

THE REAL ECONOMY

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THE REBIRTH OF INDUSTRIAL POLICY IN THE UNITED STATES

BY JOSEPH BRUSUELAS AND ETHAN SCHMIDT

THE UNITED STATES Innovation and Competition Act of 2021, a \$250 billion legislative package passed in June to facilitate the research and development of science and technology, represents a sea change in United States economic strategy and a return of government use of industrial policy.

But embracing industrial policy to solve economic and strategic problems carries with it considerable possibilities and risks.

Government-inspired industrial policy has had a mix of modest success and significant failures around the globe over the decades. The semiconductor research consortium Sematech remains a rare success for such policies in the United States. Japan, by contrast, was never able to set the global standard in the consumer electronic market in the 1990s despite considerable government support.

Now we are on the cusp of another era of government-driven policies that involve [billions of taxpayer dollars taking on economic risks](#).

The changing approach prompts a question: Will such a major shift in government policy result in stronger American manufacturing, technological or life sciences industries?

Business decisions are about return on investment. Government investment decisions balance goals related to jobs and markets with ethical values, all of which carry risks and rewards. Those goals accompany the flow of funds whether they are for national security, the building and nurturing of infant industries, or political considerations.

EMBRACING INDUSTRIAL POLICY TO SOLVE ECONOMIC AND STRATEGIC PROBLEMS CARRIES WITH IT CONSIDERABLE POSSIBILITIES AND RISKS.

The Innovation and Competition Act was ostensibly passed to counter China's economic dominance and its emerging geopolitical influence. A bipartisan group of 68 senators voted to allow the government to make economic decisions, overriding the hands-off approach that has been sacrosanct for proponents of free market enterprise.

The \$52 billion put forward in the legislation to foster a domestic microchip supply chain again puts the government in the position of trying to pick winners in the manufacturing economy.

The U.S., which has captured approximately 50% of global semiconductor sales without significant intervention by the federal government, is now willing to put forward billions of dollars toward a supply chain that would support primarily the automotive sector and, to a certain extent, gaming and consumer electronics.

Those funds, though, do not carry an explicit guarantee that the supply chain will set the standard of the next generation of technology and meet demand. Billions of dollars in direct and indirect subsidies involved in this legislation could easily be lost.

Whether the legislation was framed around countering a threat to national security or securing a guaranteed supply of semiconductors, U.S. fiscal authorities have apparently sensed that the world economy is changing and requires a different approach.

MIDDLE MARKET INSIGHT

The U.S. has gone from leaning toward a pure free market framework to subsidizing domestic industry—but only because China has the ability to shut down the supply of key goods.

What is industrial policy?

Industrial policy can be defined as government interference in the free market. It can be indirect via agriculture subsidies, tax policy, procurement practices, trade restrictions and currency manipulation, all of which have domestic beneficiaries. Or it can be direct by providing capital.

The last time we discussed whether the U.S. government should become involved in making economic decisions (and when not in the midst of a national emergency) was in the 1980s, at the height of Japan's emergence on the world stage, and at the pinnacle of economic thought regarding corporations' role within a market economy.

The U.S. government ultimately refrained from heavy intervention in the microstructure of the economy, while Japan eventually ceded leadership in consumer electronics and then missed the digital revolution that soon followed.

Japan's government had used many forms of government intervention to resurrect its economy after the Second World War, from directing production to manipulating its currency. But Japan had become a wealthy ally and trading partner, and without a military it was a benign and welcome addition to the original G5 in 1973.

That was the same year that President Richard Nixon ended the dollar's convertibility to gold. That shift was the onset of free-floating currencies among the developed economies, which among other factors would contribute to the end of Japan's run of economic dominance.

In the 50 years since the G5, now the G7, was formed, the world has undergone a technological revolution that allowed for the creation of the global supply chain and the emergence of China and the Asian tigers as economic powers. While China's five-year plans were not unlike Japan's industrial policy, the entry of an authoritarian country onto the world stage and its military flexing have become a concern.

WILL SUCH A MAJOR SHIFT IN GOVERNMENT POLICY RESULT IN STRONGER AMERICAN MANUFACTURING, TECHNOLOGICAL OR LIFE SCIENCES INDUSTRIES?

So when 68 senators voted to [shift taxpayer resources to the development of the semiconductor industry](#), the conversation definitely changed.

The legislation shows that the U.S. has gone from leaning toward a pure free market framework to subsidizing a domestic industry—but only when the other party is a national security threat with the ability to shut down the supply of intermediate and final goods.

MIDDLE MARKET INSIGHT

A lack of semiconductors contributed to a shortage of automobiles, with the subsequent increase in demand for used vehicles contributing to higher inflation.

Public goods vs. private goods

Some goods and services are more efficiently delivered by the public sector than the private sector. The classic examples are roads, bridges, fire protection and national security.

Why not privatize fire protection, or an army? There would most likely be free riders who would benefit from a neighbor's fire department. It's also more efficient to have a single supplier (the local or national government) serving the entire population.

Let's apply that example to the current health crisis. Events of the past year have shown the need for government intervention in a variety of forms. There was the government support for pure research that successfully led to the development of vaccines. There was the inability to quickly produce an inventory of personal protective equipment. And there was the responsibility for management of the distribution of vaccines.

Expanding the notion of public goods

Is there any reason not to expand the notion of public goods beyond roads, bridges, fire protection and national security? Consider several recent supply chain failures, in which the market was found incapable of producing necessary goods.

