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How We Tax Employee-Ownership is One Thing our Screwed Up Tax Code Actually Gets Right

Ike Brannon

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Our tax code is screwed up in a thousand ways and there's scarcely a cohort in America that isn't hurt by this mess.

For instance, we will sacrifice nearly $1 trillion in the next decade to encourage wealthy people to buy bigger homes, while at the same time subjecting millions of middle class households to effective marginal tax rates of over fifty percent, a higher rate than almost everyone who is a denizen of the demonized top one percent.

The corporate tax code is even more convoluted, replete with one of the highest rates in the world as well as a plethora of deductions, exemptions, credits and the like that dramatically reduce revenue collected without necessarily providing any salutary economic activity in return.

The current tax code isn't especially friendly to saving: we double-tax the returns to any savings done outside of tax-preferred accounts, and the little revenue this practice yields comes at the expense of higher growth.

However, there's one area the tax code actually gets pretty much right: the taxation of S corporations and, in particular, S corporation employee stock ownership plans.

While the tax code imposes double taxation on most corporations, taxing both profits of the firm and the proceeds paid to shareholders as dividends, S corporation profits are taxed only once, at the same rate as the other taxable income each shareholder earns.

This is a much more efficient than how we tax large corporations, which produces a lot of squawking for very few feathers, in the words of Jean Baptiste Colbert. Worse, it disincentives saving and investment.

Twenty years ago, a Republican-led Congress—working arm-in-arm with the Clinton administration—pioneered an effort to further incentivize savings by allowing Employee Stock Ownership Programs (ESOPs) to own S corporation stock.

ESOPs are retirement plans that vest employees with ownership shares in their companies at no cost to the employee. To put it simply, every year an employee-owner in an ESOP receives company stock. As the company grows, the value of the stock also increases, allowing employee-owners – at all levels of the company – to share in the appreciation. The value of the employee-owners' shares in an ESOP are taxed at individual income tax rates when the employee-owner withdraws funds upon retirement, the same as a 401(k) plan.

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However, this model did more than incentivize savings: aligning the incentives of workers and managers boosted growth and increased resilience during downturns.

That was precisely the intent. In fact, the Clinton White House's 1994 Economic Report of the President expressed concern with mediocre productivity growth, which at the time had been below its long-term average for two decades. The Report noted that anything that leads to increased worker participation—which ownership stakes most certainly encourage—tends to boost productivity.

Research supports that notion: Studies by economists Ben Craig and John Pencavel found that firms in which workers have an ownership stake of some sort are more productive.

There is also evidence that such firms are more likely to respond to economic downturns by reducing wages rather than employment, which helps to dampen business cycle fluctuations. In 2008, when U.S. employment declined by 2.8 percent, S corporation ESOP employment actually grew by nearly two percent.

While it would be a stretch to attribute much of the fifteen-year jump in productivity growth of the late 1990s and 2000s to the expansion of S corporations ESOPs, the two have occurred almost in lockstep. From 2002 through 2012, S ESOPs grew 11.5 percent per annum, on average, and their total balances now exceed $50 billion. What’s more, this growth is made all the more impressive by the concentration of S corporation ESOPs in industries like manufacturing and construction, which have tended to be more vulnerable to economic volatility.

S Corporation ESOPs have removed tax disincentives to saving and boosted the common ownership of tens of thousands of businesses across the country, a salutary creation of employee capitalism that boosts productivity and worker engagement. A bill currently before Congress entitled the Promotion and Expansion of Private Employee Ownership Act would encourage more S corporations to transition to the ESOP model, ameliorating some of the wrongs of our tax code.

It is also worth noting a key push of the Senate Finance Committee and its chair, Senator Orrin Hatch, in the last year has been the pursuit of a corporate tax code that would resemble the way we tax S corporations.

Substantive tax reform would be a welcome thing, but we should take care to not disturb the one place where we actually seem to have already gotten tax policy right.

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