensation category:

- Cash incentive plans or bonuses are typically based on annual financial and operating results and often constitute a form of profit sharing or gain sharing although they may also be based partly on individual performance.

- Restricted stock plans denote stock that is granted to employees when certain conditions are met such as ongoing employment over a period of time and (or) various performance conditions. They typically have the value of the stock at the time of grant.

- Long-term incentive plans are based on various metrics whereby the employee is rewarded for improving performance over the long-term and not based solely on the share price while they are sometimes paid with a combination of cash and (or) equity instruments.

- Performance shares involve receiving a number of shares based on the achievement of performance targets over a performance period.

- Stock options give an employee the right but not the obligation to purchase a defined number of shares of stock at a given price (typically the exercise price) for a given period of time.

Whether the incentive compensation plan gives employees incentives according to salary or other criteria would be up to management.

To prevent corporations from circumventing the law by using alternative business forms, our proposed reform would also apply to comparable plans of limited liability companies and related entities. To avoid problems that have arisen under the Employee Retirement Income Securities Act, where some firms have used multiple retirement and health plans to hide the actual distribution of the benefits that received tax-favored status, the assessment would apply to all of the incentive plans taken as a group.[17]

We would expect that this policy proposal would apply to publicly-traded corporations and privately-held corporations of a certain size but would exclude small businesses and start-ups whose economic situation differs greatly from the larger firms.

But there is nothing holy about the particular criterion we have picked. There are undoubtedly alternative ways to define the division of incentives among workers that would meet the spirit of our proposal.

The tax consequences

The principle that a firm can deduct the cost of employee benefits for tax purposes only if it offers the benefits in a nondiscriminatory way to all workers has precedent in U.S. tax treatment of employee retirement and health plans. Congress first legislated requirements for nondiscrimination pension coverage of a firm's employees in 1942.[18] Ensuing Congresses and administrations maintained the policy that a tax-qualified pension plan must apportion the contributions or benefits in a nondiscriminatory manner between the top group of highly paid employees and key owner-employees and workers who are outside the top group.

A Treasury statement on pensions in August 2000 that remains germane today states the goal behind giving "tax-qualified status" to such plans:

> *"The aim of national policy in this area should be to insure an equitable distribution of pension benefits to all Americans in order to enhance their retirement security... To the extent that employers adopt new plans… it is important that moderate and lower wage workers participating in the plans receive and vest in a meaningful proportion of the benefits."*[19]

Replace the words "of pension benefits" with "of incentive-based pay" and the statement would apply to our proposal.

Treasury uses two types of rules to ensure that all employees receive an equitable share of the tax subsidized benefits. The first are nondiscrimination protections, which ensure that the plans are inclusive of the vast bulk of workers. The second are top-heavy rules, which ensure that the benefits and expenditures from the plans do not go disproportionately to a small minority of employees, subverting the intent of giving the tax-favored status. According to Treasury: "The top heavy and nondiscrimination protections benefit the American taxpayer and protect the integrity of the pension tax preference by seeking to insure that the tax preference benefits workers throughout the income spectrum."[20]

Our proposed policy extends the principles of nondiscrimination and top-heavy protection to incentive compensation systems for corporations to get associates tax deductions. Just as Congress sought to encourage private pensions and employer provision of health insurance by giving tax deductions to those expenditures that fulfill principles of fairness and equitable use of public tax resources, we want to encourage compensation systems that increase employees' share of capital incomes by giving tax deductions to those plans that benefit all employees rather than to plans limited to the highly paid few.

Like the rules in the Employee Retirement Incomes Securities Act that governs retirement plans and health insurance, our proposed reform would not require any firm to introduce any particular form of broad-based incentive pay or indeed any such pay at all. A firm could offer profit or equity sharing solely to top managers just as it can create pension and health plans only for them. But such narrow plans would not receive tax deductions.

A board of directors that set up a broad-based compensation plan that qualified for tax advantages would be free to determine the benefits under those plans and the criteria for awarding those benefits based on their judgments of how to align employee behavior with corporate performance. The sole requirement for gaining tax deduction status is that the compensation system covers all workers rather than be limited to those at the top of the firm's earnings structure.

Finally, nothing in our plan would affect the current tax policy that allows companies to deduct no more than $1 million in executive salary as a business expense from corporate income in non-performance based compensation under Section 162(m) of the Internal Revenue Code.

The principle that Congress or the IRS in its administration of the law can decide what counts as a business expense for the purposes of corporate taxation or can define prudent standards for reasonable limits on such expenses that underpins our proposal is long established in tax law. Section 162(a) of the Internal Revenue Code declares that "There shall be allowed as a deduction all the ordinary expenses paid or incurred … including … a *reasonable* [our italics] allowance for salaries and other compensation for personal services."

The IRS applies the reasonable standard solely to private corporations on the notion that they are the most likely to exploit the tax system by awarding large salaries to persons to avoid the corporate profits tax. The person or persons controlling the corporation would pay income tax rather than the firm paying the profits tax and the person paying the income tax when they obtained the profits, say through dividends. This uses the legal vehicle of a limited liability corporation in a way that contravenes the U.S. Tax Code.

Section 162(m), which guides the tax deductible status of incentive pay beyond $1 million, contains 23 pages of discussion of pay-for-performance systems that qualify for the favorable tax treatment. Employee benefits and taxation expert Anne Moran at the law firm Stepte & Johnson LLP reviewed how the IRS and the courts determine what an employer may and may not deduct for compensation over time. She dates the introduction of the reasonableness standard to the Revenue Act of 1918.[21]

At various times, Congress has enacted tax laws to limit excessive or unreasonable executive compensation.[22] In 2008 and 2009, for example, Congress enacted executive compensation restrictions for senior executives atop the financial institutions who tapped the Troubled Asset Relief Program set up by Congress as part of the Emergency Economic Stabilization Act of 2008.[23] In 2010, the Patient Protection and Affordable Care Act limited the deductibility of the first $500,000 paid in any form of compensation for employees in the health insurance industry. Congress presumably feared that the increased revenues to insurance firms due to the new health reform law would raise pay at the top of the firms as incentive pay even though the increased revenues were not due to any action of top management.

For employee ownership, the Employee Retirement Incomes Securities Act, or ERISA, sets limits and fairness guidelines for qualified retirement plans such as defined-benefit pension plans, and various defined-contribution plans such as employee stock ownership plans, deferred profit-sharing trusts, and stock bonus plans. Whether one agrees or disagrees with the particulars, Congress regularly uses special provisions in the U.S Tax Code to implement economic and social policy.