One example was the failure to provide protective equipment to hospital workers during the pandemic. While Finland had stockpiled medical equipment before the pandemic, American states were competing with one another for limited supplies, to no one's advantage.

Another example was the energy shortage during the winter storm that hit energy-rich Texas. Electricity supply and delivery is treated as a mere commodity rather than a regulated public utility in Texas, but isn't there a limit to allowing people to suffer in the name of free enterprise? Someone needs to check that equipment can withstand a crisis and that backups are available.

A third example is the shortage of semiconductors, which came about because of the halt in production during the pandemic and the shutdown of the global supply chain. Along with backlogs in shipping of other goods supplied by our Asian trading partners, the lack of semiconductors contributed to a shortage of automobiles, with the subsequent increase in demand for used vehicles accounting for one-third of the recent spikes in inflation. So consumers are picking up the bill.

But is it right to put medical masks, electricity and semiconductors all in the same category of public goods? Should government intervention be allowed to go beyond public health and into economic development?

The special case of semiconductors

China is the principal reason that industrial policy for semiconductors is here to stay. Both President Biden and top Republican policymakers have asserted that the purpose of the 2021 legislation is to combat China's growing influence in several key areas of technology such as artificial intelligence and quantum computing, with special interest given to semiconductor production.

THE PANDEMIC HAS SHOWN THE NEED FOR GOVERNMENT INTERVENTION IN A VARIETY OF FORMS, ESPECIALLY IN PUBLIC HEALTH.

Semiconductor devices are the silicon chips etched with microscopic transistors that are the brains in nearly all modern technology, from toaster ovens to fighter jets. The production of the most advanced semiconductors is a critical economic and supply chain issue as well as a national security concern.

The production of semiconductors requires a lot of capital, and the development of competitive semiconductor factories, called foundries, often costs tens of billions of dollars, forming a significant barrier to entry in the market.

For this reason, the industry has experienced tremendous consolidation, and only three companies are capable of producing the most advanced semiconductors—Intel, Samsung and the Taiwan Semiconductor Manufacturing Company (TSMC). Of these three companies, [TSMC is the clear leader](#), in both market share and innovation.

In effect, the entire world relies on TSMC semiconductors, and any disruption to TSMC's production or supply chain could result in serious problems on a global scale. This happened during the pandemic, when quarantines and employees working from home spurred increased demand for personal electronics and a resulting semiconductor shortage.

The U.S. auto industry, so dependent on these semiconductors, was hit hard. Parking lots full of finished cars sat idle outside plants in Detroit, waiting for Taiwanese chips. This event was a wake-up call for both the U.S. and China, whose manufacturing economy was also shocked by the shortage.

Arguments for and against industrial policy

This is not the first time that the government has intervened in U.S. economic activity.

Going back to the 1930s, the recovery during the first phase of the Great Depression was driven by government employment, antipoverty programs and infrastructure investment. The initial recovery from the Depression quickly ended, however, when policy turned contractionary. That sent the economy into a deeper recession that lasted until military spending and the war effort brought it back to life.

Development of the American social safety net would not have been possible without the shock of the Great Depression, which serves as a lesson for today's policymakers. The upending of American hierarchy during the Depression and the war were pivotal in the creation of the middle class and the economic success that followed. It is clear that policymakers in both parties look at the shocks unleashed by the pandemic as a similar opportunity to remake the domestic economy.

The U.S. postwar recovery during the 1950s and 1960s was a remarkable exercise in free enterprise and consumerism. But the economy had little in the way of competition from war-torn Europe or Asia, and was aided by the Eisenhower interstate highway program and the GI Bill that sent Americans to college. Even so, the American dominance of the world economy didn't last forever.

Japan's economic postwar recovery began under state control and an antiquated hierarchy. It nevertheless managed to advance from making cheap toys and cars to supplying the world with efficient automobiles and consumer products. But industrial policy errors made sure that didn't last either.

Next up were China and the Asian tigers.

When China began to open up its economy and enter the international market in the late 1970s and early 1980s, it sat at the bottom of the value chain. China could specialize only in low-value-added goods such as textiles, textile inputs and toys.

Since the 1980s, however, China has caught up in many industries, and now Beijing has pledged to invest the equivalent of more than a trillion U.S. dollars in national objectives relating to industry, including a \$200 billion semiconductor foundry.

Japan and China offer examples of state control of industry, one within a developing liberal democracy and one under authoritarian rule. Are there lessons for the U.S. from these episodes?

Yes, Japan's industrial policy made poor decisions, losing out to technologies and production in Taiwan and South Korea. But there were other factors, such as an aging population and a lack of immigration, that stifled growth. And there was the emergence of China.

THOUGH WE CANNOT EXPECT CORPORATIONS TO ACT IRRATIONALLY AND NEGLECT TO MAXIMIZE PROFITS, NEITHER CAN WE EXPECT THE GOVERNMENT TO IGNORE THE BEST INTERESTS OF ITS LABOR FORCE AND TAXPAYERS.

MIDDLE MARKET INSIGHT

The U.S. auto industry, both automakers and their vast network of suppliers, was hit hard by the shortage of semiconductors.

As for China, it's hard to argue that the seeds of losing its economic dominance have been planted by inefficient competition among its provinces and overcapacity. China has natural resources for the digital economy and a nimble labor force. And it has begun to invest in the world's economic infrastructure.

