Executive Summary

The Business Council of Australia has been a longstanding supporter of Employee Share Ownership Plans (ESOPs). Their existence provides a means by which large numbers of Australians have the opportunity to acquire a financial stake in the enterprise that employs them. This direct ownership stake, coupled with access to a share in company profits, provides employees with a powerful incentive to contribute to the success of the enterprise.

Increased productivity and improvements in workplace relations are two of the benefits attributed to the operation of an ESOP. As an additional attraction, ESOPs can be designed to include incentives specifically aimed at encouraging longterm savings and investment. Government, Employer and Employee stand to gain if an ESOP does deliver these benefits. Yet persuasive tax incentives to attract employers to operate and employees to participate in ESOPs have, over time, been deemed necessary in both the UK and US, at significant cost to revenue.

Perhaps lessons can be learned from overseas if best-practice ESOPs are to be created in Australia. Administrative flexibility is required if individual enterprises are to focus on their own objectives in operating the ESOP. (Cumbersome and costly administration of ESOPs has been cited as a problem with the current situation in the UK). Portability could be considered to allow an employee to view ESOP membership as part of a longterm savings strategy irrespective of changes in employment.

But the 'bottom-line' in discussing the effectiveness of ESOPs appears to be the extent to which the operation of an ESOP is combined with participatory management practices and communication, from the design of the plan onwards. As Brett Hofmann, Towers Perrin principal and executive compensation practice expert observes, "the process you go through in coming up with a design and communicating it will be the key to its success . . . when employees understand how their contribution to the business affects the outcome, then they can be asked to take some responsibility for designing some sort of plan and give management the commitment to help implement the plan[1]."

What's Happening in Australia

According to Division 13A of the Income Tax Assessment Act, the definition of a qualifying ESOP is one that offers at least 75% of permanent employees of 3 years standing an ordinary share, or right thereto, in the employer's company. ESOP design varies: they can be set up as loan plans, partly paid share plans, options plans or employer funded plans. Some operate as unit trusts that buy

[1] "Remuneration Case Studies, Ten Case Studies on Why It Pays To Get It Right", Emily Carr, Centre for Professional Development (p2)

shares in the enterprise which are then allocated to employees. Shares may be offered to employees at below market price and/or accompanied by interest-free loans. Plans can be linked to performance targets or operated with the intention of creating a sense of ownership amongst employees. For publicly listed companies, no ESOP can operate without shareholder approval (as stated in the ASX Listing Rules).

The National Australia Bank offers two all-employee share ownership schemes[2]. The Staff Share Allocation Plan (SSAP) is open to every permanent employee. In contrast to the share option plan (aimed at the top 400 executives) the employee share plan is not seen as an incentive for future performance, but rather as a means of furthering overall employee involvement and sense of ownership in the bank. The SSAP offers shares free to permanent employees, who are entitled to them after three years (a requirement of the tax provisions to ensure the employee can receive the shares tax free if still employed by the bank). In addition to this plan, the Staff Share Ownership Plan (SSOP) is linked to remuneration. All employees are entitled to purchase shares equal in value to a set percentage of their remuneration package with an interest free loan. Dividends from the shares can be used to pay back this loan.

Currently, approximately 80% of Business Council member companies that are publicly listed in Australia operate some sort of employee share ownership scheme. Of these, 60% operate ESOPs, usually available on the completion of one year's service, and have a high participation rate (where the figure is available, participation is generally shown to be over 90%). The remainder have Executive Share Plans available only to senior and executive staff.

Favourable comments have been made by member companies concerning their individual ESOPs:

- Woodside Petroleum stated that "almost all employees participate in the Employee Share Plan, which has been shown to contribute to employee alignment with Company goals". *(1997 annual report)*

- The Australian Gas Light Company describes a share incentive scheme for all employees subject to the adherence to pre-set performance criteria. Three targets were set: real growth in earnings per share, reduction in operating costs and achievement of lost-time injury targets. The company stated "we believe that it is important for our employees not only to think like Proprietors, but also to participate in the benefits of improvements in the Company", and added "linking the employees with the Company as Proprietors has indeed helped focus priorities. The three performance targets were achieved, including an impressive reduction in the Lost Time Frequency Rate from 9.6 to

[2] "Remuneration Case Studies, Ten Case Studies on Why It Pays To Get It Right", Emily Carr, Centre for Professional Development (p16)

