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BROADENING CAPITAL OWNERSHIP:

An Initiative for Private Sector Production and Politics

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PREFACE

In a July 1974 speech, future-President Reagan recalled Abraham Lincoln's signing of the Homestead Act in 1862, and declared that now "we need an Industrial Homestead Act". At that time, he said, "business leaders have come to the realization that it is time to formulate a plan to accelerate economic growth and production and at the same time broaden the ownership of productive capital. The American dream has always been to have a piece of the action." The "realization" to which he was referring was given its most definitive legislative expression later in that year by the Employee Retirement Income Security Act. This Act established the distinctive characteristics of Employee Stock Ownership Plans (ESOPs) that most clearly differentiate them from other legally recognized plans for creating stock ownership in employees.* The President has ample company on both sides of the aisle in Congress in his support for ESOPs. This is evidenced by the 1981 Economic Recovery Tax Act that greatly increased incentives to corporations that adopted them.** This aspect of the realization of the American dream has grown from 150 firms with ESOPs in 1975 to perhaps 5,000 today.

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*These differences are detailed in the third section of this report.

**For a concise delineation of these changes, see Ronald L. Ludwig and John E. Curtis, Jr., "ESOPs Made Substantially More Attractive as a Result of Economic Recovery Tax Act," The Journal of Taxation (October 1981), pp. 208-211.

It is the sense of this report that we can greatly benefit by sharing our dream, and promoting its realization with the rest of the world. This viewpoint is in part, but only in part, based upon the dictum of Aristotle, Tocqueville and others that large middle classes must be created and sustained in order for societies to be stable. Means of broadening capital ownership are not only readily available, but have been acted upon on an enormous scale--most dramatically through the investment of union pension funds. But what is missing in the organization of such broadened ownership is the direct link between individual effort and individual reward that is essential to individual investment and the growth of wealth in society. This link will never be totally destroyed in any society (the entrepreneurial spirit exists in the heart of Moscow), but we should do all that is possible for its enhancement. Otherwise, broadening ownership may simply yield shrinking pieces of a diminishing pie.

ESOPs are joined by worker cooperatives and direct employee ownership of firms in their encouragement of the direct link between employee-owner effort and the product of that enterprise. This report concentrates on ESOPs because they are confined to corporations, and because U.S.-based multinational corporations that adopt ESOPs can be provided the kinds of tax incentives that are accorded to domestic corporations. Thus, there is a real potential for U.S. corporations to involve their employees in other countries (in which the governments have enacted the requisite legislation) in the <u>process</u> of private enterprise. We obviously do not promote economic freedom just by sending our products (those who condemn our process most severely are among the most voracious consumers of its products); we promote that freedom, and real peace, by sharing our process. Without such sharing, we place economic freedom and all of its benefits (including the sustenance of politics) in jeopardy.

It is contended in the first two sections of this report that both economic freedom and politics are jeopardized by the government-to-government transfer payments of traditional foreign assistance, and that they are exponentially endangered to the extent that foreign assistance is concentrated in large capital-intensive projects and/or has its dispensation determined by multilateral donor agencies. It is further contended that the organizational imperatives of both donor agencies and recipient LDC governments are such as to "naturally" produce the traditional structuring of foreign assistance--regardless of what they might prefer. Thus, for example, AID's New Directions in assistance and the current private sector initiative evince a desire for policy alternatives that might avoid the problems entailed by traditional foreign assistance, but Congressional recognition of its responsibility for the organizational environment that is the womb of these problems is sadly lacking.

The first two sections of this report, then, urge serious consideration of an ESOP-externalization program by detailing the negative consequences of traditional foreign assistance that such a program directly combats. Fortunately, it is also a program to which the Congress is likely to be receptive, as indicated by its support for the furtherance of domestic ESOPs.

Following the assessment of need for such a program, the third section explores the extent to which its desirability in the abstract is supported by the experience of ESOP-firms in the United States. Though there are several problems with the empirical data that is available with respect to this country's ESOP experience, recommendations are offered with respect to the information that is required for answering some essential questions, and how it might be accessed. It should be pointed out that though the existing data can hardly be considered adequate for rendering a highly confident judgement regarding the utility of ESOPs (and for what firms, with what characteristics, they are most and least beneficial), the handful of empirical studies that have been conducted are generally positive in this regard. The conclusions that are derivable from these investigations suggest that the operation of the plan (for example, the percentage of corporate stock that is owned by employees) in a firm may be significant to the performance of the company regardless of the characteristics of the firm.

The conclusions derived in the third section, albeit tentative, influence several recommendations that are offered in the final section with respect to modifications in the ESOP-enabling legislation of LDC governments and with regard to the structuring of assistance options by the United States government.

We have no reason to expect that the analyses of data on U.S. ESOPs that is needed will contradict the positive results of the preliminary evidence. It is hoped that the requisite data acquisition and analyses will proceed as rapidly as possible, for substantiation of these positive results would be fully supportive of a unique foreign assistance program that simultaneously encourages capital growth and the decentralization of that growth among a country's working population. In recommending no more to others than we have already adopted for ourselves, and by incorporating more people in the process of private enterprise and development, perhaps we might enhance that process for ourselves. As is evident in the two sections that follow, we think that the continuing absence of such programs and of the political decisions necessary for their promotion poses a continuing threat to both the private enterprise and the politics that afford individuals on this planet with their greatest opportunities for attaining that to which they aspire.

I. PROBLEMS ENTAILED BY TRADITIONAL FOREIGN ASSISTANCE PROGRAMS

A. SURPLUS DEBT AND THE ERA OF RESCHEDULING

Since 1955, the external debt of the developing countries has increased from $10 billion to roughly $800 billion. Assuming no further interest charges, it would take AID, as currently funded, about 160 years to retire this debt. This is a period in which some countries are viewed as practicing the "art of optimal bankruptcy", and can manipulate lenders because for the latter, "on margin, continuing the game seems attractive: the cost of new loans always appears lower than the losses that would occur if the borrowers defaulted, for the point of no return has already been passed."* In 1955, the point of no return was reached. In that year, Argentina's external debts were renegotiated. Once that occurred, debt rescheduling commenced in earnest, and continues to be the daily special; particularly when rescheduling enables a borrower to obtain a larger volume of new loans. Aliber expects these loans to eventually convert to *de facto* grants.** But then, credit-worthiness restored, the whole process will be repeated.*** The World Bank, which can be fairly characterized as having shown the way in this trip up the down staircase, does not offer any reason for expectations that are contrary to Aliber's:

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*Robert Z. Aliber, The International Money Game, New York: Basic Books, Second and Expanded Edition, 1976, p. 277.

***Ibid*., p. 278.

****Ibid*., p. 266.

> The best way for the international community to assist countries with large debt and poor export prospects remains unresolved, but increasingly emphasis falls on the need for debt relief as part of a viable package of foreign financing to support an economic program.*

This situation could not have occurred in the absence of traditional foreign aid programs, and at the same time it is symptomatic of the process by which the surplus of debt continues to grow. It might never have come about if the Marshall Plan had not been so successful. Today we recognize that there is a fundamental difference between re-construction and its consequents, and what can be reasonably expected of first-time construction efforts. The human capital necessary for development was already there to make sense of a European Recovery Program. No one should have expected the results of subsequent aid programs to mirror the results of the Marshall Plan. Perhaps no one did, but the ensuing programs of a wide variety of donors seemed to be dependent on such expectations.

Acting as if the human capital was already there, foreign aid programs followed the formula of success that had been applied in Europe. Large-scale transfer payments from donors to recipients have been the order of the day in foreign assistance policy. Where there have been deviations from the European success formula, they have been integral to the debt surplus that exists today.

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*World Development Report 1981. New York: Oxford University Press, for the World Bank, 1981, p. 59.

Instead of the outright grants of Marshall Plan aid (amounting, incidentally, to about 2 percent of the external debt of the LDCs today), loans are now the instrument for dispensing foreign aid that have the greater impact on both the development and solvency of recipients (and eventually donors). Increasing reliance on loans was intended to make development a consequent of a more business-like investment process, rather than a product of gifts in the form of grants (as we have seen, however, once rescheduling of loans has begun, the distinction between loans and grants becomes blurred at best).* Of course, the policy of transferring resources now, and deferring their costs until later has become endemic in the United States. If deficit spending and debt ceilings (ever-rising, of course) are indicators of development, then we are truly sharing our abundance with the world.

