The original documents are located in Box 53, folder "1975/11/13 - Economic Policy Board" of the James M. Cannon Files at the Gerald R. Ford Presidential Library.

ATTENTION EPB EXECUTIVE COMMITTEE:

Please note the time change in the regular Executive Committee meeting for Thursday.

Thank you.

ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

AGENDA
9:00 a.m.
Roosevelt Room

November 13, 1975

1.	Broadening Employee Stock Ownership	Treasury
2.	Proposal for review of employment and unemployment statistics	Malkiel
3.	Establishment of household test panel	Malkiel

EYES ONLY

MINUTES OF THE
ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

November 12, 1975

ATTENDEES: Messrs. Simon, Seidman, Lynn, Greenspan, Dunn, Cannon, Malkiel, Gorog, Baker, Porter, Kasputys, Penner, Walker, Hinton, Areena

1. Employee Stock Ownership Plans

The Executive Committee briefly reviewed a memorandum prepared by the Department of the Treasury on employee stock ownership plans. The discussion focused on congressional interest in broadening stock ownership proposals, the revenue impact in the short and long term, and non-tax options for providing incentives to broaden stock ownership.

Decision

The Executive Committee will consider employee stock ownership plans further at tomorrow's Executive Committee meeting.

Mr. Walker will prepare two pages of draft speech language on broadening employee stock ownership and "Investing in America," describing the objectives of such plans for consideration in an upcoming Presidential speech.

2. Other

The Thursday, November 13, Executive Committee meeting will begin at 9 a.m. in the Roosevelt Room rather than the regular 8:30 a.m. starting time.

3. New York City

The Executive Committee went into Executive Session to discuss recent developments regarding New York City's financial condition.

EYES ONLY
RBP

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

November 11, 1975

MEMORANDUM FOR THE ECONOMIC POLICY BOARD

Subject: Review of Employment and Unemployment Statistics

I am enclosing a draft of an options paper for the President on the proposed review of employment and unemployment statistics.

Burton Malkiel
Burton G. Malkiel, Chairman
Subcommittee on Economic Statistics
of The Economic Policy Board

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

November 11, 1975

DRAFT OPTIONS PAPER

Committee to Review BLS Series on Employment and Unemployment

The last formal review of the government's employment and unemployment statistics program by nongovernmental experts was that conducted by the President's Committee to Appraise Employment and Unemployment Statistics (The "Gordon Committee"), appointed by President Kennedy in 1961. The Committee's report, Measuring Employment and Unemployment, (September 1962) made many recommendations which were subsequently incorporated into the procedures used by the Bureau of Labor Statistics and the Bureau of the Census.

In the intervening years, experience with the various statistical series has revealed their strengths and weaknesses. At the same time there have been important developments in the economy which have affected our data requirements. The labor force has undergone substantial structural change associated with the large increase in the proportion of women and teenagers. The expansion of social programs that reduce the cost of unemployment may also have affected the nature of unemployment. Because these developments have a bearing on the interpretation of statistics on unemployment they warrant a new look at definitions and methodology. Moreover, unemployment statistics are increasingly being used in determining the allocation of Federal aid to State and local governments which makes it all the more important to review the concepts.

It may, therefore, be appropriate to establish another committee of nongovernmental experts to evaluate the government's definitions, procedures, and methodologies concerning data related to employment and unemployment. The two decisions that need to be made are:

(I) Should a committee be established?

(II) If so, should the review be conducted by a commission appointed by the President or should we proceed with less publicity and ask a private research organization to name the Commission. In any event a private research organization should do the study.

(Tab A is a proposed "terms of reference" for a committee.)

Pros and Con

I. Establish a committee to conduct a review of our unemployment and employment statistics.

Pro:

-- It has been nearly 15 years since the last committee report (which, as its last recommendation, suggested a review in about 10 years); the data are now of much greater significance both politically and in terms of revenue sharing; and the economy has undergone many structural changes.

-- Any proposed changes in definition and methodology may be easier to implement if they come from a nongovernment committee than if they originate informally from the Department of Labor.

-- The current Commissioner of BLS has made a commitment to Congress that such a review be undertaken.

Con:

-- The establishment of such a committee at this time may appear to be a self-serving political act to "explain away" the unemployment of the past year. These concerns would be minimized by the appointment of a distinguished professional committee.

-- The committee may embarrass the Administration with recommendations that are not acceptable. The same expert advice can be obtained on an ad hoc basis without a committee.

II. If a full-scale review is desired, should it be undertaken by a Presidential Commission?

Pro:

-- A Presidentially appointed committee has greater stature and its recommendations are more likely to be adopted.

-- It shows the President's direct interest in employment and unemployment conditions by taking steps that may improve our data.

Con:

-- A Presidential committee may be more likely to arouse adverse political reaction as self-serving than if a less formal review is conducted.

-- Since the report of a Presidential Commission will be issued after January 1977, it may be less well received if there is a change of administration.

November 10, 1975

Tab A

Terms of Reference of a New Committee to Review the Bureau of Labor Statistics Series on Employment and Unemployment

A new Employment Statistics Review Committee should address broad issues relating to:

* concepts and definitions underlying current series and their adequacy to meet current needs;
* the need for new measures;
* methodology, including survey design as well as the collection and processing of the data;
* analytical techniques and presentation; and
* release of output.

Each of these major concerns covers many subordinate issues. Some detailed aspects that need review are outlined below, first, by the statistical series and then by issues not related to a specific series.