5.6". Of the company's employees, 99% took up the share incentive scheme. *(1998 annual report)*

- The Employee Share Acquisition Plan and Employee Share Purchase Plan at Santos Limited have been taken up by 98% of employees. The company's stated intention in offering the plans to its employees was "to create a stronger link between increasing shareholder value and employee reward, (these plans) will encourage the retention of employees through the creation of a valuable asset to which they can make a direct contribution" *(1997 Annual Report).*

In Australia, ESOPs have obviously been successfully linked to the achievement of business targets. However, the Business Council has not researched the success of ESOPs in member companies and, apart from a 12 month research study currently being undertaken by the Australian Employee Ownership Association, is not aware of any major studies that have been conducted on the effectiveness of ESOPs in Australia. Instead, this submission will discuss recent work in both the US and UK where developments on this subject may prove useful if 'best practice' ESOPs are to be developed in Australia.

Benefits: Increased Productivity

The operation of ESOPs has been linked to greater productivity in enterprises although this is difficult to prove in isolation. The critical factor is more likely to be the extent to which an ESOP is combined with participative management practices.

Studies in the UK, Canada and the US all point to above average productivity increases in companies with significant levels of employee share ownership that are attributed to ESOPs[3].

In the UK, the March 1999 Budget included a proposal for "A New All-Employee Share Scheme", offering tax incentives as encouragement to enterprises and their employees. The motivation behind the scheme is revealed in the Inland Revenue's Technical Note, which states: "The long term prosperity of the UK depends on the productivity of UK business. The UK has a productivity gap of

[3] A) The UK Employee Ownership Index, measuring the relative share price performance of UK quoted companies with significant levels of employee share ownership, outperformed the market in 1998. The Index rose 12.7% over the year compared to 11.1% for the FTSE All Share Index (see www.capitalstrategies.co.uk)
B) The Canadian Toronto Stock Exchange compared ESOP versus non-ESOP public companies, finding that for ESOP companies, 5 year profit growth was 123% higher, net profit margin was 95% higher, productivity measured by revenue per employee was 24% higher and return on capital was 65.5% higher.(see www.esop-canada.com)
C) In the US, the unweighted Employee Stock Ownership Index reflects the average stock price of 355 companies listed on the NYSE, the AMEX and NASDAQ exchanges with more than 10% employee-owned stock. In 1991 the index was up 35.9% compared to increases of 26.3% for the Standard & Poor's 500-index and 20.3% for the Dow Jones average. In 1992, the index increased 22.9% compared to gains of less than 4.5% for the other two indices. (see study by Blasi & Kruse of Rutgers University and Conte University of Baltimore, cited by ESOP Association: www.the-esop-emplowner.org).

around 40% compared with the USA and around 20% compared with France and Germany. . . . the Government believes that employee share ownership has an important part to play in raising productivity by giving employees a direct interest in the success of their company. Research indicates that share ownership has a positive effect on employee productivity, especially when it is combined with other forms of active employee participation."[4]

The proposed scheme provides the employer with additional flexibility to reward productivity and performance by particular individuals or teams within the enterprise, and to employees willing to make a financial commitment to the enterprise.

Benefits: Improved Industrial Relations

Shared ownership can create an environment of common goals and shared interest between employees and management. By increasing employee commitment, ESOPs can also provide an incentive for the employee to remain with the enterprise.

However, the level of employee commitment may be dependent on whether the plan is accompanied by a participatory 'ethos' within the enterprise. In addition, where shares are only offered to senior executives, the presence of a 'them and us' culture may be exacerbated.

In the UK, Bill Callaghan, the Trade Union Council's (TUC) chief economist, welcomed the 1999 Budget's 'All-Employee Share Plan" but noted: "it is vital that this is accompanied by genuine involvement of employees in the company's decision making process. Employee involvement is a key ingredient in improving the performance of companies"[5].

In the US provisions in ESOP legislation permit owners of privately held companies to withhold voting rights on all but a few key issues, creating ownership without voice. However, Christopher Mackin[6] notes that "a combination of research evidence supporting the superior performance potential of participatory employee ownership and a relatively open debate within the ESOP field may be gradually tilting ESOP practice in a more participatory direction."