B. DEBT CREATION AND RESOURCE CONCENTRATION AS FUNCTIONS OF ORGANIZATIONAL IMPERATIVES

Like most domestic policy, foreign aid programs have adhered to the conventional wisdom of channeling assistance

*Compounding this problem is that of deficit spending on the part of donor governments. To the extent that the United States government, for example, is engaged in deficit spending in order to offer grants, then the distinction between grants and loans remains blurred for the lender. Instead of a recipient government borrowing from the U.S. taxpayers, as in the case of an AID loan, a grant to the government, in conjunction with a U.S. government dificit, simply means that the U.S. government is the borrower. The lender remains the same. Someone must eventually pay for the debt by some means. Of course, the situation being considered requires the lender to repay itself with ironic interest; ironic because there is no benefit to the lender from the interest, but there is all the cost of financing the governmental debt.

through centralized governments. Unlike domestic programs, however, a necessary consequent of this flow of foreign aid is to further concentrate the ownership of resources in recipient LDCs. A corollary of this increasing concentration is that it discourages ever-increasing proportions of recipient populations from participating in the process of development (even where they might not be excluded from enjoying some of its benefits, as in increased personal consumption).

The concentration of wealth in LDCs and their rapidly growing external debts are not coincidental. Both are encouraged by the conventional government-to-government transfer payments of foreign aid, and neither they, nor traditional development assistance, can be fully understood without taking into account the organizational imperatives that are operative for recipient governments, as well as those impinging on donor agencies.

1. The Organizational Imperatives of Donor Agencies*

There is at least a two-fold impetus for any donor agency to move the funds that are available for developmental purposes at the fastest possible rate. First, the capital requirements of developing countries are very real and urgent. Second, donor agencies that fail to move their available funds in such a manner run the risk of either being criticized for not being sufficiently responsive to LDC needs, or contributing to a

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This subsection is based primarily on Judith Tendler's Inside Foreign Aid, Baltimore: Johns Hopkins University Press, 1975, misconception of declining LDC needs. In either case, the failure to expend all of this year's appropriations almost inevitably results in a decrease in what will be available next year. There is an inherent bias, therefore, toward large projects and comprehensive programs because smaller and/or more decentralized projects require less capital per project and greater investments of time for a collection of such projects.

Larger projects and programs tend to favor capital-intensive over labor-intensive technologies, and this, in turn, results in the importation of most of the technology employed in development assistance projects. Capital-intensive projects also facilitate the movement of funds, as well as project monitoring and control by the donor agency.**

Each of the preceding biases both supports and is reinforced by the policy of financing primarily the import costs of aid projects.*** Because of this requirement, even LDCs having sufficient technology for supplying given projects are

*Of course, as Tendler notes, this is a common characteristic of organizations whose environments incorporate annual government appropriations, and is therefore hardly unique to development assistance entities. Ibid., p. 88.

**Thus, for example, the IBRD justifies its handling of a highway maintenance problem with equipment loans, rather than with labor-intensive alternatives: "This emphasis on equipment financing, meant relatively quick disbursement of loan funds and limited project supervision problems." IBRD, Transportation, Sector Working Paper, January 1972. In Tendler, Ibid., p. 105.

***Section 604 of the Foreign Assistance Act of 1961, as amended. 22 U.S.C. 2354.

encouraged to maximize the amount of foreign exchange spent (or imported technology that is donor financed) on their development projects. One of the reasons for this requirement, of course, is to avoid balance-of-payment difficulties for the donors. But clearly the very same difficulties for recipients has been stimulated by a policy that encourages borrowers to maximize the amount of foreign exchange to be spent on projects. Given the surplus debt that exists in this era of rescheduling, we must but wonder at the wisdom of the policy as we increasingly encounter visions of saving our posteriors while losing our heads.

Regardless of our evaluation of the aid product, all of these biases of donor agencies are certainly reasonable responses to the exigencies of their environments. Influencing all of them is any organization's need to reduce the uncertainty of its operative environment. The need for a less uncertain environment is reflected in the donor-creation of aid projects. Whatever the quality of recipient-inspired projects might be, their quantity may fluctuate over time in a manner that is incompatible with the yearly appropriations cycle. Thus, organizational uncertainty as to product supply is reduced by creating its own projects. At the same time, organizational uncertainty regarding the marketability of its product is best reduced by offering a product that is easily monitored. Smaller, more decentralized, more labor-intensive development projects simply do not meet this requirement. It is, however, compatible with the fact that the organizational environment necessary for <u>any</u> project-production is predominantly predisposed to large, capital-intensive, centralized projects.

Thus are the characteristics of development projects comprising the bulk of traditional foreign assistance. They not only can be seen as necessary in order to fulfill the organizational imperatives of donor agencies, they also can be understood as those that are most responsive to the organizational imperatives of most LDC governments.

2. The Organizational Imperatives of LDC Governments

It will be recognized that though "Foreign aid augments the resources of recipient governments compared to those of the private sector, thereby promoting concentration of power in the recipient countries."*, this phenomenon requires neither morally bankrupt LDC governments nor outside imperialists for its explanation.

Having already addressed the organizational imperatives of donors, those of the recipients are now assessed in order to appreciate the concentration of resources in the LDCs as a phenomenon that would be surprising only in its absence.

First, LDC governments, like all others, must provide rewards for those who support them, and though the amounts of aid that they receive may appear small by some standards, they

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*P.T. Bauer, <u>Dissent on Development</u>, Cambridge, Massachusetts: Harvard University Press, 1976, Revised Edition, pp. 106-107.

can account for a sizeable proportion of their government revenues or foreign exchange earnings. Second, an LDC government, again like all others, will naturally tend to reward no more of its citizenry (and those in no greater amounts) than it believes is necessary for maintaining itself.*

It is because of this, and the usual political ineffectiveness of the poor in LDCs, that Bauer is correct in asserting that the policies of most governments in the LDCs are not designed to relieve poverty. However, this does not establish that LDC governments would not like to eradicate poverty in their countries rather, it is symptomatic of situations in which the overriding concern is continuance of their governance and with it the capacity for discharging any policies whatsoever. A statement like:

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*This was first given formal expression as the "size principle" upon which "minimum winning coalitions" are expected to emerge in "social situations similar to n-person. zero-sum games with side-payments", by William H. Riker, The Theory of Political Coalitions, New Haven: Yale University Press, 1962, pp. 32-33.

Each successful revolution and coup d'etat provides, among other things, an additional example of a disenfranchised government that either mistakenly believed that it was rewarding a sufficient number for a "minimum winning coalition" or simply knew that it would fail due to insufficient resources (the latter, more frequently than the former, can be found in Paris or other points of escape).

A most significant difference between a revolution and a coup d'etat is to be found in their aftermaths. The former always requires that a broader constituency (a greater proportion of a country's population) must be rewarded by the new government. The latter frequently involves no more than changes at the margin; recalculations of who among the elite must be rewarded how much. "New government" might be a less accurate description of the change engendered by many coup d'etats than would "new occupants of governmental positions".

> The poor, particularly the rural poor who are the great majority are politically ineffective and thus of little interest to the rulers.*,

is too easily translated into

> The poor are of little interest to the rulers.

The statement is also unrealistic and therefore unfair to LDC governments, by way of omission; what it fails to say is more significant than what it does say.

That the policies of most LDC governments are not primarily designed to alleviate poverty should be expected even where their leadership have considerable concern for the poor. Any LDC government not only must be estimating who among its citizenry it will be required to reward in order to maintain itself, it must also be calculating how much to reward those individuals and what is to be the proportionate distribution of rewards among them. A decision to expand the proportion of its population that is to be rewarded always increases the risk of not sufficiently rewarding those who could do the government the most damage, including its replacement. Thus, the natural tendency to greater concentration in the distribution of rewards. These rewards include the foreign aid resources coming to the LDC government in a form that is highly concentrated--partially due to the organizational imperatives of the donor, and partially due to its own.

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*P.T. Bauer, Equality, the Third World, and Economic Delusion, Cambridge, Massachusetts: Harvard University Press, 1981, p. 111.

C. QUALITATIVE RESULTS OF THE DUAL IMPERATIVES

On the basis of the foregoing, it seems safe to say that both donor agencies and recipient governments have not only discovered a rock and a hard place, but can provide intimate descriptions of the space in-between. It also seems safe to say that none of them want to occupy that space, or, at the least, they would prefer other organizational imperatives than those presented by their extant environments.

Thus far, development assistance and the imperatives influencing it have been assessed in essentially quantitative terms (debt, minimum winning coalition, size of projects, concentration of benefits, etc.). The qualitative derivatives of these quantitative results demand our consideration. These have more to do with process than product. An evaluation of the qualitative process results of development assistance is expected to be necessary to the subsequent task of addressing the possibilities for either successfully changing or circumventing the existing imperatives of donors and recipients.