A. CURRENT STATISTICAL SERIES

1. The Current Population Survey (CPS)

a. Concept

Because these data are widely used for policy purposes, a major question to be addressed is what are the appropriate uses of the unemployment measure: Should it be designed as an economic measure of the excess supply of Labor? Should groups such as full-time students who are in a sense "employed" outside the civilian labor force (as it is now defined) be counted as unemployed if they seek work? Or, should the unemployment measure also refer to potential labor supply -- that is to include groups such as those outside the labor force who might be induced to enter, or those working part time who prefer full-time jobs? Can a single measure be expected to meet all analytical needs? Are supplementary measures needed? How much and what kind of statistically reliable disaggregation of the data are necessary to meet policy needs?

b. <u>Definition</u>

Several definitional problems are related to the conceptual issues including the following:

* Should groups such as discouraged workers, and part-time workers be included in the count of the unemployed? How should students be classified when they are not employed? If counted as unemployed what weight should each group get?
* Should the period for searching for a job be kept?
* Since the Armed Forces are composed entirely of volunteers, should they be treated in the same manner as any other government employees?

* What is the appropriate delineation between full-time and part-time work? 35 hours as at present, or less?

* Should the age cut-off for the official labor force figures be raised from 16 years to 18 years?

c. Methodology

The methodological issues for the Current Population Survey are primarily the responsibility of the Bureau of the Census. These problems should be considered by the Committee. They would include:

* The undercount;

* The discrepancy between the published data and the re-interview rate;

* The discrepancy between the CPS data and other surveys which interview each person directly rather than one person for all members of the household.

d. Need for additional data to supplement present series

Consideration should be given to the need for new or expanded data, such as:

* intensity of job search: an effort might be made to identify among the unemployed those who look seriously for jobs as distinguished from those who look only casually.

* extent of search among the employed and the extent of job changes by the employed and unemployed.
* measures of labor force flows -- the percent entering the labor force each month.
* measures of duration of completed spells of unemployment which are not now available.
* a measure of the extent of family income loss among the unemployed: efforts might be made to determine what other sources of support are available to the unemployed.
* expansion of the samples to provide greater detail by geographic area, by minority group or for other categories.

2. Industry Payroll Series

a. Concept

The "790" series, which yields employment, hours and earnings data, is a count of jobs and related hours and earnings; it differs in concept from the CPS series which is a count of persons, including some who may hold two jobs simultaneously or consecutively in the reference period. One major question to be addressed for this series is: What is an effective method of reconciling the employment data to account for differences in concept, scope, and survey design between the "790" and the CPS?

b. Definition

c. Methodology

The "790" might benefit from a searching review of methodological aspects that have recently given the Bureau some concern such as:

* how to improve preliminary estimates through speeding up data collection and processing;
* how to measure response error more adequately, and
* how to account adequately for new firms.

d. Need for additional data or refinements of present series

Expansion of the "790" series might include:

* a series on hours and earnings of part-time workers;
* a series covering hours and earnings of nonproduction or supervisory workers;
* a series on all employee earnings;
* hours and earnings data for the public sector and
* expansion of detail by State, area, and city.

3. Occupational Employment Statistics

The Bureau's partially-developed program to measure employment by occupation in each State needs to be evaluated to determine (1) whether it meets current need for these data and (2) how best to develop national data.

4. Labor Turnover

Consideration might be given to expanding this series to cover (1) nonmanufacturing industries, (2) classification by occupation and (3) the reasons for quits.

5. ES-203, Characteristics of the Insured Unemployed

A wealth of data is available from the administrative records of the State UI systems. Consideration should be given to the merit of special surveys of these data to determine the characteristics of the insured unemployed and to compare the results with data from the CPS. Questions are: What characteristics are needed? Should the survey relate to beneficiaries or claimants?

6. ES-202 Program

The UI universe has the capability of producing employment and wage data by detailed industry and county for each quarter of the year. Similar information is now being tabulated for the first quarter of each year based on social security records. Consideration should be given to the merit of surveying the universe of employers, periodically, to develop a "total hours" benchmark.

B. MAJOR METHODOLOGICAL ISSUES

1. Seasonal Adjustment

Adjusting for seasonal change has become routine in Bureau series, but many different techniques are available. None is perfect and each yields slightly different results. The Bureau's methods should be evaluated against other alternatives.

2. Effect of Census Undercount

What can be done to correct the effects of the Census undercount on the CPS?

3. Standard Tests of Significance

Are the standard tests of significance appropriate for interpreting month-to-month changes in economic time series, such as employment and unemployment? For example, up to now, the only tool used to make such a decision is the relationship between the magnitude of the month-to-month change and the magnitude of the standard error (or a multiple of the standard error) for the month-to-month change. As sometimes happens, changes that are viewed as not significant in terms of the month-to-month analysis may, over a period of several months, accumulate to a substantial trend movement. Question is would other methods for determining the significance of month-to-month changes be more useful?

4. Sample Design

Is the sample design now in use the most efficient in light of the needs for substantial data for programmatic and related purposes?

C. REPORTING PROCEDURES

Attention should also be given to the adequacy of the timeliness, frequency and format of reporting data. For example, should supplementary data on many special groups in the population that are collected and/ or published infrequently be collected on different cycles? The Committee should review the BLS procedures for reporting on data through press releases, publications, etc.