Thus, our proposed reform builds on Congress's historic use of the tax code to encourage taxpayers to accomplish desired activities. In our case, the economic and social policy is to reward firms that use broad-based incentive systems as a step toward restoring the historic relation between growth of productivity and growth of the real earnings of workers.

Assume that our proposed reform or some variant thereof accomplished this goal. Would it improve our economy? Would it improve our current incentive compensation system? Or would extending such incentive compensation to the bulk of American workers wreak economic havoc by reducing the income of the few current beneficiaries of such forms of pay, leading them to run a less efficient economy? To this we now turn.

The consequences of our reform

In this section of the paper we will consider first the evidence on how broad-based incentive pay works in the firms that have adopted it. Then we examine the evidence on how the concentration of incentive pay on small numbers of high earners affects their economic behavior and the contours of the U.S. economy. The way to judge our proposal is to compare how firms that operate broad-based systems actually perform compared to other firms, and how the system of tax-advantaged incentive pay for the highly paid, which it would reform, actually functions.

Broad-based incentive systems work

A large group of studies have analyzed the economic effects of broad-based incentive compensation systems in the United States and in other countries. There are analyses of samples of U.S. employee stock ownership plan companies, and of specific firms such as the British retailer John Lewis, an employee-owned partnership that has prospered through the UK's recession, or the Mondragon Corporation, a very large group of worker cooperatives in Spain engaged in manufacturing, finance, and retail industries that has been expanding in that country and worldwide ever since it was formed.

Some of these studies estimate production functions that link the sales or value added of firms to the extent to which firms offer incentive-based pay, conditional on labor and capital inputs. Other studies examine worker responses to such systems and worker preferences for an ownership stake in their firms as opposed to being paid solely by wages and salaries. And still other studies examine whether the benefits of broad-based compensation flow to workers as well as to the firm are a form of speed-up that unduly burdens workers and makes their pay excessively risky.[24]

In a backup document for this paper, we list over 100 studies of the relation between different forms of broad-based incentive compensation systems and measures of economic performance. Reviews of the academic literature on employee ownership conclude that "two thirds of 129 studies [including both performance and attitude studies] on employee ownership and its consequences found favorable effects relating to employee ownership, while one tenth found negative effects,"[25] and that "research on ESOPs and employee ownership is overwhelmingly positive and largely credible."[26]

Meta-analyses that combine estimated parameters from many studies report a strong positive association between inclusive capitalist modes of compensation and performance.[27] Many of the studies are based on cross-sectional comparisons of firms with and without broad-based incentives systems. The results of these studies are consistent with the idea that these systems affect performance but cross section analyses cannot truly determine the causal impact of the broad-based systems on the outcomes. But other studies are based on before-and-after comparisons that are more likely to identify causal patterns. Many are based on small samples. Some are based on huge samples. To our knowledge, there is only one laboratory experiment examining the relation between the ownership stake of workers and firm performance. It found higher productivity among subjects organized into employee-owned "firms."[28] All told, this is a growing area of research, with analysts working as we write to address weaknesses in data and to improve methodology.

The box on page 17 sketches three studies that exemplify the breadth of analysis. The first is a field study in which the firm randomly assigned profit sharing to establishments within a firm and found that the performance of those establishments improved relative to the control group. The second was a production function study commissioned by Britain's Treasury department that used confidential Treasury data to estimate the link between tax-advantaged programs of broad-based incentive pay and sales and value-added measures of productivity, based on both cross-sectional and before-and-after variation in the use of the programs. The third is the U.S. 2010 National Bureau of Economic Research analysis of 14 U.S. firms, which compared 41,000 worker reports on work activity and economic outcomes across workplaces with differing incentive programs and between workers with differential participation in them.

These studies and the many others in our back-up review show that analysts using different data and models find similar patterns in their statistical evaluations of broad-based incentive systems. The research documents that *on average* firms that have broad-based incentive compensation systems have better outcomes for both the firm and workers. It also shows variation across firms and workers in those benefits. Current evidence suggests that broad-based incentive systems work better when the firm gives workers autonomy at their job rather than closely moni-

A sampling of studies

The three studies used different methods and data of broad-based incentive systems to come to the same conclusion—inclusive capitalism works

A field experiment.[29] This study is based on 21 fast-food franchises owned by one firm, where researchers were allowed to randomly assign profit sharing to three franchises and nonfinancial incentives (social recognition and performance feedback) to six franchises, with the remaining 12 as controls. A pre/post comparison using monthly data found increased profitability and productivity, and decreased employee turnover, in the profit-sharing franchises relative to the control group. In addition, profit sharing had a more immediate positive effect on profitability and productivity as well as a greater long-lasting effect on employee turnover relative to the non financial incentives.

A production function study.[30] This study is based on sales and value-added data obtained by matching confidential UK data, with enough variation to allow for pre/post comparisons using firm-fixed effects in some of the regressions relating company plans to performance outcomes. The study found that "on average, across the whole sample, the effect of tax-advantaged share schemes is significant and increases productivity by 2.5 percent in the long run." The study finds different effects across sectors and among the plans studied depending on the measure of output, pointing to variation in the effects of these plans depending on their structure and the context in which they are implemented.

A study of workers.[31] This study is based on over 41,000 worker reports in 14 firms with some form of employee ownership, profit and gain sharing, and broad-based stock options. The study finds that worker co-monitoring helps overcome the incentives to free-ride because workers with a greater stake in performance monitor each other more closely and are more willing to intervene to reduce shirking behavior than workers with less stake. In addition, workers in these firms perform better the greater the depth of the incentive compensation system. The analysis shows that these systems increased employee attachment, lowered turnover, prompted employee suggestions for improvements, and worked best with other "high performance" labor practices and policies.

tors them, pays them at or above market, and offers good job security, training, and participation in decision-making.[32] With an increasingly educated work force and a technology which automates routine tasks and deploys workers in team-oriented work, many managers prefer such workplace arrangements.[33] Trying to understand more about how these and other factors interact to produce greater or less success with broad-based incentive systems is an active area of research.

In contrast to the large body of evidence on the relation between broad-based incentive systems and productivity, only a few studies examine the relation between broad-based incentive compensation systems and job security and employment growth. These studies tend to show better employment outcomes in firms that have broad-based incentive compensation systems but there is great need for additional work on employment effects—in particular, for how firms with broad-based incentive compensation systems fared in the Great Recession and the ensuing weak recovery compared to otherwise similar firms without such systems.