1. Stimuli to Rational Irresponsibility

Finance ministers for governments of LDC aid recipients must especially feel the paradoxes inherent in development assistance. Foreign exchange is desirable, but increasing the country's external debt is not. Can an irresponsible act ever be the most rational? In some situations, it appears that it can:

The very logic of development lending is to encourage economic rationality in decision making and to discourage "irresponsibility" and its syndrome of extravagant capital projects. But development assistance incentives make the extravagant project the most rational choice for a developing country to make. The incentives cause the smaller project to be left out, even though it may have a better chance of being absorbed by the economy.

If a country is arranging its public sector budget in order to maximize the amount of foreign-exchange-using projects and the amount of foreign exchange spent on any particular project, then it is not giving adequate emphasis to the task of channeling as much investment demand as is feasible into the local economy. One of the major development benefits of public sector investment program--the generation of demand for local production--is thus forfeited.*

This stimulus to rational irresponsibility is then compounded by IMF economists and others advising more austere measures for the LDC that is strung out on surplus debt. More austere measures mean that the LDC government is to reduce its public spending and/or more effectively tax its citizenry and/or devalue its currency.** In other words, by putting less into the local economy than they could, development assistance projects increase the likelihood that the local economy will subsequently have to pay for the loss by losing even more resources that would have otherwise been at its disposal.

In such an environment, everyone who might be responsible cannot afford to be, and they therefore attribute responsibility to others. Thus, in a recent 3½-hour speech, Lopez Portillo

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*Tendler, op. cit., p. 75.

**Needless to say, any economy that is in really dire straits (operationally defined by an inability to pay its outstanding external debts) is provided additional low-cost loans to get it past any existing crisis.

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addresses many things other than his responsibility, his predecessors' responsibility, or the Mexican government's responsibility, as he announced that the banks will be closed until the following Monday. It is not that he is totally wrong; it is just that he is not right. It is too late in the game to leave things out; anyone who does so might be believed, and that just perpetuates a game that never should have begun.

But the nature of the situation dictates that it is rational to deny responsibility (or to see it resting with someone, or everyone, else). It is also such that rational, even professionally "responsible" recommendations (such as those of IMF economists), have irresponsible effects. This is because the situation is irresponsible; once rules are not applied, this result is inevitable. Once it is determined that a government's obligations to pay debts are to be honored by going further into debt, obligations cannot be responsible and neither can those who are "honoring" them nor those who are allowing them to be so "honored". The era of debt rescheduling is one of rule deferral, rather than application, and, for rational individuals, its incentives foster and exacerbate irresponsibility.

The most critical change in the evolution of foreign assistance policies is to be found in the conceptions of donor and recipient responsibilities. Unfortunately, this change in conceptions has had its effects on the actual conduct of foreign assistance. It also highlights a more significant deviation from the success formula employed for European recovery than even the transition from grants to loans that was noted earlier in this paper. The Marshall Plan incorporated the unique requirement that, in order to receive any assistance from the United States government, the European recipients had to cooperate with one another in determining for themselves many of the most fundamental elements of the program (including how the total assistance pie was to be divided among the participating countries).* This was the first essential step in the transition from economic nationalism to the European Economic Community. In the year prior to the Organization for European Economic Cooperation, the <u>separate</u> European recipients of United States government loans were going through them at a pace akin to the current rescheduling era (Britain, alone, almost used up in a year a loan of over $3 billion that was expected to last at least five years).**

Ironically, we have "progressed" from a tough donor requiring that recipients make sacrifices of national sovereignty in order to cooperate for their individual and collective recoveries to quite nearly the opposite. Now, the cooperation of donors

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*The ingenious conception of this program and its administration by the Economic Cooperation Administration is conveniently omitted from any of the marxist or radical treatises on foreign aid that we have encountered. It is simply not consistent with "the highest stage of capitalism" for the United States to have sought the recovery of Europe by means that required increasing their dependence on one another while increasing their potential for independence from the United States.

**Philip E. Jacob, Alexine L. Atherton and Arthur M. Wallenstein, <u>The Dynamics of International Organization</u>, Homewood, Illinois: The Dorsey Press, 1972, p. 335.

in coordinating aid programs is viewed as being more essential than is cooperation among recipients for the development of the latter.* Indeed, if any sacrifice of external sovereignty is to occur, it would appear to be that of the donor countries.** At least that is the sentiment embodied in documents like that passed at the Sixth Special Session of the General Assembly in 1974: "Every country has the right to adopt the economic and social system that it deems to be appropriate for its own development and not to be subjected to discrimination of any kind as a result." Thus, the United Nations Declaration on the Establishment of a New International Economic Order calls for the incomprehensible: order based on indiscriminate action.***

2. Stimuli to Politicization

There are several reasons for the evolution of United States foreign assistance from a more accountable bilateral

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*This is not to deny that differences among countries, in the philosophy and substance of their polities and economies, can be so substantial as to render the European recovery formula inapplicable. This may have been the case in Latin America and the attempt of the Alliance for Progress to recapture the recipient-cooperation requirements of the Marshall Plan. Nonetheless, this does not mean that the best alternative rests on the conclusion that each country's government should be strengthened and encouraged by the nondiscrimination of others.

**Of course, as suggested earlier, the LDC governments having the greatest external debts do experience considerable restrictions on their separate internal sovereignties due to economic performance requirements stipulated by the IMF.

***This is perhaps but a natural extension of the increasing role of the World Bank in the internationalization of development programs, for its charter principles require that it make its lending decisions without regard to the political character of the borrowers.

form to one of increasing support for multilateral aid. Particularly in its contributions and support for the various international financial institutions, funds from the United States government could be leveraged (rising in proportion to the contributions of others) in order to attain the greatest total volume of funds for development assistance.

This quantitative increase in development assistance has its costs, however, Primary among these costs has been the erosion of qualitative decision making by quantitative decision making. The magnitude of that cost is indicated by the debt surplus that accompanies the current state of development assistance. That quantitative decision making became preeminent with the ascendance of multilateral development assistance should surprise no one. Indeed, it was virtually promised; one of the "benefits" of multilateralizing the distribution of development assistance was to be its relative independence from the "undue" influence of the interests of any one donor nation.

Unfortunately, we see too little influence of <u>any</u> nation's interest (donor or recipient) on development assistance. The reason for this lies not only in the fact that multilateralization further removes the point of decision making responsibility from the people who pay for the costs of the decisions. That distance is rather geographic in nature. The real distance is the psychologic; the obscuring of the potential costs that multilateralization has accomplished. This denies the taxpayers who fund the IFIs (international financial institutions) and other donor agencies of their potential for being responsible while positively encouraging the irresponsibility of both middleman and consumer recipients. Exacerbating this psychologic distance are the organizational imperatives that afflict all of the donor agencies.

The more specific and tangible is the goal of any program, the less the likelihood that multilateral organizations will have the negative effects that are attributed to them here. Thus, for example, peacekeeping forces, disaster relief, and the work of an organization such as UNICEF, are appropriate applications of multilateral effort because their coordination requirements are high with respect to multilateral action but low with respect to ideas. The more specific and tangible the goal, the less disputed will be the means for accomplishing its fulfillment, and the more appropriate will be technical, quantitative decision making. A far broader goal, requiring change in a wide variety of factors in the human environment, is much less susceptible to an application of technical, quantitative decision making that will also be useful.

Development assistance requires, first and foremost, developed ideas about how it is to be accomplished. If the multilateralization of development assistance was ever to be appropriate, it was not in a context that was noteworthy for its dearth of developed ideas about what was to be accomplished and how to bring it about.

The short history of AID's policy evolution manifests both a recognition of the uncertainties regarding development and a responsiveness to many of the problems that have been raised in the preceding discussion. That is, both the New Directions in assistance and now the private sector initiative are indicative of AID's efforts to escape the syndrome of large centralized projects and concentrated benefits that characterize traditional foreign assistance. Yet, the multilateralization of foreign aid has proceeded as if there were more answers than questions.