As for U.S. economic policy, the dominance of the idea that corporations—and society—[are best served by optimizing shareholder profits](#) appears to be ending after a 40-year run. There can be no argument that U.S. nonresidential investment has been in decline. Corporations rightfully took the opportunity of the recession after the global financial crisis to move production overseas to low-cost centers.

But the concept that the marketplace is infallible—or that corporations are responsible only to their shareholders—seems as fashionable as Def Leppard or 1980s padded shoulders.

Though we cannot expect corporations to act irrationally and neglect to maximize profits, neither can we expect the government to ignore the best interests of its labor force and taxpayers. Are there alternatives to strictly adhering to ideological precepts?

We suggest these compromises to orthodoxy:

- Expand the concept of public goods to matters of public health and beyond
- Invest in a shortened supply chain for those public goods
- Fund research and development of essential industries
- Invest in the new model of American growth

Nonresidential investment and the business cycle

YEAR-OVER-YEAR % CHANGES IN GDP NATIONAL ACCOUNTS IN NON-SEASONALLY ADJUSTED 2012 DOLLARS



Source: BEA; Bloomberg; RSM US LLP

The North American integrated supply chain

International trade should benefit consumers, expand the potential for growth and ensure a peaceful coexistence among trading partners. The development of the global supply chain allowed for the increased well-being of populations other than our own. And though damages were incurred by segments of the American labor force, those could have been addressed had the focus of the past 40 years not been on the well-being of shareholders.

But like everything else that went too far, the pandemic and the increasing number of weather events have exposed the fragility of the global supply chain. We should recognize that it's not in the best interest of nations to apply just-in-time production techniques so broadly. That's why we maintain a fire department and a standing army.

So instead of forcing corporations to accept lower profit margins by regulating their choices along a global supply chain, the creation of a North American integrated supply chain for the manufacture of essential products would appear to be on the policy menu in Washington and may become an important part of the domestic manufacturing economy.

The corporations that maintain those resources would be paid a suitable rate of return on their investment in the same manner as we regulate the return earned by public utilities.

THERE ARE RECENT PRECEDENTS FOR GOVERNMENT FUNDING FOR PURE RESEARCH, THE MOST NOTABLE BEING THE NATIONAL INSTITUTES OF HEALTH'S SPONSORSHIP OF GENOMIC RESEARCH.

Consider this example: If the U.S. has the comparative advantage of developing ventilators, and Canada has the resources for manufacturing the parts, and Mexico has the labor force for assembly, it would not be that hard to create a local supply chain and to maintain an inventory of medical equipment. That would ensure that all three nations would be safer when the next version of SARS or the coronavirus arrives.

MIDDLE MARKET INSIGHT

The dominance of the idea that corporations and society are best served by optimizing shareholder profits appears to be ending.

The Sematech example

There are recent precedents for government funding for pure research, the most notable being the National Institutes of Health's sponsorship of genomic research.

In the 1980s, the U.S. response to Japan's advancements in semiconductors was for the government to finance a research consortium of domestic chip manufacturers. Sematech—Semiconductor Manufacturing Technology—was responsible for the turnaround in the U.S. semiconductor industry in the 1980s, according to [an article](#) in *MIT Technology Review*.

The article contends that Sematech became a model for how industry and government can work together to restore manufacturing industries or help jump-start new ones. The presence of top technical people at Sematech "ensured that the right technologies, not just those championed by the most powerful companies, got funded while others were abandoned quickly," the article said.

By the late 1990s, Sematech was able to reject further public funding and "in another wrenching shift in strategy, expanded to include some international companies as it became apparent that a U.S.-only supply chain would no longer work," the article said. Based on Sematech's success, at least in the early years of its partnership with government, funding research and self-sufficiency in the production of semiconductors seems to be a good investment for the economy.

The new model of American growth

The most innovative and prosperous localities are those centered on research hubs provided by academic institutions and on production hubs where that research is put to work. Each of those hubs requires an educated, healthy and skillful labor force.

The idea of planting a manufacturing facility in the middle of exurbia has become a thing of the past. Facilities are now overseas and are unlikely to come back unless there is a complete breakdown of the global supply chain. So policy should be both aspirational and in accordance with what is necessary and feasible.

Investing in the past is unlikely to be successful. Investing in the future will have winners and losers—but isn't that what we expect from free enterprise? ■

WINNERS AND LOSERS: THE SOLYNDRA SYNDROME

Investment in the semiconductor industry is likely to draw criticism, inviting comparison to the government's ill-fated investment in Solyndra in 2009–2011. In May 2021, Sen. John Barrasso, a Wyoming Republican and the ranking member of the Senate Committee on Energy and Natural Resources, [issued a report](#) critical of alternative energy projects advocated by the Biden administration. The report labeled Solyndra and other projects that were unsuccessful as a waste of taxpayer money.

According to other reports, Solyndra's technology, which did not use silicon in the production of solar panels, lost out when China began mining silicon and swamped the market with its panels. But one analysis offered a defense for the funding of Solyndra, comparing it to the successful funding program for Tesla—which repaid its \$465 million government loan nearly a decade early.



HOUSEHOLD DEBT IS RISING, BUT IT'S NOT A CAUSE FOR CONCERN

BY JOSEPH BRUSUELAS

AS THE ECONOMY picks up steam, concerns about a debt hangover like the one that followed the 2008–2009 financial crisis are proliferating.

But with American household balance sheets the strongest in decades, we see little chance of consumer debt interrupting the current expansion anytime soon.

