

# “Does Employee Stock Ownership Plan matter? An empirical note”

Fitri Ismiyanti  <https://orcid.org/0000-0002-2353-0149>

 <http://www.researcherid.com/rid/U-6696-2018>

Putu Anom Mahadwartha  <https://orcid.org/0000-0003-0744-5478>

 <http://www.researcherid.com/rid/F-1622-2016>

## AUTHORS

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Mahadwartha, 2017

Fitri Ismiyanti, Department of  
Management, Faculty of Economics  
and Business, Airlangga University,  
Indonesia.

Putu Anom Mahadwartha, Dr.,  
University Surabaya, Indonesia.



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Fitri Ismiyanti (Indonesia), Putu Anom Mahadwartha (Indonesia)

# DOES EMPLOYEE STOCK OWNERSHIP PLAN MATTER? AN EMPIRICAL NOTE

## Abstract

Employee Stock Ownership Plan (ESOP) is a company program to provide incentives to managers to increase shareholder wealth and to align interests between the shareholders and the management. This ESOP is one of the most effective efforts to reduce conflicts of interest between the owners and the managers. ESOP program is basically intended to provide motivation and incentives for employees, so that employees will have a sense of concern (sense of belonging) to the company. Productivity is a reflection of the level of efficiency and effectiveness of work in total in a company. Productivity becomes very important, because it can describe the performance of a company. Performance is defined as the size or level at which individuals and organizations can achieve goals effectively and efficiently. This study aims to examine the effect of ESOP variables on company performance by using productivity as a mediating variable in non-financial companies in Indonesia Stock Exchange. The sample used in this research is companies that implement ESOP in the period 2000–2015. In this study, the company's performance is measured by using return on assets, return on equity and Tobin's Q, while productivity is measured by using sales per employee, cash flow per employee, and total assets turnover. Based on the results, it can be concluded that Employee Stock Ownership Program (ESOP) has a positive and significant impact on productivity.

## Keywords

ESOP, productivity, financial performance

## JEL Classification

G10, G11, M12

## INTRODUCTION

Conflicts of interest may occur between the owner or shareholder and manager and employee, or between majority and minority shareholders. Conflicts of interest may affect the productivity and performance of the company. One of the most effective efforts to reduce conflicts of interest between owners and managers is by applying Employee Stock Ownership Programs (ESOP). ESOP is a corporate issue to provide incentives to managers to increase shareholder wealth and to align interests between the shareholders and management (Jensen, 1986). Employee Stock Ownership Program (ESOP) is a program of share ownership by employees on shares of companies where employees are employed (Gordon & Pound, 1990).

ESOP is basically intended to provide motivation and incentives for employees. Thus, employees will have a sense of concern (sense of belonging) to the company. The growing sense of concern from the conscience of this employee can be expected to materialize, especially after the realization of programs to improve the welfare of employees through salary increases, allowances, bonuses, and other facilities.

In Indonesia, Indonesia Stock Exchange (IDX) continues to encourage Employee Stock Ownership Program (ESOP) to issuers or issuers to

increase the number of investors in order to enliven the trade. The implementation of ESOP is still not optimal, because there is no legal instrument specifically regulating ESOP in Indonesia.

The development of share ownership by employees in Indonesia prior to 1998 initially took the form of a share allocation at the time the company went public, so it can be concluded that it is more of a “stock allocation scheme” whereby the offerings are subsidized or secured by the company. From 1998 up to now, further developments on the ownership of shares by employees other than the 10% fixed allotment of the public offering, then more like an option program where prior to the public offering (go public), employees are given warrants that they can exercise the purchase of shares at a price in the foreseeable future of the period and its price. Implementation of ESOP can spur productivity and employee care in the company. Productivity is a reflection of the level of efficiency and effectiveness of work in a company (French & Rosenstein, 1984). Increased productivity can be achieved by minimizing all sorts of costs including the use of human resources (do the right thing) and increasing the maximum output (do the thing right). Productivity becomes very important, because it can describe the performance of a company.

According to Blasi, Conte, and Kruse (1996), firm performance also defined as measurement of goals achievement using efficient and effective resources. Shareholders, creditors, and other external stakeholders viewed firm performance as the success of managers in managing the company to achieve company's goals and objectives. ESOP can increase productivity because of its association with increased revenue (Gamble, 2000). ESOP is a form of reward that shows the alignment of company's objectives and its employees interest (Patard, 1985). Employees will realize that giving ESOPs is an additional source of income other than what they have received, which comes from salaries, bonuses and holiday allowances. Increased productivity will have a positive impact on the increase in operating profit, because the cost of production per unit becomes lower.