The presence of unions has influenced the design of ESOPs in the USA. In 1987, the AFL-CIO (a federation of 70 unions in the United States representing a wide range of industries, including health care, manufacturing, hospitality and service), set down ESOP guidelines to ensure shareholder rights, employee participation,

[4]www.inlandrevenue.gov.uk/legal.docs/index.htm
[5] TUC Budget Response – Share Ownership, 9 March 1999, www.releases.twoten.press.net
[6] Employee Ownership and Industrial Relations, Christopher Mackin, Perspectives on Work

and fairness to union members. A recent paper[7] cites a study by Freeman & Medoff (1981) comparing union and non-union settings for ESOPs. They found a difference in the type of worker that management focussed on when designing ESOPs: in the non-union environment, ESOPs were designed to attract the highly mobile worker and were aligned to business growth, while in a unionized workplace the ESOP was more likely to serve the interests of the median worker, favouring higher levels of employee participation in terms of strategy and company performance. McHugh, Cutcher-Gershenfeld & Polzin concluded that union involvement in the formation of ESOP structures tends to make them more egalitarian but added, “it is possible that an employer’s preference for control and for addressing the interests of these workers at the margin may outweigh the value it places on participation”.

Unions supported the formation of an ESOP at United Airlines as a way of influencing corporate management – a condition of their purchase was representation for the ALPA and Machinists unions on United’s Board where they went on to replace the senior management team. Employee ownership at United Airlines comprises 55% of outstanding stock coexisting with 45% public shareholdings[8].

Kardas (1994)[9] compared participatory enterprises with and without ESOPs and found that, for enterprises in the state of Washington, participatory ESOP firms had a 5% higher sales growth than participatory firms without ESOPs, suggesting employees can make a distinction between psychological and real ownership and work accordingly. It can be assumed that only in a highly participatory enterprise would positive employee performance from outside executive ranks really impact on a company’s profitability.

Again in the United States, when Cramton, Mehran and Tracy looked at the impact of ESOPs on labour disputes[10] they found that firms adopting ESOPs experienced a shift in the composition of disputes away from strikes and towards holdouts. (They defined a ‘holdout’ as ‘contract negotiations (which) continue beyond the expiration date of the previous contract without the union resorting to a strike and wages are fixed at the level under the expired contract’).

In terms of aligning employee and employer goals, research from the UK offers conflicting views. A recent survey undertaken by ProShare[11] showed 55% of employees believe that being an employee shareholder makes them more aware of the aims and objectives of the company. However, a six year study of Welsh

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[7] Employee Stock Ownership Plans: Whose Interests Do They Serve? McHugh, Cutcher-Gershenfeld & Polzin, IRRA 49th Annual Proceedings

[8] Employee Share Ownership and Industrial Relations, Christopher Mackin, Perspectives on Work

[9] Comparing Growth Rates in Employee Ownership Companies to their Participatory Competitors, Peter Kardas (unpublished research report), Washington State Department of Community Development, Feb 1994

[10] ESOP Fables: The Impact of Employee Stock Ownership Plans on Labor Disputes, Cramton, Mehran & Tracy, June 1997 – www.cramton.umd.edu/Papers1995-1999/98wp-ESOP-Fables

[11] ProShare Press Release, 1 February 1999, at www.twoten.press.net

Water by Peel and Pendlebury[12] found that ESOPs did not lead to employees taking a closer and better informed interest in the performance of their company. Instead, their results suggested that it is the more financially aware employee who joins the ESOP.

Where the ESOP provides shares to employees in addition to normal industrial entitlements, recognition of the value of the shares for total employer cost (TEC) grossing-up purposes will assist with the attraction and retention of employees. However, given that ESOP arrangements extend beyond employer/employee enterprise bargaining (ESOPs require shareholder approval in Australia) these should not be the subject of arbitrated industrial outcomes (eg. in Australia an allowable award matter in terms of s.89A(2) of the federal Workplace Relations Act 1996).

ESOPs can be a useful means of rewarding employees through performance based at-risk pay arrangements based on the achievement of productivity targets or other results. However, a review of taxation arrangements may be necessary to ensure that taxation arrangements do not distort choice between these arrangements and other forms of remuneration.

Tax Incentives

The possibility of productivity gains may not be enough to convince an employer to operate an ESOP. Government intervention in the form of simplified administration coupled with tax incentives has been required in both the UK and USA.

