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The benefits of promoting employee ownership incentives to improve employee satisfaction, company productivity and profitability.

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Julia Gillard effectively announced the end of the former Liberal/National Party coalition government's scheme to increase the amount of Australian employees who own shares in the companies in which they work at a Press Conference on May 21st 2009. This paper examines employee share ownership plans (ESOPs) in Australian businesses by reviewing overseas and local business experiences and considers the viewpoints of both Australian employers and employees. This investigation examines data from 11 founding members of the Employee Ownership Group. It looks at the performance of these companies and the benefits of the $1,000 per annum tax free share allocation compared with other forms of investment such as investing in the all ordinaries of the Australian Stock Exchange (ASX) or paying off mortgage payments ahead of time. The paper highlights that Australian companies which introduced broad based ESOP schemes did add economic value to their shareholders and that employees involved in the ESOP schemes got better value than the other investments that were tested.

Keywords: Australian organizations, All Ordinaries index, employee share ownership, Employee Ownership Group.

Field of Research: Employee Motivation. Employee Share Ownership Plans,

1. Introduction

"My colleague, Chris Bowen, the Assistant Treasurer, will be consulting with companies and with those in the employee share ownership arena for the best way of implementing these changes. The purpose of these changes is clear; we obviously understand that many working Australians do want to participate in employee share ownership scheme. However the evidence is fairly clear that the benefits have been most large at the upper income end, and consequently the Government moved, in the Budget, to address that". Thus with that statement Julia Gillard effectively announced the end of former Prime Minister John Howard's government scheme to increase the amount of Australian employees who own shares in the companies in which they work at a Press Conference on May 21st 2009. Ms Gillard, then the Deputy Prime Minister, told the Melbourne Press Conference which was held primarily to discuss the Bradley Review.

This paper looks at the problem of whether ESOPs are a viable method of providing employee incentives. It examines the performance of Employee Ownership Group companies and the benefits of the $1,000 per annum tax free share allocation compared to other methods of investments. The literature review examines

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employee share ownership plans in Australian businesses by reviewing overseas and local business experiences and considers the viewpoints of both Australian employers and employees. The Methodology investigation examines data from members of the Employee Ownership Group between 2005 and 2010.

The analysis and results concluded that Australian companies which did introduce ESOP schemes, did add economic value to their shareholders and that employees involved in the ESOP schemes got better value that the other investments that were tested.

2. Literature Review

The Howard Government's promotion of ESOP's was not new in Australia. In the early 1950s, the philosophy of Prime Minister Robert Menzies encouraged profit sharing schemes wherever possible (Stradwick 1992 p10). In 1974, under Gough Whitlam, a prime minister of the Labor Party, the legislation evolved further: it fostered not only the employees' participation in, but also limited their use of ESOP as a vehicle for aggressive tax planning (Nelson, 2000).

Many employers in Australia were and continue to be keen to participate in ESOPs. Although Australia compares unfavourably with the USA, it is on par with Germany and other Organization for Economic Co-operation and Development (OECD) countries in the take up of ESOP. The US, whose ESOP was legislated in the 1930s as a mechanism for employees to acquire equity in their places of employment (Pugh, Jahera Jr. & Oswald, 1999), is the volume leader in ESOPs. For example, it has 11,500 ESOPs operating with at least 10 million employees (3.5% of total population) at an asset value of over US$500 billion.

ESOPs are well supported in the USA. In a 2010 interview President Obama said, "*The idea behind these ESOPs is that if employees have a piece of the action, they're essentially shareholders in these companies, then you are aligning the interests of workers with the interests of the company as a whole. Now, what that means is, is that when a company has a tough time, workers have to take a hit because they're owners, essentially. On the other hand, when things are going well, they're getting a share of the profits. And so theoretically, at least, it's something that can help grow companies, because the workers feel like they're working for themselves, and they're putting more of themselves into their job each and every day. I think that it's something that can be encouraged".*

The US has other employee sharing schemes involving 15 million additional employees (5.1%) (NCEO, 2006). A report from the US Treasury Inspector General for Tax Administration finds that ESOPs held about 15% of the total assets in non-government corporate retirement plans in 2007.(NCEO 2010) In the UK, more than 2,000 companies—most of them large-scale publicly listed companies—are implementing various employee sharing schemes whose population coverage is estimated at more than three million employees (5% of the population) (ESEO 2006). In its last census, Australia had ESOPs covering over 400,000 employees and valued between A$9 and 12 Billion (DEWR, 2005). While its ESOP involves just 2% of its total population, Australian had set to increase this figure by 2009 to be at par with the UK. More recently, the Australian Federal government has set a benchmark to increase employer participation from 4% to 11% for all companies (DEWR, 2005).