Employee awareness will ensure the quality of the product, as all employees feel possessed thus will take care of the company's long-term sustainability (Shearman & Sterling, 1989). All employees need to understand how the company operates and how their performance affects the company's performance. When employees feel as the owners of the company, they will increase professionalism in the work, because the company's revenue into employee income, as well as company costs, will be the burden of employees. If the employee's sense of concern for the company can be realized, it will encourage the increase of company value, or, in other words, stock price will also move up.

Implementation of ESOP will also increase the company's cash funds or additional working capital in the company (Beatty, 1995). This will have a positive impact on the increase in corporate profits, because the cost of funds from the results of ESOP is relatively cheaper than credit funds. With the ESOP, employees will realize that the go public program is not only dividing ownership of shares with outsiders, but also with the employees of the company itself. In addition to improving the sense of belonging, other effects are education to invest in employees and the opportunity to get a bonus either from dividends or stock bonuses. Agency theory explained the relationship between ESOP and company performance. Agency theory suggests that public companies are characterized by specific agency costs. These costs are borne by shareholders (the original owner of the company) who rely on managers (agents) to maximize shareholders wealth (Hallock, Salazar, & Venneman, 2004). The degree to which managers use their ability to maximize shareholder wealth depends on the percentage of ownership of managers within the firm because there is a separation of ownership and control (Lambert & Larcker, 1987). ESOP will increase the percentage of insider ownership. The business decision made by managers that also an insider ownership will increase shareholder wealth, and firm performance (Freiman, 1989).

Based on the description that has been presented in the background, we can formulate research question in this research is there direct influence of Employee Stock Ownership Plan (ESOP) on company performance or indirect influence of Employee Stock Ownership Plan (ESOP) on company performance with productivity as moderate variables?

# 1. LITERATURE REVIEW

## 1.1. Employee Stock Ownership Program (ESOP)

Employee Stock Ownership Program (ESOP) is a share ownership program by employees of shares of the company where the employee is hired. There are several reasons why companies implement ESOP (Estrin & Jones, 1992), among others, owners of companies want to include workers in ownership, entry of share ownership in the stock market, one solution in crisis prevention in dismissal of employees to get tax benefits, productivity, and prevention of expropriation by other companies. There are various approaches that companies usually use to implement this program: stock grants, direct employee stock purchase plans, stock options plans and employee stock ownership plans (Conte & Svejriar, 1990).

Employee Stock Ownership Plan (ESOP) is a type of pension plan designed to receive corporate contributions to a fund manager who will invest in the company's shares for the benefit of employees (Bonin, Jones, & Putterman, 1993). This approach is an Employee Stock Ownership Program formulated by Luis Kelso, an investment banker who has a strong idea of a capitalist system that will become stronger if employees are included in the company's stock ownership. Thus, the legal relationship between employees and companies is not only limited to labor relations, but also employees, as well as owners of the company. The means used to provide the opportunity to participate in the ownership of the company's shares is through the ESOP. The ESOP is a compensation plan based on the equity (shares) that employees provide for their performance against the company (Conte & Tannenbaum, 1978; Conway, 2000). Ownership of shares by company employees (insiders) gives the impression of a financial investment. Such ownership will give a great feeling towards satisfaction, as well as commitment and control to the company (Klein, 1987).

## 1.2. Productivity

Productivity is the ratio between the outcome of the activity (output) and any cost (sacrifice) to realize the result (input). Inputs can include produc-

tion costs and equipment costs. While the output may consist of sales, earnings (revenue), market share, and defects (Craig & Pencavel, 1992), productivity is the ratio between the results of an employee's work and the sacrifices that have been incurred. This is in accordance with the opinion of Pugh, Oswald, and Jahera (2000) that productivity is the ability to benefit as much as possible from the facilities and infrastructure available by producing optimal output even if the maximum possible.

Increased productivity can be achieved by minimizing all sorts of costs including the use of human resources (do the right thing) and increasing the output as much as possible (do the thing right). In other words, productivity is a reflection of the level of efficiency and effectiveness of work in total. In this study, productivity is measured using sales per employee (S/EMP), cash flow per employee (CF/EMP), and Total Assets Turnover (TAT).

