Employee ownership: unlocking growth in the UK economy

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About the authors

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Patrick Briône and Chris Nicholson also co-authored ‘Employee empowerment’ in January 2012.

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Executive summary

All three party leaders say they want to redefine capitalism, promote economic growth and foster a fairer distribution of the rewards of growth. The deputy prime minister has announced a major push on employee ownership in an attempt to combat “crony capitalism”. This initiative builds on a liberal tradition that dates as far back as John Stuart Mill who promoted the cause of employee ownership and partnership between capital and labour. More recently Conservatives have promoted employee owned businesses in public services and Labour, whether through Blue Labour or the ‘Purple book’, have also promoted the cause of co-operatives and employee owned businesses.

There are good reasons why now is a good time to be promoting employee ownership, co-ownership and employee share ownership. Employee ownership and share ownership have been shown to improve company performance and productivity. Employee ownership reduces absenteeism, and fosters greater innovation and a longer term approach to business decisions. Greater employee ownership within the firm leads to less of a differential between the high and the low paid, and wages which are at least as high as in comparable firms.

Whilst the evidence is that the greatest impact on company performance is from firms which are 100% employee owned or co-owned (significant 25%+ ownership), employee share ownership schemes generally also have a positive impact on company performance. Where employee ownership and share ownership are present alongside employee participation the effects are strongest.

Significant employee ownership is not always appropriate. For companies which are heavily reliant on their human capital, where good customer service is important, or where the nature of the work means that there is a high degree of autonomy amongst the workforce, then employee ownership is shown to be particularly valuable. On the other hand, financing demands mean it is unlikely to be easy or appropriate
for high risk high growth companies or capital intensive companies.

For employees, holding a significant individual ownership stake is not always of benefit. If employees hold too many of their assets in the company in which they work, they risk losing not just their job but also their savings if the company goes bankrupt.

Whilst the US and the UK were early pioneers of employee ownership and employee share schemes, in the last decade other European countries have caught up and in some cases exceeded the UK in terms of their prevalence.

The UK government has four HMRC tax advantaged schemes. Two are all-employee schemes, Share Incentive Plan (SIP) and Save As You Earn (SAYE). Two are more selective, Company Share Option Plans (CSOP) and Enterprise Management Incentive scheme (EMI). Only the EMI scheme has increased in popularity in recent years.

In view of the relative decline in attention given to employee ownership and share ownership by the private sector over the past few years – despite the clear evidence of its benefits the – time is ripe for government to give this a renewed push and focus. This should be an important part of the government’s growth strategy and its drive to bring about a fairer and more responsible capitalism.

We make recommendations in three key areas:

**Promotion of employee ownership and share ownership**

There is a strong consensus amongst promotional and research bodies and the APPG on Employee Ownership that much could be achieved by government having a clear focus on the promotion of employee ownership and share ownership and a more consistent and coherent approach. We share this view.

We recommend that a single minister, probably within BIS, be permanently given responsibility for promotion and co-ordination of policy with respect to employee ownership and share ownership. He/she would be a champion of the case for employee ownership and share ownership within government and the wider economy, ensuring that all current and proposed government legislation has regard to the needs of employee owned and co-owned companies. The minister would promote this agenda amongst companies, professional advisers, and business schools. He/she would also work with banks and other financial institutions to identify, for example, any financing gaps where government intervention might be required.
Employee ownership

Technical tax and legislative changes required to boost employee ownership and share ownership

There are several relatively small technical changes which would make a big difference in the attractiveness of employee ownership and employee share schemes. These changes are outlined in the main report. They are designed, in the main, to remove unnecessary barriers to employee ownership and share ownership and to ensure a level playing field between, for example, collective and individual ownership of shares by employees. Some of these changes have also been recommended by the Office of Tax Simplification’s March 2012 review of tax advantaged employee share schemes.

Securing a significant boost in employee ownership and share ownership

If there is to be a major transformation in the role that this sector plays in the economy, further measures are required.

We make a number of proposals here:

- A ‘right to request’ that a broad-based employee share scheme be established for employees in firms employing over 250 employees.
- A ‘right to request’ that an employee ownership bid is considered when a business (or a substantial stake in a business) changes hands. This is most likely when there is business succession but longer term the government should also seek to examine whether the insolvency process could be made more attractive for employee buy-outs.
- There is a danger that, in the effort to promote employee ownership and co-ownership, the opportunity is missed to boost significant employee share stakes of less than 25%. We believe that there are good reasons for government and society to seek to establish a norm that employees should own, say, at least 5% of the companies in which they work. This is unlikely to happen organically. We think that there is a need to provide a nudge for companies to start the journey towards greater employee ownership. To facilitate this we propose that there should be a right to request a 5% stake in the business, either through shares being gifted to employees or facilities for them to buy up to a 5% stake. We estimate that amongst the FTSE 100 this would imply an employee shareholding of less than £10,000 per employee in 30 companies, and for three
quarters of companies a shareholding of less than £50,000 per employee. Clearly such a stake will not be realistic or desirable in all cases, but employees should have a right to request it. A 5% shareholding, if voting rights were exercised collectively, could be sufficient to justify an employee being on the Board. In France, for example, if employees have a 3% shareholding in a company they have a legal right to a seat on the Board. We set out in this report possible ways to incentivise companies and employees to achieve a 5% shareholding. In cases where a 5% shareholding is unaffordable for employees there would still be the scope to give them at least ‘5% influence’ – albeit through the use of different classes of shares.

Further fiscal measures should be considered such as a Capital Gains Tax discount when a business or substantial shareholding is transferred to employees (similar to ESOPs in the US) and/or the possibility of ‘acceleration’ of corporation tax benefits for a company and income tax benefits for employees to facilitate larger scale transfers of shares.