A close look at both household and national balance sheets indicates that this concern is somewhat overblown and misses the growth in household wealth—however inequitably distributed—over the past few decades and its ability to finance public debt and infrastructure improvement.

Focusing on the ratio of debt to household wealth—as opposed to the far less useful debt-to-GDP ratio—elicits a different, constructive and encouraging outlook.

In addition, it implies that the American economy has far more fiscal space than has traditionally been acknowledged, which contributes to the conversation on addressing long-neglected infrastructure and social needs.

Household wealth and debt

Consumer credit as a percentage of gross domestic product, which is the customary way to look at household debt, has been in decline since the 2008–2009 financial crisis.

During the sluggish decade-long recovery from that crisis, households were coping with housing market losses, job losses and the decelerating growth of real personal income as the economy finished its transition from high-wage manufacturing to lower-paying service-sector employment.

A BETTER WAY TO VIEW THE ACCUMULATION OF HOUSEHOLD DEBT IS TO MEASURE IT RELATIVE TO HOUSEHOLD WEALTH. BY THIS MEASURE, HOUSEHOLDS ARE ON SOUND FOOTING.

MIDDLE MARKET INSIGHT

There is a large basket of pandemic savings that higher-income households can draw from while households at lower levels of income continue to spend what's available on necessities.

The result was household deleveraging, with consumer debt as a percentage of nominal gross domestic product falling from 98% in 2008 to 74% in the months before the pandemic.

But perhaps a better way to view the accumulation of household debt is to measure it relative to household wealth. The ratio of debt to net worth is a measure of the ability of households to support the debt they have taken on.

As our analysis shows, household debt as a percentage of household net worth has moderated across the postwar decades as wealth accumulation became accessible to the middle class through higher wages, government mortgage programs and tax benefits. Household debt as a percentage of net worth declined from 19.4% in the 1950s to 4.3% in 2009.

Since the financial crisis

In the decade since the 2008–2009 financial crisis, the four-quarter average of the ratio of household debt to net worth increased to 7.75% in the first quarter of 2021, which by itself might cause some consternation.

But in the context of increased costs of education and housing—both of which are investments in household capital—a ratio of debt to net worth of less than 8% is still well below historical levels of debt.

But it is also important to note that the peculiar demographics of the United States require an increase in medical care and allocation of capital to support the retirement of the baby boomers, which will need to be financed by that increase in overall national wealth.

In addition, household debt has increased by 24% in nominal terms compared to the second quarter of 2012, when household debt resumed its growth after the Great Recession.

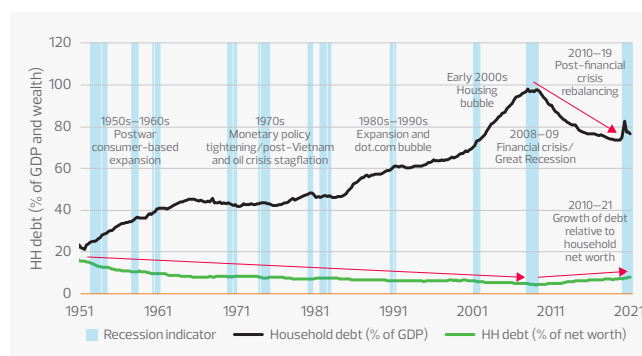
But during the same period, household net worth has increased by a total of 78%. Even taking into account distributional concerns, this implies that both the

household and national financial positions are far better off than generally understood—and suggests that households today are able to support current levels of debt.

In the sections that follow, we look in more detail at household debt and accumulation of wealth.

Household debt as a % of GDP and household wealth

FED FLOW OF FUNDS HOUSEHOLD DEBT AND NET WORTH DATA



Source: Federal Reserve; BEA; Bloomberg; RSM US LLP

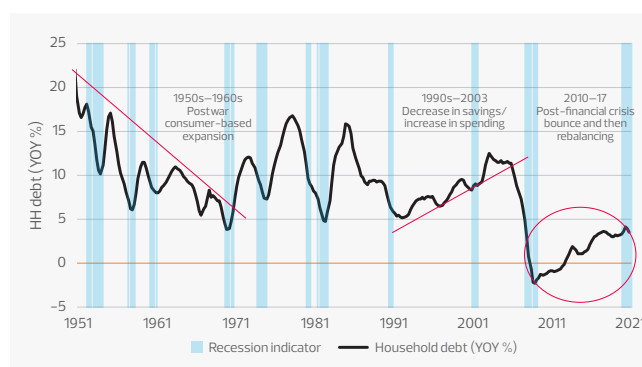
Household debt

Household debt declined during the 1950s and 1960s compared to the immediate postwar era of education and housing loans. It increased during the dreary 1970s and then again in the booming 1990s as credit card use became a way of life and as the economy experienced strong growth during the initial phase of the technology revolution.

But the growth of household debt collapsed after the housing bubble turned into the financial crisis of 2008–2009, recovering somewhat in its aftermath but at substantially lower rates of accumulation.

Growth of household debt

YEAR-OVER-YEAR PERCENT CHANGES



Source: Federal Reserve; NBER; Bloomberg; RSM US LLP

FOCUSING ON THE RATIO OF DEBT TO HOUSEHOLD WEALTH—AS OPPOSED TO THE FAR LESS USEFUL DEBT-TO-GDP RATIO— ELICITS A CONSTRUCTIVE AND ENCOURAGING OUTLOOK.