## 1.3. Company performance

According to the Minister of Finance of Republic of Indonesia based on Decision No. 740/KMKOO/1089 dated June 30, 1989, what is meant by performance is the achievement of the company in a certain period, which reflects the soundness level of the company. In this study, the performance of the company is divided into two, namely the company's financial performance and market performance. The company's financial performance is measured using Return on Assets (ROA) and Return on Equity (ROE), while market performance is measured by Tobin's Q ratio.

## 1.4. Effect of ESOP on productivity

Every company has a different purpose. But in running the business, a company expects employees to have high productivity in the work. This is an ideal wish for a profit-oriented company. However, not all employees recruited by the company have the same working pattern. Every employee of course has a different motivation and background to each other. This gives rise to different work patterns and work results.

Appreciation and proper use of motivators will create a conducive atmosphere or result in higher productivity. They include a system of incentives and efforts to increase job satisfaction through various means.

Craig and Pencavel (1992) state that embedding money incentives on increasing productivity is a powerful enough stimulus to raise the active participation of the workforce. ESOP is given to employees who excel. This is of course expected to trigger employees to improve their performance. The company hopes that with the Employee Stock Ownership Program, employees will be motivated to improve the quality of its performance, because through this program it is expected that employees will feel the company so the level of labor productivity in the company will increase in accordance with the target to be achieved by the company.

### 1.5. The Effect of productivity on performance

Company performance is always related to productivity. Productivity is an important factor in maintaining and developing a company. A company is called productive if it can achieve its goals by transferring inputs to output at low cost. Productivity serves as a measure of individual development in developing performance qualities. Productivity is one measure of corporate performance. Productivity is believed to improve company performance.

### 1.6. Effect of ESOP on performance

Pugh, Oswald, and Jahera (2000) showed that managers with ESOP program will support the goals of the company to maximize shareholders wealth. However, they will more risk averse to support aggressive firm strategy. The willingness to align their interest with shareholders interest is sufficient to show that ESOP decrease agency cost. Employee share ownership (ESOP) tends to side with incumbent managers and increase employee incentives, so the impact of ESOP on companies is critical.

## 1.7. Hypotheses

Based on literature review and previous research, the hypotheses in this research are formulated as follows:

*H1: ESOP has a positive effect on productivity.*

*H2: Productivity has a positive effect on company performance.*

*H3: ESOP directly and positively affects to company performance.*

## 2. RESEARCH METHODS

### 2.1. Sample

The sample of this research is companies that implement ESOP in Indonesia Stock Exchange in the period 2000–2015. Data collection technique used in this research is purposive sampling method which based on research objectives and limits and certain criteria in decision making. Samples used are companies that implement ESOP in Indonesia Stock Exchange in the period 2000–2010 selected based on the following criteria: companies that implement ESOP in Indonesia Stock Exchange (BEI) from 2000 to 2010 and companies that fall into the non-financial category.

### 2.2. Variable definition

ESOP is defined as the number of shares owned by employees of the allotment of securities. ESOP is measured using a score of companies that implement ESOP code 1 (one), while those who do not implement ESOP are coded 0 (zero). Company performance consists of financial performance (ROA and ROE), and market performance (Tobin's Q). Return on Assets measures the company's ability to generate net income based on certain asset levels.

$$ROA = \frac{\text{Net Income}}{\text{Total Assets}}$$

Return on Equity measures the company's ability to generate profits based on certain share capital. This ratio is a measure of profitability from the point of view of shareholders.



$$ROE = \frac{\text{Net Income}}{\text{Total Equity}}.$$

Tobin's Q Ratio is used as an indicator for market performance measurement. This ratio represents the market value of all securities divided by the replacement cost of the asset:

$$Q = \frac{EMV + D}{EBV + D}.$$

Productivity measurement indicators use ln sales per employee, cash flow per employee, and Total Asset Turnover. Sales per employee is defined as the ratio of the number of sales to the number of company employees in one period:

$$\ln \frac{S}{EMP} = \frac{\ln \text{sale}}{\text{number of employees}}.$$

Cash flow per employee is defined as the ratio of company cash flow to the number of employees in a period:

$$\ln \frac{CF}{EMP} = \ln \frac{EBIT + \text{Depreciation} + \text{amortization}}{\text{number of employees}}.$$

Total asset turnover is defined as a ratio that measures a company's ability to use assets productively. Total assets turnover is measured by sales divided by total assets:

$$TAT = \frac{\text{sales}}{\text{total assets}}.$$

### 2.3. Data analysis technique

Data analysis technique is done by PLS (Partial Least Square) method. PLS is an alternative method of SEM based variance. PLS produces statistical parameter estimates that describe some of the variance to the maximum as it does in OLS multiple regression analysis (Hair et al., 2010). The hypothesis will be tested using smart PLS software.