Establishment of a more ‘off the shelf’ legal structure than an employee benefit trust – perhaps along the lines of a US ESOP structure.

The case for greater employee ownership and share ownership is clear – it will boost economic growth, provide greater diversity and resilience in the economy, benefit employees and lead to a fairer distribution of the benefits from growth. There is an unprecedented opportunity now to take forward this long standing liberal idea. It should be seized with both hands.
1 - Introduction

“A John Lewis economy”, “Moral capitalism” or “Responsible capitalism”. The three party leaders, Nick Clegg, David Cameron and Ed Miliband have been rushing to try to paint their own picture of how the current structure of our economy should change. This is not surprising when faced with the following challenges:

- What can be done to restart economic growth by improving the supply side of the economy?
- How can the economy be rebalanced and made more resilient to economic shocks?
- Can the benefits of economic growth be spread more evenly, so that it is not just top executives and bankers who benefit?
- Can the distribution of economic and political power be more widely spread so that individual citizens have greater control over the decisions which affect their lives?

The deputy prime minister, Nick Clegg, in his January 2012 Mansion House speech sought to set out his vision of how this should be done. Quoting John Stuart Mill, he set out to “end the feud between capital and labour” by promoting the virtues of employee share ownership and employee ownership – or as he termed it the “John Lewis economy”. He added that:

“Liberals recognise that narrowing wage inequality is not solely a task for the state. We also need to put much more power in the hands of the other stakeholders in the economy – shareholders and employees – when it comes to setting top pay. Trusting not the unfettered market, nor the interventionist state, but trusting people. That is the core of the more responsible capitalism: power in the hands of people. Strong economic citizens able to keep vested interests in check.”
This paper examines the case for promoting greater employee ownership and share ownership and how this might best be achieved. It follows on from the previous CentreForum paper “Employee empowerment: towards greater workplace democracy” published in January 2012 and draws on the liberal principles of association and partnership set out by John Stuart Mill:

“...the civilizing and improving influences of association, and the efficiency and economy of production on a large scale, may be obtained without dividing the producers into two parties with hostile interests and feelings...the relation of masters and work-people will be gradually superseded by partnership, in one of two forms: in some cases, association of the labourers with the capitalist; in others, and perhaps finally in all, association of labourers among themselves”


There have been over the last 20-30 years many studies and reports arguing the case for employee owned firms and the benefits which employee share ownership can bring. This report will review this evidence but also make the economic and political case for why now is a particularly appropriate time for the cause of employee ownership and share ownership to be promoted by government. It will also set out policy proposals for boosting this sector of the economy.

Why now?

Employee ownership and share ownership have an important role to play in boosting economic growth, promoting a fairer distribution of income and wealth, and giving individuals greater control and autonomy over their own lives.

Employee ownership and share ownership has been shown to improve company performance and productivity. It enables employees to identify more closely with the success of the company and so increases their incentive to work hard. It reduces absenteeism, fosters greater innovation and promotes a more flexible approach to labour utilisation within the firm as well as a longer term approach to business decisions. All of these factors will be important in boosting economic growth.

Secondly, at a time of mounting concern about increases in
inequality of income and wealth, there is good evidence that employees having a significant stake in the ownership of the firm tends to lead to greater income equality. In addition, where shares are individually held by employees, there is the potential for significant asset accumulation. This can be important as a means of fostering a savings habit to encourage individuals to take personal responsibility for saving for their old age.

Finally, having a say in the control of the firm in which people work as well as ownership of assets gives an individual greater control and autonomy over their own lives.

There are therefore economic, social justice and political reasons why employee ownership and share ownership are important, and why it is particularly important now.

**What do we mean by employee ownership and employee share ownership?**

It is important to distinguish between firms where employees own the firm, those where they have a significant ownership stake, and those where employees own shares but where their percentage shareholding is relatively minor. In the case of the former this can include worker co-operatives, fully employee owned companies where ownership is held collectively, eg the John Lewis Partnership, or individually, eg Prospects. We will call these employee owned firms.

Firms such as Circle Healthcare and Unipart where employees have a significant stake of at least 25% (the level at which a shareholding gives a right to block special resolutions which are needed to change the Memorandum and Articles of Association of a company and hence can block attacks on control mechanisms etc), but where there is also substantial outside investment, will be referred to as co-owned firms.

The third category is firms (indeed the vast majority of FTSE 100 and FTSE 250 companies) which have employee share schemes but where this represents a relatively small proportion of the shareholding of the company concerned. We include such companies in this report as research evidence shows that there are positive effects on firm performance when such companies have employee share schemes and that such schemes can have very positive distributional benefits for workers. In the rest of this report we will refer to these as employee share ownership firms. In our view those firms with employee share ownership can be used as a
base on which to build towards more significant share ownership.

One of the reasons why this is important was touched on in our previous report on ‘Employee empowerment’ – there is a strong case for arguing that employees have a right to an influence over key decisions which affect their lives. One of the objections to such an approach is that this would move away from a fundamental precept of the Anglo-American capitalist model: that it is the owners of a company who choose the Board. However if the employees of a company have a significant stake in the ownership of the firm then, even within the Anglo-American capitalist model, there is a strong case for there to be an employee on the Board.

Such a gradual approach towards much more significant co-ownership is practical and was envisaged by John Stuart Mill in the quotation cited on page 9.

In this report, submitted as part of the ongoing employee ownership review, we look at the incidence of employee owned and employee share ownership firms (Section 2); the theory as to why employee ownership and share ownership might be beneficial for firms (Section 3) and the evidence for this (Section 4); the advantages of share ownership for employees (Section 5); the potential drawbacks of employee ownership for some firms (Section 6); the different forms which employee ownership and share ownership can take (Section 7) and the experience of other countries in this area (Section 8); and finally we examine potential policy measures which government might take to boost this sector and making recommendations (Section 9).
2 How common are employee ownership and share ownership?