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

November 11, 1975

MEMORANDUM FOR THE ECONOMIC POLICY BOARD

Subject: Establishment of A Household Test Panel

In connection with the recommendation for a full scale review of employment and unemployment statistics as well as reflecting the continuing need for evaluating new concepts and methods that could improve the quality of the ongoing unemployment statistics derived from the CPS, the Subcommittee on Economic Statistics strongly supports the establishment of an experimental panel of households. Such a panel would permit testing and evaluation of the proposals of the full scale review we recommend. A review panel was initially recommended by this Committee last year to assist in examining the impact of adding questions to the CPS, changing procedures and techniques (e.g. telephone vs. personal interviews) and insuring the continuing high quality of the CPS. The estimated annual cost of such a panel would approximate $450,000. The agencies should explore the possibility of funding this project with available 1976 monies.

Burton Malkiel

Burton G. Malkiel, Chairman
Subcommittee on Economic Statistics
of The Economic Policy Board

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

November 11, 1975

MEMORANDUM TO: The Economic Policy Board Executive Committee

FROM: Charles M. Walker CW
Assistant Secretary of Treasury for Tax Policy

SUBJECT: Re ESOP Proposal

Attached is material on the above matter for your consideration.

Date: NOV 11 1975

MEMORANDUM FOR: SECRETARY SIMON

From: Charles M. Walker CW
Assistant Secretary (Tax Policy)

Subject: ESOPs (Employee Stock Ownership Plans)

The attached memorandum describes a modified form of ESOP, which we call ISOP (Individiual Stock Ownership Plan). The ISOP is designed to build on the strengths of ESOP, while eliminating or minimizing its drawbacks. ISOP would provide a substantial incentive for broadened stock ownership in a form we could accept and that should prove attractive to Senator Long.

The ISOP would be a salary reduction plan. That is, employees would elect whether to participate by electing a reduced salary and having the difference (up to a maximum limit of, say, $1,500) paid into an ISOP. To channel the tax incentives where they will do the most good in inducing broadened stock ownership, the maximum contribution limit would be phased out over a specified earned income range (say, $10,000-$25,000). The tax benefit would be deferral of tax on the amount paid into the ISOP.

Like an IRA (Individual Retirement Account), an ISOP would be a retirement plan, with the restrictions on withdrawals that implies. But unlike IRA and ISA (Individual Savings Account), ISOP would be an employer-sponsored plan. This would tend to emphasize the ESOP parentage.

We suggest that ISOP investments be limited to stock, but not necessarily employer stock.

The ISOP concept is very flexible. For example, an employer contribution (deductible to the employer) could be substituted for the salary reduction feature. Or a required employer contribution could be coupled with the salary reduction feature. Again, the employee can be given complete investment discretion in choosing his stock investment or he

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname						
Initials / Date	/	/	/	/	/	/

Form OS-3129
Department of Treasury

can be required to invest all or part of the account in employer stock. Finally, the contribution limits and phase-out can be varied as required by revenue considerations. These options are further described in the memorandum.

Additional background is provided in the attachments to the memorandum.

Attachment

cc: Mr. Stephen Gardner
Mr. Gerald Parsky
Mr. Harold Eberle
Mr. Robert Gerard

Date: NOV 11 1975

MEMORANDUM FOR: SECRETARY SIMON

From: Dale S. Collinson
Tax Legislative Counsel Designate

Subject: ESOPs (Employee Stock Ownership Plans)

This memorandum describes a modification of the ESOP approach to encouraging broadened stock ownership, which is designed to incorporate the advantages of that approach while minimizing or eliminating its disadvantages. Also discussed are some options that can be incorporated into the modified Kelso approach. Additional detail and background information is provided in the attachments.

Background

The Treasury Department has generally opposed the allowance of special tax benefits for employee stock ownership plans (ESOPs), commonly known as Kelso Plans. We have been concerned about the increased risk to employees inherent in channeling their retirement savings into a single investment, stock of their employer, and by the multiplication of that risk resulting from the leveraged financing aspect of the typical ESOP. Further information regarding ESOPs is provided under Tab A.

More recently we have become aware, in discussions with practitioners, of the self-dealing problems that can arise in a closely-held corporation situation, where the valuation of employer stock is difficult and the sales price to the employee plan may be set at an unrealistically high level.

On the other hand, the Department has favored the general objective of broadening stock ownership so that a broader segment of our populace will have a stake in corporate economic activity and the tax laws and government regulations affecting such activity. The extent to which broad corporate ownership already exists, through life insurance and retirement savings in employee pension plans, is detailed under Tab B.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname						
Initials / Date	/	/	/	/	/	/

Form OS 3129

Over the past several months, the Department has considered a number of alternative approaches to the goal of broadened stock ownership. Each of these has, however, serious drawbacks. For example, we have considered the creation of an individual savings account (ISA) limited to investment in corporate stock. Such an ISA would be modeled after the present law individual retirement account (IRA). That is, an employee could set up a special account and deduct contributions to the account, which would then be used to purchase stock. The main drawback of this approach is that individuals who have already accumulated substantial savings could obtain a deduction for simply shifting a portion of those savings each year into an ISA, thus sheltering their other income from tax with no increase in savings and perhaps no change in their ownership of stocks.

A second alternative we have considered is the extension of tax-exempt treatment to the earnings (dividends and capital gains) on stock in an ISA. Under this approach, no deduction would be allowed for the initial contribution to the ISA (thus eliminating the shelter problem) and the earnings of the account would be tax-exempt even when later withdrawn from the account. In effect, the present tax-exempt status for municipal and state government securities would be extended to stock held by an ISA account. While the long-term revenue loss is roughly the same under the two approaches (initial contribution deduction versus tax-exemption), the revenue loss from the tax-exemption approach is much lower in the early years. Thus, the tax-exemption approach may be viewed as not providing as great a tax incentive. Also, taxpayers are likely to prefer the deduction approach, which permits income to be shifted from high tax to low tax years.