Household wealth

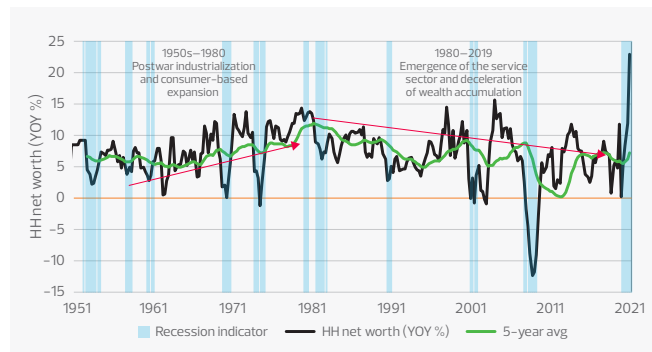
One would expect household wealth to exhibit long-term patterns of growth based on the demand for labor and—as we've seen in the past four decades—the availability of alternate supplies of low-paid labor.

As our analysis shows, household wealth increased on trend during the 1950s until 1980, when labor representation lost its ability to influence wage growth. From the 1980s on, household wealth accumulation slowed, with the exception of productivity gains during the five-year technology boom of the late 1990s.

In the run-up to the pandemic, the growth of household net worth was already in decline during the global manufacturing recession. Recent increases in net worth have coincided with government programs to maintain household income. We expect wealth accumulation to return to normal patterns as the economy reopens and government injections of income end.

Growth of household wealth

FEDERAL RESERVE FLOW OF FUNDS DATA



Source: Federal Reserve; BEA; Bloomberg; RSM US LLP

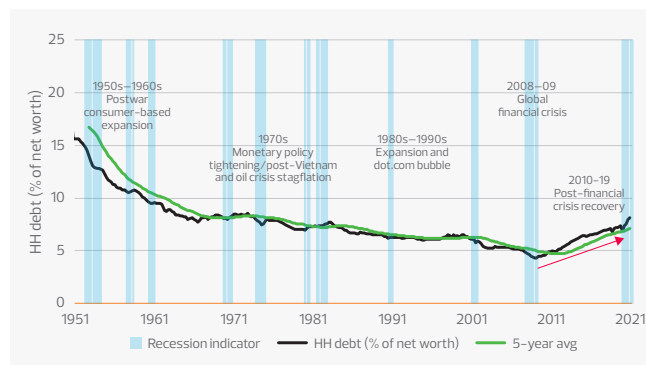
Household debt as a percentage of wealth

The numbers show that wealth accumulation outpaced debt accumulation for the six decades before the 2008–2009 financial crisis. In the past decade, however, wealth accumulation has been outpaced by increases in debt. Is this a function of households acting irresponsibly?

The last time the ratio of debt to net worth was as high as 7% was in 1987, in the middle of a 15-year period of declining wealth accumulation when labor representation was fast losing ground. By 1987, the baby boomers were well into adulthood, going into debt to buy houses and everything that goes into them.

Several decades later—accompanied by higher housing and education costs, the need to finance retirement and the changing nature of employment opportunities around technology and life sciences—the next generation is doing the same thing.

Household debt as a % of net worth in the postwar era



Source: Federal Reserve; BEA; Bloomberg; RSM US LLP

Normally, households take on more debt as they enter adulthood, with expectations of financing that debt with increasing income throughout their productive years.

After the pandemic, the likelihood of households suddenly taking on unsustainable levels of debt seems remote. Instead, there is a large basket of pandemic savings that higher-income households can draw from while households at lower levels of income continue to spend what's available on necessities.

We would argue that the increase in debt accumulation over the past 10 years is not cause for alarm. Rather, the current level of wealth suggests the ability to tackle both the overhaul of the nation's infrastructure and the inequality of wealth accumulation.

The takeaway

We have the means and the ability to build the infrastructure necessary for the new economy, to promote digital-age manufacturing, and to address inequalities of wealth accumulation and access to capital. ■

NEGATIVE-YIELDING DEBT SURGES AS RISK OF DELTA VARIANT RISES

BY JOSEPH BRUSUELAS

LAST YEAR the issuance of negative-yielding debt generally declined as the global economy prepared to reopen. It was a sign from investors that the worst of the pandemic would soon be over.

But over the past 90 days a different story has emerged, as rising economic and social risks linked to the delta variant around the world have rattled investors and pushed them back into the safety of government-issued debt. The result is that the total global issuance of negative-yielding debt has again surged above \$15 trillion.

We have already lowered our forecast for U.S. gross domestic product to 7% this year in part because of what is looking like a fourth wave of the virus in the United States, and because the delta variant has taken a significant toll on emerging markets like Vietnam. This renewed spread of the virus strongly implies downside risk to our current-year forecast should the variant continue to spread or government efforts to increase the vaccination rate fail.

The securities markets are reflecting this anxiety. The total volume of negative-yielding debt moved back above \$15 trillion on July 16 for the first time since early February. Issuance of negative-yielding debt bottomed out at \$12.6 trillion on Feb. 6, 2020, and began its recent strong upside move around June 25, 2020, that has yet to materially abate. This is part of the larger story of the decline in the benchmark U.S. 10-year Treasury yield to

a recent low of 1.12% on July 20, down from the cyclical peak of 1.74% on March 31.

Seeking a safe haven as the delta variant spreads



Source: Bloomberg; RSM US LLP

The potential for the spread of the delta variant is growing. Roughly 100 million Americans are unvaccinated, and the delta variant accounted for 83% of all COVID-19 cases in the United States in mid-July, based on genetic sequences from positive tests collected by the Centers for Disease Control and Prevention. That is up from 50% during the week of July 3.