Workers with profit sharing, employee ownership, and/or stock options report greater job security in national and company-based surveys than do other workers. Consistent with these survey reports, two studies that tracked employment in firms with broad-based employee ownership plans relative to otherwise-similar firms in their industries found that the firms practicing inclusive capitalism had greater employment stability and firm survival. An additional study of U.S. cooperatives found that cooperatives adjusted pay rather than employment when demand changed, which should stabilize employment. But studies of the relation of profit sharing to employment stability yielded no clear generalization. In addition, three of four studies that compared the employment growth of employee-owned firms with that of other firms found faster growth in the employee-owned firms while the fourth found no relation.

In sum, the limited studies of employment effects indicate that employee ownership and profit sharing are linked to greater employment security and growth or in the worst case have little relation to those outcomes.[34]

Narrow incentive pay systems don't work

The current system of incentive pay in many firms allocates most incentive pay to a relatively small number of key persons in the firm or a small percentage of all employees. As long as the pay for performance plan meets the IRS's criterion, amounts paid in excess of $1 million as incentive pay are deductible as a cost of business. This narrow form of incentive compensation distributes a substantial portion of the gains of economic growth to the few persons at the top of the earnings pyramid.

Twenty-five years ago many experts on executive compensation believed that the compensation committees made up of members of the boards of publicly owned firms could set stock options and related incentives that would resolve the so-called "principal-agent" problem between shareholders and top management. The notion or hope was that the committees would engage in arms-length negotiations about pay that would align the interests of management with shareholders and lead to decisions that would grow the economy.[35]

The executive compensation scandals of the early 2000s, exemplified by the collapse of Enron Corp., raised doubts about this interpretation of setting incentive pay for top management. Even before the Enron scandal, however, something seemed amiss in the way boards set incentive contracts. Boards seldom indexed incentive contracts to the overall performance of the stock market or to that of competing firms. Stock options, for example, almost always reward executives for an increase in the value of the stock even if most or all of the increase could be attributable to an industry or market-wide effect. As a result, the stock market boom of the late 1990s that raised share prices of all firms, including those that performed less well than others, or general inflation, show up as increases in the tax deductible "performance-based compensation."

This practice of not indexing corporate pay for performance contrasts with efforts to develop pay-for-performance standards for school teachers, where the performance targets invariably take account of the likely growth of performance as a student ages. The corporate governance reforms that took place after Enron did not significantly change the executive compensation system. The Sarbanes–Oxley Act that Congress enacted in 2002 developed specific mandates and requirements for financial reporting and made senior executives take individual responsibility for the accuracy and completeness of corporate financial reports. It also changed a minor part of the tax code governing tax deductibility of nonqualified deferred compensation for executives.[36]

Today, compensation experts are more skeptical that boards of directors appointed by executives and compensation consultants hired by firms can solve the principal-agent problem. Harvard Law School professors Lucian Bebchuk and Jesse Fried argue that most public corporations are governed in ways that do not produce arms-length negotiations over pay. The result, they find, is that some compensation policies are more indicative of rent-seeking than pay for performance.[37]

To our knowledge, there is no evidence that performance contracts for the few improve the future performance of firms, which is their presumptive rationale. In fact, a growing number of studies of executive compensation find that the incentives lead insiders to game the incentive system. One of the ways in which management game the system is through backdating stock options—that is by issuing options on a later date than the date to which the options are listed. This is advantageous to management when the share price has risen between the date the option was actually given and the date on which it was purportedly given.

Finance professors Randall Heron at Indiana University and Erick Lie at the University of Iowa estimate that between 1996 and 2005 18.9 percent of options that were unscheduled and "at-the-money"—meaning they were priced at a strike price which equaled the market price of the underlying security—were manipulated in some such fashion, and that 29.2 percent of firms manipulated options to top executives at some point in the same period.[38] Backdating options has aroused considerable ire, including in Congress, where Sen. Charles Grassley (R-IA) pressed officials to take action on the grounds that "it is behavior that … is disgusting and repulsive."[39]

Backdating is not, however, per se illegal. The law allows a firm's compensation committee to run a stock option granting program as it sees fit as long as it discloses what it is doing to investors, does not seek tax-advantaged treatment for payments that would not meet the IRS's interpretation of incentive pay in section 162(m), and properly reports the backdated option in its financial statements.[40] Failure to disclose the facts about backdating options rather than the backdating process itself was the crux of the mid to late 2000s backdating scandal that led federal prosecutors and investors to go to court against companies and executives that seemed to exploit backdating for personal gain and possible misuse of the tax treatment of incentive pay.[41]

Other modes of gaming incentive compensation systems, such as spring-loading options—the practice of awarding stock options right before a positive announcement expected to boost share prices—also may or may not be legal, depending on the circumstance. To an outside observer, they seem similar to the illegal insider trading that the Security and Exchange Commission is supposed to monitor, but in 2006 then SEC commissioner Paul Atkins raised the hackles of many analysts by declaring that such manipulation of the incentive system was not only legal but also good for the firm. His argument was that since the executives made more money from the inside information the firm would be need fewer options to retain their services.[42]

Erroneous financial statements and other improper reporting are of course not legal. Yet evidence produced by the Government Accounting Office and the Securities and Exchange Commission shows that such behavior is surprisingly frequent.[43] Researchers who have examined financial restatements in the GAO data generally find that erroneous statements are related to the incentive compensation contracts paid company executives, who presumably benefit from the misstatements. [44]

Eight of ten studies of the SEC data find that improper reporting is more frequent when CEOS and presumably other top executives have incentive compensation contracts that would allow them to benefit. But accounting professor Chris Armstrong at the University of Pennsylvania and business professors Alan D. Jagolinzer and David F. Larcker of Stanford University, have challenged this finding with a propensity score analysis that matches CEOs in a better way than the earlier work. They find firms where CEOs have relatively higher levels of equity incentives have, if anything, fewer accounting irregularities than others.[45] Their finding does not deny that improper reporting is common nor that it may be economically motivated but rather questions the ability of economists to explain it with measured incentives to the CEO.