By the time this report is read, the annual meeting of the IMF will have occurred. Undoubtedly, many bankers and government officials will have urged that the organization be given more money and power. These bankers and government officials have a crisis on their hands, and it is rational for them to seek insurance for the consequences of their decisions (particularly in light of their track record to date). Having lacked the qualitative answers that they needed before making myriad quantitative decisions, they are now locked into a game that has only one answer, and it is quantitative--more money ... more insurance ... to protect themselves from the consequences of their own actions. We are told that, "The difference between now and the banking crises of the 1930's is that now we have a safety net."* One wonders who "we" is, and whether expanding the safety net won't simply encourage both the donor-

*Tazdeusz Rybczynski of Lazard Brothers, quoted in Newsweek, September 6, 1982, p. 62.

lenders and borrowers to continue doing what they have been doing. Unfortunately, one does not need to wonder long.

Where the terrain is so uncertain as that occupied by development aspirations and assistance, the creative potential of politics is essential. And the decisions that must be made in order for assistance to make a substantial contribution to the aspirations of development are not the technical and quantitative. The latter may be useful, but never in lieu of the political decisions that are absolutely required.

Political decisions are the most difficult to make; perhaps that is why there is so much anti-politics about, even from individuals who would never view their actions as being anti-political. The latter may simply view themselves as promoting accomodation, coordination, management, planning, multilaterali-zation, and other forms of human endeavor. They will not have asked whether all of this activity is a result of political decisions, or whether it is occurring in the absence of such decisions. They might not think of their "integrative" efforts as, even possibly, being antipolitical, or as modes of insuring against having to make political decisions.* Political decisions require that priorities, and not simply wants, be determined. What people want more "becomes the enemy of what they want less. Politics is therefore something like choosing a wife;

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*Bernard Crick's In Defence of Politics, Baltimore: Penguin Books, 1964, remains its best defense.

rather than shopping in a five-and-ten-cent store."* In these terms, it is understandable that rational individuals will avoid politics, but they are thereby evading responsibility and courting what they want less: "The person who wishes not to be troubled by politics and to be left alone finds himself the unwitting ally of those to whom politics is a troublesome obstacle to their well-meant intentions to leave nothing alone."**

The multilateralization of development assistance supplants politics in the donor community as surely as its dispensation of assistance reinforces the poverty of politics in the LDC recipients. Politicization is the replacement for politics, and, unfortunately, their only similarity is linguistic. Insurance, protection and evasion become the order of the day in any politicized society (be it of donors or recipients), as is evident in Bauer's description of the qualitative dangers inherent in the quantitative concentration of resources effected by the traditional distribution of foreign aid:

> Since official wealth transfers go to governments and not to the people at large, they promote the disastrous politicization of life in the Third World ... when social and economic life is extensively politicized ... People divert their resources and attention from productive economic activity into other areas, such as trying to forecast political developments, placating or bribing

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*E.E. Schattschneider, The Semi-sovereign People: A Realist's View of Democracy in America, New York: Holt, Rinehart and Winston, 1960, p. 68.

**Crick, op. cit., p. 16.

> politicians and civil servants, operating or evading controls. They are induced or even forced into these activities in order either to protect themselves from the all-important decisions of the rulers or, where possible, to benefit from them. This direction of people's activities and resources must damage the economic performance and development of a society, since these depend crucially on the deployment of people's human, financial and physical resources.*

Extensive politicization decreases the likelihood that any individual resident of a country, selected at random, is able to enjoy full participation in the country's money economy in the absence of active bargaining with occupants of authoritative positions in the country's government. Thus, the most authoritative political actors in a given arena are the most authoritative economic actors as well, and vice-versa.

It is ironic, at least, that the collectivity of donors and recipients of traditional development assistance has not only served to reinforce the politicization of life within LDC recipients, but has itself, by multilateralization, become increasingly imbued with the same characteristics.

Of course, there are many observers who, rather than being appalled by the concentration-politicization that both encourages and is reinforced by traditional development assistance, would applaud this event. Among this appreciative audience might be Heilbroner, who some time ago concluded that we must accept

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*Bauer, Equality, The Third World, and Economic Delusion, op. cit., pp. 103-104.

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"the need for political authoritarianism and economic collectivism during the early stages of development of many nations."* Political authoritarianism is a contradiction in terms; to the extent that a government is authoritarian, politics is not tolerated. Crick provides clarification: "A political system is a free system--though the order is thus: freedom depends on politics as politics depends on government."**

Since it matters greatly which of the two contesting viewpoints expressed in the preceding paragraph is correct, it must matter even more that a decision--choosing one or the other--be made. In the absence of this, what is now being experienced is the least desirable outcome: concentration-politicization results that are more conducive to collectivism-authoritarianism than to its alternatives, yet no one (to our knowledge) ever decided on this as an objective of development assistance.

It is this sin of omission, the evasion of fundamental political choice, that is basically responsible for the litany of committed sins that Bauer ascribes to foreign aid. Our belief that development assistance must, and can, incorporate politics as both an influence and a goal at least partially accounts for an additional belief that foreign aid strategies need not buttress and intensify the tendency towards concentration-

*Robert L. Heilbroner, The Great Ascent: The Struggle for Economic Development in our Time, New York: Harper Torchbook, 1963, pp. 148-149.

**Crick, op. cit., p. 186. This is at the heart of Bauer's recommendation that in their allocations of aid, donors should favor "governments who govern rather than plan." Op. cit., p. 133.

politicization. A necessary condition for both of these beliefs was established by the determination that the concentration of power in the LDCs is a "natural" phenomenon whose explanation does not require resort to rapacious actors, whether foreign or domestic. Instead, it was maintained that even the best-intentioned actors, representing both donors and recipients, will, due to their organizational imperatives, rely on the mechanisms of traditional foreign assistance. These mechanisms, while reinforcing the organizational imperatives from whence they come and being magnified by multilateralization, give much the same impetus to the concentration-politicization results as would be produced if both donors and recipients had intended it.

The beliefs expressed in the preceding paragraphs are necessary for us to act as if development assistance, AID, AID's private sector initiative, and even this report can make a difference in the world of surplus debt that has been interpreted in this paper. To that end, we proceed in the next section with an exploration of the art of the possible in the narrow spaces that appear between rocks and hard places.

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II. THE PRODUCTION OF POLITICS AND THE POLITICS OF PRODUCTION

A necessary condition for the existence of politics in a society is that there be rules that provide each member of the populace some degree of authority to act that cannot be proscribed by those of its members having greater authority to act. This requires that the citizens of a society retain the ultimate authority to define and alter the authority to act of governmental officials. The latter have greater authority to act on a day-to-day basis (but not to self-define this authority), because the ultimate authority has promulgated a set of decision rules (a constitution) that has provided for this.*

Clearly, a private enterprise economy is dependent on the constitutional rules of a society. A constitution can prohibit, protect, or say nothing about individual property rights. This sets some limits on the applicability of the program that is recommended for consideration in this report; that is, the program would only be applicable in LDCs where individual property rights are not prohibited.

While dependent for its existence on the constitutional rules of a society, private enterprise can be stimulated and

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*Our perspective is strongly influenced by Vincent Ostrom's "John R. Commons's Foundations for Policy Analysis," Journal of Economic Issues, Vol. 10, No. 4 (December 1976), pp. 839-857. In turn, the view expressed here, that politics and a private enterprise economy are *institutionally* compatible, allowing for their reciprocal sustenance, is responsive to the work upon which Ostrom builds: John R. Commons, Legal Foundations of Capitalism, Madison: University of Wisconsin Press, 1959.

nurtured by public and private actions such that the individual benefits of its process and production are so widespread that the base of support for its constitutional protection cannot be violated by governmental action without running severe risks of its replacement by another government. Thus, the nurturing of a private enterprise economy can stimulate the production of politics such that government must be more responsive to both; such that government must govern more and plan less.

The production of politics in a society should be both a goal and an integral part of development assistance--unless it should be decided that concentration-politicization is a preferred outcome. To succeed in this requires engaging in the politics of production, and this entails an assistance strategy that involves the influencing of an LDC government's economic policies. It also means that the strategy will emphasize the process, rather than the products, of production. An example of the latter is worth repeating again:

> The case of Productos Quemanyo is an example of a firm whose plans for capital improvements were profoundly affected by the requirements of government. Productos Quemanyo, located in Peru, produces and processes cheese butter and yogurt. In response to government tax incentives in the early 1970s to reinvest profits in capital improvements, Productos Quemanyo purchased from foreign suppliers new butter-making equipment although existing equipment was not in any need of replacement. The old equipment, which was functioning well, is still being stored by the firm to use if the newer machines break down. As part of the capital improvements under this incentive, the firm purchased a yogurt producing system from an U.S. firm. However, before production of yogurt

began, the government issued a new price control that forced the firm to sell yogurt at a price below the production costs.*

The initial incentive encouraging a process (reinvestment of profits for capital improvement) was fine, but it was negated by the disincentive with respect to the product (price control).

