

EMPLOYEE SHARE OWNERSHIP AND THE PROGRESSIVE ECONOMIC AGENDA

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About Per Capita

Per Capita is an independent think tank dedicated to building a new progressive vision for Australia. Our research is rigorous, evidence-based and long-term in its outlook, considering the national challenges of the next decade rather than the next election cycle. We seek to ask fresh questions and offer fresh answers, drawing on new thinking in science, economics and public policy. Our audience is the interested public, not just experts and practitioners.

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Executive Summary

The expansion of share ownership amongst employees advances a number of important economic priorities identified by the Federal Government, and has the potential to give Australia a stronger and fairer economy.

Rewarding employees with increased ownership in the companies in which they work increases productivity, advances flexibility with fairness in the workplace and builds a national savings culture. However, to secure these benefits, it is critical that employee share ownership is extended widely to ordinary workers rather than concentrated at the top levels of management.

Employee share plans are frequently criticized for concentrating risk, for duplicating superannuation and for being regressive, but carefully designed policy can address each of these shortcomings.

Existing Australian policy towards employee share ownership lacks this careful design. This report compares the employee share policies of the UK, the United States and Australia. It finds that, despite the wider economic benefits of employee share plans, ordinary Australian workers have little or no incentive to participate in them.

Taxation arrangements mean that Australian workers can be penalized for participating in employee share schemes rather than making equivalent investments in the sharemarket. In Britain and America, on the other hand, tax structures favour employee share schemes over ordinary equity investments.

The paper models the results of a standardised A\$10,000 investment in alternative employee share schemes held for 10 years compared against a benchmark investment returning 5.4% p.a. after tax. Under this framework, American schemes return 9.3%-10.2% p.a. and British schemes 9.7%-10.5% p.a. Australian schemes in contrast return 4.5%-5.8% p.a., which at the lower end is even less than the benchmark investment.

The report argues that share schemes should seek to incentivise investment in employee-owned companies and should certainly not penalize such investment as the Australian 'deferred' scheme does.

The 'deferred' scheme results in the employee paying an additional \$7,141 in tax over and above the benchmark investment in ordinary equities.

In its recent Budget, the Rudd Government announced changes to employee share schemes that put a \$60,000 means-test on the \$1,000 tax-exemption for employee share grants, and remove the ability to defer tax until the employee actually sells the shares.

The changes seek to preserve tax revenues and make the schemes more accessible to lower-income workers, while maintaining the overall policy objective of supporting employee share ownership.

As it was completed before the Budget announcement, this paper does not analyse the effects of these changes in detail. Yet the proposed changes leave low-income workers exactly where they were prior to the announcement. The changes are only more progressive in the relative sense that they remove employee share schemes altogether for higher-income workers.

They do have the effect of increasing Treasury revenue, but at least some of this could be recouped through tighter enforcement rather than a cut-back in the schemes themselves. In fact, research in this paper shows



Executive Summary

that Treasury can actually collect more tax from the abolished tax-deferred scheme than from ordinary investment in the sharemarket.

Since the Budget, the Government has agreed to a review of its proposed changes and a policy options paper is expected shortly. The Government should simplify the existing dual scheme structure into a single, simplified scheme where employees are offered a tax-exempt amount and given the ability to defer tax above this amount.

The concern about multi-millionaire executives using schemes to defer high levels of tax can be overcome by placing a cap, say \$10,000, on the total value of shares (and options) that can be claimed annually under the scheme.

If Treasury must remove tax-deferral and means-test the scheme in order to boost tax revenue, the threshold should be raised to allow greater participation and the removal of the tax-deferral should be a temporary measure, to be lifted when the fiscal position improves.

The paper makes a number of policy recommendations as follows:

- Implement a single ESO package under which employees can take an increased exemption amount (in the range of \$1,500 to \$5,000) tax free with normal CGT on disposal, and any additional amount with both income tax and CGT (at the normal rate) deferred until disposal
- Remove the distortion under which capital growth under certain ESO-plans is effectively subject to twice the rate of tax relative to capital growth in ordinary listed equity holdings
- Remove the taxation of unrealized gains on employee share holdings
- Remove the taxation point at cessation of employment in the case of redundancy, retrenchment or retirement
- Offer smaller companies the ability to release a streamlined offer document, outlining top-level financial projections and risk assessments, rather than a full prospectus
- Extend tax deductibility for an amount equal to the value of the shares and options granted to an employee upon which the employee will ultimately pay income tax up to a ceiling of \$10,000 annually per employee
- Allow companies to pay up to 20% of SGC payments as employee share allocations into an ESO plan for participating employees. These allocations are taxed exactly the same as SGC payments, but can be accessed after 10 years rather than at retirement age

Per Capita believes these measures will extend employee share ownership beyond senior executives to ordinary workers with important benefits for the economy, contributing to a more prosperous and fairer Australia.



Section I: Introduction

Following the election of the Rudd Labor Government in November 2007, Per Capita released our flagship report *Memo to a Progressive Prime Minister*. In this report, we argued for a vision of an “Investing Society” as the governing project for the incoming Government. This vision demanded a long-term approach by government which values investment alongside consumption: a new kind of government, with new policy themes, to grab the new national opportunities.

The five key features of the Investing Society are:

- *Full-cost economics*: a holistic understanding of private and social costs/benefits, capturing externalities, options, and risk, plus market design which correctly allocates costs/benefits between private sector, citizen and the state.
- *Debt for investment, not consumption*: a step-change in value-creating investment relative to debt-funded consumption, with an acknowledgement that debt is no bad thing when invested in productive capacity.
- *A national investment effort, public and private*: recruitment of private capital alongside government funds to create new infrastructure, enhance workforce skills and motivation, and widen the circle of social inclusion and participation.
- *An intergenerational investment horizon*: a long-term approach to value which captures the enduring returns of today’s investments for future generations.
- *New measurement systems*: a comprehensive accounting of outcomes and returns based on empirical evidence. An Investing Society is meaningless unless competing investment decisions can be evaluated and prioritised in a systematic manner.

We argue that this vision of a new fusion of economic and social policy represents the contemporary application of enduring progressive values: fairness, community, and the “virtuous circle” whereby fairness and prosperity reinforce each other.

But we also argue that to take shape in society, this vision demands new ways of speaking by Government, as well as specific new policy initiatives. To do this, we need to move beyond the debates of the past like the economy versus the environment, and ask new questions like how do we integrate environmental costs into economic decision-making. We need to embrace fairness with flexibility, to combine the best of the public sector with the best of the private, and to seek out those policy solutions which deliver ‘win/win’ outcomes across traditional political divides.

