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Broad-based Employee Stock Ownership Incentives and Contracting Efficiency

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Abstract: Neoclassical price theory implies that the incentive effects produced by broad-based employee stock ownership compensation plans will be overwhelmed by the problem of free riding. Yet the use of such plans is relatively common. This paper seeks to explain this apparent dichotomy. Using the theories of the firm of Alchian and Demsetz (1972) and Demsetz (1983) and the analytical structure of Jensen and Meckling (1976), I develop a microeconomic rationale for the use of broad-based stock incentives in the presence of a central monitor. I show that the ability of stock to align owner and employee interests is a function of marginal monitoring costs. At the margin, when monitoring costs are large relative to their benefits, the value of shirking to employees is minute. Hence, the small gain promised by stock ownership is sufficient to motivate reduced shirking. The theory rigorously unifies much of the common litany of explanations for the efficacy of such plans: monitoring and information costs, employee self-selection, the small cost of changing behavior, and alignment of employee with employer interests. Two pairs of refutable implications are derived. First, the optimal level of individual employee ownership is negatively related to firm size and positively related to marginal monitoring costs. Second, the change in firm value attributable to employee stock ownership is positively related to both the level of individual employee ownership and marginal monitoring costs.

1. Introduction

Neoclassical price theory implies that the incentive effects produced by broad-based employee stock ownership compensation plans will be overwhelmed by the problem of free riding. When an incentive is divided among n employees, each employee bears the full cost of any additional individual effort but receives only 1/n of its value [e.g., see Bhagat, Brickley, and Lease (1985), FitzRoy and Kraft (1987)]. Hence, "... the idea that joint ownership can do much for incentives when the number of workers is large seems wrong on the face of it" [Kandel and Lazear (1992)].

Nevertheless, directors are advised that stock ownership aligns employee and owner interests and stock-based group incentives are increasingly common [Jones and Kato (1995), Richardson (1995), Rutledge (1996), Wysocki (1995)]. In addition, empirical evidence supports a positive link between profit-sharing and productivity and, to a lesser degree, between employee share ownership and productivity [Beatty (1995), Blasi, Conte, and Kruse (1996), Cahuc and Dormont (1997), Conte and Svejnar (1990), Jones and Kato (1995), Kumbhakar and Dunbar (1993), Kruse (1992), and Weitzman and Kruse (1990)].

A diffuse litany of non-rigorous arguments typically is invoked to explain this apparent contradiction between economic theory and business practice, including peer pressure, mutual