The present memorandum examines a new approach, the Individual Stock Ownership Plan (ISOP).

Description of ISOP

The suggested ISOP has the following characteristics:

-- It would (like an ESOP) be a qualified employer-established benefit plan meeting the participation, nondiscrimination and other relevant qualification requirements.

-- The tax incentive (not available under an ESOP) would be the allowance of an exclusion from an employee's income for amounts contributed to the plan.

- o That is, the ISOP would be a salary reduction plan. Employees would elect individually whether to participate by taking a reduced salary.

-- The maximum reduction in salary would be specified, for example the lower of $1,500 or 15 percent of salary.

- o The maximum reduction in salary would be phased out for individuals with earned income between specified levels, such as $10,000 to $25,000. The phase out would be based on the preceding year's income, so as to facilitate stability of the salary reduction program on a year-to-year basis.

-- An individual's account in an ISOP could be invested only in stocks, but each employee could elect (which he cannot do in an ESOP) how to allocate his account between an investment in the employer's stock and an investment in a pool of representative listed stocks.

-- The ISOP (like an ESOP) would be a retirement plan, with an employee being allowed to withdraw his account only upon retirement, disability or separation from the service of the employer.

-- The ISOP would be prohibited from borrowing in order to purchase employer stock, the leveraged financing aspect of ESOP.

Advantages of ISOP

ISOP would not totally avoid the disadvantages of other approaches. For example, the exclusion from income allowed under ISOP would be economically equivalent to the deduction for contributions under the ISA approach, with the same potential for creating tax benefits without necessarily inducing increased savings or increased stock ownership. The phase out of the maximum allowable salary reduction for earned income is an attempt to minimize the "tax shelter" potential by focusing the tax incentive on those who are less likely to have already accumulated substantial savings.

Advantages of ISOP include:

-- It builds on ESOP, which has already captured substantial Congressional support.

-- Use of employer-established plan avoids identification with Administration sponsored IRA and ISA (which use individual employee-established account approach) and thus minimizes probability of partisan criticism.

-- Use of employer-established plan increases likelihood of utilization.

  o Employees more likely to be responsive to employer-sponsored plan than bank or other solicitation for individual account.

  o Though the employer will not receive direct tax benefits for establishing an ISOP, it can provide tax benefits to employees without affecting its maximum allowable deductible contributions to employee pension, profit-sharing or stock bonus plans. Thus, employers will have every incentive to establish ISOPs.

-- Permitting employees to direct investment in a pool of stocks permits spreading of risk, opens coverage to those who may be unable to purchase employer securities (government employees and employees of closely-held corporations unwilling to let employees participate in ownership), and provides employees of declining companies with a fair investment opportunity.

-- Permitting employees to invest in stock other than employer stock also reduces self-dealing problems.

-- Prohibition of borrowing to purchase stock avoids the leveraging aspect of ESOP, and the inducement for employees to speculate with their retirement savings.

-- Phase-out of maximum salary reduction concentrates tax benefits where they will have the greatest impact on increased savings and broadened stock ownership.

ISOP Options

1. Employer deduction rather than salary reduction. The ISOP proposal could be modified to provide for an employer deduction for contributions to an ISOP rather than an exclusion from the employee's income for a reduction in salary. The employer would be required to contribute on behalf of all eligible employees.

To the extent that employers are not already contributing to pension plans the maximum amount deductible under present law, the allowance of an employer deduction would not provide any additional tax incentive beyond that in existing law. Thus, if an employer deduction is to provide an effective incentive, it would be necessary to allow the employer to deduct more than 100 percent of the amount contributed. For example, employers might be allowed to deduct 150% of contributions.

Considerations:

-- Direct employer tax benefits increase likelihood employer will establish an ISOP plan.

  o However, if employer increases total compensation payments, he will have increased cost; and this will tend to dissuade employer from establishing plans.

-- Employer deduction more likely than salary reduction approach, to be viewed as a business tax benefit, which could attract business support and labor opposition.

- o However, tends to induce larger compensation payments, which would affect strength of business support and soften labor opposition.

-- Because of higher corporate than individual average marginal tax rates, corporate deduction causes higher revenue loss per dollar of investment and 150% corporate deduction causes much higher revenue loss.

-- Employer deduction meaningless to tax-exempt employers (governments, charities, labor unions, etc.), so participation effectively limited to non-exempt sector.

-- Employees may identify less with their stock ownership if they have less choice in the matter.

- o Such lack of identification partially explains the lack of awareness of employees' stake in business through their pension plans.

- o The employees would have reduced choice regarding both whether to participate and how their account should be invested. While in theory the law could mandate that employees have investment choice, they are less likely to assert their rights with respect to "employer contributions" than with respect to "their income" which they have elected not to receive.

2. Combination of salary reduction and employer contribution features. The ISOP proposal could be modified to require, or permit, employer contributions matching all, or part, of the employee's contribution.

Example: Employees could elect to reduce their salary by a maximum of $1,000 (or, if less, 10 percent of salary). Employers would be required to contribute 25 percent of the amount contributed by each employee and would be allowed a deduction of 150 percent of the amount contributed.