Another example of these old debates is the supposed contest between bosses and workers. This contest presupposes a mid-20th century industrial economy. The new question is how employers and employees work together to increase productivity and share the rewards.

One policy initiative that would help to answer this question is a renewed drive to boost employee share ownership - where staff take equity shares in the companies in which they work. Employee share ownership (ESO) consolidates many of the elements of the new progressive agenda. It increases productivity, encourages savings, and provides both flexibility and fairness in the workplace.

The new Government's economic agenda comprises two distinct prisms – the long-term prism of microeconomic reform, and the short-term prism of macroeconomic cyclical management. The long-term prism focuses on productivity, workplace relations, taxation reform and savings. The short-term prism is a more recent development, a response to the sudden economic downturn in 2008-09. It entails fiscal stimuli, tax cuts and interest rate cuts designed to reignite consumer spending and business investment.

The policy picture changes according to which prism the Government looks through. Each prism offers a different set of policy solutions and the Government's optimal response will be a blend of the two, balancing the short- and long-term. The solutions will occasionally clash, and in a crisis, the demands of the short-term horizon will often prevail. For example, the increase in national savings integral to the long-term agenda will be trumped by the need to stimulate consumer spending in the near-term. However, this does not mean that savings will disappear from the policy suite, but that it will be put on hold until the immediate economic outlook improves.

This paper explores how ESO fits into this new agenda, and is structured around the three themes of productivity, savings and flexibility with fairness in the workplace. Firstly, it examines the evidence linking remuneration and productivity. Secondly it assesses the relative returns to labour and capital in seeking ways to extend workplace fairness and flexibility and thirdly, it outlines the case for a national savings culture. The paper then deals with several of the common objections to ESO schemes, before outlining a standardized model for comparing international ESO regimes in Australia, the UK and the United States. It concludes with a set of recommendations for a new, streamlined policy to promote ESO.

Section II: Productivity

"Productivity is, in the long term, the key to building a more internationally competitive economy – one that can produce more output from its existing resource base; one that can grow faster without fuelling inflation and consequently, driving up interest rates..."

Kevin Rudd, "Towards a Productivity Revolution",
Speech to The Australian/Melbourne Institute Conference, 28 March 2008

The Rudd Government has placed productivity at the centre of its economic agenda. Along with participation and population, productivity is one of the 3 P's which the Government believes will sustain long-term economic growth. But what does this mean in practice? How can workplaces actually boost productivity over time?

Employee shareholders know they will share in the returns of improved company performance and that they're able to directly affect this performance through their own productivity

First, we must distinguish between the productivity of capital and of labour. Typically, capital productivity is improved by financial markets which allocate capital to the highest return opportunity. Entrepreneurs seek to attract capital by generating ever higher returns and the role of government is to ensure the free, transparent flow of capital under enforceable contracts.



Labour productivity is more challenging, however, as it is not possible to constantly ‘reallocate’ labour across an economy in pursuit of higher returns. Instead, firms seek to increase the productivity of their employees within a given workplace by linking productivity and reward.

There is an established body of academic work demonstrating a positive effect of variable output-based remuneration on productivity (measured as output per person per hour). Put simply, employees are more productive when their pay increases with productivity. In one study, employees in the Safelite Glass Corporation were found to be 44% more productive when their remuneration was linked to output (Lazear, 2000).

This effect is similarly observed when productivity is linked to employee reward through share ownership. Employee shareholders enjoy the returns of improved company performance and can affect this performance through their own productivity.

A host of studies demonstrate that employee shareholders do in fact demonstrate greater productivity. A 1987 paper by the US General Accounting Office showed that firms which embraced employee ownership increased their productivity growth rate by over 50%. A study of Australian firms showed that companies operating ESO plans enjoyed sales per employee 12% greater than the relevant industry median (FitzGerald, 1993). Jones and Kato (1995) found that Japanese firms experienced a 4-5% increase in productivity by introducing an ESO plan, although this increase did not materialise for 3-4 years after the plan’s introduction. And finally, a study by Douglas Kruse and Joseph Blasi of 250 companies that adopted ESO plans found that these firms increased sales per employee by 2.3% p.a. over would what have been expected without a plan.

In addition to specific productivity benefits, a second set of research indicates that companies with ESO plans demonstrate higher performance across a number of parameters. An analysis of seventy separate studies by Blasi et al. (2003) considered the effects on company performance of “partnership capitalism” (defined to include employee stock ownership, broad-based stock options, profit sharing and employee participation). This found that companies that embraced any one of these four approaches experienced a 4% gain in productivity, a 14% gain in return on equity, a 12% gain in return on assets, and a 11% gain in profit margins (controlling for other factors).

One indication that Australian companies understand the importance of ESO for productivity is that numerous leading companies, including BHP Billiton, Lion Nathan and OPSM, have offered matching share plans under which the company matches the employee’s investment into their individual ESO plan at the company’s cost. The fact that these matching schemes are offered at significant company expense highlights the value these companies place on employee share ownership.

What are the macroeconomic implications of these productivity effects for Australia? A 2004 report prepared by Econtech for the Employee Ownership Group modeled the effects on productivity of a doubling of the coverage of ESO plans in Australia, from 200,000 to 400,000 employee shareholders. This showed that the productivity boost to national income ranged between \$240m and \$480m p.a.

The evidence is clear. While employee share ownership is not a silver bullet solution to the challenge of long-term productivity growth, it is an important element of the policy toolkit in delivering the Prime Minister’s “Productivity Revolution.”



Section III: Flexibility & fairness in the workplace

“We have put before the Australian people a plan, it’s our agenda for work...to get the balance right between fairness and flexibility in the workplaces of the nation.”

Kevin Rudd, Election Victory Speech, 24 November 2007

The mantra of the Rudd Government’s industrial relations policy is that it seeks to offer flexibility with fairness at work. Reading between the lines, this means flexibility for employers who must cope with the changing demands of a dynamic economy, and fairness for workers who can reasonably expect living wages, minimum standards and due process in the workplace.

Much of the debate since the 2007 election has focused on the specifics of the legislation to roll back Work-Choices, yet once this has been implemented, the Government will be seeking new ways to extend flexibility and fairness. ESO holds potential on both fronts.

ESO plans offer employers greater flexibility on several levels. They broaden the range of remuneration options open to employers, giving them an additional point of competitive advantage in the labour market. They offer employers greater control over cash flow, allowing them to offer non-cash remuneration and manage their cash distributions in line with the business cycle. Finally, ESO plans provide employers with an excellent mechanism for succession planning, an issue which has proven particularly challenging for small- and medium-sized family-owned businesses.