If tax advantages are to be offered to both employers and employees, there is obviously a cost to Government revenue that must be weighed up against the expected economic benefits of higher productivity, higher investment or objectives of wealth diversification. The following provides a brief overview of tax incentives in the UK and USA.

- ***United Kingdom***
  Currently, a range of Inland Revenue approved and non-approved schemes operate in the UK. Approved schemes, for example, the Qualifying Employee Share Ownership Trust (QUEST), allow tax deductions for corporate contributions and no PAYE or National Insurance Contributions (NIC) liabilities. In contrast, non-approved schemes are subject to income tax and NIC (levied on all non-approved share gains at a rate of 12.2%).

  But despite broad support from political parties and unions, ESOP membership is not widespread in the UK. Cumbersome administration, high

[12] Employee share ownership and financial awareness, Maurice Pendlebury and Michael Peel, Cardiff Business School, published in Accounting & Business, March 1999 (Association of Chartered Certified Accountants)

compliance costs and lack of tax incentives have been blamed. To achieve the Government's desired productivity gains, the Chancellor intends to double the number of companies in which all employees have the opportunity to own shares (currently 1,750 companies offer all-employee share schemes). His proposed "All Employee Share Ownership Scheme" promotes long-term shareholding by employees in their companies. In his Budget speech, the Chancellor stated "This will be the most tax advantaged all-employee share ownership scheme Britain has ever had. Our only stipulation is that it really must be shares for all - offered across the company's entire workforce."[13]

Shares for the proposed scheme will be held in an employee trust, and tax incentives include[14]:

- Employees can allocate part of their pre-tax salary to shares in their employer's company without paying income tax or National Insurance Contributions (NIC) on those shares. Employers get a deduction for the full amount of the salary allocated in this way in computing their Corporation Tax profits. In addition, employers can give shares to their employees tax and NIC free if they are held for 3 years.
- Shares held for 3 years are subject to income tax on the amount of salary allocated to those shares, but gains arising while an employee is in the scheme are tax free.
- Further tax incentives are planned to encourage longer term shareholding by employees
- Companies are entitled to a statutory deduction in computing their taxable profits for the value of the free shares and the costs of setting up and running the schemes.

The Inland Revenue notes that additional measures and possibly another scheme may be needed to help smaller and unlisted companies, which lack a market for their shares.

- ***United States***

  In 1974, Senator Russell Long spearheaded a campaign to adopt tax incentives in support of ESOPs, with the redistribution of wealth, rather than productivity gains, as his overall intention[15]. Twenty-five years later, around 10% of the American workforce are involved in ESOPs that own $222 billion in corporate assets. ESOPs in the US are retirement-type plans (a defined contribution plan) in which a trust holds stock in the employee-participants' names and to which the employer makes defined yearly contributions. In most cases, ESOPs are a contribution to the employee, not an employee purchase. Only when an employee retires or leaves the company do they receive either their stock (if there is a public market for the shares) or the value of the stock.

[13] www.hm-treasury.gov.uk/budget/1999/speech.html
[14] A New All-Employee Share Scheme, A Technical Note by the Inland Revenue, www.inlandrevenue.gov.uk/legal.docs/index.htm
[15] Employee Ownership and Industrial Relations, Christopher Mackin, Perspectives on Work

Approximately two thirds of ESOPs are created to buy the stock of a retiring owner of a private company or as an employee incentive or benefit plan. Tax incentives include:

- The company can deduct contributions to the ESOP, including payments on loans the ESOP takes out to buy company stock;
- The company can deduct dividends paid on ESOP-held stock; and
- Owners of closely held companies who sell to an ESOP can avoid paying capital gains tax on the sale proceeds by reinvesting them in securities of U.S. operating companies.[16]

Not to be confused with ESOPs, Stock Option plans (a right to buy a given amount of company stock at a given amount) also operate in the US. While in the past these options were aimed at 'key' employees, they are increasingly offered to all staff. Tax-qualified options allow employees to defer taxation until shares are sold or to pay capital gains tax rather than income tax. Another form of employee benefit are the 401 (k) plans, allowing the employee to put aside money on a pretax basis and save it for retirement. Employee contributions are often matched by the employer with company stock, with the resulting retirement benefit dependent on company performance.