The moral of the preceding story is that the strategy employed in the politics of production should seek to enhance the inputs to the quality and quantity of production, and discourage any disincentives to production. The latter should be provided by the market. Once somebody begins providing incomes on the basis of consumption, then deviation from this rule might be accepted.

If this sounds like a supply-side orientation, that is because it should. Several supply-side options for U.S. foreign assistance will be offered in the concluding section of this report. These are options that can be employed in support of the program to be proposed in the next section. A supply-side orientation with respect to the politics of production is essential to the production of politics. The program to be considered in the next section is compatible with this perspective, or it would not be presented.

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*Harvey W. Wallender, III, "Technology Transfer and Management in the Developing Countries," Fund for Multinational Management Education, Aspen Institute for Humanistic Studies, December 1978. Cited in Molly Hageboeck and Mary Beth Allen, Private Sector: Ideas and Opportunities, A.I.D. Program Evaluation Discussion Paper No. 14, June 1982, pp. II-35-36.

Since the use of the term "supply-side" is now accompanied by adjectives of opposite extremes, and is further confused by being lumped together with Federal Reserve policies,* it might be helpful to explicate our more circumscribed use of the term. A supply-side option is one that employs an incentive that (1) encourages new, and/or improved, and/or increased production; (2) is provided by decreasing an existing burden, or disincentive to this production effect (such as taxes, tariffs, import quotas, or various government regulations); (3) is applicable to all individuals or firms possessing characteristics specified by the option; (4) does not preclude any individual or firm from attaining the characteristics specified by the option; and (5) does not specify any product or products.

What would otherwise be a supply-side option, but fails on the fifth criterion, is not fundamentally different from

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*Thus, for example, Galbraith is willing to refer to the supply-side orientation as "fantasy" even though his only assessment of it is in combination with Federal Reserve policies: "It is visibly as well as logically impossible to combine an expansion of the economy, encouraged by tax reduction, with a contraction occasioned by the rigorous application of monetary policy." John Kenneth Galbraith, "The Way Up from Reagan Economics," Harvard Business Review (July-August 1982), p. 8. He does go on to say that, "there is no evidence that past taxation was a greatly constraining influence on either business effort and initiative or investment." The use of the word "greatly" in this context reminds of the scientific escape clause of "other things being equal"; there is definite evidence of taxation's constraining effects, though these are unlikely to be "great" enough for Galbraith. See Vito Tanzi, The Individual Income Tax and Economic Growth: An International Comparison, Baltimore: The Johns Hopkins Press, 1969.

government expending a portion of its revenues to a specified group of producers. Once the contradictory game of "supply-side-for-specific-products" is begun, such curious exercises as defining "windfall" profits also commence in earnest. In the meaning of supply-side employed here, any subsidy of specific products is a "windfall" profit, i.e., it favors some producers relative to other producers not on the basis of the quality of their performance, but on the basis of what they are producing (even if they are doing a rotten job of it). It should be obvious that this increases the likelihood of politicization. Therefore, our fifth criterion is critical to a politics of production that will positively contribute to the production of politics.

Without our fifth criterion there is apt to be a "lopsided concentration on the 'seller'", as noted by Hageboeck and Allen, because rather than emphasizing the <u>process</u> of selling and production, emphasis is given to <u>what</u> is to be produced and sold:

> Apparent consumer reluctance to buy refrigerated and frozen meat in the Near East and some Southeast Asian countries has negated investments in processing and transport facilities and blocked programs to expand income from livestock raising. Many of the officially sponsored programs to introduce nutritionally valuable foods based on oilseed and fish flour protein have foundered on the same rock of consumer resistance.
>
> Planners seeing good technical prospects for a new production line may easily underestimate competition from alternatives even on the domestic markets. Assured of protection against imports, plans to develop substantial poultry industries in Nigeria and Dahomey still ran into marketing difficulties before attaining their targets because of the availability of relatively lower priced

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beef and fish. A tree fruit development in the Kassala area of Sudan was eventually largely abandoned, unable to cover its transport costs in competition with other supplies on the Khartoum wholesale market.*

The primary constraints on the use of supply-side options have been considered in the preceding section: the organizational imperatives of both donors and recipients, and the economic performance requirements of the IMF to which many LDC governments are virtually obliged to adhere. Thus, for example, while we are in obvious sympathy with Wanniski's view that LDCs would substantially benefit from lowering the rates at which incomes are taxed, and raising the thresholds (levels of income) at which any given rate is applied,** there are very real constraints on the capacity of LDC governments for following his advice. An LDC government can more effectively gauge its maintenance of a "minimum winning coalition" necessary for maintaining itself by its control of transfer payment (demand-side) benefits than it can by a supply-side program. This is because the former allows greater governmental control of who are to be the beneficiaries of government largess. Of course, tax policy _can_ be so employed, by means of selective deductions, exemptions and allowances that violate the fifth criterion for supply-side options that was discussed above, but an across-the-board change in rates and thresholds not only increases the

*J.C. Abbott, "Marketing Issues in Agricultural Development Planning," in Reed Moyer and Stanley Hollander, eds., _Markets and Marketing in Development Economics_, Homewood, Illinois: Richard D. Irwin, Inc., 1968, p. 95. Cited in Hageboeck and Allen, _op_. _cit_., pp. I-3 & I-4.

**Jude Wanniski, _The Way the World Works_, New York: Simon and Schuster, First Touchstone Edition, 1979, p. 247.

incentives for production, it also decreases governmental control over the distribution of these benefits among the LDC population. To compound the problem, those who do benefit may not sufficiently (as defined by the government) attribute their increased resources to the change in government tax policy. In short, an LDC government that embarks upon a supply-side program invites greater uncertainty into its calculations of requirements for maintaining itself. And governments, like individuals, have a propensity for wanting to reduce, not increase, their uncertainties.

Fortunately, there is a model supply-side program already in operation that will allow an LDC government to expand the size of its winning coalition at the same time that it broadens the base of capital ownership in the country. As such, it simultaneously combats the very core of both concentration and politicization. In the next section, we assess the operation and effects of this program.

III. BROADENING CAPITAL OWNERSHIP IN SOCIETY

ESOP proponents frequently cite the small proportion of the United States population that owns the bulk of the individually owned corporate stock in this country as a justification for the promotion of ESOPs (the figures cited in several speeches by the leading proponent of ESOPs in the Congress, Senator Russell Long, are 1 percent of the population holding 50 percent of the market value of individually owned corporate stock in the United States, and just 6 percent owning more than 80 percent of such stock). So what is one to think when encountering Peter Drucker's estimates that the pension funds of U.S. employees may own 60 percent of the equity capital of U.S. business by 1986?* Or, then, picking up the newspaper, a headline jumps out: Worker Control of Industries: Pension Funds Makes It Possible.**

What seem like incompatible estimates are not at all. The percentages offered by Senator Long are of individually owned corporate stock. The percentages offered by Drucker are of all corporate stock. As might be expected, individually owned corporate stock had declined from over 90 percent of all stock in 1945 to less than 65 percent in 1975.***

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*Peter F. Drucker, The Unseen Revolution. New York, Harper & Row, 1976, p. 1.

**By Clayton Fritchey, Newsday. Reprinted in The Sacramento Bee September 28, 1982, p. B11.

***Robert Hamrin, Broadening the Ownership of New Capital: ESOPs and Other Alternatives, Staff Study for the Joint Economic Committee, Congress of the United States, U.S. Government Printing Office, June 17, 1976, p. 14.

So capital ownership in the United States is being broadened, but it is primarily accounted for by accounts in pension funds of individuals who do not know what they own. This is not to deny that they are better insured against the risk of loss by having their pension fund accounts invested in a diversified portfolio of stocks and bonds. However, this insurance obscures the links that must be drawn between individual effort and reward in order for individuals to value the process, and their roll in the process, by which their wealth is generated. It is our belief that private enterprise and politics alike are threatened by the distortion of the relationship between individual inputs and outputs. Broadly owned capital can coexist with the smallest of minorities possessing the capacity for self-governance, but the productivity of the society will decline with its human capital.

ESOPs not only maintain the linkages between effort, production and reward; they require and strengthen them, as we shall shortly see.