What about employees on the other hand? How do ESO plans provide them with greater fairness in the workplace? The most important feature of ESO for employees is that it offers them access to returns on capital, in addition to their returns on labour. The benefits of Australia’s 15-year economic boom have flowed disproportionately to investors (owners of capital) rather than workers (owners of labour). The economics journalist Ross Gittins has observed (2007) that the share of national income going to workers is the smallest it’s ever been, having shrunk from 70.2% in 2001 to 66% in 2007. This lost share flows instead to investors through corporate profits.

ESO addresses this imbalance by giving workers access to the flow of corporate profits. It ensures that workers are not unreasonably excluded from this flow by institutional or information barriers.

ESO also leads to greater human capital accumulation, with benefits for both the individual worker and the wider economy. By providing a direct link between workers’ output and workers’ returns, ESO plans illuminate the value of superior skills and experience and provide clear incentives for workers to accumulate further skills and experience. In this way, ESO plans shine a light for workers on the value of their own human capital investment, in particular those workers who have been unable to access further education and training.

The ESO plans that deliver the greatest benefits, both to employers and employees, are those that combine share ownership with participation in the management of the business. It is those companies that are willing to embrace ‘open book management’ that will extract the greatest productivity and retention dividends from an ESO scheme.

In line with the Government’s workplace policy objectives, ESO provides both flexibility for employers, in remuneration, cash flow and succession planning, and fairness for employees, in greater access to returns on capital and a clearer illustration of the benefits of human capital accumulation.



Section IV: A national savings culture

“The second component of our five point plan is Government action to foster a culture of savings. Providing attractive incentives to save can help take the pressure off inflation, help people save for their future, and help lift national savings. This is particularly important at a time when we face elevated inflationary pressures. We have already proposed First Home Saver Accounts, to help young homebuyers save for the future. The Government believes there is more to be done in the area of building a national savings culture...”

Kevin Rudd, “Building Australia’s Economic Future”,
Speech to Lord Mayor’s Business Breakfast, Perth, 21 January 2008

There is no doubt Australia’s extended economic prosperity over the last 15 years has been fuelled by cheap debt. We have taken the receipts of the commodity boom and added a healthy dose of ‘financial leverage’ to stimulate consumption, particularly in our retail and construction sectors. We borrowed heavily to indulge our twin passions of shopping and homebuilding. Over the last decade, our net private foreign debt (excluding government borrowing) has almost tripled, from \$221bn in June 1998 to \$609bn in June 2008. With the onset of the global financial crisis, Australia, along with other rich indebted nations, is facing a painful adjustment.

The solution to this predicament is twofold: 1) to build a stronger national savings culture and 2) to encourage the use of debt for value-creating investment, rather than for short-term consumption. In the context of the present paper, we will focus on the first part of this solution.

The Government is right to focus on savings as part of its long-term economic agenda. Its initial efforts in this area have concentrated on making property investment more accessible through its First Home Saver Account scheme. More recently, the Government’s attention has moved to managing the volatile economic situation with an emphasis on stimulus rather than saving, but in the long-term, savings initiatives will remain part of the economic strategy.

ESO can play a valuable role within a national savings culture. It offers workers an additional savings channel alongside superannuation, and one over which they have more direct control. ESO allows workers to accumulate a different class of equity, one which complements the traditional blend of assets held in their superannuation funds. Workers have a greater ability to influence the rate of return of employee share schemes and, with the right information, a greater ability to assess the attendant risks.

For now, the development of a national savings initiative may be pushed down the Government’s to do list as a result of the downturn. However, ESO plans can still contribute to the long-term economic agenda both by deepening the savings base of individual workers and broadening the asset classes which they hold, smoothing risk and increasing aggregate returns.

Section V: Common criticisms of ESO plans

There has been a number of recurring objections to previous attempts to promote ESO plans in Australia. The most common of these are:

- 1) that ESO encourages excessive concentration of risk for employees;
- 2) that ESO plans simply duplicate the superannuation system; and
- 3) that ESO plans favour senior executives over ordinary workers.



Let us deal with each of these in turn.

Excessive concentration of risk: Clearly, employee share holdings in their employer company change the risk profile of the employee's savings base. This then leads to two related questions. Is an employee share scheme inherently riskier than other asset classes? Or is the problem that employees might place too much of their total savings into ESO plans?

We would argue that ESO schemes if anything less risky than other ordinary equity because employees have better information about the outlook for the company and a greater ability to influence its performance. Critics fear that employee equity in small companies is more volatile and less liquid than the listed equity available to retail investors, but even if this were the case, it must be balanced against the greater information about and influence over company performance.

Excessive concentration in a single asset is a risk in any portfolio allocation. ESO plans are no exception, although this has nothing to do with the inherent characteristics of these plans. One means of managing excessive concentration of savings would be for firms with ESO plans to provide a short, annual consultation for employees with an independent financial adviser.

The desire to expand ESO coverage does not imply greater ESO holdings for those workers already in schemes; instead it calls for wider coverage (more participating companies) and deeper coverage (extending to more employees within each company). In this sense, neither wider nor deeper coverage concentrates the risk of employee share holdings for individual employees.

Duplication of superannuation system: Some have argued that ESO is of little value because it duplicates roles already performed by compulsory superannuation – an arms-length savings facility weighted towards higher-return equity classes. Yet this argument overlooks the distinct benefits of ESO plans.

The desire to expand ESO coverage does not imply greater ESO holdings for those workers already in schemes. Instead, it calls for more participating companies and more coverage in each company

Unlike superannuation, ESO plans offer an investment vehicle which gives workers a degree of influence over their investment returns. Unlike superannuation, ESO plans boost productivity across the economy. Unlike superannuation, ESO plans give employees an incentive to invest in their own human capital. Returns from ESO plans are accessible in mid-career rather than in retirement only. But perhaps the biggest difference with superannuation is that ESO plans strengthen the connection between ownership of a business and responsibility for its performance.

None of this means that ESO plans should displace superannuation. Superannuation is one of the great Australian policy successes, and plays a critical role in sustaining our national savings. But ESO plans have the potential to be a valuable complement to the superannuation system.



Regressive nature of ESO plans: Finally, there is a criticism from some within the labour movement that ESO plans favour senior executives over ordinary workers. Yet research shows that executive compensation is typically lower in companies with ESO plans than in those without. The results of a remuneration survey by the US National Centre for Employee Ownership “strongly suggest that ESOP companies have a much more restrained approach to executive compensation than many of their non-ESOP peers. Executives in ESOP companies make less than their peers in similar non-ESOP companies, both in current and deferred compensation.” (NCEO, 2005).