Should government officials falter in their efforts to increase the pace and magnitude of vaccinations, we would again expect to revise down our estimates for GDP growth, the pace of hiring and inflation. ■

THE ALTERNATIVE

ALTERNATIVE ANALYSIS FOR INFORMED MIDDLE MARKET DECISION-MAKING

HOW AN ESOP CAN PRESERVE A CONSTRUCTION BUSINESS, AND A LEGACY

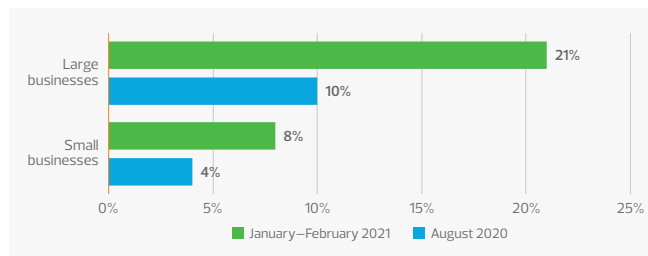
BY NICK GRANDY

AFTER MORE THAN A YEAR of whipsaw change brought on by the pandemic, many business owners have decided to retire. A recent survey of business owners conducted by the Wilmington Trust found that the pandemic is behind this rush to retire, adding another unexpected wrinkle to a devastating year.

But what's the right succession plan? This is no small consideration for an owner who has spent a career building a business and wants to see that legacy continue.

For many in the construction industry, that answer is increasingly found in the employee stock ownership plan, or ESOP, which allows for continuity in the sale process, and can provide tax savings as well.

Owners pushing up retirement because of COVID-19



Source: Wilmington Trust Business Owners Outlook: The Rush to Retire
Note: Small business is <\$5M revenue; large business is >\$5M revenue

An aging industry

Indeed, the construction industry is ripe for a transition to the next generation. The median age of construction workers increased by 1.3 years to 42.9 from 2010 to 2020. For the economy as a whole, this increase was 0.5 years over the same time frame.

And many owners of construction businesses are at an age where they need to consider succession planning. According to the latest survey by research firm Future Market Insights, on ownership transfer and management succession, a majority of those surveyed plan to exit their business in the next five years or so. But at the same time, more than 50% reported that they do not have an ownership transfer plan.

The exit strategies usually fall into five categories:

- Liquidate the business
- Sell to an external third party (competitor, private equity, etc.)
- Sell or gift to a family member
- Sell to employees
- Sell or gift to both family and employees

ESOPS FUNCTION TO REWARD EMPLOYEES WITH AN OWNERSHIP STAKE IN THE BUSINESS, WHILE ALSO PROVIDING A TAX-ADVANTAGED TRANSITION FOR OWNERS AND THE SPONSORING ESOP COMPANIES.

Amid this range of choices, the ESOP has increasingly stood out in recent years in the construction industry as well as other sectors.

Employees as owners

An ESOP is a qualified employee retirement plan governed by the Employee Retirement Income Security Act (ERISA). ESOPs function to reward employees with an ownership stake in the business that they work for, allowing them to share in the successes of the company while also providing a tax-advantaged transition plan for owners and the sponsoring ESOP companies.

Once the company adopts the ESOP trust, that trust can purchase shares of stock from the owner using borrowed funds from the company, a bank or the selling shareholder.

Advantages

An ESOP can provide certain advantages to a selling shareholder, including the continuity of the existing company and tax savings.

An ESOP can provide an owner with a structured exit over a longer time frame, should the owner want to stay involved. This is typically achieved because the owner is not required to sell 100% of the business in the transaction—although an owner can defer tax on the gains made from the sale of an ESOP if the ESOP holds 30% or more of the stock, along with meeting other requirements. By not having to divest fully, an owner can continue to be involved with the business while determining the proper succession plan.

The second advantage is tax-related, and not just for the owner.

If the sale of the company involves at least 30% of the stock from the seller—and the company is a tax-paying C corporation at the time the ESOP acquires the stock—the seller may defer paying capital gains taxes under section 1042 of the Internal Revenue Code. This can lead to tax savings for the seller.

MIDDLE MARKET INSIGHT

Using an ESOP can provide an owner with a structured exit over a longer time frame, should the owner want to stay involved.

Another major tax advantage has to do with the financing. Businesses can borrow money to fund ESOPs and repay these loans with pretax dollars because both the principal and the interest are deductible when repaying an ESOP loan (as opposed to just the interest being deductible in a conventional loan). This can be a significant savings and improve cash flows for the company.

Consider this example: A company, taxed at a 35% tax rate, wants to borrow \$1 million. The firm arranges conventional financing at 10% annual interest and makes equal annual principal payments over five years. The accompanying chart represents the summary of after-tax cash incurred by the company with conventional lending versus ESOP financing.

There is a \$350,000 cost difference between conventional debt lending and ESOP financing. This makes the ESOP financing less risky to lenders and allows for greater cash flows for the company.

Disadvantages

There are some disadvantages to ESOPs as well. One involves balance sheet leverage. If a company borrows money and then lends it to the ESOP to enable the ESOP to make a leveraged purchase of company stock, this will hurt the company's equity position (as liabilities will increase and equity decreases). This reduction could have an impact on the company's financial leverage and affect both bonding capacity and potential financing with third-party lenders.