Employee share ownership plans can take many forms, depending on the type and size of the business, and the aim for introducing the scheme (Nelson, 2000). For instance, for publicly listed companies, the most common ESOP is the Fully Paid Voting Share, because it conforms to the standard listings rules of most stock exchanges.

Share options are very popular in ESOPs especially amongst senior management as part of performance targets. Usually, executives are given these share options free of charge or as part of their salary package. The exercise price of the option is set at a price that reflects the performance target for the executives. If the company wishes to achieve an increase in their share price in two years of at least twenty percent (20%) then the exercise price of the option would usually be today's share price plus 20%. This method, although widely used does have some flaws. The former Minister for Education and Workplace Relations Brendan Nelson believed that some of these option schemes and some executive equity and salary packaging arrangements were out of step with community expectations. He thought that properly regulated ESOPs available to all workers would negate or make transparent excessive senior executive option schemes (Nelson, 2000).

It has been reported that many of Australia's top companies were using cosy hedging schemes and financial instruments for executive options circumventing Australian Securities and Investment Commission (ASIC) rules. These schemes allegedly allow executives to sell or hedge options during the vesting period without telling shareholders and in effect turning something that had been sold to the shareholders as performance pay into guaranteed pay and ensuring the executives were getting shares with no downside risk. (Gettler, 2006, p. B1). Examples like this are not uncommon and can spoil the perception of ESOPs by existing shareholders. "Regan (1991) (as cited in Bowden, 1997)

Employee share ownership plans in Australia were used in the 1990s for very aggressive tax planning. In 1999 in its submission to the 'Enquiry into employee share ownership in Australia', the Australian Tax Office (ATO) stated:

> "*The picture that has been built to date is one that indicates that a small, but aggressive segment of the legal, financial planning and accounting professions have moved to exploit government initiatives in relation to employee share ownership, incentives to increase productivity in the work place, and provision for retirement through superannuation"* (Nelson, 2000, p2).

Many family-owned companies had acted on the advice of the financial advisors mentioned and introduced ESOPs in to their companies solely because of the promised taxation benefits. Unfortunately for them, the Australian Taxation Department charged Fringe Benefit Tax on the shares or disallowed tax deductibility on the ESOPs. This ATO ruling negated any taxation benefit on issuing shares to family member employees and in many cases huge tax and legal liabilities resulted. Most of the ESOPs were later disbanded when the Howard government asked the ATO to offer the companies involved an opportunity to go back to the status quo, without imposing heavy fines, providing they paid the taxation due, plus interest.
The primary taxation concessions provided for in the taxation legislation (in 2006) is

the tax exempt benefit of up to $1,000 per employee per year (DEWR, 2005). Based on 2006 company tax rates this would give employers a tax saving of $300 per employee involved in the ESOP scheme. However they would get the same concession if they paid the $1,000 as a bonus or as part of wages. In the employer's case, tax savings in its self does not provide a sufficient motivation to implement an ESOP. Especially when the establishment of an ESOP involves the expense of publishing a formal prospectus, setting up a trust company and the costs associated with the on-going administration of the scheme. This could be part of the reason that while general awareness of the ESOP concept among Australian businesses is high, only 4% of all Australian non government businesses had a broad based plan which was open to at least 75% of employees (DEWR, 2005).

In Australia there does not appear to be any quantitative research studies that effectively measure the improvement of a company's competitive position or its efficiency after the introduction of an ESOP. However, strong anecdotal evidence suggests that there is an improvement in efficiency (Stradwick, 1992).

Brian Sheehan (1981) completed a study of Australian companies that operated schemes of financial participation using employee share ownership plans. It is interesting to note that of the following companies studied: W.L.Allen Foundry Co. Pty. Ltd.; C.M.V. Group; Dynavac Pty. Ltd.; Fletcher Jones & Staff Pty. Ltd.; Lend Lease Ltd.; Siddons Industries Ltd.; Walter Reid & Co Ltd.; Waltons Ltd. and Western Hart Ltd., only Lend Lease Ltd. and C.M.V. Group survive today.