Finally, business management professors Gerard Sanders of Brigham Young University and Donald Hambrick of Penn State University find that firms whose CEO compensation packages were loaded with options had greater variation in performance than other firms.[46] If the gains to the winners exceed the losses to the losers, this would raise total output and would likely be in the interest of the broader economy, though not to risk-averse shareholders. But Sanders and Hambrick found that riskier behavior produced more big losses than big gains. The upshot: The executive options led them to take risky actions that could result in big payoffs for the executives, but the risky actions more often hurt the firms and economy.

The view that the narrow incentive compensation system based on rewarding only a few executives does not work is now more widespread. In December 2009, Jeff Immelt, the chairman and chief executive of General Electric Co. stated it best when he said: "We are at the end of a difficult generation of business leadership … tough-mindedness, a good trait, was replaced by meanness and greed, both terrible traits. Rewards became perverted. The richest people made the most mistakes with the least accountability."[47]

Harvard Business School professors Rakesh Kurana and Andy Zelleke reflect the new skeptical thinking about the ability to set up incentive compensation systems that resolve the principal-agent problem that is their presumed intent. They argue that most management-operated corporations in the 1990s and 2000s set up executive compensation plans "for the purpose of creating vast wealth for senior executives," rather than for developing their firms and the economy.[48] Indeed, in June and July 2009 the Harvard Business Review ran a blog in which compensation experts debated "how to fix executive pay," which presumed that the system of pay setting was not working right.[49]

What impresses us is the difference between the evidence that broad-based incentive systems work to strengthen the link between pay and performance in ways that improve the operation of the economy and the evidence that the current narrow-based incentive system either does not work or works perversely.

The implications of reform

Taxes

Limiting tax deductions of incentive pay only to systems that are broad-based might seem to be a minor technical tweak of a particular part of the tax code. It is much more than that. This policy reform would eliminate a part of the code through which taxpayers subsidize the pay of top executives and others who receive income for narrowly focused equity and profit/gain sharing plans such as nonqualified stock options, certain restricted stock plans, performance shares, bonuses, annual cash incentives, long-term incentives, and other performance-based plans that appear to have failed to give the right signals to decision-makers as opposed to broad-based incentive plans that are more likely to do so.

There is limited evidence on the magnitude of tax deductions for nonqualified plans overall that suggests that the deductions are huge. In 2010 the Senate Permanent Committee on Investigations released Internal Revenue Service estimates based on corporate year-end tax returns between July 1, 2007 and June 30, 2008 that showed corporations deducted a total of $86 billion in stock option deductions alone.[50] The committee noted that the deductions were $52 billion more than the stock option expense item shown on the books of the same corporations.

The propriety of these deductions angered Sens. Carl Levin (D-MI) and John McCain (R-AZ) such that they proposed a bill to end "excessive corporate deductions for stock options."[51] The committee's data relate solely to stock options so that the deductions for all nonqualified plans have to be much larger.[52] Our analysis of Standard and Poor's Execucomp database given earlier also indicates that the corporate deductions for narrowly-based incentive plans—those covering the top 5 percent of employees—are likely to be huge, since most of the relevant forms of incentive pay is in compensation plans that cover top earners only.

In short, taxes not collected as a result of substantial corporate tax deductions related to plans labeled as "performance-based" under the current reading of Internal Revenue Code Section 162(m) constitute a significant use of federal tax resources. Since these plans are not "qualified" plans under ERISA, they are not subject to the rules of nondiscrimination and fairness in using taxpayer resources in this way. The rising importance of capital-related labor earnings and its contribution to inequality, and the evidence that some beneficiaries game the system rather than improve the performance of the economy indicates that this is a poor way to expend federal tax money.

Company responses

We consider the possible responses of firms to the proposed reform according to their current use of incentive-based compensation systems. Let's consider first those firms that have inclusive capitalist incentive compensation plans for the bulk of their employees.

Some of these firms would likely find that their current incentive compensation plans are sufficiently broad-based to fit the new requirement for tax deductions or that their current plans could be tweaked modestly to fit the new rules. Based on publicly available SEC filings, for example, we believe that many of Google's equity sharing plans would likely comply under this policy as would those of Cisco noted above. These broad-based incentive plans would likely largely maintain their current corporate tax deductions under the new law without changing substantively their modes of pay. Based on publicly available information broadly discussed in the media, among the Fortune 100 alone, for example, Microsoft (36), UPS (43), Apple (50), Cisco (58), Intel (62), and Publix Supermarkets (99) have received media meaningful attention for having inclusive broad-based incentive plans.

But some firms would likely find their current incentive compensation systems to be "top-heavy" with too much capital-related income going to a few high earners in the firm to qualify for tax-favored treatment. Since our reform would make maintaining the status quo more costly, firms in this second category would have an incentive to change their incentive plan. Their management and boards would have to decide whether it would be better to redesign their plans and include the bulk of employees to achieve tax-qualified status or to maintain their current top-heavy balance and pay the taxes associated with their current plan.

It is possible that some firms might choose to discard their current broad-based incentive compensation plans and to focus all incentives on executives just as some firms have dropped pension or health insurance plans for all employees under ERISA while maintaining plans for executives or other highly paid workers. Yet the senior management at these companies presumably instituted broad-based plans for workers as part of a profit-maximizing competitive strategy, so closing down such a plan would seem to be unlikely. It is hard to imagine, for example, that companies in the Fortune "100 Best Companies to Work For in America" that have broad-based profit/gain sharing, employee stock ownership or stock option plan would close their plans.[53] Still it is a possible response and merits attention.

Consider next a third category of firms—those that currently have incentive systems for a small number of executives and highly paid workers but do not extend these plans to other workers according to public data. Our analysis of the best available information on a sample of Fortune 100 firms from the SEC public data says that this is probably true for Bank of America, Hewlett Packard, IBM, Costco, Target, Medco Health Solutions, Best Buy and Fed Ex as a few illustrative examples, although our analysis of SEC filings from 1997-2010 suggest that Bank of America has at least one equity plan that appears to extend to more than 5 percent of its employees. The information in SEC filings regarding performance-related incentive plans varies by company so that some of these firms may in fact have broader-based systems than we could discern from the public record.[54] The choice of firms with narrowly-based plans would be between introducing a broad-based or broader-based plan to obtain tax benefits or to maintain the current plan, though possibly at lower levels, and to pay corporate taxes on this expenditure. Since the tax cost of the nonqualified incentive system to the corporation would rise unless the firm expanded coverage to many more employees, some of these firms would expand coverage and meet the goal of increasing access to capital incomes to more workers.