The key policy lever here is the design of the ESO scheme. To secure the full benefits of ESO, schemes should extend as far down into the organisation as possible, ideally providing 100% coverage of employees. One approach might be to make ESO offers to executives conditional on appropriate matching offers being made to rank and file employees. This would ensure that the scheme is as fair as possible, and delivers the greatest potential productivity dividend.

In some senses, this reflects the fact that company culture is as important as scheme design. A management team that demonstrates a willingness to extend ESO as widely and deeply as possible can expect employees to reciprocate this goodwill in the form of increased productivity and workplace loyalty.

One final point similarly suggests that companies with ESO plans offer better treatment for workers. Companies with ESO plans tend to be more resilient, providing greater protection for workers in a downturn. One study showed that over the period 1988-2001, US public firms with 5% or more employee ownership were only 76% as likely to disappear as firms without such employee ownership. In the current economic climate, this feature of ESO plans is particularly significant.

Section VI: International employee share scheme comparisons

This section provides an overview of the legislative environment for employee share ownership (ESO) in Australia, the United Kingdom and the United States. To illustrate the effects of alternative ESO policy regimes, we have built a simple comparative framework which models the results of an A\$10,000 investment in alternative ESO schemes held for a period of 10 years.

The section describes the various share schemes available in each of the three jurisdictions. We highlight the differential treatment of income tax, capital gains tax, minimum investment periods and maximum investment caps under each scheme.

We explain our modeling approach and outline the underlying assumptions and other important variables, including inflation, tax, interest rates, dividend payout rates and equity returns.

We then examine returns to employees under each scheme, and compare these to the returns enjoyed by a typical Australian investor outside an ESO plan. We also consider the impact on government tax receipts of each scheme.

Finally, we raise several questions outside the scope of this simple comparative exercise, such as outcome of the comparisons if all tax were normalized to Australian tax rates.

International ESO regimes

This section considers six distinct ESO regimes across three countries. A short summary of the key features of each scheme is outlined below.

Tax-exempt scheme (Australia)

Under the Australian tax-exempt scheme, an employee may receive up to \$1,000 of shares p.a. free of income tax. Any additional shares received above \$1,000 are taxable at the employee's applicable marginal rate. All shares acquired under the tax-exempt scheme are subject to normal capital gains tax (CGT) upon disposal, irrespective of whether they were originally subject to income tax. If the shares are held longer than one year, CGT is levied at the employee's marginal income tax rate on half the capital gain. If held for less than twelve months, CGT is levied at this rate on the entire gain.

Tax-deferred scheme (Australia)

The Australian tax-deferred scheme allows employees to postpone payments of income tax on the value of shares received. Income tax is payable on the full value of the shares on the day of sale or after 10 years, whichever is sooner. There is no cap on the value of shares that can be acquired (or tax that can be deferred). If the shares continue to be held beyond 10 years, CGT is applicable upon disposal to any growth after that date. The effect of this treatment is that any capital growth after the employee receives the shares is essentially taxed at double the normal CGT rate (assuming the employee holds the shares for longer than 12 months).

Both the tax-exempt and tax-deferred schemes are subject to certain other requirements, namely that they are available to at least 75% of employees with three years' standing and that no employee may hold more than 5% of the firm's voting shares.

Share Incentive Plan (UK)

The British Share Incentive Plan (SIP) offers workers four classes of employee shares: Partnership Shares, Free Shares, Matching Shares and Dividend Shares. An employee can acquire up to £1,500 p.a. in Partnership Shares with pre-tax income, which are not subject to CGT if held for five years or more. In addition, an employee can be given up to £3,000 p.a. (non-taxable) in Free Shares, also not subject to CGT after five years' ownership. With post-tax income, the employee can further acquire two Matching Shares for each Partnership Share held (up to £2,500 p.a.), similarly CGT-exempt if held for five years. Finally, up to £1,500 p.a. of dividends can be reinvested tax-free in Dividend Shares in the employer company. The same CGT provision applies, although the dividends used to buy Dividend Shares are taxed when the shares are withdrawn from the plan.

The SIP also offers employers Corporation Tax concessions, including deductions for the costs of offering Free and Matching Shares, and the costs of offering Partnership Shares where this exceeds employee contributions.



Save as You Earn Scheme (UK)

The Save As You Earn (SAYE) scheme differs from the other five schemes in that it enables employees to acquire options to buy shares rather than actual shares. In most respects, it has the same characteristics as a standard ESO plan, except for the important difference that there is no downside for the employee. If the share price doesn't exceed the exercise price of the options, the employee can simply take the accumulated savings in cash.

Under the SAYE scheme, British workers accumulate savings in a specialist interest-bearing tax-free account. When the SAYE account is established, the employer company offers options at up to a 20% discount to the current share price. The employee contributes a monthly post-tax sum for an agreed period - 3, 5 or 7 years - at the conclusion of which the government provides a tax-free co-payment based on the duration of saving. The accumulated funds can either be used to exercise the options to buy shares or taken as cash: a 'no lose' situation for the employee. If the options are exercised, the shares are subject to normal CGT liabilities.

Employee Share Ownership Plan (USA)

The Employee Share Ownership Plan (ESOP) allows employees to use pre-tax income and third-party loans to buy shares. Initially, the company establishes an ESOP trust. Where this is funded through loans, repayments of principal may be deducted from Corporations Tax (up to 25% of payroll) and interest payments are fully deductible. If the ESOP is not funded by a loan, up to 15% of payroll is deductible for principal repayments. Companies may claim further tax deductions for dividends paid on ESOP shares where those dividends are used to repay an ESOP loan or paid directly to workers.

Employees who hold shares in accounts within the ESOP trust do not pay income tax on these shares, as the shares are acquired on their behalf by the ESOP trustee. Employee pay CGT on any capital gains when the shares are distributed outside the ESOP trust, usually when the employee leaves the firm. If over 30% of an unlisted company's shares are sold into an ESOP trust, CGT is deferred for as long as the proceeds are continually reinvested in domestic (US) securities.

423 Plan (USA)

The 423 Plan is similar in many respects to the ESOP, the principal difference being that employees hold their shares personally rather than through a trust. 423 Plans are usually used in public companies, and under these plans, employees can acquire shares or options at a maximum 15% discount to their present value. CGT is payable at the standard US rate upon disposal of the shares. 423 Plans cannot be limited to a company's senior employees.