Considerations:

- -- Increases employee incentive to participate.
- -- Unlike pure employer deduction plan, does not exclude tax-exempt sector.
- -- May increase employer interest in establishing plan, except to extent causes increased compensation costs.
- -- Revenue loss per dollar of investment is greater than pure salary reduction plan but much less than pure employer deduction plan.
- -- May introduce complexities (e.g., rules for vesting employee's interest in employer contributions).
  - o Vesting questions also arise under pure employer deduction plan but could be resolved under new 1974 pension reform act rules applicable to all qualified plans. Special rules providing faster vesting may be required where there is direct linkage between employee and employer contributions.

3. Limitation of investment discretion. Rather than giving employees full authority to direct how the investment of their ISOP account would be allocated between employee stock and a pool of listed stocks, the ISOP proposal could provide that a minimum portion of the account (say, 50%) would have to be invested in employer stock. The employee's authority to direct investments would then extend only to the remaining portion of the account.

Considerations:

- -- Increases employer incentive to establish an ISOP by increasing assurance that ISOP accounts will be source of employer financing.
- -- Permits substantial diversification reducing employee risk while retaining ESOP objective of providing employee stake in success of employer's business.
  - o Where employer has a declining business, retains ESOP disadvantage of forcing unwise investment.

-- Reintroduces unfairness for government employees and others to whom employer stock would not be available.

  o Could have exceptions for such cases allowing employees to exercise full investment control, but would introduce complexity and possible complaints from employees denied full investment control.

4. Changes in contribution limit and phase-out. The ISOP proposal can be designed with any desired combination of contribution limit and phase-out of the contribution limit. The following table shows the revenue loss for various such combinations.

Rough Estimates of "ISOP" Plan Revenue Losses
(Salary Reduction Only)
1976 Levels After 5 Years

Phase-out rate (by earned income) ($000)	Maximum Contribution $1,000	$1,500	$2,000	$2,500
	Revenue Loss ($ millions) 1/			
10 - 25	88	89	90	91
15 - 30	120	142	165	187
20 - 35	152	196	239	282
25 - 40	184	249	314	378

Office of the Secretary of the Treasury
Office of Tax Analysis
November 10, 1975

1/ The total annual stock investment varies with the phase-out rate and the maximum contribution limit from about 4-1/2 times the revenue loss ($10-$25,000 phase-out rate and $1,000 maximum contribution limit) to about 3 times the revenue loss ($25-$40,000 phase-out rate and $2,500 maximum contribution limit).

Attachments

A

<u>ESOP PLANS</u>

This memorandum provides background information on Employee Stock Ownership Plans, or ESOPs, under current law.

<u>General Structure of ESOP Plans</u>

ESOP plan financing is offered as an alternative to corporate borrowing. A qualified stock bonus or profit-sharing plan, using borrowed funds, purchases the employer's stock. The employer receives immediate cash, which it uses for expansion. In subsequent years, the employer contributes annually to the plan sufficient funds to pay principal and interest on the loan.

The effect of an ESOP plan is that the employer finances expansion through an issue of stock, rather than borrowing directly. An ESOP plan should be particularly appealing to smaller enterprises having limited capacity for further debt financing and a limited market for issuance of their stock. Also, the ownership group may prefer, if their ownership is to be diluted by a stock issue, to give employees rather than outsiders a stake in the business.

ESOP plan promoters tell employers that they should adopt an ESOP plan so that they can obtain a tax deduction for amounts used to repay corporate "borrowing" (the annual cash contributions to the plan). In fact, the employer's annual payments under an ESOP plan may simply be made in lieu of direct compensation payments or contributions to a stock bonus or profit-sharing plan that the employer would otherwise have made. If so, an ESOP plan will not generate additional tax deductions.

Mr. Kelso also argues that ESOP plan financing is a revolutionary way of giving employees a stake in the business. But this may be accomplished as easily under a traditional profit-sharing or stock bonus plan.

The unique feature of ESOP plan financing is that it is a leveraged alternative to a traditional stock bonus plan providing annual contributions of the employer's stock. In effect, the employer capitalizes the future expected payments and obtains immediate cash, while the employees obtain a block of stock on margin. Assuming the annual cash payments under ESOP will be equivalent in value to the amount of stock that would have been contributed under a stock bonus plan, the employees will receive more stock under ESOP than under the stock bonus plan if the price of the stock is generally going up and they will receive less stock if the price is going down. (The converse will obviously be true for the employer.) Many persons doubt the wisdom of providing special incentives for leveraged investment by employee pension plans in employer stock, particularly where the employer's business is declining or faces an uncertain future (e.g., railroads).

Advantages Available to ESOP Plans Under Current Law

ESOP plans receive special consideration under current law. Under the Tax Reduction Act of 1975, an additional investment credit of 1 percent will be available for taxable years beginning before January 1, 1977, to the extent that such amount is paid over to a qualified ESOP. Each participant must be fully vested at all times in his share of the employer securities acquired with such amount, and must have the right to direct the manner in which such securities are to be voted. Only common stock may be used, with voting power and dividend rights of other common stock issued by the adopting employer.

The Employee Retirement Income Security Act of 1974 similarly includes a number of special provisions benefiting ESOP plans. Such plans are exempted from the fiduciary responsibility provisions requiring a fiduciary to diversify investments in order to minimize the risk of loss. There are also a number of special exceptions from the prohibited transaction provisions. ESOP plans are exempted from the general prohibition against investing more than 10 percent of plan assets in employer securities. An employer or a third party (such as a majority shareholder) may transfer company stock to such a plan without violating the self-dealing requirements, so long as the consideration is adequate. Moreover, loans may be made to an employee stock ownership plan without regard to the provision otherwise prohibiting the extension of credit between a plan and a party in interest, so long as the proceeds are used to purchase company stock and the interest rate is no more than a reasonable rate.