Another disadvantage is that the ESOP trustee needs to monitor the ESOP's repurchase obligations. The timing of redemptions will need to be monitored to ensure that there is significant cash or liquid assets available to meet those obligations, the price of which will be determined

ANOTHER MAJOR TAX ADVANTAGE OF ESOPS HAS TO DO WITH FINANCING. BUSINESSES CAN BORROW MONEY TO FUND ESOPS AND REPAY THESE LOANS WITH PRETAX DOLLARS.

Conventional debt (US\$)				
Year	(1) Principal	(2) Interest	(3) Deduction	(1+2+3) After-tax cash cost
1	200,000	100,000	(35,000)	265,000
2	200,000	80,000	(28,000)	252,000
3	200,000	60,000	(21,000)	239,000
4	200,000	40,000	(14,000)	226,000
5	200,000	20,000	(7,000)	213,000
Total	1,000,000	300,000	(105,000)	1,195,000

ESOP financing (US\$)				
Year	(1) Principal	(2) Interest	(3) Deduction	(1+2+3) After-tax cash cost
1	200,000	100,000	(105,000)	195,000
2	200,000	80,000	(98,000)	182,000
3	200,000	60,000	(91,000)	169,000
4	200,000	40,000	(84,000)	156,000
5	200,000	20,000	(77,000)	143,000
Total	1,000,000	300,000	(455,000)	845,000

annually through a formal valuation process. Moreover, if the value of the company does not regularly increase, employees may feel that the ESOP is less attractive for them than other profit-sharing plans.

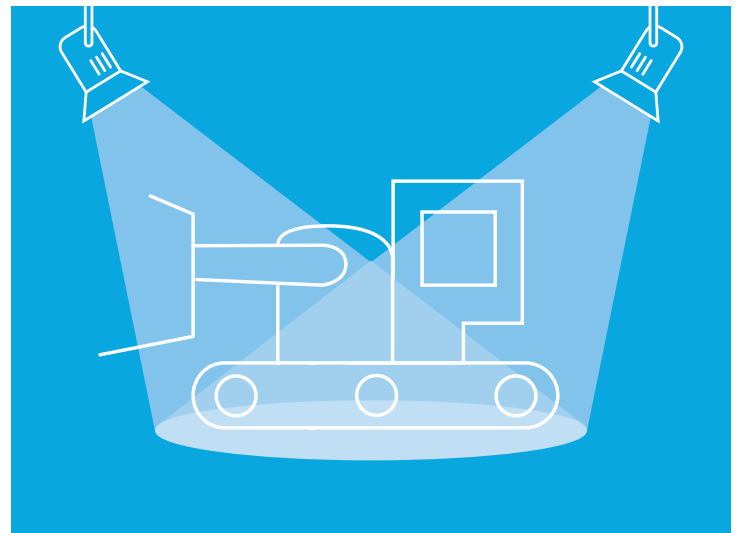
The last disadvantage is that ESOPs require significant management time and resources to meet rules on accounting and requirements of the Internal Revenue Code and the Department of Labor. Compliance can be burdensome and will require continued annual fees for services such as formal valuation and audits.

The takeaway

A contractor interested in pursuing an ESOP should meet with business advisors—including attorneys, lenders, certified public accountants, fiduciaries and other

administrative professionals—to discuss implementation and perform a feasibility analysis. This analysis should test the assumptions that go into selection of an ESOP, identify the expected benefits for employees, and help to determine whether an ESOP is a viable exit strategy.

While ESOPs are not for all contractors, they can be a great succession strategy for the right organization to help transition the business to the next set of leaders. For successful business owners in the construction industry, as well as in other sectors, retirement can be a challenge, but leaving behind a strong company as a legacy can make it a lot easier. ■



WHY THE HOUSING MARKET HAS MORE ROOM TO RUN

BY NICK GRANDY

THE HOUSING MARKET is as hot as ever, helping to lead the economy out of the recession as builders scramble to keep up with demand. Rising prices have followed, with the median price of new and existing homes jumping 22% and 21%, respectively, from April 2020 to May of this year.

But the surge has prompted a question: Is the housing market in a bubble like the one that preceded the financial crisis of 2008 and 2009?

A close examination of the data shows that we are just not there. Not only are inventories below their historical averages, but buyers are also more creditworthy—two significant differences from the housing bubble of the years before the Great Recession.

What's more, underlying demand linked to demographic changes and the recent rise in coronavirus cases will continue to push people to the suburbs in search of more space, even as low interest rates and a lack of supply drive prices higher.

Household finances are also strong. Even though the ratio of household debt to household wealth has increased recently, it is well within manageable levels.

So while prices are rising, the housing market has more room to run, and will most likely avoid a repeat of the housing crash that nearly brought down the U.S. economy over a decade ago.

The 2008 housing bust

Revisiting the previous housing boom, and the crash that followed, can highlight what's different this time. Before the Great Recession, homebuilding reached all-time highs, with starts and permits climbing well above the 1.5 million annualized rate that represents equilibrium in the market.