Comparative framework

Per Capita has compared these six schemes using a simple investment profile. We propose that an employee chooses to allocate A\$10,000 of pre-tax income to an ESO scheme and retains that investment for 10 years, reinvesting all post-tax dividends and selling the shares at the end of the final year. We model the returns profile generated by each scheme in order to understand the relative rates of return to the employee

through capital gain and dividend payments, as well as the impact on government tax receipts. As a benchmark, we have also modeled the returns of this investment to a private Australian individual outside an ESO scheme.

It is important to note that this framework examines ESO plans from the perspective of employee and government, but does not explicitly model the costs and benefits to the employer (a complex exercise beyond the immediate scope of the paper).

Assumptions

We have assumed uniform rates of inflation and return on equity across all three countries. We have used individual country tax rates for both income and capital gains, and proposed that our model employee is in the highest marginal income tax bracket. Dividend payments are unfranked and taxed at the applicable marginal rate prior to reinvestment. We have also used long-term exchange rate assumptions to estimate where the various caps are triggered in an A\$10,000 investment.

The model assumes that the investment is funded from pre-tax salary, rather than debt. This means that the tax relief on interest payments available to employers under an American ESOP is not included in our calculations, but this does not affect either employee or government returns. The full set of modeling assumptions is presented in the table below.

Table 1: Modelling Assumptions

Variable	Country	Assumption
Inflation	All	2% p.a.
Real interest rates	All	3% p.a.
Dividend yield (pre-tax, unfranked)	All	2% p.a.
Real equity return (post-dividend payment)	All	8% p.a.
Initial pre-tax investment allocation	All	A\$10,000
Investment duration	All	10 years
Income tax rate (top marginal bracket)	Aust	46.5%*
	UK	41%
	USA	35%
Capital gains tax rate (10 year holding period)	Aust	22.5%
	UK	18%
	USA	15%
Exchange rate (per \$A)	UK	£0.40
	USA	US\$0.70

*Note: Includes Medicare levy of 1.5%
Sources: ATO, HMRC, IRS, Oanda, Per Capita

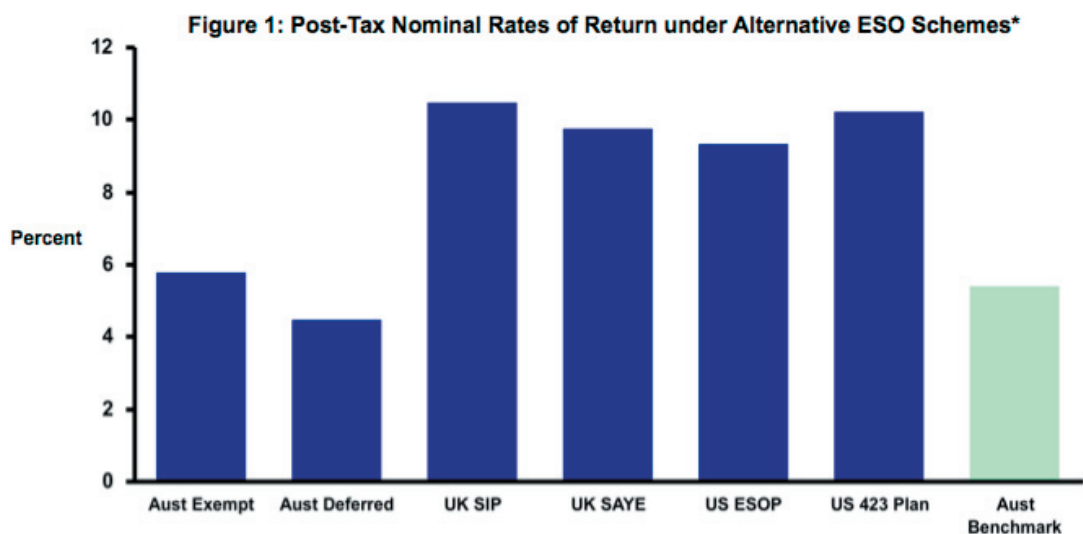


Returns to employees

The post-tax nominal rates of return to employees under each of the ESO schemes are illustrated in Figure 1 below. This figure shows that the British and American schemes offer employees far higher rates of return than their Australian equivalents. The UK SIP scheme each delivers 10.5% p.a., effectively meaning that in this scenario, equity returns to the ESO plan are untaxed (although dividend yields are). This is because the A\$10,000 investment falls below the £8,500 cap of annual tax-exempt ESO investment permitted under a SIP. Under a UK SAYE plan, the employee receives a return of 9.7% p.a. While SAYE schemes are subject to both income tax and CGT, the government co-payment and employer discount on options almost entirely offset these liabilities.

In a US 423 Plan, the employee receives a 10.2% annual return. The 15% discount offered on acquisition of the shares fully offsets the 15% CGT on disposal, and the employee pays a small amount of income tax on the 15% discount upon disposal plus recurring taxes on dividend payments. A US ESOP offers an annualized return of 9.3%, reflecting the income-tax exemption on acquisition, dividend taxes and the 15% CGT obligation on disposal.

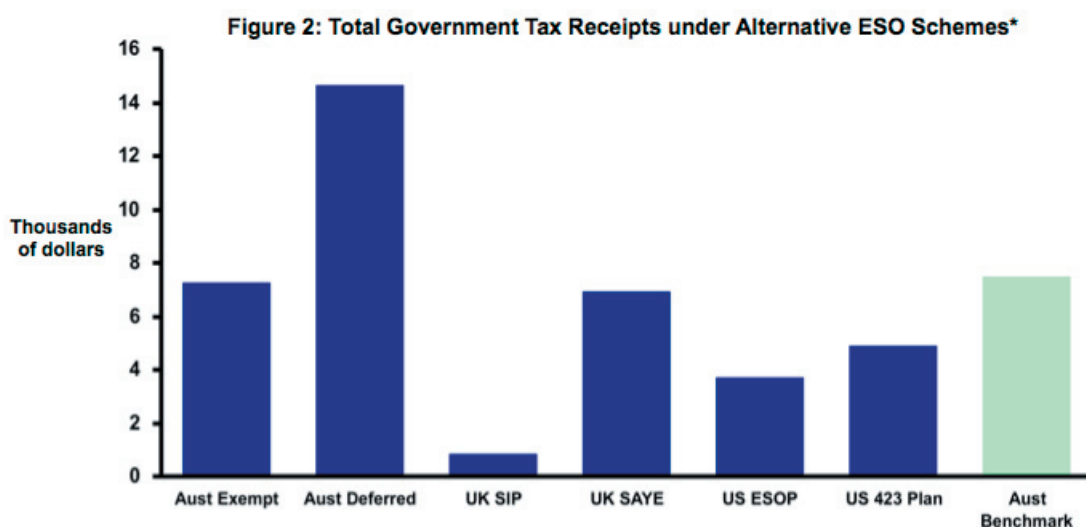
The Australian tax-exempt scheme returns 5.8% p.a. to employees, only slightly higher than the 5.4% p.a. received by the benchmark Australian investor outside an ESO scheme. This small difference reflects the impact of initial \$1,000 of tax-free shares received under the tax-exempt plan. In our modeling scenario, employees in an Australian tax-deferred scheme fare worse than the benchmark investor, with returns of 4.5% p.a. This is a function of the effective doubling of the tax rate on capital gains for employees in a tax-deferred scheme.