Data collection and analysis of four United Kingdom bus companies which used ESOPs suggests similar results and that, in the UK at least, employee ownership of the ESOP variety may be a transient phenomenon. In 1994 three of the four companies were sold by their employees to other bus companies, while the fourth underwent a flotation followed by a merger which substantially reduced the employee share (Pendleton et al., 1998).

Extensive research has been conducted in America. Brady in 1995 pointed out that deeper commitment improves companies' possibilities to create sustainable competitive advantage (Brady, 1995), whereas others have found that the positive impacts are only short term unless combined with participation (Pugh et al., 2000).

The largest and most significant study to date of the performance of ESOPs in closely held American companies by Douglas Kruse and Joseph Blasi of Rutgers University in 2000, found that ESOPs increase sales, employment, and sales per employee by about 2.3% to 2.4% per year over what would have been expected without an ESOP. Douglas Kruse, Joseph Blasi and Michael Conte, tracked from 1992 through 1997 the average percentage increase in stock price of all publicly traded companies with a public record of 10% or more employee ownership and more than $50 million in market value. ESOP companies grew 193%, while the Dow was up 145% and the S&P 500 140% (NCEO, 2002). There appears to be a strong correlation between employee 'ownership' and corporate profitability (Hays, 1999 p62).

In 1987, the U.S. General Accounting Office (GAO) did a 'before and after' study. The GAO study found that ESOPs had no impact on profits, but that participative managed employee ownership firms increased their productivity growth rate by 52%

per year. In other words, if a company's productivity growth rate were 3.0% per year, it would be 4.5% after an ESOP (NCEO, 2002). According to Susan H. Marcille, partner in Ernst & Young Human Resources Consulting Group of Atlanta, Georgia "It gives people something to be excited about". They're motivated to work harder because they're sharing in the eventual success of the business." (Hays, 1999, p60).

3. Methodology

The author approached the Australian Federal Government's department which was promoting ESOPs in Australia for suitable companies to research as part of the study. They recommended the members of The Employee Ownership Group (EOG) since their membership all had ESOPs operating in their companies. This exploratory investigation reviewed literature, both academic and government, and information freely available regarding publicly listed companies (ASX All Ordinaries). In particular, information was also sought from:

The Employee Ownership Group (EOG) and the ASX performances of their members for the five years 2006-2010. These included ANZ Bank (ANZ), Boral Limited (BLD), Commonwealth Bank of Australia (CBA), Computershare Limited (CPU), Insurance Australia Group (IAG), Lend Lease Corporation (LLC), Metcash Limited (MTS), National Australia Bank Limited (NAB), Macquarie Banking Group Limited (MQG) Oil Search Limited (OSH) and Westpac Banking Corporation (WBC).

A comparison of after taxation investment in a cross section of shares in the All Ordinaries Index and a similar investment in a standard home loan during that period was also conducted to assess the economic value of the $1000 tax free share allotment.

The outcomes of this review resulted in the identification of significant implications for managers and employee shareholders in Australian businesses and for government.

4. Findings and Benefits for Employees

The eleven original member companies of the EOG were examined over the five year period 1st July 2006 to 30th June 2010. The $1,000 tax free share issued by these companies to their employees was used to buy shares in the company at the start of each financial year during the above period. Dividends on the shares were added and taxation was deducted.

Companies such as: Oilsearch, Computershare and CBA easily outperformed the ASX and employees in those companies would have been very satisfied with their shareholding investment. Whilst the other original EOG members did reasonably well, Macquarie Bank and Lend Lease only managed a return on investments in keeping with the All Ordinaries Index.

Figure 1: A comparison of ESOP with other investments.