The UK has a long history of employee share ownership schemes and for many years was one of the world leaders in this area. Firms that meet the Employee Ownership Association’s criteria for being described as employee owned or “co-owned”, (where employees have a significant stake,) currently account for around two per cent of the UK economy, with an annual turnover of £25 billion.

On top of this, there is widespread participation in the four official HMRC tax advantaged share ownership schemes: SIP, SAYE, CSOP and EMI, summarised in the box opposite.

In addition there are many non-HMRC tax advantaged employee share schemes. They are particularly prevalent among larger firms, with over 97 per cent of FTSE 100 (and 82 per cent of FTSE 250) firms having a tax-advantaged scheme in 2003, though only 35% of smaller listed companies.1 Since 2003 the number of firms participating in at least one of these schemes has risen steadily, as shown in Chart 1.

However this does not mean that all employees are benefitting from such schemes. A recent Baker & McKenzie survey showed that only 10 of the 116 companies that have been in the FTSE 100 since 2008/9 have a SIP and 40 have an SAYE scheme, ie less than half have one of identified employee schemes.

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1 Agenda, ‘Sharing the wealth: can employee share schemes improve company performance?’, 2007.
Employee ownership

The UK currently has two all-employee schemes that enjoy favourable tax treatment: Save As You Earn (SAYE) and the Share Incentive Plan (SIP), plus two other more selective schemes – CSOP and EMI (which can include all employees should firms wish).

**Save As You Earn (SAYE)** is an employee-contribution scheme that provides up to a 20 per cent discount on buying shares, which are then generally delivered after either three or five years. Employees have an option to buy the shares at the initial market price (less the discount) and if the share price has dropped since the share options were awarded the employee is under no obligation to buy the shares. This provides an effective way for employees both to save (up to £250 per month) and to have the possibility of a risk free gain if they choose to exercise the option and then sell the shares. When they sell the shares they will be subject to Capital Gains Tax (subject to the £10,100 annual exemption) on any gain. However in the short term it fosters less of a culture of ownership due to the delay in delivering the shares, after which point they can be quickly sold on – in effect, it is similar to a share option plan rather than a share ownership scheme.

**Share Investment Plans (SIPs)** have four modules for employees to acquire shares. The first consists of a share gifting module where firms give away shares to their employees (up to £3000 per employee per year without the employee having to pay income tax or National insurance on the shares value). The second is a partnership module where employees can contribute their own pre-tax income towards buying shares (up to £1,500 per year, with no time limits). Thirdly there is a matching shares module for combined contributions. This is a more flexible model that also offers a route for employees to gain shares even when they could not afford to contribute much of their own income towards it. The final module is that dividends paid on employee shares may be reinvested in so-called dividend shares. With all modules shares must be held in a trust for 5 years before being transferred into the employees’ ownership free of income tax and NICs.

**Company Share Option Plans (CSOPs)** allow UK employees to participate in share options and again they will pay Capital Gains Tax (subject to the £10,100 annual
exemption) only when they sell any shares for which they have exercised the option to buy rather than being subject to income tax/national insurance. There is a limit of £30,000 on the value of shares awarded. Unlike SAYE or SIP, CSOP does not have to be available to all employees and so can be awarded on a more discretionary basis. However, some companies have found it to be particularly effective as a scheme for part time and low paid employees. It enables these employees to contribute to and share in the companies’ success without the low paid employee having to save or part with any money, as employees can use an advantageous loan arrangement to fund the purchase of the shares under option if they cannot afford them, and repay through the proceeds.

**Enterprise Management Incentive (EMI)** was devised for smaller companies and allows companies with gross assets of no more than £30 million and fewer than 250 employees to award options of up to £120,000 per employee. The total options over shares cannot have a market value of more than £3 million. Once again this does not have to be awarded to all employees. Tax is only paid as capital gains tax when the options are exercised and shares sold although even this can be subject to generous entrepreneurs relief.

The increase in the total number of schemes disguises major variation between the types of scheme used. Whilst the total number of schemes has increased, the number of companies operating all-employee schemes has actually declined over the last five years, from a peak of 1,530 in 2006-7 down to 1,270 in 2009-10. SAYE (Save As You Earn) schemes in particular have been in decline for some time, with barely half the number today than there were in 2000-1. Of the more selective schemes, CSOPs have dropped from 4,270 companies in 2000-1 to only 1,490 in 2009-10.

In fact, the only scheme to have increased in prevalence over the last few years is the Enterprise Management Incentive (EMI) – a selective scheme usually used to target small numbers of key employees such as executives, and only available to smaller firms. As the name implies it is directed at fostering enterprise in small firms, rather than targeting employees per se. Out of 12,500 companies operating a tax-advantaged employee share ownership scheme in the UK in 2009-10, 10,610 of them were running EMIs. Even this, however, can be misleading, as the HMRC report points out:
The number of EMI companies granting awards in any one year is much lower than the total number of EMI companies, suggesting that EMI companies do not make new or repeat awards each year.”

Of the 10,610 companies officially operating an EMI in 2009-10, only 2,190 actually granted any options that year. Closer examination of these statistics therefore suggests that the apparently positive picture painted by the headline figures is misleading and that conventional employee share ownership schemes in the UK have declined. This finding is supported by an EU-wide study of profit sharing and employee share schemes in 2008 which found that the UK was the only country where the incidence of employee share schemes had declined.