But other firms in this group might decide that the costs from expanding coverage would fall short of the benefits and would be willing to pay their top layer of employees incentive pay even at the additional cost. This would direct additional shareholder attention at the efficacy of the performance systems. At the minimum, the government would no longer be subsidizing the benefits to a small number of highly paid workers.

Finally there are the firms that have no incentive systems at all. To the extent that some of these firms eschew pay for performance and financial participation through lack of knowledge, we would expect the new law to direct their attention at the potential benefits from such compensation systems. They can only add to the number of workers covered by such systems.

It is difficult, of course, to predict how many firms fit into the different categories described above and the proportion within each category that would respond in the anticipated ways. To get some notion of the incentives facing the firms to which they would presumably respond, we assessed the impact of our proposed policy on several large Fortune 500 companies that currently have broad-based equity or profit sharing programs and are viewed as models that other firms imitate. As noted, many of these firms would likely meet the criterion for tax-qualified status and thus have no reason to change their plans.

By contrast, data from the SEC filings of one of the largest Fortune 100 firms that has a narrowly defined incentive compensation plan places it into the category of firms that would have to make a big change in policy to quality for tax favored treatment. Including all employees in this plan would force this firm to re-evaluate its incentive pay system. If the company were to spend the same amount as it currently does, then it would have to figure out a way to include a broader group of employees in its plans or make the stock awards for managers considerably smaller and include many other employees. Or it could pay taxes on its narrowly based incentive plan.

Given that firms with broad-based incentive compensation plans at present are likely to fit under the nondiscrimination/top heavy rules that we propose, we expect that our policy will increase the extent of inclusive capitalist compensation just as Congress's limitation of tax deductions for pension and health insurance plans spurred firms to develop those plans for all workers. Because many corporations in a variety of industries function successfully with broad-based plans that link labor earnings to capital income, we would expect to see those firms becoming the models for corporations that have not used those plans. Compensation consultants would presumably benchmark clients' performance against corporations that have successfully used broad-based plans.

There is one final problem with how our plan is likely to work. Some firms might try to game our proposed reform much as they have gamed the current system. They would institute broad-based profit-sharing plans to qualify for the tax status but in fact just redefine the current fixed wages of their employees as "profit sharing" so that they would comply without actually running a pay-for-performance scheme for all workers. Whenever a tax system offers lower rates on one form of payment than another, people will seek to rearrange their finances to gain the tax incentives. As noted, some firms have sought to meet ERISA requirements for qualified pension and health plans by using multiple plans to hide the actual distribution of the benefits. But this has not been a common response.

The IRS has experience in assessing the "reasonableness" of management salaries in privately owned firms and could presumably readily build up similar experience in determining bogus pay for performance schemes. If this turned out to be a major problem, we would recommend a strong penalty for such fraud.

Worker responses and risk

Our analysis of worker behavior in *Shared Capitalism at Work* and the analyses of other studies show that workers respond positively to incentives associated with access to capital income.[55] As noted, most American workers say that they would prefer being worker-owners or participants in profit sharing to working simply for wage and salary pay. But it could be that workers are incorrectly assessing their own best interests.

The theory of diversification suggests that workers should diversify their capital assets rather than rely on ownership stakes or profit sharing from the performance of their employer. Analysts of retirement income find that many workers invest large proportions of their 401k defined-contribution pension savings in a company stock account. The stock market crashes of 2000 and 2008 devastated the savings of workers who invested too much in their own company stock in 401k plans.

There are more and less risky forms of employee stock ownership. Buying company stock with worker savings in a 401k plan from wages is more risky than getting a grant of company stock through an employee stock ownership plan, which is typically based on company contributions or loans to buy stock that is distributed to workers with tax incentives and not financed by worker savings. In ESOPs, workers do not typically pay for their shares with their savings or wage concessions.

Similarly, if workers receive a matching contribution in company stock in a 401k plan to encourage them to make contributions to their 401k plan as long as the contribution itself is diversified, then the company stock match is less risky. Restricted stock and stock options not funded with worker savings also have lower risk. When incentive pay comes on top of regular pay and benefits, rather than substituting for it, and is paid as part of the improved productivity that it creates, there is no problem of risk aversion.

In fact, this appears to be the case among workers at companies with inclusive capitalist incentive performance plans. Workers generally receive such pay on top of their regular pay and benefits, along the lines of efficiency wage or gift exchange theories of wages.[56] The magnitudes of typical performance gains are consistent with the typical profit and gain sharing bonuses.

Portfolio theory recommends diversification of assets to decrease risk, but this does not rule out company performance-based income for workers. We asked Harry Markowitz, who invented portfolio theory, to consider if stock in one's company could be part of an efficient diversified portfolio. The Markowitz chapter in our NBER volume makes it clear that it can.[57] Portfolio theory does not propose that everyone own a completely diversified basket of securitized assets worldwide, in which case there would be no home ownership, sole proprietorships, "principals" in corporations, or workers with shares in their company. The analysis by Markowitz indicates that with standard risk aversion parameters, workers can prudently hold on to about 10 percent of their own assets in employee stock ownership of their firm with only a modest loss in utility due to risk.

This suggests a potential corollary to our proposal would be to prohibit 401k plans from holding more than 10 percent of their assets in company stock funded by worker savings and to prohibit individual worker accounts from having more than 10 percent of their assets in company stock funded by worker savings. Company matches in stock not attributable to purchases from worker savings would be excluded from the 10 percent rule.

Finally, harking back to the discussion of job security and employment effects of incentive pay, to the extent that the variability in incentive pay substitutes for variability in employment associated with fixed wages and salaries, some workers will find that linking their pay to company performance will provide greater job security in recessions, which reduces the risk of job loss albeit at the cost of riskier earnings.[58]

Conclusion

Our nation needs to repair our economic system in ways that make the benefits of economic progress accessible to many more Americans. In an era when earnings based on access to capital income is a major source of pay for a few highly paid employees and not others, the use of federal tax deductions should not favor narrow incentive compensation capital income plans. Increasing the link between the pay of more regular employees and the performance of their firm through broad-based incentive compensation systems would expand the access of workers to capital income and help restore the relation between the growth of worker incomes and economic growth of the firm.

Our proposal would also reduce within-firm inequality in compensation differences between executives and the rest of the work force. Our analysis of how existing broad-based incentive compensation systems work demonstrates that the expansion of these systems would likely have positive effects on productivity that analysts have not found for existing narrow-based forms of incentive pay.