A Savings Vehicle

ESOPs can offer employees a tax-attractive method of saving. Depending on how superannuation contributions are taxed, ESOPs may compete as a method of longterm savings with the benefit of greater flexibility in accessing those savings. In Australia, ESOPs may be an additional avenue for combating the historically low level of household savings.

In the UK, Proshare research shows 93% of employees believe their ESOPs help them save for the future, and 89% see employee share ownership as an easy way to start investing[17].

In the US, ESOPs can be seen as a specialised form of pension plan investing in employer securities (ESOPs were established with the 1974 passage of the Employee Retirement Income Security Act). When an ESOP employee with 10 years service reaches 55, they are given the option to diversify 25% of their ESOP account amongst at least three other investment alternatives. At age 60 they have the chance to diversify 50%, or have it distributed to them[18].

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[16] www.nceo.org
[17] Proshare Press Release, 9 March 1999 at www.twoten.press.net
[18] www.nceo.org

Concerns

Short Term Profit

Employees may see membership of an ESOP as an easy way to make a quick profit, selling their shares on the market as soon as possible. In the UK, the current Inland Revenue approved schemes have been criticised as failing to encourage longterm shareholding by employees because "in most cases employees sell shares almost immediately and are exposed to little or no risk"[19]. If increased savings or longterm commitment to an enterprise are the intended outcomes of ESOP operation, the structure should reflect this and offer incentives to ensure these results are attained. In the UK, tax incentives are increasingly designed to make longterm ownership and all-employee ownership an attractive option.

Longterm Savings

Unlike superannuation contributions, ESOP investment is not diversified, creating an element of risk. For a worker already dependent on the enterprise for his income, additional savings directed to the ESOP increase financial dependence on that enterprise. If ESOPs are to be promoted as a longterm savings vehicle, the protection of employee investments should be considered.

A second potential problem is the changing workplace environment, where the number of employees spending their entire career with one company is decreasing. ESOP design should contain 'portability' provisions – for example, when an employee leaves his company, the value of his shares in the ESOP might be rolled-over into the ESOP of the new employer, into a long-term managed fund, or shares of other Australian enterprises, with no tax liability. These measures would increase the likelihood of ESOPs being viewed as a longterm savings option.

Dilutory Effect

If shares are offered to employees at below market cost, there is a dilutory effect on the value of existing shares[20], in the same way that new shares offered to employees dilute the value of existing shares. (A notable feature of Westpac's recent past has been regular share buybacks to keep earnings per share intact[21]). Shareholders may deem the overall effect to be positive in the longterm if the ESOP enables the company to attract and retain staff who add value to the enterprise. (In Australia, the ASX Listing Rules ensure that no ESOP can operate without shareholder approval).

Conclusion

[19] A New All-Employee Share Scheme, A Technical Note by the Inland Revenue, www.inlandrevenue.gov.uk/legal.docs/index.htm
[20] Ted Rofe, Australian Shareholders Association, AFR article 17 May 1999
[21] 'Bonanza for bank-sector staff from windfall gains', Hans van Leeuwen, AFR article 17 May 1999

The purpose for introducing the ESOP, whether it be an incentive scheme to attract good staff and bind them to the enterprise, the goal of increased productivity or a Government-led push for wider savings, should be reflected in the ESOP design and structure (for example, schemes can be linked to targets specific to the enterprise). Taken in isolation, ESOPs will not cure all industrial problems. To have value, they must be part of an overall strategy intent on encouraging employee commitment to the enterprise for which they work.

According to Australian Stock Exchange figures[22], total share ownership in Australia stands at 40.3% of the population, with 17% investing since 1995. Public awareness of the advantages of investment in shares is high. If the Government means to encourage the further development of ESOPs in Australia, there is no time like the present.

The Business Council believes consideration should be given to the following:

- A policy framework that enables simplification of the administration of ESOPs, particularly for unlisted companies
- Where ESOPs are to be used as an at-risk pay component no distortions should be created between the taxation for these arrangements and non-performance based taxation concessions
- The potential for operating ESOPs as tool to increase the level of longterm savings and investment in Australia should be further examined (and also include analysis of the interface between ESOPs and superannuation arrangements).

Most importantly, the Business Council believes a review of the effect of operating ESOPs in Australian enterprises is required, not only to identify their prevalence and provide an analysis of structural differences, but to consider whether the benefits apparently achieved by the operation of ESOPs overseas are also possible in Australia.

[22] www.asx.com.au