*Note: Assumes 2.0% p.a. inflation
Sources: ATO, EOG, HMRC, IRS, NCEO, Per Capita analysis

Impact on government tax receipts

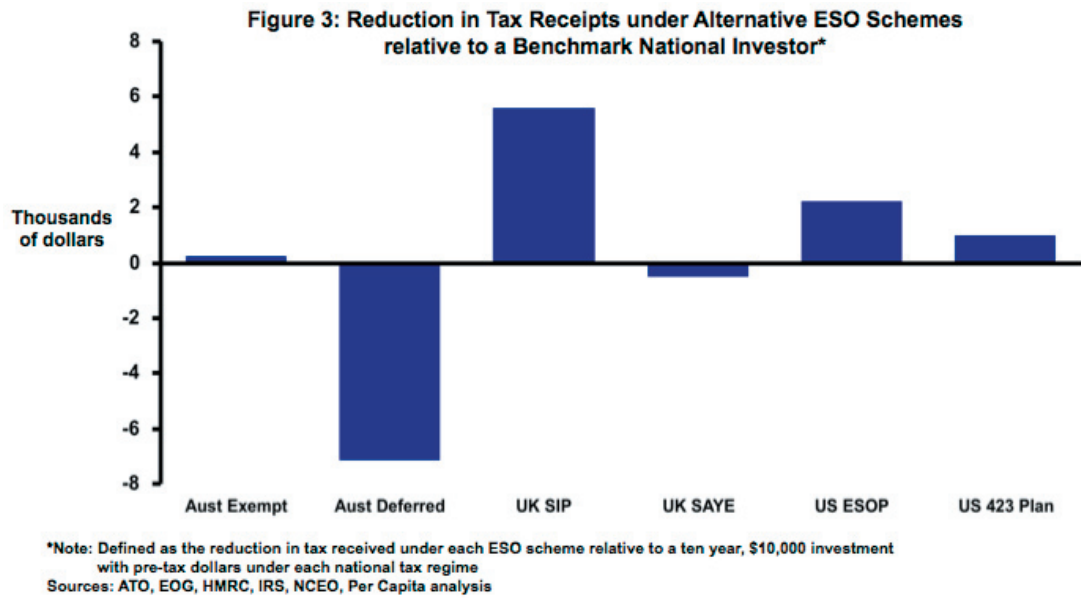
The total government tax take under each of the ESO schemes is illustrated in Figure 2 below. This is the sum of the undiscounted nominal tax receipts, including the income tax payable on the initial endowment in year zero, all taxes on annual dividend payments and any income and capital gains tax payable upon disposal in year 10.



*Note: Defined as the nominal undiscounted sum of tax receipts over ten years
Sources: ATO, EOG, HMRC, IRS, NCEO, Per Capita analysis

Unsurprisingly, this shows that the Australian schemes deliver the highest tax receipts to government. This is partly a function of higher tax rates, and partly reflects the lower tax discounts given to ESO scheme participants. Curiously, the government collects far more tax on an Australian deferred scheme (\$14,645) than it does from a benchmark investor (\$7,505), reflecting the effective doubling of taxation on capital growth under the deferred scheme. The Australian exempt scheme, meanwhile, generates tax payments of \$7,288. A UK SAYE scheme offers relatively high tax receipts (\$6,917) as it incurs both income tax and CGT. Under a SIP, the UK government collects tax on dividend payments only (\$856), while the US government collects \$3,732 under an ESOP and \$4,916 under a 423 Plan.

What is perhaps more interesting is the net effect on government tax receipts under each scheme relative to the total tax received from a benchmark investor outside an ESO scheme under each country's tax regime. Figure 3 below depicts the reduction in tax receipts under an ESO scheme compared to what the government would otherwise have received from its benchmark investor.



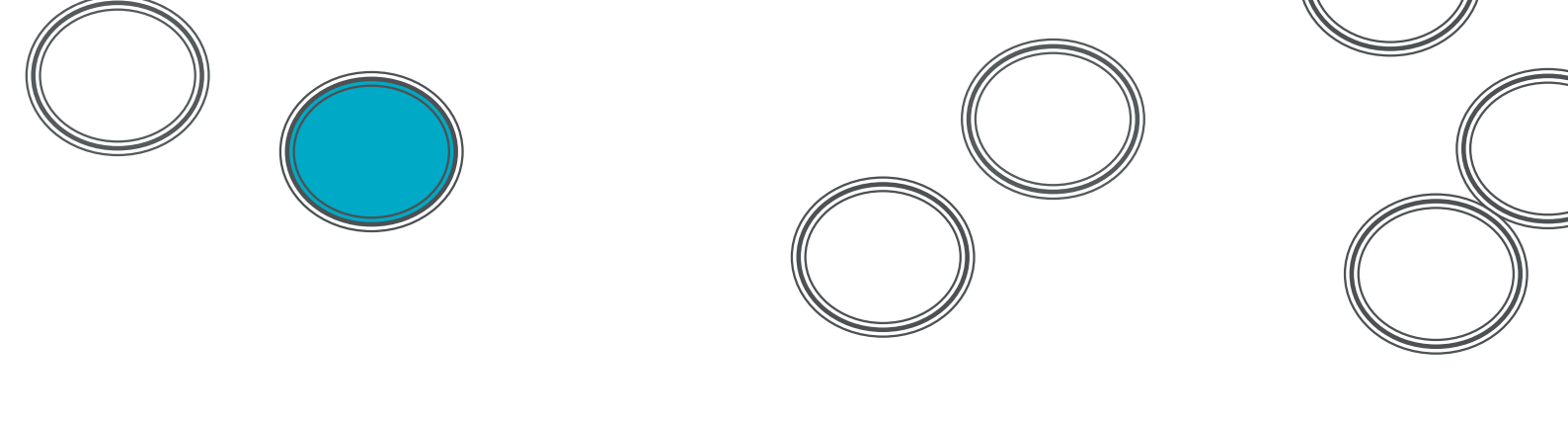
We see that the UK forgoes the most tax under its SIP scheme (\$5,568). The two US schemes cost the government \$1,000-2,200, while the Australian tax-exempt scheme is effectively revenue neutral. The Australian tax-deferred scheme, on the other hand, generates an extra \$7,141 for government relative to the benchmark investment. The obvious corollary is that, for this investment value over this duration, an employee would avoid the tax-deferred scheme. However, this may not be true under other modeling scenarios. The UK SAYE scheme also generates additional tax for the government (\$492). It is notable that this scheme is generous to both employee and government, but this is because the employer company provides a significant subsidy to the cost of the share options.