Table 1 overleaf shows the latest figures for 2009/10 for incidence and revenue foregone for HMRC schemes.

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3 PEPPER IV Report, Inter-University Centre Split/Berlin, Institute for Eastern European Studies, Free University of Berlin, 2008.
Table 1: Incidence and revenue foregone for HMRC schemes 2009/10

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<th>Exchequer cost £m</th>
<th>Beneficiaries</th>
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<tr>
<td>SAYE</td>
<td>180</td>
<td>760,000</td>
</tr>
<tr>
<td>SIP</td>
<td>220</td>
<td>6,500,000(a)</td>
</tr>
<tr>
<td>CSOP</td>
<td>100</td>
<td>40,000</td>
</tr>
<tr>
<td>EMI</td>
<td>130</td>
<td>16,900</td>
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Note (a) This is the number of awards across all 4 modules and employees can receive shares in more than one module and more than one award in a year. This is therefore an overestimate of the number of beneficiaries.

The Exchequer cost of SAYE schemes in some years has exceeded £500m. They are clearly heavily dependent on the state of the stock market as to whether options are exercised. It is difficult to determine accurately the number of individual employees participating in the plans at any given moment. However, it is clear that despite the recent fall in the number of schemes SIPs remain by far the largest source of shares for employees. This is due to their concentration in larger firms and high rates of take-up. In 2009-10 170,000 awards of free shares were made to employees through a SIP whilst over 3 million employee purchases of shares were made through the Partnership module (though there could be overlap between these figures and some individual employees participating more than once).

In 2009-10 around 760,000 employees were granted share options via a SAYE scheme – though only 170,000 employees chose to exercise such options during that year. This was down from 240,000 the year before and over 500,000 in 2001-2 when over 1.3 million grants were made. Fewer grants are therefore being made under this scheme and an even lower proportion of employees are choosing to take advantage of them.

This is not surprising. At a time of poor stock market performance it is less likely to be advantageous to exercise share options. Furthermore a savings based scheme will be less attractive for both savers and savings scheme administrators when interest rates are so low.

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As for EMI schemes, despite the large increase in the number of companies operating them, the fact that they are concentrated amongst smaller companies and can be restricted to only a few employees means that they do not reach large numbers of individuals; in 2009-10 only 16,900 employees were granted options under the scheme. EMI schemes do, however, tend to give out more shares per employee (possibly reflecting their concentration among smaller businesses and their use to reward higher paid employees with equity in place of cash), with an average value of shares granted per employee of £9,200 compared with £4,100 for SAYE and only £690 for each award of free shares under a SIP.

Comprehensive information is not available on the total proportion of equity held by employees in most large UK firms. One of the best examples of employee share ownership in a large publicly listed firm is Tesco, which last year won the “Best overall performance in fostering employee share ownership” award by ifs ProShare. In 2011 Tesco distributed free shares worth £110 million (reported by ifs ProShare to be equivalent to around 1.5% of total equity) to 220,000 of its 260,000 employees via its “Shares in Success” scheme. However, only around 100,000 of its employees own shares at any one time due to the fact that they are often sold on swiftly after being received. Therefore whilst the rewards may be significant, the total proportion of the company that is owned by employees is likely to be little more than a few per cent at most.

BT, another often quoted example, at 31 March 2011 had 0.9% of its equity held by employees as part of BT’s share incentive plan (SIP) and 2.7% of its equity held under a corporate sponsored nominee account which primarily caters for employees and ex-employees. In addition, employees can hold BT shares through an ISA or a nominee holding where the name of the ISA provider or nominee provider is shown on the register and not the employee’s. It is estimated that 60% of BT employees currently participate in their share plans and that around two thirds hold on to their shares after the plan has matured.

It is noteworthy that both BT and Tesco, who in our previous report on employee empowerment were case studies of companies which were particularly good at employee participation, are also companies amongst those making considerable use of employee share schemes. Employee ownership, employee share ownership, and employee participation tend to go hand in hand.

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3 Why employee ownership?

“Greater employee ownership could bring economic and social benefits to both the public and private sectors in the UK, according to the available research.”

That was the conclusion of the most recent comprehensive independent review of the published academic evidence on the relationship between employee ownership and firm performance. In a foreword to the review Sir Stuart Hampson, former chairman of the John Lewis Partnership, summed up the general direction to which it points:

“Some of it is utterly compelling; some is much more equivocal or nuanced. It all seems to point to one clear outcome, namely that, properly structured, and with appropriate attention to leadership and management style, employee-owned businesses have the potential to transform our economy and individual businesses, to spread wealth and make work a better and more fulfilling experience.”

Employee owned firms have been shown to grow faster, retain more workers, become more productive, pay better wages for equal or better profitability and survive better during periods of recession, than non employee owned firms. Furthermore employee ownership offers a number of advantages to the employees themselves, spreading the ownership of capital amongst a larger cross section of society and providing savings and pensions for many in the private sector who might otherwise struggle to obtain them.

In 1968, Michael Quarrey and Corey Rosen of the National Centre for Employee Ownership in the US first demonstrated a specific causal link between employee ownership and company performance. They found that on average the adoption of stock

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6 ‘The employee ownership effect: a review of the evidence’, Matrix Evidence
7 Foreword, ‘The employee ownership effect: a review of the evidence’, Matrix Evidence
ownership plans increased annual sales growth by 3.4 percentage points and employment growth by 3.8 percentage points compared with expected figures from the pre-ESOP period. In the decades since, a multitude of studies have gone on to draw the same basic conclusions:

i) employee ownership has a positive, measurable impact on corporate performance; and

ii) this impact is greatest when ownership is paired with participative management.