Inner model equation:

$$\text{PRODUCTIVITY} = \gamma_1 \cdot \text{ESOP} + \zeta_1.$$

$$\text{PERFORMANCE} = \gamma_2 \cdot \text{ESOP} + \zeta_2.$$

$$\text{PERFORMANCE} = \beta_1 \cdot \text{PRODUCTIVITY} + \gamma_2 \cdot \text{ESOP} + \zeta_2.$$

## 3. RESULT AND DISCUSSION

### 3.1. Statistical description of research variables

Descriptive statistics are intended to explain the description of data of all variables included in the research model. Based on the result of observation of data, Table 1 below presented the characteristics of the sample used in the study, including minimum value, maximum value, average value, and standard deviation for each variable studied.

Based on Table 1 above, the average value (mean) of ESOP is 0.28 with the standard deviation 0.551. The average of ESOP of 0.28 gives an illustration that the implementation of ESOP program in Indonesia so far is still not optimal or, in other words, from the many companies listing in the stock are still few who implement the program. Productivity by using ln sales per employee, cash flow per employee, and total asset turnover as measurement indicator has mean value of 7.82, 3.52, and 1.33. The standard deviation of each indicator of 1.47, 2.32, and 0.43. Company performance is measured by Return on Assets (ROA), Return on Equity (ROE), and Tobin's Q. The average for the ROA of the sample company is 10.23 with the standard deviation of 12.14. The average value for ROE is 13.42 with a standard deviation of 26.15. Tobin's Q ratio (Q) shows an average value of 3.82 and a standard deviation of 2.36. The value of Tobin's Q ratio is above 1 (one), this means that the investment in the asset produces a profit that gives a higher value than the investment expenditure. This condition will stimulate the growth and development of new investment in the company sampled research.

### 3.2. Hypotheses testing

The result of significance of ESOP influence to productivity, significance of productivity influence to performance, and significance of ESOP's direct influence on performance is shown by parameter coefficient value and *t*-statistic significance value presented in Table 2 below.

Table 2 above shows the output that describes the results of testing the research hypothesis are as follows:

**Table 1.** Descriptive statistic

Variable	N	Min	Max	Mean	Std. Dev
ESOP	278	0	1	.28	.551
Sales per employee	278	3.09	10.32	7.82	1.47
Cash flow per employee	278	.06	9.71	3.52	2.32
TAT	278	.65	3.12	1.33	.43
ROA	278	.00	43.73	10.23	12.14
ROE	278	.00	45.65	13.42	26.15
Q	278	.32	13.41	3.82	2.36
Valid N (listwise)	278	–	–	–	–

### Hypothesis 1

The first research hypothesis states that the ESOP has a positive effect on productivity. Based on the test results, Table 2 shows that the magnitude of the parameter coefficient between ESOP to productivity is 0.278 and *t*-statistics is 3.826 significant (level significance 5% = 1.96), which means there is a positive effect of ESOP on productivity. The higher the implementation of ESOP, the higher the productivity of the employees, and vice versa. So hypothesis 1 in this research is accepted.

### Hypothesis 2

The second hypothesis states that productivity has a positive effect on company performance. The results of hypothesis testing showed that the magnitude of the parameter coefficient between productivity to performance of 0.328, which means there is a positive effect of productivity on performance. So the higher the productivity of the employee the higher the company's performance is generated with the *t*-statistics of 2.437 significant (level of significance 5% = 1.96). So hypothesis 1 in this research is accepted.

### Hypothesis 3

The third hypothesis in this study stated that ESOP directly and positively affects company performance. The test results show that the ESOP did not show any significant effect on the performance. This is indicated by the value

of parameter coefficient between ESOP with performance equal to  $-0.038$  with *t*-statistic equal to 1.494 (*t*-statistic less than *t*-table). So hypothesis 3 in this research is rejected.

In addition, testing of the structural model is done by looking at the value of R-square which is a goodness-of-fit test model. The model of ESOP influence on productivity gives R-square value of 0.027, which can be interpreted that the productivity constructive variable can be explained by ESOP variable of 2.7%, while 97.3% is explained by other un-researched variables. The model of ESOP influence and productivity on performance gives R-square value of 0.025 which can be interpreted that the construct variable of company performance can be explained by ESOP variable by using productivity as mediating variable equal to 2.5%, while 97.5% is explained by other variable not examined.