Extending ownership, profit, and gain-sharing incentives to more workers will not improve the earnings of all workers. Workers in firms that are doing badly will not see their earnings rise because of the performance of the firm. They will have to do what American workers in declining industries and firms have always done to improve their economic lot: move to new sectors or employers. But our proposal will lead to greater access to capital income for the middle class.

This proposed reform will spur greater efforts by firms to bring the benefits of ownership and decision-making responsibility to a larger proportion of the society. It will go a long way toward repairing the current system of tax deductions for incentive pay that supports firms that concentrate capital income programs at the top of the company. Bringing the benefits of incentive pay and capital ownership in the form of labor earnings related to capital incomes will strengthen American capitalism at a time when it desperately needs strengthening.

Endnotes

1 This represents the inflation-adjusted earnings for the worker in the middle of the earnings distribution.

2 The CIA Factbook, which gives Gini coefficients for inequality for 135 countries around the world in 2008, records the United States as having the 41st highest of level inequality. See column listed as CIA Gini in, "List of countries by income inequality," available at http://en.wikipedia.org/wiki/List_of_countries_by_income_equality. According to the OECD, the United States has the 27th highest Gini coefficient of the 30 OECD countries, surpassed only by Portugal, Mexico, and Turkey. See OECD, "Growing Inequality: Income Distribution and Poverty in OECD Countries" (2008), Figure 1.1, available at http://www.oecd.org/document/53/0,3343,en_2649_33933_41460917_1_1_1_37419,00.html.

3 Indicative of the pattern in the recession, the Bureau of Labor Statistics, Weekly and hourly earnings data from the Current Population Survey shows an increase in the ratio of earnings for full time workers at the ninth decile to earnings at the first decile from 4.87 in 3rd quarter 2007 to 5.03 in 3rd quarter 2010.

4 Emanuel Saez and Thomas Pickety, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics* 118 (1) (2003): 1-39.

5 Scott Jaquette, Matthew Knittel, and Karl Russo, "Recent Trends in Stock Options." Working Paper 89 (U.S. Department of the Treasury, Office of Tax Analysis, 2003), p. 14 and Table 1, p, 28, bottom of table entitled "Pro-Rated Population Statistics, Total Spread Income, 1997-2001.

6 The calculations of profits on stock option exercises (which are referred to as "Total Spread Income" in the Office of Tax Analysis working paper in footnote v) are based on Standard and Poor's Execucomp, using the method of Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation." Working paper 8866 (NBER, 2002). This method uses Execucomp's data on stock option profits to the top five in order to establish an estimate of all stock option profits in Execucomp corporations. The apparent decrease in stock options is partly explained by a concomitant large increase in another component of executive compensation, namely, restricted stock grants, which these numbers do not include.

7 Alan Krueger, "Measuring Labor's Share." Working paper 7006 (NBER, 1999), available at http://www.nber.org/tmp/34282-w7006.pdf. Comparing the income of an owner of a professional sports team to that of his player, Krueger notes that if the owner pays the player more and reduces his own salary by the same amount, labor's share would be unchanged. A more realistic example would be when executives reduce the pay of an entire workforce and increase their own pay by the same amount, labor's share would be unchanged.

8 The calculations of stock option exercises are based on Standard and Poor's Execucomp, using the method of Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation."

9 President Ronald Reagan, Speech Presented at the White House, August 3, 1987. " Thomas Jefferson dreamed of a land of small farmers, of shop owners and merchants. Abraham Lincoln signed into law the 'Homestead Act' that ensured that the great western prairies of America would be the realm of independent, property-owning citizens—a mightier guarantee of freedom is difficult to imagine…. I can't help but believe that in the future we will see in the United States and throughout the western world an increasing trend toward the next logical step, employee ownership. It is a path that befits a free people." President Barack Obama, comment on Employee Ownership on September 28, 2010, where he stated the he would "absolutely be interested in taking a look at it (legislation on ESOPs) … as "aligning the interests of workers with the interests of the company as a whole … theoretically at least it's something that can help grow companies, because the workers feel like they're working for themselves, and they're putting more of themselves into their job each and every day. I think that it's something that can be encouraged," reported in *Employee Ownership Report*, vol xxx, (6) (Nov-Dec 2010)..

10 See "Wegmans Food Markets Inc.," available at http://www.answers.com/topic/wegmans-food-markets-inc; "Wegmans and Its Employees" (2008), available at http://www.slideshare.net/ganeshramb/wegmans-and-its-employees.

11 Matthew Boyle, "The Wegman's Way," *Fortune Magazine*, January 24, 2005, available at http://money.cnn.com/magazines/fortune/fortune_archive/2005/01/24/8234048/index.htm.

12 "Cisco Sysems/On the record: John Chambers," SFGate.com, February 29, 2004, available at http://articles.sfgate.com/2004-02-29/business/17412116_1_silicon-valley-cisco-systems-role-models.

13 Matt Hamblen, "Cisco's CEO Reflects on the Company at 20," Computerworld, December 20, 2004, available athttp://www.computerworld.com.au/article/5525/cisco_ceo_reflects_company_20/.

14 Douglas Kruse, Richard Freeman, and Joseph Blasi, eds., *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options* (Chicago: University of Chicago Press, 2010), p. 41-76.

15 Douglas Kruse, Richard Freeman, and Joseph Blasi, eds., *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-based Stock Options* (Chicago: University of Chicago Press, 2010), p. 65.

16 Employees on probation, part-time employees, and employees who have not reached certain reasonable minimum tenure requirements, as would represented employees who chose not to participate, could be excluded. The policy would not apply to purely individual incentive plans, such as sales commissions.

17 Many firms with shared capitalist forms of compensation have multiple incentive plans to encourage workers along different margins. Thus, the nondiscrimination and top-heavy protections would have to cover not only each plan separately but the entire group as a whole. Ideally, companies would have a single plan for stock options, a single plan for profit sharing, and so forth and would specify how each plan works separately and how they work as a group in ways that shareholders, employees, and the government could easily and transparently understand the full structure of compensation and who benefits.

18 Government Accountability Office, "Private Pensions: Top-Heavy Rules for Owner-Dominated Plans" (2000), cites the Revenue Act of 1942, p. 77-753, 162.