Implicit in these two maxims is also a third – employee ownership means just that: firms that are owned, either entirely or to a significant degree, by all or most of their employees. Schemes that distribute negligible proportions of their equity, or those in which share ownership is entirely concentrated in the upper echelons of corporate management (including family owned and run firms), do not typically enjoy the same benefits as those that practice more comprehensive employee ownership. This is not to say that such firms do not show improved performance – the evidence is that they do – it is simply that the benefits may be different or less pronounced.

How is it that firms that are owned by their employees perform better?

The most obvious and often cited reason for improved employee behaviour is that ownership aligns the incentives of each employee with the profitability of the business – employees will work harder because they themselves reap the rewards. Once the economic theory is examined more closely, however, things are not so straightforward. As James Meade argues:

“In an n-man Co-operative the individual worker who shares the profit with his fellows will still get some direct benefit from any additional profit due to his own effort; but it will be only 1/nth of the result of his own efforts. If, to reap the technical n advantages of scale n must be large, then the direct advantage in financial incentives of the Co-operative over the Entrepreneurial firm may be small.”

In other words, because workers share the results of hard work among large numbers of themselves, the direct ‘incentive’ effect is negligible.

Meade goes on to say, however, that “...even in this case the sense of participation may be greater and thus provide a stronger social motivation to do the best for the firm as a whole, i.e., for the whole partnership of fellow workers.” The implication here is that the effectiveness of employee share ownership has in many cases more to do with psychology than with economics. Estrin et al argue that “Psychologists note that the pride of ownership could have a more fundamental effect on employee behaviour; there may be strong interactive effects so the impact of profit-sharing and employee share ownership combined could exceed the sum of each effect taken singly.”

This psychological effect then feeds back into behaviour in the workplace. Rather than there being simplistic individual incentives to work hard due to a share in profit, the effects are more complex and subtle. The Estrin paper suggests that employee ownership “provides incentives against rivalrous behaviour in the workplace, and in support of positive collusion between individuals to raise effort and productivity. In these cases positive peer group pressure to increase work intensity may begin to replace the traditional tendency to overlook or even support colleagues’ shirking. Profit-sharing may therefore work particularly well as a group incentive scheme in firms where the production process or the nature of the product limits the prospects for individualized incentive schemes.”

The acquisition of psychological ownership is helped by increased information about the organisation that workers as shareholders become entitled to, and the increased control they may feel over their working environment. When workers no longer feel as though the problems they face at work are the inescapable result of poor management, and start to feel that those problems are things that they themselves can and should take an active interest in solving, the result is an improvement for all parties.

Firms that are entirely owned and run by their employees can also benefit from a number of cost reductions. They experience

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no significant bargaining costs as workers are willing collectively to award themselves whatever remuneration is sensible from the business’ perspective. No work is therefore lost to industrial action. In addition, there may be reduced supervisory costs as workers, who feel and act like owners, become more willing to monitor one another in the workplace.

There are also significantly reduced inefficiencies that can arise in other firms from a reluctance to share information: this can happen either upwards from workers to managers or downwards from managers to workers, for fear that the other group will use the information to their advantage when it comes to collective bargaining. In the atmosphere of improved trust and cooperation that employee ownership can instil, this is less of a problem. As one author succinctly puts it: “employees will be much more willing to share what they know if the company is willing to share the gain that results.”

There is also currently great concern that shareholders are exercising insufficient control over management (particularly on issues such as boardroom pay) and that business decisions are excessively influenced by short termism.

The focus for directors under an Anglo-American capitalist model is often maximizing shareholder value in the short term even at the expense of long term sustainability. This is particularly so if their own remuneration is determined by short term considerations. However when employees are also the shareholders they have a longer term interest in the business as a whole. They care deeply about long term sustainability because it offers them long term job security.

Employee ownership is not only effective because it improves the attitudes of shareholders by turning them into employees. It also improves the attitudes of employees by turning them into shareholders. The 2009 MacLeod & Clarke report to Government found that employee ownership “was a profound and distinctive enabler of high engagement”, an important factor in making sure that employees are motivated and productive. In a survey of 96 employee owned companies:

“Ninety-one per cent said greater employee commitment was ‘the biggest win of being employee owned’; 81 per cent said staff take on more

responsibility; 72 per cent said staff work harder; 66 per cent believed staff were more innovative; and 61 per cent said they were more productive.”

This is a long way from a naïve reliance on employees to be inherently nice, responsible people which employee ownership is sometimes caricatured as. Rather than relying on them to be responsible, it makes them become responsible, by getting employees to feel and act like owners, in a way that neither employees nor shareholders tend to do currently in most publicly listed companies.

Over the last couple of decades there have been many studies that have examined the performance of employee owned firms of different types using a variety of economic indicators.

The largest of all the recent studies is a 2000 Rutgers University study by D. Kruse and J. Blasi, looking at Employee Stock Ownership Plans (ESOPs) in the United States. They paired several hundred ESOP companies with non-ESOP companies of comparable size, industry and region, then compared figures for growth of sales and employment in the periods before and after the various ESOPs were adopted. Some of their key results are outlined in the table below.

Table 2- Difference in Post-ESOP to Pre-ESOP Performance

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<tr>
<td>Annual sales growth</td>
<td>+2.4%</td>
</tr>
<tr>
<td>Annual employment growth</td>
<td>+2.3%</td>
</tr>
<tr>
<td>Annual growth in sales per employee</td>
<td>+2.3%</td>
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These figures are striking. With an annual average growth advantage of 2.3%, a company adopting an employee share ownership scheme would, after 18 years, have outstripped a rival starting from an equal position by over 50%.