Finally, under the Internal Revenue Code as in effect currently and prior to enactment of the Employee Retirement Income Security Act of 1974 and the Tax Reduction Act of 1975, a lump-sum distribution of employer securities receives favorable treatment. Upon such a lump-sum distribution, only the cost of the securities to the distributing trust will immediately be subject to federal income taxation. Taxation on the gain element will be deferred until the securities are sold or otherwise disposed of in a taxable transaction.

Proposed Legislation

There have been a number of proposed bills dealing with ESOPs. S. 1370 (93rd Congress, 1st Session) would have provided a charitable deduction for contributions made by third parties (other than the employer) to a qualified deferred compensation plan (including an ESOP) for the benefit of persons other than the contributor and related parties. To the extent that plan assets were invested in company stock, a corporate deduction would have been allowed for dividends paid by the company on employer securities held by the trust if such dividends were currently distributed to plan participants. Finally, to the extent that employer contributions to an ESOP were used for the purpose of paying off any indebtedness incurred in order to acquire company stock, an additional deduction would have been allowed for 50 percent of the amount of the acquisition indebtedness paid by the trust during the taxable year. Thus, the total corporate deduction would equal 150 percent of the amount contributed. This special deduction, however, was available only where the trust owned a controlling interest in the employer. The Treasury Department's report opposing S. 1370 is attached.

In the 94th Congress, a number of bills have been introduced with respect to ESOPs. These include H.R. 462, introduced by Mr. Frenzel; and H.R. 7420, introduced by Mr. Kemp for himself and others, dealing also with other matters designed to stimulate job creation.

Notwithstanding the current limitations upon the deductibility of contributions to an ESOP, both H.R. 462 and H.R. 7420 would provide for the full deductibility of such contributions to the extent that they were used by the plan to repay indebtedness incurred for the purchase of qualifying employer securities. In addition, a deduction would be allowed for dividends paid by a company on employer securities held by an employee stock ownership plan, provided that the dividends were distributed to participating employees or used to pay off such acquisition indebtedness. Finally, a charitable deduction would be allowed for contributions to an ESOP if made with the express approval of the plan, and for the benefit of persons other than the contributor and related parties. In no event, however, could contributions be allocated for the benefit of a particular participant if the value of his account equaled or exceeded $500,000, less his accumulation under any other ESOP.

Commercial Problems

ESOPs raise a number of problems from a business point of view. The first relates to the nature and value of the employer securities held by the ESOP. The value of employer securities is important in determining (1) the company's tax deduction where employer securities are transferred directly to such a plan; (2) the reasonableness of any purchase price where employer securities are purchased by the plan either from the company or from a third party. Valuation is not difficult where securities are traded on the open market. In the case of a closely-held corporation, however, valuation presents a far more difficult problem. A professional appraisal will generally be required.

In addition, the nature of the employer securities held by an ESOP will be of particular concern in the case of a closely-held corporation. Specifically, must dividends be paid, and should the stock give participants the right to vote? Many closely-held corporations do not pay dividends, in part because the payment of dividends would reduce the capital available for corporate needs. As a result, such closely-held corporations would be reluctant to adopt an ESOP because of their concern over a policy which would require the use of dividend-paying shares. Voting rights create similar problems for closely-held corporations. The controlling shareholders of such a corporation may be unwilling to give employees any voting rights, although they would be prepared to issue nonvoting stock.

Further problems may arise when an employee ceases his employment. Closely-held corporations are reluctant to issue stock to individuals who are not in their employ. Terminated employees, on the other hand, have little or no use for unmarketable stock. The corporation and the employee, therefore, have a joint interest in an arrangement for converting the stock into cash. Among the possibilities are a mandatory buy-sell agreement, a put, or a right of first refusal. Under the mandatory buy/sell arrangement, an employee would be required to sell his stock back to the employer at a price established pursuant to the buy-sell agreement. The other two options would give an employee the right to sell his stock back to the company if he so desired, at a price determined by agreement or on a negotiated basis. However, most institutional loan agreements provide that company stock may not be redeemed without the consent of the lender. As a result, any form of buy-back arrangement will present problems for the closely-held corporation that is required to rely upon bank financing.

Securities Law Problems

Finally, there are a number of federal securities law problems where company stock is used in connection with an ESOP. These problems arise upon the acquisition of company stock, the distribution of company stock, and the sale of company stock by employees.

When an employer contributes stock directly to its ESOP, or when the plan uses company contributions to purchase stock from the employer, registration under the Securities Act of 1933 currently will not be required. In this case, the "no sale" theory will apply under existing Securities and Exchange Commission interpretations.

Similarly, registration will not be required when the plan uses company contributions to purchase stock on the open market, although there may be problems under the Securities and Exchange Act of 1934.

On the other hand, registration will generally be required under the Securities Act of 1933 when employee contributions are used to purchase company stock, because each contribution will, in effect, constitute an investment decision with respect to the purchase of company shares.

Upon the distribution of company stock to employees, there will be different considerations. Unless the interests in the ESOP and the underlying stock have been registered, the distribution must generally be registered or there must be an exemption. The Securities and Exchange Commission has informally taken the position that "no sale" will occur when a recipient agrees to take the stock for investment and not for resale. Under this approach, however, the employee will end up with "restricted stock."

When he goes to sell his restricted stock, there must again be an exemption from registration. The private placement exemption may be available, but generally, the only market for the employee's stock may be the employer corporation.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ISTANT SECRETARY

APR 30 1974

Dear Mr. Chairman:

You have asked the views of the Treasury Department on S. 1370, a bill to amend the Internal Revenue Code of 1954 to facilitate acquisition of ownership of private enterprises by the employees of such enterprises.

