REMUNERATION
PLANNING
CORPORATION

23 September 1999

ENQUIRY INTO EMPLOYEE SHARE OWNERSHIP

As discussed with you previously, in response to a request from Dr Nelson (Chair) and Dr Emerson at our testimony to the Committee on Thursday 24 June 1999, we enclose a letter from Dr Vince Fitzgerald of the Allen Consulting Group, entitled "Saving Through the Firm Revisited", dated 6 August 1999.

In his letter, Vince states the following:

> "...I have never seen any conflict between my support for compulsory superannuation - ensuring a reasonable degree of self-provision for retirement -and my support for other savings vehicles, more relevant to other stages of the lifecycle. The new generation ESOP's meet virtually all the criteria for ideal-savings schemes -
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> - their source is the net extra "cake" of improved productivity and profits, which they in turn help encourage;
> - taxed on a pure deferral basis, they present strong incentives to save at no ongoing cost to public revenues; and
> - the elements of employer sponsorship and (moderate) lock-in enhance the initial encouragement to save and the maintenance of the savings in the committed form. "

At the end of his letter, Vince concludes that there needs to be a "...combination of measures that improve **both** our productivity **and** our saving performance. A conducive regime for ES0Ps would target precisely that powerful nexus."

The term "new generation ESOP" is a term that refers to employee share plans which have the following characteristics.

- tax deductible funding by the employer out of current revenue;
- deferral of taxation consequences until sale of shares; and
- while the prime purpose of the ESOP is to provide investment in shares of the employer, to mitigate downside risk exposure, employees should be able to invest in other appropriate investments as well.

To conclude, the areas most in need of legislative amendment to encourage employee share ownership are twofold.

1. The need to extend the maximum tax deferral for qualifying Division 13A plans from 10 years to the time of sale of the shares (ie. so employees have the financial resources to pay the tax on those shares). The ten year deferral limitation is the major taxation obstacle for the implementation of qualifying Division 13A plans in Australian companies not listed on a Stock Exchange.

2. The unavailability of prospectus relief for offers to employees of shares or rights to shares in unlisted companies. Prospectuses, which are necessary for each offer of shares or rights to shares to employees, can cost up to several hundred thousands of dollars per prospectus.

Removal or amelioration of these obstacles will improve Australian levels of productivity and savings.

We trust this information is of assistance, please feel free to ring me if you have any queries or require any clarification.

Yours sincerely

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6 August 1999

Saving through the Firm Revisited

You asked if I could provide some written comments revisiting the conclusions of the report that Remuneration Planning Corporation commissioned me to prepare in 1993: *Saving through the Firm: Employee Share Plans-Context, Role and Implications for Enterprise Performance, Saving and Taxation.*

I am happy to do so, noting that the context is the current inquiry into employee share ownership schemes by the House of Representatives Standing Committee on Employment, Education and Workplace Relations.

From a reading of some of the transcripts of hearings of the Committee, I take the main relevant issue-on which *Saving through the Firm* presented evidence, analysis and conclusions-to be broadly this:

- Is increased participation in employee share ownership plans (ES0Ps) likely to produce net additional private and national saving? In respect of impacts on saving, how does the potential contribution relate to that of superannuation?

I note that *Saving through the Firm* canvassed a wider range of issues concerning ES0Ps, in particular their potential to assist in achieving measurably higher enterprise performance and productivity. There is an extensive body of evidence-both overseas and Australian-supporting the conclusion that indeed there is typically a significant positive contribution of this kind. If so, the economic 'cake' is already larger before the question of net effects on saving arises. That is, there is a clear basis for 'win-win' economic outcomes.

As regards the effects on saving, there are three levels to the analysis:

(i) whether there are *gross* positive effects on saving (before any offsets)-and very obviously there are, whenever involvement in, or subscriptions to, employee share ownership plans increases;

(ii) whether these gross positive effects translate into *net* positive effects on *private* saving-i.e. whether there are any offsetting reduction in other saving is only partial-noting the simultaneous presence of a major and obligatory form of saving by employees, via superannuation; and

(iii) whether effects on *public* saving, via taxation, would further offset net private saving effects-perhaps leaving little if any net effect on *national* saving.

In revisiting these aspects of the issue, I emphasise that the major analysis of them in *Saving through the Firm* was in respect of so-called 'new generation' ES0Ps typically involving employee subscriptions out of a bonus or share of profits (and no leverage), pure deferral of (not outright relief from) tax, and a period of 'lock-in' before discretionary disposal. Savings embodied in the shares subscribed to through such plans would appear to have a typical life 'in the system' of something over 5 years-the report suggested a wide distribution around 7 years, based admittedly on evidence which was rather thin, and still is. The precise duration does not matter greatly, however:

- The first key point here is that these savings are *medium-term* savings, locked in for an initial period and typically held for somewhat longer than that, often until termination of employment with the sponsor.
- The second key point is that these savings are, by definition, invested in equity in the businesses concerned.' The rate of return, typically with a moderate paid dividend component and substantial capital gain component, is likely to be considerably higher than government's cost of funds (the bond rate) typically in the order of 10 per cent real-albeit with higher risk ('beta'). Nevertheless it is clear, and detailed modelling presented in *Saving through the Firm* confirmed this, that after a transition period of a few years, any permanent increase in participation in ES0Ps will lead to an ongoing *increase* in tax flows, not a decrease. In an accrual world, this is true even in the transition period - ie. taxes are accruing to the revenue even if not yet brought to account. *There is, in other words, no offset in reduced public saving* ... rather the possibility of some augmentation, albeit probably modest.