A. ESOPs IN PERSPECTIVE*

Ordinarily, a corporation that wishes to purchase additional land, equipment, and/or buildings will take out a loan from a bank, and then repay the loan with interest over time. A

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*This section is primarily based upon (1) Research Institute of America, Inc., Assessing Employee Stock Ownership Plans (ESOPs), December 3, 1979; (2) Thomas R. Marsh and Dale E. McAllister, "ESOPs Tables: A Survey of Companies with Employee Stock Ownership Plans," The Journal of Corporation Law, Spring 1981, pp. 551-623; and (3) Hewitt Associates, ESOPs An Analytical Report, Deerfield, Illinois: Hewitt Associates, 1976.

corporation with an ESOP does basically the same thing, but with some significant new wrinkles. An ESOP borrows the money from a bank, and turns it over to the employer in exchange for company stock. With that money from the ESOP, the employer expands and/or modernizes per the purpose of the loan, and makes annual payments to the ESOP so that it can make its annual payment to the bank.

The benefit of the ESOP-middleman for the employer corporation is provided by tax legislation. Under the 1981 Economic Recovery Tax Act, stock that is "contributed" to an ESOP in exchange for operating capital (from which the bank loan is ultimately repayed through the ESOP) is deductible in the following amounts: (1) stock equal in value to payments of loan interest during the year are fully deductible, and (2) stock equal in value to payments of loan principal during the year, or up to 25 percent of the compensation of all employees participating in the ESOP, whichever is less, is tax deductible. If loan principal payments are greater than the 25 percent of compensation, and the company's contribution to the ESOP matched or exceeded it, that excess can be carried over to succeeding years.

The net result is that the proportion of corproate equity accounted for by the new capital expansion/modernization provided for by the loan (equity that might not have otherwise existed) is owned by members of the ESOP.

This is only the beginning of the uniqueness of ESOPs, for the United States government provides tax deductions and/or credits to firms with a wide variety of employee benefit plans. And ESOPs are included in but one of three categories of plans meeting the requirements of the defined contribution type of deferred employee compensation that are specified by the Internal Revenue Code.* These three categories are: profit-sharing, money purchase pension, and stock bonus plans. Each of these types can create stock ownership in employees with the financial encouragement of the federal government, but ESOPs are only generic to stock bonus plans (though they may be combined with a money purchase plan). That is, any ESOP is necessarily a form of stock bonus plan, but only some stock bonus plans are ESOPs.

Though all defined contribution plans must make periodic contributions to an account set up for each participant in the plan trust, only profit-sharing plans are required to base employer contributions on company profits. Table 1 differentiates among the three major types of defined contribution plans. Since ESOPs are necessarily stock bonus plans, any differences between the latter and the other two types are shared by ESOPs.

*These do not provide the guaranteed retirement benefits of defined benefit plans.

TABLE 1

Differences between three major types of defined contribution plans, by characteristic

Characteristic	Money-Purchase Pension Plan	Profit-Sharing Plan	Stock Bonus Plan
Requires fixed-formula contributions	YES	NO	NO*
Contributions vary with profits	NO	YES	NO
Benefits must be distributed in employer securities (especially stock)	NO	NO	YES
Guaranteed retirement benefit	YES	NO	NO

In addition to the differences between ESOPs and profit-sharing plans that is provided by comparing the two appropriate columns, ESOPs have two primary differences from other stock bonus plans. Whereas the latter, generally, must be <u>sufficiently</u> invested to allow for the required stock distributions to terminating participants, ESOPs must be <u>primarily</u> invested in employer stock. The other major difference is that unlike other plans, ESOPs alone are permitted to engage in money lending or other extensions of credit between the plan and a party in interest (employer, employees, directors, 10 percent shareholders, etc.). The possible effects of these two critical

*Leveraged ESOPs--those borrowing money from lenders outside the company, and in turn purchasing stock from the company--must receive annual contributions from the company sufficient to retire the loan principal and interest.

differences are best related in the following story about the founding of Arrow Metal Products Company's ESOP by its President, in 1975:

> "Since we founded our ESOP, we haven't had to borrow any money at all," says Jack Lamp. "Our capital expenditures since then have totaled about $1 million, and the ESOP has funded most of that." The company's sales now stand at about $1.8 million a year, up from $150,000 when Lamp bought the firm and rescued it from failure in 1968.
>
> Arrow now has 25 employees, all of whom have benefited from the ESOP, too. Under the former profit-sharing plan, coming up with a cash contribution of about 8% of payroll annually was a strain for the company. Now Arrow contributes stock worth up to 15% of its $620,000 payroll each year ... The value of a share, as determined by an independent appraiser, has risen from $4.22 to $10 today.
>
> As they would in a pension plan, Arrow employees usually leave their allotment in the trust until they retire (though early withdrawals are possible under some circumstances). Then they "put" the stock to the company or to the trust--that is, sell their shares back at fair market value. Thus the company ultimately does hand them cash--and perhaps much more than the shares were worth in the first place, if the company has prospered and the shares have appreciated in value.
>
> Arrow gets use of their cash in the meantime. The company also takes a standard tax deduction on the value of every share given to the trust, up to 15% of payroll. Thus by raising contributions from 8% of payroll (all it could afford when it was putting in cash) to about 15% now, Arrow gained a tidy sum through deductions. Since the company pays tax at the full 46% corporate rate, each dollar's worth of stock contributed earns 46¢ in cash for the business.
>
> There's a catch for Jack Lamp ... In order to give the ESOP stock, the company issues new shares. That dilutes Lamp's ownership. Arrow's employees now own about 33% of the company ...
>
> But dilution doesn't deprive Lamp of his control of the corporation. Through a trustee he appoints, he directs the way the ESOP votes its shares ...

And dilution can carry a shiny silver lining: It creates a convenient "in-house" market for Arrow's shares. This permits Lamp occasionally to cash out some of his equity in the company--on terms vastly more favorable than the Internal Revenue Service otherwise allows. Last year, for example, Lamp sold 9,000 of his 80,000 shares to the ESOP for $10 a share. Where did the trust get the money? From the company--in the form of an ESOP contribution (for this purpose it gives cash, rather than the usual stock, to the trust). Arrow took a corporate tax deduction on the transaction, and Lamp paid personal taxes at the capital gains rate.

Compare that to what would occur, under IRS rules, if Lamp had tried to cash in those shares by selling them back to the company directly. The company would have had to redeem them with after-tax dollars, and the IRS would have called it a "constructive Dividend," making Lamp liable for taxes at the regular income rate. Thus the company would forgo a deduction worth 46% and Lamp would have to pay up tp 50% in income tax rather than 20% in capital gains tax. That adds up to an additional 76% penalty on the same transaction, at maximum rates.

Owners of small closely held companies usually find no other reasonable means of redeeming shares of stock, unless they want to sell the whole company (the IRS offers very favorable tax treatment for that).*

Since an ESOP must be primarily invested in employer securities and there are none of the usual prohibitions regarding financial transactions among company, employees and employer, the stock in the ESOP accounts of Arrow's employees could grow more rapidly than they otherwise would. This occurred as the company and its profitability grew. We cannot tell, but it is possible that the tax deductions that helped this growth were more than offset by the increase in gross income of the company.

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*Doran Howitt, "Employee Ownership: A Capital Idea," Inc., April 1982, pp. 35-36.

In addition, the company can continue into the indefinite future, beyond Lamp's, or any of the employee's lifetimes. The ESOP provides a ready market for their stock. Twenty-five employees cannot be either suddenly jobless, or without say as to their future, because of the whims of nature. Their capacity for self-governance grows with their ownership, and private enterprise and politics alike thrive on the enhancement of these capacities.*

Many observers contend that it is financially irresponsible to invest a worker's savings primarily in the stock of the business in which he works. Pick up almost any article on employee morale in ESOP-firms, and concurrence with this view can be found among a minority of its employees. It is true that losses as well as profits from stock ownerhship are greater for employees in most ESOP firms than would be the case if they were otherwise employed. Given this, and the varying preferences of individuals, it is beneficial to have variance among firms as to their employee benefit plans. The individual then has the opportunity to choose his employer on the basis, at least in part, of his own willingness to assume risk.

*It should be noted, with respect to self-governance, that all stock allocated to most ESOPs after December 31, 1979, carries with it participant voting rights on at least major issues. Since the program under consideration in this report concerns both the production of politics and the politics of production, any recommendation with respect to voting rights cannot be taken lightly. We recommend that stock allocated to an individual account be fully voted by the plan participant, or their elected representative, when it is fully vested in the participant (around ten years for most plans). This recommendation applies to potential LDC ESOPs as well as to those in the U.S.