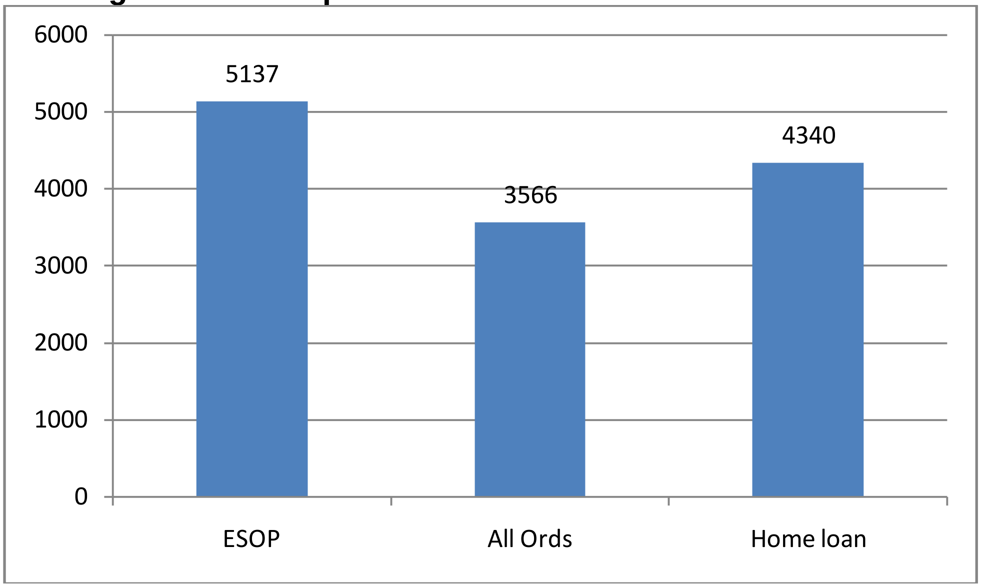

Figure1: *$1000 ESOP scheme compared to an after taxation amount invested in the All Ordinaries Index or invested/paid off a standard home loan 2006-2010*

On average, the eleven original members of the EOG comfortably outperformed the All Ordinaries Index. Even taking into account the translations of the $1,000 of shares into taxable income and investing the proceeds into a standard housing loan the ESOP shareholders came out in front.

Implications for employees are that the $1000 employee tax free share allocation, as implemented by the 11 original members of the EOG is economically viable. Even if the employees were not issued the shares free, but as part of a wage package, the employees are 35.6% better off than if they invested that money across the All Ordinaries Index of the Australian Stock Exchange. If they had taken the $1000 as part of their annual salary and paid it off their standard home loan they would still be 15% worse off than taking shares. The limitations of these findings are that the data has been averaged across the eleven companies in the study.

How do employees really benefit? From an employee's point of view even the words ownership can have many different meanings. Most would be positive, but some employees could be suspicious and see ESOPs as a means of switching hard earned performance gains from cash payments into bogus share schemes.

Loren Rodgers (2001) using his Ownership Culture Survey™ (OCS), a survey-based approach to measuring the psychology of ownership. Based on work with USA employee ownership companies over 15 years, there are five major meanings of ownership for most employees. The findings are:

- Financial Payoff: ownership as a financial benefit--as owners, people expect at some point to receive cash value
- Participation: owners being included in the decisions that affect their day-to-day work; wanting to have a say over the issues that affect their working conditions
- Influence: having a part in broader, company-wide decisions. Owners want a degree of influence over strategic issues

- Community: a bond with their fellow owners; they want to feel that the whole company is "in this together"
- Fairness: being treated fairly by the company; owners want sensible rules and they do not want "special treatment" for specific individuals (Rodgers, 2001 p62).

The above meanings with the exception of ‘Participation’ could be categorized using the Herzberg’s ‘Motivation Theory’ as Hygiene factors and if an effective ESOP was introduced it could act to minimize dissatisfaction, but an ESOP alone would not be a motivator. To employees, the ‘Participation’ meaning of share ownership is more likely to be the factor that results in employee motivation and higher performance (Hersberg, 1968). Thus it is possible that the introduction of a broad ESOP without combining an employee participation program is unlikely to achieve the outstanding success and benefits sought. Those employees who feel like owners are those with higher relative levels of share ownership and perceptions of participation, and this feeling is significantly related to relatively high levels of commitment and satisfaction with the organization. This approach suggests, therefore, that ownership does make a difference (Pendleton et al., 1998). Participation may also be one of the factors that contribute to the success of Executive ESOPs because unlike the normal employee, executives do participate in the decisions that affect their day-to-day work. A comparison of an employee-owned and a 'conventional' firm found that employee participation was higher in the employee-owned firm, and that, the greater the perceived extent of participation, the higher the level of organizational commitment (Rhodes and Steers, 1981).

Perhaps more importantly, employees may also gain a greater understanding of the stock market and factors that influence the performance and prosperity of the business (Nelson, 2000). This may appear on the surface that this would foster the free enterprise capitalistic system, but further research would need to be carried out to determine if this was the case.