Implications

There are two principal implications to draw from this exercise. The first is that there is a strong correlation between returns enjoyed by employees and tax forgone by government under any ESO scheme (excepting the SAYE scheme, as outlined in the paragraph above). The UK SIP generates both the greatest post-tax returns to employees and the highest revenue 'losses' to government. At the other end of the scale, the Australian tax-deferred scheme penalizes employees and rewards government relative to the benchmark investment, at least under these assumptions.

This is perhaps an obvious finding, but is nonetheless a useful policy guide for government. It implies that the simplest way to access the wider benefits of employee ownership (productivity, savings, workplace flexibility, etc) is to forgo some level of tax receipts in order to attract employees into ESO schemes. Employees are only likely to join ESO schemes if they offer superior returns to the best alternative investment, and this usually relies on tax concessions in one form or another. The trade-off is thus quite simple.

The second implication is that there is an anomaly in the Australian tax-deferred scheme which renders it deeply unattractive under any reasonable investment parameters. Specifically, this is the feature under which the entire capital gain is taxable at the employee's marginal income tax rate (rather than 50% of the gain being taxable, as with other investments over 12 months). This is a strong deterrent to participation in



the tax-deferred scheme, one with no obvious economic rationale. If it wishes to stimulate further ESO, the Australian Government would be well advised to remove this anomaly.

Finally, there is a further task beyond the scope of this paper which may prove informative. This would be to replay the exercise normalizing all the tax rates at Australian levels. This would remove the effect on employee returns of lower tax rates in the UK and US. It would offer a perspective on which of the six schemes under review is most/least attractive in a purely Australian context, a useful insight for national policymakers.

Section VII: Policy recommendations

This paper has argued that employee share ownership is an economic policy tool that advances a number of the Federal Government's key economic priorities – productivity, workplace flexibility and fairness, and a national savings agenda. It has also considered a number of the common criticisms that surround employee share ownership, and argued that the most persuasive of these can be addressed with careful scheme design.

So how might the Federal Government embrace ESO in order to advance its economic agenda? We believe the answer lies in the careful design of the tax and regulatory framework surrounding ESO. There are three underlying principles of tax and regulatory design: efficiency, equity and simplicity. The current treatment of ESO plans fails at least two of these principles.

The treatment of ESO is not equitable compared with other forms of savings. Under Division 13A of the Income Tax Assessment Act, shares distributed under a Deferred ESO-plan are effectively subject to twice the level of tax on capital gains relative to a parcel of investment in equities acquired by ordinary means.

It would be logical to tax any growth in value of ESO shares in the same way as other capital gains, while still taxing any discounted element as ordinary employment income. The time of taxation should not, however, be any earlier than the time when the employee realizes that income, and capital gain, by selling the shares

A similar distortionary treatment occurs with the taxation of unrealized capital gains on employee share holdings retained for more than 10 years under the Deferred Plan (see below). Apart from land tax (which is explicitly a redistributive tax on the rich), there is no other asset class for which individuals pay tax on unrealized increases in paper value. This treatment should be changed so that employees only pay capital gains tax once they sell their ESO plan shares.

A further inequity may arise under the Deferred Plan where an employee may be taxed on unrealized gains in the case of redundancy. No comparable economies treat cessation of employment in the case of redundancy, retrenchment or retirement as a taxation point for unrealized gains. Australia should redress this anomaly to bring us into line with accepted international practice, as well as on the grounds of basic fairness.

The current arrangements around ESO plans also breach the design principle of simplicity. At present, ESO plans can be enacted under one of two mutually exclusive frameworks. An employee can either acquire \$1,000 of shares tax-free and pay normal capital gains tax on 50% of the capital gain upon disposal (the 'Exempt Plan') OR they can defer all taxation (on income and capital gain) until a later time up to 10 years after grant (depending on specific events) and pay tax at ordinary marginal rates (the 'Deferred Plan'). This level of tax can be up to double the amount of tax paid by someone holding the shares as ordinary investment.



By common consensus, the Exempt Plan is the more popular of the two main Australian ESO schemes, yet it still contains significant legacy problems which have arisen because Division 13A has not been revised to reflect broader economic changes since it was enacted in 1995. The most obvious of these is that the \$1,000 exemption in the Exempt Plan has not been adjusted for wage inflation in the ensuing 14 years, and is now worth less than 2% of the median wage. Median wages have risen over 40% in nominal terms since 1995, so an increase in the exemption appears justified. A range of \$1,500-\$5,000 for the exemption (3-9% of median income) would appear more reasonable.

To rectify both complexity and legacy issues, the dual-framework approach (Exempt or Deferred) should be amended to offer a single ESO package under which employees can take the first \$1,500-\$5,000 tax free, with any additional discount subject to ordinary income tax at the time of disposal and capital growth being taxed at CGT rates at that time.

This will entail some cost to Treasury's revenue stream, but will generate disproportionate value through the wider economy through productivity and savings dividends, and will also increase company tax revenues.