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Of course, it is also contended by ESOP proponents that as employees increase their share of ownership in the firm for which they work, they increasingly preceive themselves as working for themselves. Their productivity is therefore expected to increase, and they minimize their risks by increased effort. In addition, they have a share in something that can pay for itself.

1. The Heartbeat of ESOPs: Capital Pays for Itself

The potential for capital to pay for itself (as illustrated in the case of Arrow) is essential to a basic idea underlying the support of both ESOP and supply-side incentives for broadening the ownership of capital. This idea is that there is concentrated access to credit because there is concentrated profit from previous enterprise. And, there was concentrated profit from previous enterprise because there was concentrated access to previous credit. This circularity is perpetuated because of the expense of productive capital, and the fact that it can pay for itself. The growth of technology obviously accounts for increased production, increased sales, and an increasing proportion of whatever profits are derived by the owners. Putting all of this together, the argument is that if the access to credit necessary for the individual ownership of technology is not broadened, then wealth will become increasingly concentrated. Thus,

> ....Unlike thrift plans, stock purchase plans and stock option plans, the ESOP is a credit device and requires no cash outlay whatsoever from those to whom new equity opportunities are to be extended. It instead makes the

> magic of non-recourse corporate financing work for new owners, based on credit designed to be amortized with expanded future corporate profits ... the ESOP should not be adopted for financing growth, unless the expansion capital will pay for itself.*

Before urging ESOPs as a part of any foreign assistance strategy, it is necessary to determine that companies, having adopted them, are both growing and at least as profitable as they were prior to their adoption.

B. ASSESSING THE PERFORMANCE OF FIRMS WITH ESOPs

This section had anticipated a survey of the empirical research conducted on ESOPs to date that would answer the growth and profitability questions raised above. In addition, the intent was to identify the characteristics of firms for which ESOPs appear to be most (and least) useful.

Of the four studies that make a reasonable attempt to draw a cross-section of ESOP firms, and have a sample size of greater than ten corporations, one offers no measure of profitability or productivity, and none of the studies provide information regarding the profitability and/or productivity of the firms prior to their implementation of ESOPs.

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*Norman G. Kurland, "Beyond ESOP: Steps Toward Tax Justice", in The Tax Executive, April and July 1977, Part I, p. 196. Kurland's ideas here are derived from and are strongly supportive of those in Louis O. Kelso and Particia Hetter, Two-Factor Theory: The Economics of Reality, New York, New York: Random House, 1967 and in Louis O. Kelso and Mortimer J. Adler, The Capitalist Manifesto, Westport, Connecticut: Greenwood Press, 1958.

We had no idea during the initial conception of this report that there would be such a paucity of reliable information regarding the growth and profitability of the firms that have adopted ESOPs.*

The need for an ESOP-like initiative in U.S. foreign assistance is obvious, unless the first two sections of this report are totally rejected. But we risk insulting the intelligence of LDC leaders if we are to urge them to adopt the enabling legislation for ESOPs in their countries, and then tell them (1) there is no comprehensive list of U.S. corporations that have ESOPs, (2) there are probably somewhere between 3 and 5 thousand such firms, but we are not sure, (3) because we are unsure of what companies are comprised by the universe of firms having ESOPs, we cannot know or even estimate the degree to which the samples contained in the few empirical studies that have been conducted are representative of that

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*The four studies to which we refer are (1) Marsh and McAllister, op. cit.; (2) Economic Development Administration, United States Department of Commerce, "Employee Ownership: A Report to the Economic Development Administration," Survey Research Center, Institute for Social Research, University of Michigan, 1978 (the prinicpal results of the EDA study are summarized in Michael Conte and Arnold S. Tannenbaum, "Employee Owned Companies: Is the Difference Measurable?", Monthly Labor Review. Vol. 101, July 1978, pp. 23-28); (3) Randy G. Swad, "ESOPs and Tax Policy: An Empirical Investigation of the Impact of ESOPs on Company Operating Performance," Dissertation, Louisiana State University, 1979; and (4) Matthew J. Bonaccorso, et. al., "Survey of Employee Stock Ownership Plans: Analysis and Evaluation of Current Experience," Thesis, University of California, Los Angeles, Graduate School of Management, December 1977. The latter study is the one out of the four that engages in no measure of profitability or productivity, but the mailing list of potential ESOP firms that it employs was utilized by the Swad study. In the text, these studies are referred to as M-M, EDA, Swad and UCLA, respectively.

universe, (4) Congress would provide the enabling legislation for ESOPs without providing the IRS, Department of Labor and/or the Department of Treasury with specific means (or a requirement that they devise specific means) for the identification of firms adopting ESOPs and for evaluating their effects.

There is a basic problem in not having data on productivity and/or profitability, and growth, prior to, as well as after the adoption of ESOPs by the firms included in the samples of the empirical studies. The problem is compounded by the fact that it is not advisable for a firm to adopt an ESOP in the first instance if it is not profitable for the simple reason that a deduction from no (or negative) profit hardly does the firm any good. It is therefore expected that most ESOP companies are more profitable at the inception of their ESOP than is the average non-ESOP company. Thus, when M-M show us that productivity has increased for most industrial groupings at greater rates for ESOP firms than for non-ESOP firms, it is by no means clear that this would not have occurred in the absence of ESOPs. Nonetheless, if we knew that these results were based on a representative sample, they would at least be consistent with our expectations regarding the positive consequences of ESOPs.

Similarly, the studies conducted by EDA and Swad are consistent with our expectations for the universe of ESOP firms. Both Swad and EDA provide evidence that the utilization of the plan may be more important than the characteristics of the firm for corporate profitability. Both find that the extent to which corporate equity is allocated to the individual accounts of employees is more positively associated with corporate profitability than is any other variable. However, there are enormous differences between the studies as to the characteristics of firms in their samples. For example, the percentage of ESOP firms with less than 100 employees constitutes 62 percent of the UCLA sample, 37 percent of the M-M sample and 18 percent of the EDA sample. It would appear, on the basis of this single factor that if one of the three samples is representative of the universe of ESOP firms then the other two cannot be, but, again, there is no good reason to expect any of these samples to be representative of the cross-section of ESOP firms.

Nonetheless, even if each sample is highly unrepresentative of the universe of ESOP firms, it is intriguing that within each of these highly disparate samples the percentage of company stock held in the ESOP trust was positively correlated with productivity and/or profitability, and in two of the three studies these were the strongest relationships attained. This suggests that with ESOPs the politics of production might be occurring as we would expect. Nonetheless, our confidence in the positive consequences of ESOPs must be blended with some degree of caution as the options for promoting their extension into LDCs are tendered in the following section.

IV. INTRODUCING ESOPs IN THE LDCs

If ESOP firms can be searched and extracted from IRS 5500-series forms, and merged with 1120 corporate returns (and it appears that this is possible), then the analysis that can yield results in support of our expectations of growth and profitability is possible. Of course, it also makes possible the contradiction of these expectations, but that is a risk far preferable to that of promoting in LDCs what cannot be supported by the U.S. experience.

In any event, the present section is presented in the spirit of positive expectation.

Just as tax incentives for creating stock ownership in employees can be provided without linking it to ESOPs, so can tax incentives for encouraging direct private investment in LDCs be extended without regard to any form of employee stock ownership. But we believe that these incentives cannot expect to enhance private investment and enterprise, and simultaneously combat the twin processes of concentration-politicization, in LDCs to the extent that can be provided by an ESOP-related program. The central reason for this is that as an ESOP initiative is implemented and acted upon, there is an ever-increasing proportion of a host country's work force that acquires a vested interest in the company for which they work. As such vested interests are increased within companies, and expanded in the country's economy, there is broadened and intensified support for the private enterprise system itself. And, as this occurs, the security of private investment from the capricious actions of governments and their oppositions is enhanced. A potential investor in Jamaica, for example, may well wonder what is to prevent the loss of that investment to a future Michael Manley. Supply-side incentives linked to an ESOP strategy sends a clear message to the potential investor that the host country is interested in the long-term success of private enterprise, and not simply a short-term influx of capital.

In addition, a supply-side ESOP initiative is one that can be utilized by LDC governments for broadening their constituencies with greater likelihood of strengthening their continued governance than risk of losing their positions. With increased economic authority, the ESOP participant is apt to acquire the expanded notions of self-governance that is essential to private enterprise and politics alike. The LDC government that successfully communicates the cause and effect of this process, and that is both supportive and responsive to it can join in that process with its new constituents.

