SUMMER 2005 VOL.46 NO.4

MITSloan
Management Review

Intelligence

Is Employee Ownership Counterproductive?

A brief synopsis of *When Labor Has a Voice in Corporate Governance* (National Bureau of Economic Research working paper, April 2005) by Olubunmi Faleye, Vikas Mehrotra and Randall Morck

Please note that gray areas reflect artwork that has been intentionally removed. The substantive content of the article appears as originally published.

REPRINT NUMBER 46402

GOVERNANCE

Is Employee Ownership Counterproductive?

A new report reveals that companies with significant levels of employee control systematically underperform.

Turning workers into shareholders improves corporate performance, or so advocates of employee ownership maintain. Their logic is simple: Workers with a stake in their company's future are more likely to take a long-term view, which translates into higher productivity and other gains.

But new research from the National Bureau of Economic Research casts doubt on those claims. In their April 2005 working paper, "When Labor Has a Voice in Corporate Governance," Olubunmi Faleye, an assistant professor of finance and insurance at Northeastern University, and Vikas Mehrotra and Randall Morck, both members of the finance faculty at the University of Alberta, report that companies with significant levels of employee control systematically underperform — in large part because workers can hold management hostage to their short-term concerns.

These findings are of more than academic interest in the United States, given current levels of employee ownership. According to data collected by the National Opinion Research Center in 2002, some 23 million Americans, or 23.3% of employees at for-profit companies, own company stock through employee-stock-ownership programs, stock-purchase plans, 401(k) plans and other programs. Together, ESOPs, stock-bonus plans and profit-sharing plans invested primarily in employer stock hold more than $500 billion in assets, according to the National Center for Employee Ownership, while employer-focused 401(k) plans account for another $160 billion or more. (These figures do not include participation in stock-option or stock-purchase plans that invest in other companies.)

How do such holdings affect corporate performance? To answer this question, the researchers analyzed a broad range of financial measures for over 2,100 companies from 1995 to 2001. At 226 of these companies (the "labor voice" companies), employees owned and voted at least 5% of outstanding shares since 1990 or earlier; the remaining 1,888 companies reported labor stakes of less than 5% or none at all. (Excluded from the sample were 22 companies in which employees owned at least 5% but where management voted employees' shares.)

The differences between the subsamples turned out to be sizable, even when controlling for potentially confounding factors such as corporate governance, the availability of investment opportunities, current profitability, current debt, past financial circumstances, and industry. For example, Tobin's q — a common measure of shareholder wealth creation — is 23 percentage points lower at companies where workers vote at least 5% of the shares. At companies where labor's stake is at least 10%, the performance penalty is even larger — 39 percentage points. To put these figures in perspective, the mean level of Tobin's q across the entire sample is close to 140%. (The study measures Tobin's q as the market value of common equity plus the book value of preferred equity and long-term debt divided by the book value of assets less short-term debt.)

The researchers also dug deeper into the data to identify several mechanisms that help account for the performance gap between labor-voice and nonlabor-voice companies. Productivity, for example, suffers when employees have a significant say in how companies are run. Sales per employee fall as labor control rises, and so too does total-factor productivity growth — indicating that when it comes to transforming capital and labor into output, labor-voice companies are increasingly falling behind.

Moreover, companies with significant levels of employee ownership typically have less long-term investment, lower risk and consequently lower growth. Capital spending is 2.6 percentage points lower at labor-voice companies — a significant difference given that mean capital spending across the sample is roughly 12% of net property, plant and equipment. Spending on research and development as a share of net property, plant and equipment is also lower by 20 percentage points once companies with no R&D investments are excluded from the sample. And labor-voice companies have lower operating risk, as measured by the standard deviation of their return on assets over a four-year window.

The impact of these strategic choices is substantial: Real sales growth is lower by 3 to 5 percentage points at labor-voice companies, depending on whether the threshold for inclusion in the labor-voice category is set at 5%, 10% or 15% employee control. Similarly, employment growth is lower by 3 to 4.5 percentage points at such companies.

The problem, the authors explain, stems from the incentives of employee shareholders. Their interest in the company's future is typically dwarfed by day-to-day concerns, such as ensuring that their jobs remain secure and their wages are paid. Consequently, they tend to favor low-risk strategies that generate stable cash flows over riskier projects that could generate greater profitability and growth. In addition, workers may shy away from productivity-enhancing investments in equipment or innovation with the potential to make their jobs obsolete.

Since ownership is highly dispersed at most companies, employee shareholders can impose these preferences on management, even if their holdings fall short of majority control. With 10.6% of outstanding shares, labor was the largest voting block at the median labor-voice company. The median level of managerial ownership for such companies was 6.83%, and the median nonaffiliated block-equity holding was 6%.

So, is employee ownership altogether a bad idea? No, says study co-author Randall Morck. Instead, he argues, these results suggest that "employee ownership needs to be done in a different way." The traditional approach — giving workers ordinary shares — has two effects. "If the workers' financial state is tied to the share price, there's the incentive effect that people have traditionally talked about," he explains. "But if they have voting control, there's a second effect that distorts corporate decisions to benefit workers at the expense of other shareholders."

The solution, Morck believes, lies in separating the two effects. By giving workers nonvoting shares or shares that are held in a trust — or by designing other programs that allow them to participate in share-price gains — companies may be able to reap the benefits of employee ownership without paying the costs.

The paper is available online at www.nber.org/papers/w11254. For more information, contact the authors at o.faleye@neu.edu, vmehrotr@ualberta.ca or randall.morck@ualberta.ca.

— Mary Kwak

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