19 Government Accountability Office, "Private Pensions," p 6.

20 U.S. Treasury as quoted in Government Accountability Office, "Private Pensions," p. 43.

21 See Anne E. Moran, "Reasonable Compensation, 390-4th Tax Mgmt. Portfolio" (Washington: Bureau of National Affairs, 2009).

22 These include the 1984 Golden Parachute provisions that deny tax deductions to employers and impose an additional tax on employees receiving "excess" golden parachute payment efforts, the 1993 denial of tax deductions of executive pay beyond $1 million, and the 2004 tax change regarding nonqualified deferred compensation arrangements.

23 Jeff Martin, Henry Atkins, and J. Henry Oehmann III, "The road ahead: executive compensation provisions for TARP recipients under the American Recovery and Reinvestment Act of 2009" (Washington: Grant Thornton, 2009).

24 Indicative of the relation between broad-based incentive pay systems and worker well-being, the latest list of Fortune's 100 best employers shows that 4 of the top 10 were firms with extensive broad-based incentive programs. (See, "100 Best Companies to Work For," CNN Money, available at http://money.cnn.com/magazines/fortune/bestcompanies/2010/.) The National Center for Employee Ownership analysis of the firms on the 100 best employers' list over time shows that this is a general pattern.

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26 Steven F. Freeman, "Effects of ESOP Adoption and Employee Ownership: Thirty years of Research and Experience." Working Paper 07-01 (Organizational Dynamics Programs, University of Pennsylvania, 2007).

27 C. Doucouliagos, "Worker participation and productivity in labor-managed and participatory capitalist firms: a meta-analysis" *Industrial and Labor Relations Review* 49(1) (1995): 58-77; Douglas Kruse and Joseph Blasi, "Employee Ownership, Employee Attitudes, and Firm Performance: A Review of the Evidence," in David Lewin, Daniel J.B. Mitchell, and Mahmood A. Zaidi, eds., *Human Resources Management Handbook, Part 1* (Greenwich: JAI Press, 1997); Martin L. Weitzman, Martin L and Douglas Kruse, "Profit Sharing and Productivity," in Alan Blinder, ed., *Paying For Productivity: A Look at the Evidence* (Washington: Brookings Institution, 1990).

28 N. Frohlich, J. Godard, J. A. Oppenheimer, and F. A. Starke, "Employee versus conventionally- owned and controlled firms: An experimental analysis," *Managerial and Decision Economics* 19 (4/ 5) (1998): 311-26.

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30 Oxera, "Tax-advantaged employee share schemes: Analysis of productivity effects, Reports 1 and 2" (2007).

31 Kruse, Freeman, and Blasi, eds., *Shared Capitalism at Work*,

32 Kruse, Freeman, and Blasi, eds., *Shared Capitalism at Work*, p. 276

33 For examples, see Industry Week's Best Plants Profile at Peter Alpern, "Batesville Casket Co.: IW Best Plants Profile 2009" Industry Week, December 16, 2009, available at http://www.industryweek.com/articles/batesville_casket_co-_iw_best_plants_profile_2009_20624.aspx?Page=1.

34 Margaret Blair, Douglas Kruse, and Joseph Blasi, "Is Employee Ownership an Unstable Form? Or a Stabilizing Force?" in Thomas Kochan and Margaret Blair, eds., *Corporations and Human Capital* (Washington: The Brookings Institution); Craig Ben, and John Pencavel, "The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest," *American Economic Review*, 82 (1992 and 1993): 1083-1105; "The Objectives of Worker Cooperatives," *Journal of Comparative Economics* 17 (2) (June), p. 288-308; Douglas Kruse, "Profit Sharing and the Demand for Low-Skill Workers," in Richard Freeman and Peter Gottschalk, eds., *Generating Jobs: Increasing the Demand for Low-Skill Workers.* (New York: Russell Sage Foundation, 1998), p. 105-153; Douglas Kruse, Richard Freeman, and Joseph Blasi, "Do Workers Gain by Sharing? Employee Outcomes Under Employee Ownership, Profit Sharing, and Broad-based Stock Options," in Kruse, Freeman, and Blasi, eds., *Shared Capitalism at Work: Employee Ownership, Profit Sharing, Gainsharing, and Broad-based Stock Options* (Chicago: University of Chicago Press); John Logue and Jacquelyn Yates, "The Real World of Employee Ownership" (Ithaca: Cornell University Press); Rhokeun Park, Douglas Kruse, and James Sesil, "Does Employee Ownership Enhance Firm Survival?" in Virginie Perotin and Andrew Robinson, eds., *Advances in the Economic Analysis of Participatory and Self-managed Firms*, Vol. 8 (Greenwich: JAI Press, 2004); John Pencavel, *Worker Participation: Lessons from the Worker Co-ops of the Pacific Northwest* (New York: Russell Sage Foundation, 2002); Michael Quarrey and Corey Rosen, "Employee Ownership and Corporate Performance" (Oakland: National Center for Employee Ownership, 1993); Gorm Winther and Richard Marens, "Participatory Democracy May Go A Long Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States," *Economic and Industrial Democracy* 18 (3) (1997): 393-422.

35 Jensen and Murphy famously claimed that executives were not being paid for their contribution to corporate wealth. Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top Management Incentives," *Journal of Political Economy* (1990): 225-265. Incentive-based pay would cure this problem and give them the incentives to make the right decisions.

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37 Lucien Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge: Harvard University Press, 2004).

38 Randall Heron and Erick Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?" *Management Science* 55 (4) (2009): 513-525. They also report that the two-day filing requirement that took effect on August 29, 2002 cut the fraction of grants that were manipulated in half, which implies that regulatory changes have the potential for altering at least this form of manipulation.

39 U.S. Senate Committee on Finance, "Grassley takes aim at stock options backdating, executive compensation tax loophole," Press release, September 6, 2006, available at http://finance.senate.gov/newsroom/chairman/release/?id=fa3baac7-174f-4e3e-b16d-2ed-a0b6cec87.

40 A website that makes this point strongly http://www.backdatingisnotacrime.com/. Some analysts argue that backdating actually is in the interest of shareholders since it allows them to pay executives less than they would with genuine options by removing the risk premium associated with genuine options.

41 In November 11, 2010 the New York Times ran an article by Peter Lattman, whose title tells the story. Peter Lattman, "Backdating Scandal Ends With a Whimper," *The New York Times,* November 11, 2010, available at http://dealbook.nytimes.com/2010/11/11/backdating-scandal-ends-with-a-whimper/?src=busln.