Based on results such as this, the National Centre for Employee Ownership in the United States feels confident enough to assert: “Researchers now agree that “the case is closed” on employee ownership and corporate performance. Findings this consistent are very unusual. We can say with certainty that when ownership
and participative management are combined, substantial gains result.”

A UK review undertaken by Matrix Evidence noted the equivocal nature of a number of the research findings. Nevertheless the report’s authors concluded that

“Evidence suggest that businesses owned by employees perform at least as well as businesses operating under other models of ownership... that under certain circumstances, there are productivity gains from being employee owned ... [and that this] tends to be most noticeable when ownership is combined with participation in decision-making”

This last point, on the need to combine ownership with participative decision making, is something that almost all studies in this area seem to agree on. Even the National Centre for Employee Ownership concedes at the end of its above quoted statement that “Ownership alone and participation alone ... have, at best, spotty or short-lived results.”

This is one possible explanation of why some of the evidence that the Matrix review looked at proved to be so ambiguous – in practice a lot of companies fall short of participative management. Another explanation is provided by Pendleton who argued that one of the reasons for the equivocal nature of much of the research has been that diverse firms have been analysed together - those which are entirely employee owned with those where there is a small employee stake.

Ownership both relies on and reinforces the positive effects of participation. Worker-shareholders of course have certain increased rights to information and influence simply by virtue of their being shareholders, but where their share ownership portion is small and the company large, influence can be very limited. In some cases executives feel that they can use share ownership to reward and incentivise shareholders without having to pay any increased attention to them or relinquish any managerial power. This, of course, is a mistake, as the benefits of a more democratic workplace are many and workers will not feel empowered when in practice

16 A Pendleton, ‘Employee ownership in Britain: diverse forms, diverse antecedents’. 
nothing has changed. A recent Cass Business School report shows that “EOBs [employee owned businesses] with high profit per employee give employees greater autonomy in the workplace and are more likely to seek innovative ideas from employees.”

Of the numerous indicators looked at by this 2010 Cass Business School study, perhaps the most important relates to how employee owned business react differently during periods of recession:

“EOBs are more resilient: their performance is more stable over business cycles, displaying less sales variability. During the period of growth from 2005 to 2008, non-EOBs experienced higher average sales growth per annum (12.1%) than EOBs (10.0%). However, the average sales growth of EOBs between 2008 and 2009 was 11.08%, significantly surpassing that of non-EOBs (0.61%) during this period of recession.”

This is then also reflected in employment growth:

“EOBs experienced greater employment growth than their non-employee-owned counterparts in the period of economic growth from 2005 to 2008 (an average increase in employment of nearly 7.5% per annum in EOBs compared with less than 3.9% in non-EOBs). After the recession set in during 2008–09, this rate increased even faster, with EOBs increasing employment numbers by more than 12.9% compared with 2.7% in non-EOBs.”

That the advantages of employee-owned businesses are amplified during periods of economic downturn is supported by other studies, such as a 2010 Georgetown University/McDonough School of Business paper from the USA. The Employee Ownership Association also maintains an Employee Ownership Index of companies with more than 10% employee share ownership which has outperformed the FTSE All Shares Index by an average of 11% pa since 1992.

Although the effect may be weaker, it appears that the positive

17 For more detail on this issue, see the CentreForum publication ‘Employee empowerment: towards greater workplace democracy’.
The effects of employee ownership are also present where there are smaller employee holdings of shares. The largest research study in the UK looking at employee share schemes (ie not employee owned businesses) and their effect on firm performance was that carried out by OXERA for HMRC.\textsuperscript{20} This used data from over 7500 firms over a seven year period and compared the performance of firms with employee share schemes and those without. The report found that having any type of employee share scheme in the long run increased productivity by 6.1%. However on average it found that there was no significant beneficial impact of tax advantaged schemes over other types of share schemes. The performance effects of tax advantaged schemes varied with size of the firm, whether the firm was listed and also by industry type - eg manufacturing had particularly beneficial effects.

Employee ownership and employee share ownership therefore have the potential to play an important role in helping the UK to recover from its current economic difficulties. As the Cass report states:

“The employee ownership model is also widely perceived as better for job creation, and also for doing so at a much faster rate than the non-employee ownership model. With the current policy focus on entrepreneurship and new business start-ups to re-energise the economy on the one hand, and small businesses bearing the brunt of job losses and facing difficulties accessing finance on the other, the employee ownership model therefore holds greater potential for businesses and employment.”\textsuperscript{21}


5 Benefits for employees

Employee ownership improving the financial performance of firms should not be the only criterion on which it is judged. In practice most people in society are not motivated by the sole aim of maximizing private wealth. Other things - quality of working life and environment, health, leisure time, personal relationships etc - matter a great deal.

John Stuart Mill famously listed some of the benefits he saw as arising from employee ownership:

“... the healing of the standing feud between capital and labour; the transformation of human life, from a conflict of classes struggling for opposite interests, to a friendly rivalry in the pursuit of a good common to all; the elevation of the dignity of labour; a new sense of security and independence in the labouring class; and the conversion of each human being’s daily occupation into a school of the social sympathies and the practical intelligence.”

There is evidence, among other things, that more participative managed employee ownership can improve employee health and well being, including more job satisfaction and lower staff turnover. One survey of ICOM member companies found that 97% felt that employee ownership reduced their staff turnover.

There is also evidence that employee owned companies, rather than simply substituting shares / dividends for wages or providing job security at the cost of lower wages, actually provide higher total remuneration for most employees. The Cass Business School study found that:

22 John Stuart Mill, ‘Principles of political economy with some of their applications to social philosophy’ 1848, Book IV, Chapter VII.  
“Profitability of the EOBs in this study has been comparable with non-EOBs while wage costs and employee costs are significantly higher for EOBs....That EOBs reward employees better and also tend to intake at a much faster rate is clearly more desirable from the viewpoint of better economic performance.”