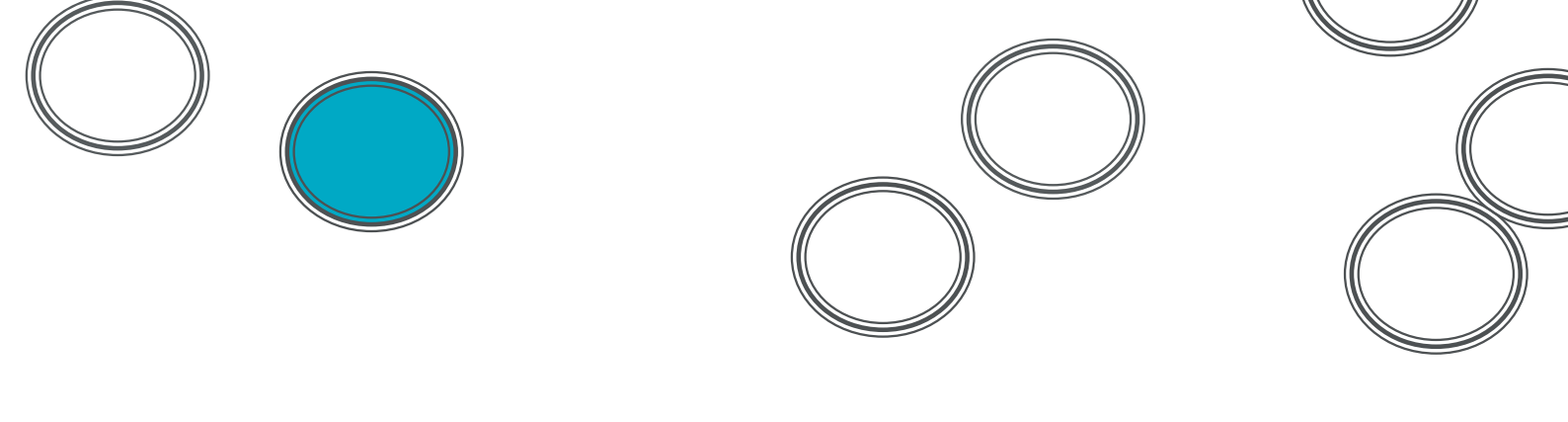
A further measure to reduce the regulation surrounding ESO schemes is to offer smaller companies the ability to release a streamlined offer document, outlining top-level financial results, projections, risk factors assessments rather than a full prospectus under the Corporations Act. This decreases the significant costs of producing a full prospectus which are prohibitive for many small- and medium-sized companies, and will thus improve the take-up of ESO plans by these firms.

A second type of reform beyond the adoption of a single ESO scheme would further extend the take-up of employee share ownership in Australia. This reform would link ESO schemes to the primary savings platform in Australia, superannuation. We propose that employees be entitled to take up to one fifth of their Superannuation Guarantee Contribution (SGC) in employee share allocations where companies choose to offer such plans.

These reforms will increase both the spread of ESO plans through the economy and the depth of ESO penetration within individual companies

These allocations would receive the same tax treatment as other SGC payments. The only difference would be that the employee would be entitled to liquidate the shares after 10 years, rather than waiting until retirement, reflecting the fact that ESO's are typically medium-term savings plans rather than retirement plans. The cap of 20% of total SGC payments would prevent excessive concentration of employee savings in a single asset. This proposal would not affect an employee's entitlements relating to other ESO schemes.

A final reform worthy of consideration addresses one of the major barriers to the wider use of both employee share plans and option plans among ordinary employees. (Importantly, option plans offer employees protection against falls in the value of company shares). Currently, there is no tax deduction for an issuing company for the value of shares, and rights to shares, acquired by employees under a plan (except for the \$1,000 deduction under the Exempt Plan).



The extension of tax-deductibility to these expenses would be a sensible step to broaden the penetration of employee share and option plans, provided safeguards are in place to ensure that the benefits flow to all employees. A recurring criticism of employee options has centred on their use within exorbitant pay packages of senior executives. To ensure this wide distribution of benefits, it would be both equitable and in line with international practice to extend tax deductibility to an amount equal to value of shares and options granted to an employee upon which the employee will ultimately pay income tax. To prevent excesses in the scheme, we believe this tax deduction should be capped at \$10,000 p.a. per employee, or about 18% of the median wage.

We believe that these reforms, taken together, will increase both the spread of ESO plans through the economy and the depth of ESO penetration within individual companies. In doing so, they will greatly advance the Government's economic policy agenda.

Summary of recommendations:

- Implement a single ESO package under which employees can take an increased exemption amount (in the range of \$1,500 to \$5,000) tax free with normal CGT on disposal, and any additional amount with both income tax and CGT (at the normal rate) deferred until disposal
- Remove the distortion under which capital growth under certain ESO-plans is effectively subject to twice the rate of tax relative to capital growth in ordinary listed equity holdings
- Remove the taxation of unrealized gains on employee share holdings
- Remove the taxation point at cessation of employment in the case of redundancy, retrenchment or retirement
- Offer smaller companies the ability to release a streamlined offer document, outlining top-level financial projections and risk assessments, rather than a full prospectus
- Extend tax deductibility for an amount equal to the value of the shares and options granted to an employee upon which the employee will ultimately pay income tax up to a ceiling of \$10,000 annually per employee
- Allow companies to pay up to 20% of SGC payments as employee share allocations into an ESO plan for participating employees. These allocations are taxed exactly the same as SGC payments, but can be accessed after 10 years rather than at retirement age



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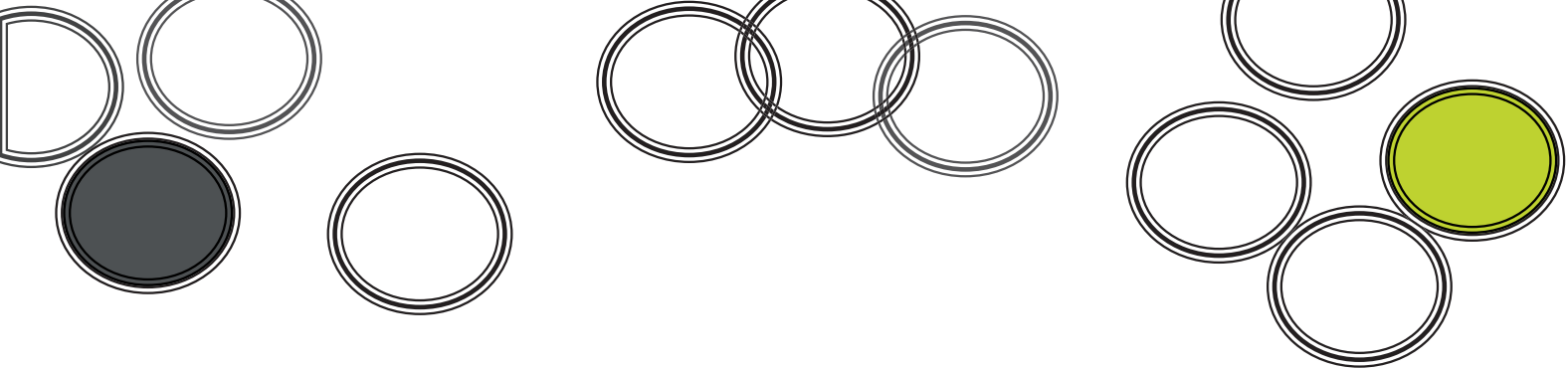
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