The Treasury Department opposes the enactment of S. 1370.

We understand that the general intent of S. 1370 is to provide additional tax incentives for the adoption of Employee Stock Ownership Plan (ESOP) financing, as advocated by Louis O. Kelso on behalf of Bangert & Co. Incorporated before the House Committee on Ways and Means on March 9, 1973. ESOP financing and the provisions of the bill are described below.

ESOP Financing

ESOP financing is intended as an alternative to conventional bank loan financing by corporations. Under ESOP financing, the needed funds are obtained indirectly through a trust established under a profit-sharing or stock bonus plan. The trust borrows the money and uses it to buy employer stock from the employer. The employer agrees to contribute to the trust sufficient funds to pay interest and principal on the loan. The effect of the arrangement is very much the same as if conventional financing had been utilized and a contribution of employer stock equal in market value to the amount of the loan had been made to a stock bonus trust. The principal differences are that, under ESOP financing, the trust is liable to repay the loan if the employer defaults, and the trust's investment in employer stock is in effect leveraged.

ESOP financing has the advantages of encouraging the growth of the private retirement system, encouraging stock ownership, and (hopefully) improving employee productivity. However, it has the disadvantage of decreasing employees' retirement security. Since the stock bonus trust is buying employer stock with borrowed funds (i.e., on margin), a reduction in value of employer stock would result in a significant reduction in the funds available for retirement. In a low market, employer contributions would have to be used to repay loans rather than to buy investments at bargain prices.

An example will illustrate the effect of ESOP. Suppose that $100,000 in stock would have been contributed each year for five years to an employee stock bonus plan. The number of shares contributed each year would have varied inversely with variations in the market price of the stock. Suppose further that the employer adopts an ESOP financing plan in lieu of the stock contribution plan. Under the plan, the trust borrows $500,000 and purchases $500,000 worth of stock from the employer. The employer contributes each year $100,000, plus the amount necessary to pay interest on the loan. The effect of ESOP financing is to fix, as of the time of the loan and stock purchase, the price at which the annual employer contributions will be converted into stock. This magnifies the advantages to the employees of an upward trend in the price of the employer's stock and multiplies the disadvantages of a downward trend. Because it is buying stock on margin, the trust's gains and losses are leveraged. Thus, if a share of stock is worth $10 in the first year, and it appreciates 10 percent per year, the trust will own 50,000 shares worth $805,000 in the sixth year ($16.10 per share). If it depreciates 10 percent per year, the trust will own 50,000 shares worth $295,000 in the sixth year ($5.90 per share). By contrast, if the trust had purchased $100,000 worth of stock each year, the risk would have been less. If the stock appreciated 10 percent per year, the trust would have owned 37,908 shares worth $610,319; if the stock depreciated 10 percent per year, the trust would have owned 69,367 shares worth $409,265.

A basic question posed by ESOP financing is whether employee trusts should be encouraged to enter into such more speculative leveraged investments, as opposed to a more conservative investment policy designed to maximize the security of the employees' provision for retirement.

Provisions of S. 1370

Section 1 of the bill would allow income, gift and estate tax deductions for contributions to trusts maintained under qualified pension, profit-sharing or stock bonus plans. The trusts would be treated as public charities eligible for income tax deductions up to 50 percent of an individual's contribution base. Contributions to trusts created by the donor, or by a corporation which controls or is controlled by or under common control with the donor taxpayer would not qualify for this special treatment.

The Treasury is opposed to the use of the charitable deduction as an incentive to make contributions to qualified trusts. Among other things, the deduction for a contribution to a charitable organization is justified on the basis that it encourages the financing of organizations which achieve social objectives which would benefit the public in general. The direct benefits of ESOP will be limited to corporate employees. The deduction would be available for contributions to qualified plans under section 401. While a plan must be nondiscriminatory, i.e., it cannot favor the highly compensated employee, officer or shareholder, often the plan will include only a fraction of the employees in the business. Thus, the benefits of ESOP are very limited and would not justify treating a contribution as a charitable deduction.

Section 2 of the bill would allow a corporation a deduction for "qualified dividends." A qualified dividend would be defined as a distribution to a qualified profit-sharing or stock bonus trust with respect to stock held by such trust, if the distribution is currently passed through to employees covered by the plan.

Under present law dividend distributions may not be deducted by the distributing corporation, and corporate earnings thus are subject to a double tax, first at the corporate level and again at the shareholder level. Alterations in this system, if they are to be made, should be general and not confined to such limited situations as those covered by section 3. For example, we see no justification for according more favorable treatment to dividends on stock held by a profit-sharing or stock bonus trust than to dividends on stock owned directly by employees or by the general public.

Section 3 of the bill would increase the limitation on deductible contributions to profit-sharing and stock bonus trusts from 15 percent of compensation to 30 percent and would increase the limitation on deductible contributions to a combination of pension and either profit-sharing or stock bonus trusts from 25 percent of compensation to 50 percent.

Increasing the amount and limits on contributions to profit-sharing and stock bonus trusts for all employees is contrary to the purposes of the pension legislation presently being considered by Congress. The pension bill passed by the Senate and the Ways and Means bill, H. R. 12855, contain limits on the maximum retirement benefits which could receive tax shelter treatment. To the extent that S. 1370 would allow additional contributions to qualified plans for the highly compensated executives it would defeat the intention of these limits.