At times when wages are stagnant or falling for many workers, this is clearly a significant benefit.

In some cases, of course, wages for most employees are higher at the expense of the best paid employees/top managers, who receive less than they would in other firms. All political parties in the UK are desperately searching for a way to curb the excesses of executive pay and address the growing pay differentials between top and bottom employees, without having to resort to direct government legislation on pay caps. Median boardroom pay in the FTSE 100 rose by 12% in the year up to October 2011, whilst most other UK pay was frozen or falling.

On the other hand the difference between employee owned firms and more conventional firms is significant in this regard. In early 2011 Tesco announced that their new chief executive would receive a £1.1 million base salary, bringing his basic salary to a similar level to Sainsbury’s and the John Lewis Partnership’s chief executives (£920,000 and £950,000 respectively for 2010/11). But once you add bonuses, benefits and share options to their base salaries, then a huge disparity develops.

Further to his £920,000 salary in 2010/2011, Sainsbury’s Chief Executive took home an estimated £2.28m, so a total of £3.2m. The chief executive of Tesco, after bonus, is expected to make £6.9 million this year. By contrast, the chief executive of the John Lewis Partnership benefited from the company standard bonus of 18% of salary, taking home an extra £142,000.

David Cameron recently expressed a preference for relying on shareholder activism to rein in executive pay, rather than attempting to put more workers onto remuneration committees which he has described as a “gimmick” and “tokenism”. However, there are limited signs that such shareholder activism is effective. The evidence seems to be that employee ownership is more effective in curbing executive pay.

More generally, employee ownership and participation as business models can make a significant contribution towards the kind of more equitable “good capitalism” that politicians are keen to promote:

“a comparison of 100 per cent employee-owned companies, in which there was also some sort of participatory management, found that income, wealth, power, prestige and privileges were distributed more equally among the workers in an Employee Owned and Managed (EOM) firm than in a conventional capitalist firm”.

Employee ownership can also be useful in encouraging saving by employees and promoting a “share owning democracy” where a larger proportion of the population are capital owners and can thus share in the benefits more equally from economic growth. This often tends to accrue to capitalists more than workers.

Currently around 40% of Gross Value Added (GVA) goes to capital (business profits plus self employment income) and the share of GVA of the bottom half of wage earners has declined from 16% in 1977 to 10% in 2010 (after taking account of bonuses). There is therefore a strong case for seeking to ensure that employees, and particularly those in the lower half of the income distribution, have greater opportunity to benefit from the capital share as well as the labour share.

As Nick Clegg said recently in his speech on the challenges to capitalism, “we don’t believe our problem is too much capitalism: we think it’s that too few people have capital”.

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6 Is employee ownership more appropriate for some firms than others?

There are, of course, potential disbenefits as well as benefits of employee ownership, and certainly significant employee share ownership will not be appropriate in all cases. The flipside to employee owned companies doing relatively well in a recession is the evidence that they grew less rapidly when the economy was growing at a faster rate in the early 2000s. For some rapidly growing entrepreneurial companies significant employee ownership may not be appropriate. Those that require a large and continual influx of new capital to grow may need to allow at least some external ownership.

Likewise it may not be appropriate for some very capital intensive companies where employees would realistically not be able to provide the scale of capital required. For example, analysis of the market capitalisation of the FTSE 100 companies indicates that for many mining and oil and gas companies the cost per employee of employees holding a 50% stake in the company would be over £1 million. That is simply unrealistic. Indeed for reasons of risk diversification it would be a very bad idea for a worker to rely so much on the success of the same institution for their savings and pensions as they do for their wages. The larger the amount of capital at risk the less sense it makes.

The larger a business, the harder it may be to raise capital without external ownership, and more complex structures will be required in order to facilitate employee participation.

There are also problems that co-operatives and employee owned firms can face in raising new capital. Sometimes there is a tendency towards underinvestment, as the lack of external shareholders and
limited resources of the workers can make it difficult to raise funds.\textsuperscript{29} For example, Loch Fyne Oysters, an employee owned company since 2003, announced in February 2012 its sale to a private equity backed company in order to finance its growth. Analysis of ownership change in the bus industry post-privatisation in “Your Choice: how to get better public services” shows how transient employee ownership was in most cases.\textsuperscript{30}

Employee ownership can therefore have a role currently even if it is not used for long term stability. A challenge is whether it is possible to satisfy the financing needs of companies like Loch Fyne Oysters without them having to abandon employee ownership. In addition to equity not being available for employee owned business, this is sometimes compounded by the reluctance of traditional financial institutions to lend to pure employee owned firms.

The Cass Business School study found that small businesses with employee ownership perform better than larger employee owned companies.

“Our results show that EOBs with fewer than 75 employees do significantly better than non-EOB firms on the same scale for Profits before Interest and Taxes (PBIT) and also on PBIT per employee. This is true both for the financial year ending 2005 and the financial year ending 2008. By contrast, there was no significant difference in the performance of EOBs and non-EOBs above this size.”\textsuperscript{31}

However, firms which are heavily reliant on their human capital, those where good customer service is important and those where the nature of the work means there is a high degree of autonomy amongst the workforce, are those where employees have typically had a significant stake.

Three very significant employee owned companies are the consulting engineers Arup and Mott MacDonald and the business consulting group PA Consulting. Although not “employee owned” as such, professional partnerships such as accountants, lawyers and doctors have some of the characteristics of employee owned companies. This was also the case in the past with some of the large merchant banks, although as they became integrated banks

with higher capital requirements they tended to move away from their previous partnership structures.