Hence the issue boils down to whether there are likely to be net effects on *private* saving. If there are, they will certainly flow through to national saving for plans of this kind.

I would be more cautious now about giving any precise numerical estimates for net national saving effects than when *Saving through the Firm* was written, because:

There have been schemes allowing other equities to be held, but here I focus on the classic type of scheme where the equity is in the enterprise itself.

- over the mid to late 1990s Australian households (and others, notably US households) have exhibited historically low measured saving relative to household disposable income. That is, consumption levels have risen relative to that measure of income; and
- the means by which that has been effected has been significantly increased use of debt-in the first instance, debt secured against dwellings and then, more recently, increased use of revolving (mainly credit card) debt. This can be attributed to the financial deregulation of the 1980s (making it easier to access credit), and to the achievement over the 1990s of a low inflation/low interest rate environment (making credit cheaper, or at least easier to service). At the same time, or at least over the mid/late 1990s, many households (more so in the US than in Australia) have experienced significant, mainly unrealised, gains on equity holdings (e.g. Commonwealth Bank, Telstra, AMP)-which are not picked up in the normal savings measures.

These facts have been adduced to cast doubt on whether e.g. compulsory superannuation is producing any net increase in private saving-and analogous doubts could be raised about employee share plans. Yet those researchers who have analysed the evidence in detail hold to their conclusion that the offset to compulsory superannuation from substitution out of other saving is likely to be substantially less than half-in the order of 30 to 40 per cent.

The various foregoing points appear to be in conflict. They can, however, be reconciled-by realising that when debt is increasing and significant stock market gains (which are in principle part of income and part of saving) are being made but not being counted, the normal household saving ratio measure can even go negative. In fact, I believe that in the absence of compulsory superannuation it might well have gone negative over recent quarters. *There is thus no reason to conclude from a low household saving ratio that locked-in saving via compulsory superannuation is not having a significant positive net effect on private saving, now.*

Equally, in the case of locked-in saving via employee share plans, the mainly overseas evidence for positive net savings effects marshalled in *Saving through the Firm* remains broadly valid, notably:

- US evidence (based on extensive and repeated surveys) that those with access to employer sponsored savings vehicles including ES0Ps have higher net saving than otherwise similar people; and
- Japanese evidence of high transfer rates from episodic bonus payments to long-term committed savings (rather than to near-term consumption).

It must be recognised that while consumption may exceed current income, households must still constrain their consumption spending to be within their disposable incomes (including any realised gains) plus *net increases in debt.* Paper gains on equities cannot be spent directly-they can be spent only if realised. In this regard:

- Australian households are currently limiting their use of debt to levels that require about the same percentage of income to service as in the early 1990s, before the decline in inflation and interest rates began. Accordingly, increases in debt secured against housing have slowed down significantly over the past year or so as servicing costs approached those levels. If interest rates rise substantially, that will very likely force cutbacks in consumption-i.e. *increased* saving on the usual measures.
- The present bull market will in due course end, and some of the unrealised stock market gains evaporate. Again, that would tend to increase measured saving.

In short, the factors that have been operating may reverse, but for the time being are still obscuring the net effects on saving of compulsory superannuation. Those effects are nevertheless occurring-albeit rather difficult to measure. And similarly, those factors are making it harder to produce an estimate of what net increase in saving would flow from increased participation in ES0Ps of the 'new generation' type. But in my view, the *net* effects of increased participation would be a substantial fraction of the *gross* effects-just as I concluded in *Saving through the Firm.*

Finally, may I say that I have never seen any conflict between my support for compulsory superannuation-ensuring a reasonable degree of self-provision for retirement-and my support for other savings vehicles, more relevant to other stages of the life cycle. The new generation ES0Ps meet virtually all the criteria for ideal medium-term savings schemes:

- their source is the net extra 'cake' of improved productivity and profits, which they in turn help encourage;
- taxed on a pure deferral basis, they present strong incentives to save at no ongoing cost to public revenues; and
- the elements of employer sponsorship and (moderate) lock-in enhance the initial encouragement to save and the maintenance of the savings in a committed form.

The analysis of why Australia needs to generate more domestic savings-in order to maximise our ability to complete and grow-that I set out in *National Saving: A Report to the Treasurer* also remains broadly valid today. That analysis particularly highlighted the power of combinations of measures that improved *both* our productivity performance *and* our saving performance. A conducive regime for ES0Ps would target precisely that powerful nexus.

Best wishes

Yours sincerely

Vince FitzGerald