## 4. DISCUSSION

The findings of this study generally indicate that the implementation of ESOP is one effort to improve labor productivity within the company. Productivity also has an influence on improving company performance. In this research, there is no direct influence between the implementation of ESOP with performance improvement, but indirectly the implementation of ESOP can influence the improvement of company performance with the variables that is productivity.

**Table 2.** Inner weights result

Relationship	Original sample estimate	Mean of subsamples	Std. Dev	t-statistic
ESOP → Productivity	0.278	0.278	0.062	3.826
Productivity → Performance	0.172	0.328	0.083	2.437
ESOP → Performance	-0.072	-0.038	0.073	1.762

In this study, productivity measurement using sales indicators per employee, cash flow per employee, and total assets turnover. The results of PLS estimation show that of the three measurement indicators, cash flow per employee has the highest loading factor as an indicator that represents productivity measurement. The result of hypothesis testing about influence of ESOP to productivity shows that ESOP have positive significant effect to productivity. It can be interpreted that the higher the implementation of ESOP, the higher the productivity in the company or the lower the implementation of ESOP, the lower the productivity, where in this case productivity is measured from cash flow per employee.

Based on the findings above, it can be concluded that the ownership of shares by employees bring a positive impact on the increase of cash flows per employee within the company. Implementation of ESOP in the company into a corporate strategy to generate employee morale so as to increase employee productivity. This is in line with Pugh, Oswald, and Jahera (2000) who state that attaching money incentives to productivity increments is a powerful enough incentive to increase the active participation of the workforce, in which one effort can be made by giving an ESOP which is a reward or a form compensation is expected to realize a common goal, both for employees and for the company.

Based on the estimation result, productivity has a significant positive effect on a company performance. The relationship shows that the higher the productivity of employees in a company, the higher the performance generated in the company, and vice versa. In this study, performance measurement indicators use return on assets, return on equity, and Tobin's Q ratio. From the test results, it can be seen that of the three measurement indicators return on equity has the highest loading factor value so that used to represent the measurement indicators of the performance variables.

Productivity is an important factor in maintaining and developing a company. A company is called productive when it can achieve its goals by transferring inputs to output at low cost, in this case productivity serves as a measure of individual development in developing quality performance. In line with this, the test results in this study indicate that productivity proved able to improve company performance.

The result of hypothesis testing shows that there is no direct influence between ESOP with company performance. Although the long-term research period is 11 years, direct Employee Stock Ownership Programs have not been able to influence the company's performance.

Pugh, Oswald, and Jahera (2000) stated that by definition, ESOP increases the percentage of inside owners in a company. If the new owner really has decision-making authority, then based on the agency theory, efforts will be made to increase shareholder wealth, and is expected to improve the company's performance. But the results of this study have not been able to prove the theory. This is probably due to the large portion of shares from the allotment of ESOP shares is still relatively small, ie employees are entitled to get an average share of only 5% of the offered shares. Ownership of shares by employees is limited to a minority interest. Although the employee acts as the owner of the company, decision-making remains top management and parties with majority ownership or representation. So the impact of share ownership by employees is still not seen on the resulting performance. Another reason related to corporate culture. The ESOP program involves three elements, namely the elements of shareholders, management, and employees. Each company has a different culture in motivating employees. This will affect the decision of the purpose of carrying out the policy. If in a company employees are not too close to the world of stock would be a barrier in the implementation of the ESOP program. In addition, not all employees are entitled to buy ESOP shares. So the performance of some employees who own the company's stock is not enough to represent the performance of all employees that will improve the performance of the company.

These findings are in line with research conducted by Conte and Svejriar (1989) who stated that the ESOP has no significant effect on the growth rate of firm performance and there is no difference in performance either before the implementation of ESOP or after implementation ESOP. Similar results also presented in Pugh, Oswald, and Jahera (2000) study which concluded that the implementation of ESOP decreased financial returns in large firms and did not have a significant effect on small firms. The ESOP announcement also has no positive effect on the increase of company value.



## CONCLUSION

Based on the results of the analysis and discussion that has been done, it can be concluded that Employee Stock Ownership Program (ESOP) has a positive and significant impact on productivity. So the higher the level of implementation of the ESOP, the higher the productivity generated within the company, and vice versa.

Productivity has a positive and significant impact on company performance. So increased productivity in the company will improve the performance of the company. And then, the implementation of ESOP directly has no effect on company performance, but indirectly ESOP influences the company performance by using productivity as a mediating variable.

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