A. LDC ENABLING LEGISLATION

The enabling legislation required of any given LDC government may be quite extensive, depending on the extent to which its legal conception of property rights is consonant with that of the United States. In addition, all of the critical elements of the Employee Retirement Income Security Act of 1974 (ERISA) must already be extant in the LDC legal structure, or the adaptability of ESOPs will perhaps be prohibited in the near future. We refer, for example, to the legal conception of trust, and its corollary, fiduciary responsibility. ERISA presents a structure of elements for legally protecting employees and their deferred compensations from the abuse of employers and others, and they should be quite as essential in LDCs as they are in the United States.

B. LEGAL MODIFICATIONS FOR STRENGTHENING ESOPs IN LDCs

1. Allow dividend pass-through to be deducted by the ESOP firm.*

   a. Allow dividends payed to stockholders who are not participants in the plan to be deductible to the corporation in proportion to corporate stock that is in ESOP trust.

2. Instead of deductions from taxable income, lower the rate on taxable income by amounts that are inversely pro-rated to the proportion of corporate stock in the ESOT and/or the annual contribution to the trust relative to the maximum allowed.

3. Consider no taxation on capital gains from the sale of stock in ESOP firms, or tax only the product of capital gains and the proportion of stock in the firm that is not owned by employees.

   a. This should help to alleviate the reticence of publicly traded corporations to adopt ESOPs due to stock dilution.

4. Generally, seek to implement incentives that are keyed to the stock in the company that is held in the trust.

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*This, and other thoughtful suggestions might be adopted from Luis L. Granados, "Employee Stock Ownership Plans: An Analysis of Current Reform Proposals," Journal of Law Reform, Vol. 14, No. 1 (Fall 1980), p. 45. Also, recall our recommendation of full voting rights on stock that is fully vested to the individual plan participant. See p. III-8, fn, above.

C. U.S. ASSISTANCE OPTIONS FOR PROMOTING ESOPs IN LDCs

An ESOP initiative could be effected with no changes in U.S. legislation. That is, if there were demonstrable evidence from the U.S. experience with ESOPs to support the enhanced growth-profitability expectations, persuasion and technical assistance might be sufficient for an LDC to enact the enabling legislation for ESOPs.

However, in terms of the overall context of this report, there are some changes in the Foreign Assistance Act that would obviously be preferred. Sections 102(11) and 102(12) would be modified with a bias to bilateral rather than multilateral assistance.

Section 111 of FAA would be amended so as to incorporate ESOPs.

Several sections in Title IV--Overseas Private Investment Corporation would be amended so as to give preference to firms that are either planning or implementing ESOPs. Section 234, in particular, would be amended throughout to provide preference for firms that are or will be implementing ESOPs. This could extend to the design and implementation of the ESOPs and trusts, themselves.

In addition, there are several supply-side options that might be employed for encouraging U.S.-based MNCs to take a leadership position with respect to the implementation of

ESOPs in an LDC. Designing incentives for the introduction of ESOPs in LDCs seeks to encourage a form of investment which (1) will reduce the criticisms of private investment in LDCs by enabling a more broad-based section of the population to share in the profitability of the firms developed through that investment, and (2) will increase the likelihood of profitability for the U.S. investor. The installation of ESOPs in subsidiary firms of U.S. MNCs could have these results.

U.S. tax law governing taxation of foreign source income of U.S.-based firms, multinational corporations (MNCs), and individuals offers several opportunities for modifications that would provide incentives for implementing ESOPs in LDC firms financed through U.S. investment. The obvious strategy is to offer additional tax benefits to firms that adopt plans meeting the statutory requirements of ESOPs as adopted by the LDC government's enabling legislation, and that provide employees with a required minimum percentage of company equity ownership. Allocations to employees would be required to favor neither foreign (e.g., U.S.) employees nor highly compensated employees.

U.S. tax law attempts to reduce or eliminate double taxation on the earnings of U.S. investment in LDCs by allowing corporate stockholders in foreign subsidiaries to credit payments of income tax to foreign governments against U.S. tax due.*

*IRC § 901-905.

The foreign income taxes which qualify for the foreign tax credit are limited. In order to qualify for the credit, the foreign tax must be either an income tax or a tax imposed in lieu of income taxes otherwise generally imposed by the foreign country. Many levies and fees paid by a firm to the foreign government or its agencies do not presently qualify for the tax credit.* U.S. investors and MNCs could be encouraged to install ESOPs in new and existing firms and plants in LDCs through modifications to U.S. tax law which would expand the set of taxes, levies and fees qualifying for credit against U.S. income tax when paid by an LDC ESOP firm. This would be especially appropriate if the set of new taxes, levies, and fees qualifying for tax credit were those oriented toward providing additional compensation for the plant's workers.

Examples of such fees and taxes are the Venezuelan social security tax levied on employers; the Philippine privilege tax measured by percentage of gross receipts and payable as a condition for doing business; Thailand's business tax; any imputed rent tax or tax based on the value of the taxpayer's capital assets; and any <u>ad valorem</u> levies, value-added tax, sales tax, turn-over tax or tax based on gross receipts rather than net-income or profit.** Subsidiaries that qualified as LDC ESOP firms, but not others, could be allowed to credit these additional taxes against U.S. income tax due.

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*IRC § § 901 and 903.

**26 USCS IRC § 903, "Interpretive notes", pp. 301-302.

LDCs, an MNC whose subsidiary qualifies as an LDC ESOP could be allowed more liberal deferral of taxation through reinvestment in the subsidiary (the LDC ESOP firm). This tax preference could be made more relevant to the purpose of expanding employee stock ownership by requiring the amount reinvested in excess of normal limitations to be reinvested through an ESOP.

Eventually the MNC will want to bring back or repatriate some of the profits it has been reinvesting in the LDC ESOP subsidiary. Under present U.S. tax law, "developing country source earnings of controlled foreign corporations having the same owner for ten years or more may be repatriated through liquidation at the capital gains rate."* However, the "foreign tax credit is not allowed with respect to distributions taxed at the capital gains rate."** The parent MNC of an LDC ESOP firm could be allowed to repatriate profits taking advantage of capital gains treatment without losing foreign tax credit. Special requirements might be in order as a condition for use of this special ESOP benefit. For example, for every two dollars repatriated under this preferential provision, the MNC (or its LDC ESOP subsidiary) might be required to contribute an extra dollar to the ESOP.

Finally, the U.S. is a party to reciprocal tax treaties with many LDCs. These tax treaties could be modified in such

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*Ibid. pp. 129-130.

**Ibid. p. 131.

a way that U.S. tax incentives for the implementation of ESOPs would be offered only if reciprocal tax incentives would be offered by the LDC government. It should not be difficult to convince an LDC government to offer this preferential treatment, since the ESOPs it encourages will enable its own citizens to obtain ownership of what would have been a foreign-owned firm.

1. AID's Potential Assistance

AID's Mission representatives in any LDC that enacted the enabling legislation for ESOPs would be in a critical position. The explanation of the plan to employer-owners and employee-owners should be mutually understood. AID might determine that it will only assist firms that incorporate, as part of the plan, a program for improving the workplace environment. This might include increased worker participation in gradually more inclusive areas of company decisionmaking. The point is that depending on its commitment to such a foreign assistance program, and other decisions it might make regarding assistance to firms, the effort involved could be quite time-consuming.

AID should consider financing the design and implementation of plans with respect to an LDC government's legal requirements--either with its own personnel, or with contractors. AID might also engage contractors to assist in the training of those individuals in the LDC who appear interested as well as capable of designing and implementing ESOPs in accordance with their government's legal requirements.

More important than the technical decisions with respect to legal and financial requirements that could be provided by mission personnel would be their contribution to the conception of employee-owner that entails a redefinition of the "jobs." If the direct link between effort and product, and between production and reward, is not accomplished, then the most beautifully designed plan is worth little more than the paper on which it is displayed. The growing awareness, and actualization, of self-governance is what can be stimulated by an operating ESOP. The capacity for self-governance grows with the conception of ownership, and the nurturing of this capacity will enable the mutual flourishing of private enterprise and politics. From the growth of citizen self-governance, the institutional development that is most needed can occur--these consist of sets of structured incentives to individuals and communities to invest in themselves. This is what ESOPs, ideally, are ultimately all about.

ESOPs, we believe, are the mechanism having the greatest potential for furthering the goals that have been expressed in this paper, and the empirical evaluation that is required in order to substantiate this belief should not be delayed. Private enterprise and politics will not be extinguished by the failure to promote an ESOP-related foreign assistance program, but the failure would be one of denying our most valuable assets--the processes that afford us the incentives and opportunities to realize the best in ourselves--with the rest of the world.

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