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The Secretary
Standing Committee on Employment. Education and Workplace Relation
Suite R 1 116 Parliament House
CANBERRA ACT 2600

January 24th 2000

**Cost/benefit of incentives to promote employee ownership**

Dear Sir or Madam:

Further to my submission dated April 30th 1999, 1 attach an article which explains how to maximise the return to tax payers for any fiscal benefits provided to encourage employee ownership. The enclosed article "Democratising employee ownership" was published last month in *Board Report,* the Journal of the Corporate Directors' Association.

The article points out that employee ownership can be counter-productive unless genuine participation is introduced. Genuine participation requires changes in corporate constitutions to "guarantee individual rights" and provide "an independent appeals systems" for employees as well as ensuring that they can exercise the votes of their shares.

One way of changing corporate constitutions to achieve these objectives is to create a Corporate Governance Board (CGB) as considered last year by the Parliamentary Joint Statutory Committee on Corporations and Securities (JSCCS) for all listed companies whether or not employee ownership was involved. As CGB are elected on the democratic basis of one vote per shareholder instead of the usual plutocratic basis of one vote per share, they protect employees and all other minority shareholders.

It was for this reason that the AEOA made a submission last year to the JSCCS (No. 79) supporting both the establishment of a CGB and the election of directors cumulative (preferential) voting for publicly traded companies in Australia. These proposals were also supported by submission No. 83 by the Corporate Directors' Association of Australia.

The attached article describes how stakeholder governance maximises the benefits of employee ownership. The introduction of stakeholder ownership, as described in my earlier submission, provides the most cost and politically effective way to introduce employee ownership.

I submit that any fiscal encouragement to promote employee ownership should be tied to the introduction of CGB's and cumulative voting for directors as considered by the JSCCS. Also, that the most fiscally efficient technique for promoting employee ownership is through the introduction of Ownership Transfer Corporations as described in my submission of April 30th 1999.

Yours faithfully

Shann Turnbull
Principal

# Shann Turnbull

## Democratising employee ownership

Employee ownership without participation in control can be counter-productive to adding shareholder value. This occurs when management votes the shares of their employees to entrench their own position, remuneration and perks. Employees are now the biggest shareholders in BHP and many other large Australian companies.

However, the sharing of control as well as ownership with employees can be counterproductive with a unitary board. All nontrivial sustainable employee-owned industrial firms in the world possess two or more boards. This was a finding of Paul Bernstein in his book on *Workplace Democratization: Its internal dynamic*s.

Bernstein identified six minimally necessary conditions for sustainable employee governance: (i) participation in decision making, (ii) economic return to the participants based on the surplus they produce, (iii) sharing management-level information with employees, (iv) guaranteed individual rights, (v) an independent appeals system, and (vi) a complex participatory democratic consciousness. The lesson for publicly traded corporations with growing employee ownership is that they need to introduce each of these six minimally necessary conditions if they are not to jeopardise the performance of their business or give employee ownership a bad name.

Without a division of power into different boards. it is not possible to establish either " an independent appeals systems" or provide "guaranteed individual rights". The division of information and control rights into what I describe as a "compound board" also facilitates constructive "participation in decision making" and "sharing management-level information".

It is not constructive to have an employee representative appointed to the management board, as done at the Australian Broadcasting Commission to promote either "participation in decision making" or "sharing management-level information". This simply introduces unconscionable conflicts of interest for the nominee(s). It generates suspicion by the nominees' board colleagues that confidential information will be widely shared and/or a suspicion by the nominees' constituency that their nominees have been captured and/or has misplaced loyalties. A compound board avoids the lose/lose position for all parties.

The decomposition of decision-making labour into the components of a compound board provides operating advantages *even if firms are not employee-owned*. The complication in structure is more than offset by the simplification and improvement in decision making. Non-executive Directors (NEDs) on unitary boards become subjected to the problems of information overload and having to make decisions on strategic technical issues beyond their experience, training or knowledge. The competitive advantages of compound board increases, as businesses become more complex and knowledge intensive. The success of VISA International is based on it being controlled by hundreds of boards each with its own exclusive functional or regional discretions.

NEDs cannot properly carry out their duties for shareholders to monitor and evaluate management unless they have access to qualitative information about management independent of management. The best source of this information is the employees, customers and suppliers.

These strategic stakeholders are recorded in the books of a business to provide firms a basis to facilitate the formation of self-nominated and self-elected stakeholder councils in the form of employee forums, customer panels and supplier assemblies. The establishment of formal advisory boards with these crucial stakeholders provides a basis to obtain both operational and competitive advantages. It was for these reasons that Harvard Professor Michael Porter recommended the involvement of strategic stakeholders in both the ownership and control of companies in his 1992 report for The Council on Competitiveness.

The need to introduce stakeholder governance becomes increasingly critical as the extent of employee ownership increases. Stakeholder Councils introduce an internal loyal opposition to any misguided strategies, policies or self-dealing by employees. In this way they can directly protect the interests of investors much more effectively than institutional shareholders that do not have detailed operational information. Stakeholder Councils introduce internal competition for corporate control, which can act far more quickly, economically, sensitively and efficiently than competition for control through the stock market.

Policies for encouraging employee ownership will become counter-productive as employed shareholders increase unless stakeholder governance is also introduced. For taxpayers to obtain the best value for tax incentives used to further employee ownership stakeholder governance will need to be tied in for medium and larger sized firms.

An additional incentive for formally including stakeholders in the governance of publicly traded firms is the lack of involvement by shareholders in making management accountable. Institutional investors are now the largest owners of public companies but are mostly negligent in taking an active interest in corporate governance. The number of significant institutional investors in either Australia or the UK is less than the number of individual members in either of their respective national Parliaments. So even if institutions were active it would raise questions as to the political legitimacy of capitalism.

Even in 1976, when the proportion of institutional ownership was less than half its present level, Peter Drucker, wrote, *The Unseen Revolution: How Pension Fund Socialism Came to America.* The irony is that while more voters than ever are sharing in the ownership of public corporations, control is becoming ever more concentrated. This is undermining the accountability of firms and so their political legitimacy.

Employee ownership provides a way to not only improve economic performance but to also provide political legitimacy to business. For employee ownership to achieve both objectives, companies will need to introduce the six minimally necessary conditions identified by Bernstein. This depends on stakeholder governance, which directly enriches democracy and provides the firmest possible basis to establish the political legitimacy of corporations.

*Shann Turnbull introduced loan financed share plans to Australia when he organised their US inventor. Louis Kelso, to visit Australia in 1975 with the publication of his book. Democratising the Wealth of Nations. He is a founding member and past President of the Australian Employee Ownership Association*