5. Findings and Benefits for Employers

On average the 11 companies in the study comfortably outperformed the All Ordinaries index of the ASX. Their share price was better, their Price Earnings Ratio was higher and they all maintained strong dividends throughout the five years of the study. It would appear that taxation benefits would not be a major reason to for the study group members to commence ESOPs within a company. Employee motivation, employee rewards, worker participation and changing the organization culture are more likely to be some of the reasons why employers establish ESOPs (Conte, 2005).

Employee share ownership plans are introduced for a variety of reasons. A common goal in introducing an ESOP is to “align employee/employer interests to motivate and retain valued employees” (Nelson, 2000, p3) employee share ownership (ESO) is a human resource strategy or workplace relations strategy that can be used to motivate employees by giving them a stake/share in the company’s success (DEWR, 2005).

Generally, employers choose to introduce an employee share ownership plan (ESOP) for one or more of the following major reasons (Stradwick, 1992):

- to improve organizational competitiveness, productivity and efficiency

- as a form of employee participation
- as a form of employee reward
- as a form of defence against takeovers or as a rescue operation
- to enable employee ‘buy outs’ or privatize a government business entity
- To foster the free enterprise system.

ESOPs can also be used as a tool to improve employer/employee relations or to foster a cultural change. ESOPs can also be used as part of a remuneration plan as an employee performance incentive component in workplace agreements. In addition, ESOPs may be used as a method of succession planning or employee buy-outs in Small and Medium Enterprises (DEWR, 2005).

It would appear that researchers in America now agree that “when ownership and participative management are combined, substantial gains result. Ownership alone and participation alone, however, have, at best, spotty or short-lived results” (NCEO, 2002 p18).

The Nelson Report (2000) found similar results in their analysis of ESOPs and concluded that “it may be that companies with employee share plans are better performing enterprises, but that firms with such plans tend to exhibit more progressive management practices and a progressive organizational culture. On the whole, this leads to better performing enterprises” (Nelson, 2000, p5).

6. Implications for Australian Organizations

According to the House of Representatives Inquiry into Employee Share Ownership, “[a] very low number of unlisted companies have employee share plans (data on this is not reliable, but estimates range from negligible, through 3 per cent to about 20 per cent)., the main reasons for employers not putting plans in place are cumbersome administration, cost implications, difficulties with approval and corporate structure not considered to be appropriate” (Nelson, 2000, p18).

In the Australian Government’s favour, they are trying to address these issues about the ‘red tape’ costs. However, Family Businesses also have other business issues that the introduction of ESOPs into their businesses may help address. In a 2005 Survey of Family Business Needs study by Glassop, Waddell and Ho of Deakin University, in conjunction with KPMG and Family Business Australia, discovered that the main three ‘Business Issues” were; balancing short-term and long-term business decisions, maintaining loyalty of non-family members and the availability of willing and able successors (Glassop, Waddell & Ho, 2005).

Combining ESOPs with employee participation could address the issue of balancing short-term and long-term business decisions, employees would be very interested in short term goals, but more so in working towards their long term security. Thus ESOPs may be able to ‘align the interests of the employee with the employer’ and increase the perception by employees that their financial interests coincide with that of their employer (DEWR, 2005). When employees gain a financial interest in the company for which they work, this motivates employees to ‘think like owners’ leading to a conscious choice to actively enhance performance by working longer hours, lower absenteeism, and better productivity (Nelson, 2000).

Are ESOPs effective in Australia? Anecdotally yes, but faced with a paucity of qualitative research into ESO schemes in Australian workplaces, particularly in relation to the nature of the link between ESO schemes and enterprise performance, it is very difficult to judge their value or effectiveness (Barnes et al., 2006). Quantitative research can be carried out on listed companies using the resources available from the ASX but these must be combined using qualitative research.

7. Conclusion

Although the present $1,000 tax free employee share scheme is economically viable for both employees and employers, the size of the benefit represents less than 2% of the average wage and this is probably not enough to provide a really big incentive. However, since the Gillard Government is unlikely to lift the tax free threshold during the life of this parliament, it is highly unlikely that employers would be motivated to start and maintain an ESOP in their companies.

It would appear that the Howard Government's target of a 175% increase in the amount of employees involved in ESOPs by 2009 was very ambitious, but possible if the Howard government had retained power. The costs of establishing and maintaining an ESOP in Australia against the possible benefits to existing shareholders and employees needs to be fully analysed, together with research on what further government incentives companies will need to introduce ESOPs. This study was limited to only 11 large Australian companies and it is evident that broader and more in depth analysis with need to be carried out to fully determine the benefits or otherwise of Employee Share Ownership Plans.

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