Section 4 of the bill would allow a special deduction whenever contributions paid by an employer to a stock bonus or profit-sharing trust are used by the recipient trust for reducing "stock acquisition indebtedness," defined as indebtedness incurred by the trust to make certain purchases of employer stock. The special deduction would be equal to 50 percent of the amount of employer contributions to the trust used by the trust to reduce stock acquisition indebtedness during the taxable year. The special deduction would be in addition to the regular deduction for employer contributions, and the combined deductions might equal as much as 150 percent of employer contributions.

This section of the bill would create a tremendous premium on deferred compensation, i.e., a 150 percent deduction for deferred compensation vs. a 100 percent deduction for current compensation. We believe that such a bias in favor of deferred compensation is unwise and runs counter to the recent trend in tax legislation, which has attempted to achieve neutrality as between deferred compensation and current compensation or to favor current compensation. For example, the maximum tax on earned income under section 1348 of the Internal Revenue Code, which was enacted in 1969, was intended in part to encourage highly compensated employees to take income currently rather than to defer the receipt of such income.

Finally, it should be noted that the impact of the bill is not limited to ESOP financing. The charitable contribution provisions would apply to all qualified trusts. The deduction for qualified dividends would apply to all profit-sharing or stock bonus plans. The increase in deduction limits would apply to all qualified plans. The special deduction related to stock acquisition indebtedness would apply to all stock acquisition indebtedness of profit-sharing or stock bonus trusts.

Revenue Effect

The revenue effect of S. 1370 is very difficult to estimate because it requires a guess of how people would react to the new tax incentives. The revenue effect of sections 1 and 2 would probably not be great. The increases in percentage limitations on contributions by employers to qualified trusts might result in a substantial revenue loss, but it is difficult to predict how many corporations would make additional contributions in excess of the present limitations.

Presumably, many employers would take advantage of the special deduction for reduction of stock acquisition indebtedness since a $1.50 deduction would be available for every $1.00 of expense. Employers would have a very strong incentive to persuade pension trusts to enter into ESOP financing arrangements, even if it meant increased contributions to the trust. Thus, athough the revenue effect is very difficult to estimate, we believe there would be very significant revenue losses -- perhaps as much as, or more than, $1 billion per year. For instance, the corporate deduction for contributions under qualified plans was $11.1 billion in 1969 and $12.2 billion in 1970. Assuming roughly $16.0 billion is currently deducted, if 25 percent of those deductions related to profit-sharing or stock bonus plans, if the profit-sharing or stock bonus contributions would be increased by 25 percent because of the tax incentives offered by this bill, and if all of the profit-sharing or stock bonus contributions were used to pay off stock acquisition indebtedness, the resulting revenue loss might be in the neighborhood of $1.5 billion per year.

The Treasury Department is strongly opposed to the enactment of S. 1370. While in particular cases ESOP financing may prove advantageous to employees, on the whole it decreases the security of funds held by employee trusts. Where a stock bonus or profit-sharing trust is a major ingredient in the employees' retirement plan, it is questionable whether the trust should commit any substantial portion of its funds to ESOP financing. Moreover, the extent to which profit-sharing plans should invest in stock of the employer is itself a much debated question among plan administrators, many of whom believe such plans should hold a diversified investment portfolio. For instance, H. R. 4200, the pension bill passed by the Senate on September 9, 1973, contains limits on the amount of assets which may be invested in the securities of any corporation. Accordingly, the tax laws should at least be neutral with respect to ESOP financing rather than according a massive tax incentive, as under section 4 of S. 1370, to induce employers and plan administrators to adopt ESOP financing.

In any event, we do not believe that any advantages that may result from ESOP financing are sufficient to justify the significant revenue loss that would be incurred under S. 1370.

The Office of Management and Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

Frederic W. Hickman

Frederic W. Hickman
Assistant Secretary

The Honorable
Russell B. Long, Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

Dispersion of Stock Ownership

Direct Share Ownership.

The New York Stock Exchange *1975 Fact Book* gives the following figures on share ownership. These estimates are derived from occasional NYSE surveys of the population.

1952	6,490,000
1956	8,630,000
1959	12,490,000
1962	17,010,000
1965	20,120,000
1970	30,850,000

Thus, the frequency of share ownership has risen from 1 in 16 adults in 1952 to 1 in 4 adults in 1970. This dispersion of share ownership is the more remarkable given that persons have been being displaced in relative aggregate share ownership by institutional holders, especially pension plans. Growth in share ownership appears to have slackened since 1970.

Indirect Share Ownership

While direct ownership of corporate shares has spread so also has indirect ownership. About half of pension funds is placed in corporate shares. The *Life Insurance Fact Book*, 1971 reports the following figures on employee pension plan coverage.

1959	16,710,000
1955	24,108,000
1960	31,908,000
1965	38,854,000
1969	46,249,000

The rate of growth in employee pension plan coverage is decelerating and no more than something over half the work force will be covered by plans, baring major new developments which extend plan adoptions to classes of employers not now providing coverage.

In addition, 80 percent of the American population is covered by life insurance. However, only 14 percent of insurance company assets is corporate share value and the percentage for life companies is not much more than half that.

Holders of mutual fund shares are counted as direct holders in the NYSE surveys of ownership.

Cannon

ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE

November 12, 1975
8:30 a.m.
Roosevelt Room

AGENDA

1.	Proposal for Review of Employment and Unemployment Statistics	Malkiel
2.	Establishment of Household Test Panel	Malkiel
3.	Broadening Employee Stock Ownership	Treasury