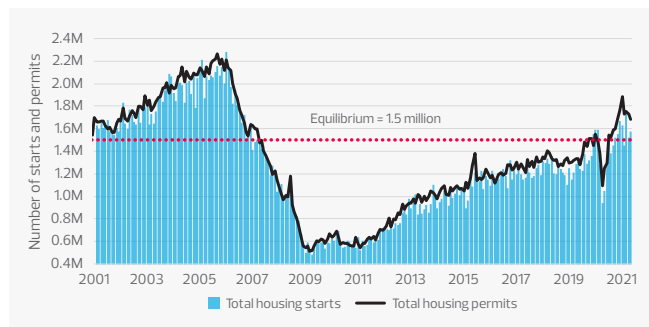
The National Association of Home Builders confidence index hit new heights in 2005, reaching 72. Money was flowing into the housing markets, the government was promoting homeownership for all, and financial institutions vastly expanded those who could qualify for financing.

Relaxed lending standards fueled the surging demand, and adjustable rate mortgages, often provided with little or no money down and unverified income, became a time bomb in the financial markets.

It couldn't last. Borrowers eventually could not repay their mortgages, causing them to default, and the bubble popped.

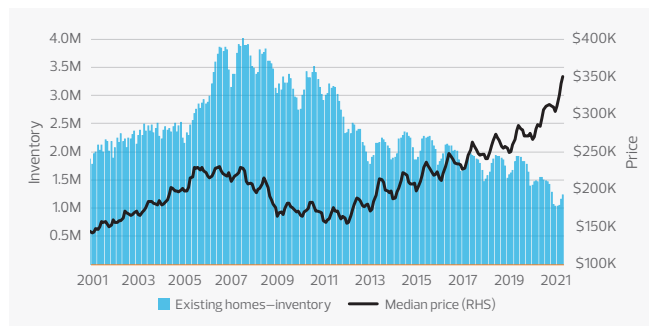
CONCERN ABOUT A BUBBLE IN THE HOUSING MARKET HAS FOLLOWED ITS RECENT SURGE. BUT THERE ARE KEY DIFFERENCES BETWEEN TODAY'S HOUSING MARKET AND THE PRE-GREAT RECESSION HOUSING MARKET.

U.S. housing starts and permits AND LONG-TERM EQUILIBRIUM LEVELS



Source: U.S. Census Bureau; RSM US LLP

U.S. existing home inventory and prices



Source: U.S. Census Bureau; RSM US LLP

After the bust, the market went into a slump as builders, and buyers, lost confidence. Builders over the next decade, wary of taking on risk, significantly underbuilt new homes as inventories of existing homes for sale gradually declined.

At the same time, the seeds for an inventory crunch were being sown. Millennials reached their peak homebuying age, and corporations like American Homes 4 Rent, which was founded in 2012, saw an opportunity to generate cash flow by snapping up single-family houses at low prices and renting them. This strategy, which only further constricted supply, is now being deployed by some of the nation's most established builders.

Fast forward to today. Builders are catching up, with housing starts and permits climbing above the 1.5 million unit annualized equilibrium in October 2020 and largely

MIDDLE MARKET INSIGHT

Not only are inventories below their historical averages, but buyers are also more creditworthy—two significant differences from the housing bubble of the years before the Great Recession.

staying there since then. The National Association of Home Builders confidence index has been above 80 since September.

What's different this time

Concern about a bubble has followed. But there are key differences between today's housing market and the pre-Great Recession housing market.

- **Existing home inventory levels are significantly below historical averages.** At a little more than 1.2 million homes as of May, inventory is significantly below the historical average of 2.5 million. The supply of existing homes sits at two and a half months, far below the six-month supply that creates equilibrium in the market.
- **Buyers today are more creditworthy.** During the pandemic, many lenders raised their borrowing standards. Lenders were requiring higher credit scores, larger down payments and even second employment verifications. The tightened standards were in part an outgrowth of the pandemic, when lenders faced substantially more risk as unemployment hit record levels and entire parts of the economy closed. While it is likely that these standards will loosen, lending requirements remain more stringent than before the Great Recession, resulting in more creditworthy buyers.

The takeaway

While it may feel that housing is primed for a bubble, the economics are straightforward. With limited supply and robust demand, prices will continue to rise. ■



MIDDLE MARKET WANTS TO HELP REBUILD INFRASTRUCTURE

AFTER DECADES of watching America's infrastructure decline, senior executives at middle market businesses are pushing to fix the nation's basic systems—and they're eager to participate in that rebuild, according to the proprietary RSM US Middle Market Business Index survey. Here are some key takeaways from what 404 executives told RSM in the survey, which was conducted from April 7 to April 28, 2021:

BUSINESSES WANT TO PARTICIPATE

51% overall responded that they were likely to participate in the vendor selection process for their business.

- That's a significantly higher total than the **30%** who responded this way in 2017.

80% responded affirmatively when the question was restricted to businesses that have at least one project that would represent a significant opportunity for their business.

- Four years ago, that number was **59%**.

CLIMATE CHANGE IS PART OF THE EQUATION

63% said they had already reduced their carbon footprint to zero, were working to get there, or were acting to reduce their carbon footprint, even if it's not to zero.

For more on the middle market and infrastructure, read [the full report](#).

REAL BUSINESS INSIGHTS FOR MIDDLE MARKET COMPANIES

Check out *The Real Economy: Industry Outlook* and get data-driven, sector-specific insights from RSM's senior industry analysts, a select group of professionals dedicated to studying economic and industry data, market trends and the emerging issues faced by middle market businesses like yours.

Each outlook provides unique perspectives and planning opportunities affecting businesses in the following industries:

- Business and professional services
- Consumer products
- Financial services
- Health care
- Manufacturing and energy
- Life sciences
- Real estate and construction
- Technology, media and telecom

Look for the Summer 2021 issue coming soon!



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