42 See "Can Granting Stock Options Be Considered Insider Trading," White Collar Crime Prof Blog, July 10, 2006, available at http://lawprofessors.typepad.com/whitecollarcrime_blog/2006/07/can_granting_st.html. The comment of Damon Silvers, general counsel of the AFL-CIO, captured the response of many business and financial market experts: "It's also true that if you let your employees steal from the cash register, you don't have to pay them that much." "Making Insider Trading Legal," The Big Picture, July 12, 2006, available at http://bigpicture.typepad.com/comments/2006/07/making_insider_.html.

43 Two data sets provide the relevant information. The Government Accountability Office has reported on financial statement restatements beginning with "Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges" (2002), which most academic analyses have used. In 2007 the GAO issued "FINANCIAL RESTATEMENTS: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities," (2007), available at http://www.gao.gov/new.items/d06678.pdf, with the database downloadable from http://www.gao.gov/special.pubs/gao-06-1079sp/osm.html. The Securities and Exchange Commission issues quarterly reports of Accounting and Auditing Enforcement Releases, which can be downloaded from: http://www.sec.gov/divisions/enforce/friactions.shtml.

44 This is a large literature. See D. Bergstresser and T. Philippon, "CEO incentives and earnings management: Evidence from the 1990s," *Journal of Financial Economics* 80 (2006): 511-529. See also, N. Burns and S. Kedia, "The impact of performance-based compensation on misreporting," *Journal of Financial Economics* 79 (2006): 35-67, and the references they give.

45 Christopher Armstrong, Alan D. Jagolinzer, and David Larcker, "Chief Executive Officer Equity Incentives and Accounting Irregularities" *Journal of Accounting Research* (2010).

46 Wm. Gerard Sanders & Donald C. Hambrick, "Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance" (Academy of Management, 2007).

47 See Francesco Guerrera, "GE Chief Attacks Executive 'Greed'," *The Financial Times*, December 9, 2009, available at: http://www.ft.com/cms/s/0/fe1e3f7c-e507-11de-9a25-00144feab49a.html?nclick_check=1.

48 Rakesh Khurana and Andy Zelleke, "You Can Cap The Pay, But The Greed Will Go On," The Washington Post, February 8, 2009, available at http://www.washingtonpost.com/wp-dyn/content/article/2009/02/06/AR2009020602794.html.

49 "How to Fix Executive Pay," Harvard Business Reivew Blog, available at http://blogs.hbr.org/hbr/how-to-fix-executive-pay/.

50 The stock option-related tax deduction is substantive relative to all corporate tax deductions and thus to federal corporate tax receipts. The IRS's 2007 Statistics of Income: Corporate Income Tax Returns, showed that the corporate income subject to tax in tax year 2007 was $1.25 trillion on which was paid $331.4 Billion in corporate taxes.

51 The Senate data was released on June 16, 2010 and is available at: "Senate Investigations Subcommittee Releases New Data on Excessive Corporate Stock Option Deductions Totaling $52 Billion," Press release, June 16, 2010, available at http://levin.senate.gov/newsroom/release.cfm?id=325708. Sens. Levin and McCain have introduced S. 1491, the Ending Excessive Corporate Deductions for Stock Options Act.

52 Neither the Internal Revenue Service's Statistics of Income Division nor the Congress's Joint Committee on Taxation break out the corporate tax deductions for these nonqualified plans in their various reports. The Internal Revenue Service's "2007 Statistics of Income: Corporate Income Tax Returns" (2007), available at http://www.irs.gov/pub/irs-soi/07coccr.pdf, shows that while 5.868 million corporations file returns (p. 39 under number of returns in line 1), a full 3.87 million, presumably small businesses, have assets under a half a million dollars. We initially examine data on about 1.9 million corporations that file tax returns relevant to this subject on p. 39-40 where the corporations are broken down by the size of total assets. It is clear that the largest corporations clearly account for much of the associated "tax deduction." Under total deductions, there is a line item for Compensation of Officers for $479.2 billion for all filing corporations in 2007 in Table 2, Returns of Active Corporations (p. 39). We note that the total tax deductions for "Compensation of Officers" amounts to $101.42 billion for the 29,355 corporations with assets above $50 million. The total deductions for "Compensation of Officers" amounts to $77.99 billion for the 12,192 corporations with assets above $250 million. This about one-third of 1 percent of all corporations with assets above half a million dollars actually accounts for a large share of this associated tax deduction.

53 The National Center for Employee Ownership conducts research annually on the percentage of Fortune Magazine's 100 Best Companies to Work For in America and regularly finds that 30-60 percent of those companies have various broad-based equity and profit sharing plans. In 2007, 56 percent of the companies that had stock on the list had broad-based equity plans. See National Center for Employee Ownership, "Employee Ownership Update" (2007). See also, February 1, 2006 where again more than half of the companies had broad-based employee ownership.

54 The variability in the information that corporations give in their SEC filings in the proxies and in proposed shareholder resolutions where the board requests approval for performance-related incentive plans, makes it hard to identify the exact number of employees participating in the plan and receiving benefits in any year.

55 Kruse, Freeman, and Blasi, eds., *Shared Capitalism at Work*.

56 Kruse, Freeman, and Blasi, eds., *Shared Capitalism at Work*.

57 See Harry M. Markowitz, Joseph R. Blasi, and Douglas L. Kruse, "Employee Stock Ownership and Diversification," Annals of Operations Research, 176 (1) (2010): 95-107. See also, Joseph Blasi, Harry Markowitz, and Douglas Kruse, "Risk and Lack of Diversification under Employee Ownership and Shared Capitalism," in *Shared Capitalism at Work* Douglas Kruse, Richard Freeman, and Joseph Blasi eds., (Chicago: University of Chicago Press, 2010). The paper also appeared as a NBER Working Paper.

58 This was part of the theme of Martin Weitzman, *The Share Economy* (Cambridge: Harvard University Press, 1984.

About the authors

Richard Freeman holds the Herbert Ascherman Chair in Economics at Harvard University and is a research associate at the National Bureau of Economic Research in Cambridge, Massachusetts .

Joseph Blasi is the J. Robert Beyster Professor in the School of Management and Labor Relations at Rutgers University, and a research associate at the National Bureau of Economic Research in Cambridge, Massachusetts.

Douglas Kruse is a professor in the School of Management and Labor Relations at Rutgers University, and a research associate at the National Bureau of Economic Research in Cambridge, Massachusetts.

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