Retail firms which are heavily reliant on their workforce to supply good customer service have tended to use employee share schemes. Aside from the oft quoted example of the John Lewis Partnership we noted in section 2 the scheme Tesco has for employees, and Asda and Sports Direct have also had successful employee share schemes. In the case of Asda this enabled some employees by 2011 to have built up shareholdings worth £16000 over a three year period and in the case of Sports Direct, employees were reported on average to have generated “bonuses” of £43000 over a two year period.

Some of the large former state owned utilities such as National Grid and BT have also had a tradition of promoting employee share ownership since privatisation. Whether this is simply a result of history is unclear but one can see that both are companies where many employees have a relatively high degree of autonomy, working remotely; hence, strong commitment to the company’s interest is important to compensate for a relative lack of supervision.

Whatever the benefits of employee ownership and share ownership it is not a guarantee of business success. Employee owned or co-owned firms are not immune from poor business decisions. In the UK Baxi Boilers was substantially employee owned but as a result of some poor decisions had some financial difficulties which led to the employee owners agreeing to a takeover by a conventionally owned firm. The fact that Enron or Lehmann Brothers (25% in the latter’s case) had substantial employee ownership did not prevent them going bust.

Likewise, the fact that employees own a significant stake in a firm does not make them immune from takeover or merger. Eaga Partnership, restructured to become an employee owned business in 2000, was bought out by Carillion in 2011 after the employee share-owning trust voted to waive the staff’s right to a cash pay-out and transfer its holding to Carillion shares without consulting its members. We mentioned above the experience of the municipal bus companies which were privatised in the 1980s and 1990s.
7 Forms of employee ownership

There are several different forms that employee ownership can take. The differences between them can be important in determining how many of the potential benefits of employee share ownership arise. The key questions are:

- How **broad** is the scheme – does it cover all employees or just a select few? Do all participants have the same equity or can it be unequal?
- How **deep** is the scheme – what proportion of total shares are held by employees?
- How are shares **financed** – by the company, the employees, a loan or some combination?
- How are shares **held** – individually, or collectively in a trust? If in a trust, how is the trustee appointed and how are the voting rights of the shares exercised?
- What **rights and restrictions** are attached to the shares – are they full voting shares, or just ‘phantom shares’ that only actually deliver cash? Are there any time limits on how long they can / must be held for?

It is not the intention of this paper to recommend a single model of employee ownership as being superior to all others, or most appropriate for all firms to adopt. Clearly one of the advantages of employee ownership is that it increases the diversity of ownership forms in the economy, and diversity between different forms of employee ownership is an important aspect of that. However, depending on which particular benefits are of most interest (higher growth / more responsible capitalism / more savings and better remuneration for workers) there are clearly certain features of employee share ownership schemes that are more relevant than others.

Returning to the five key questions that distinguish different forms of employee ownership (breadth, depth, financing, holding, and rights and restrictions), answers will vary according to the aims of the scheme.
**Breadth:**
The purest forms of employee ownership with the broadest ownership are worker cooperatives. Pure cooperatives have no external shareholders and operate on a democratic principle of ‘one member, one vote’ rather than voting power being determined by the number of shares held or capital invested per worker. Then there are employee owned firms such as the John Lewis Partnership which are not strictly speaking co-operatives as they do not adhere to all the seven co-operative principles adopted by the 1995 Congress of the International Co-operative Alliance.

Research indicates that the firms with the best performance and those most likely to witness improvements in corporate governance are broad-based. A particularly comprehensive study published in 2010 in the United States compared firms that had share ownership schemes for the bottom 90% of employees with firms that had share ownership schemes only for executives. The study measured the success of the schemes in terms of cost- and industry-adjusted return on assets and found that “for both performance measures, the coefficient on aggregate option incentives for firms with broad-based option plans is positive and statistically significant and the coefficient on incentives for firms without broad-based plans is negative.”\(^{32}\) In other words, where share ownership schemes were implemented only for the executives, company performance actually *declined* compared to where no such schemes existed.

In the UK, however, as in the US, many firms still prefer to award shares only to their executives. Whilst there may still be benefits in doing so, it is important to recognise that “narrow-based and broad-based financial participation are distinct and separate phenomena.”\(^{33}\) Moreover we should not expect companies that put shareholding power only into the hands of executives and senior management to do a much better job of holding those same executives to account. As J.S. Mill wrote when writing of the benefits of cooperatives:

> “to attain, in any degree, these objects, it is indispensable that all, and not some only, of those who do the work should be identified in interest with the prosperity of the undertaking”.

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**Depth:**

The degree to which a firm is majority or minority owned by employees clearly has an impact on some of the potential benefits of employee share ownership. Schemes which only reward employees with small proportions of shares in an attempt to incentivise them are regarded by some advocates of industrial democracy as a “sham” where “owning small proportions of company shares (as is the case in most share ownership plans), exposes employees to the risks of ownership but not its potential gains”.\(^34\)

It is certainly true that firms in which employees have a larger stake are more likely to experience a culture of ownership, with the resulting productivity gains, and have an increased probability of seeing changes in corporate governance due to the voting power of the employees.

That is not to say, however, that firms with a minority employee stake are necessarily going to have low rates of employee participation. Any firm is always free to establish employee participation schemes and many do so with no employee share ownership component whatsoever. Firms with well designed participation schemes combined with a significant minority employee ownership stake still have the potential to raise employee engagement and performance.

Most authors agree that there is a point below which these schemes cease to show much improved performance. The Employee Ownership Association uses a criterion of minimum 30 per cent ownership to qualify as “employee owned”, but many other authors suggest that there are at least some benefits to be had below this level.

Cubbin and Leech (1983) argue that the extent of shareholder control is dependent on both the proportion of shares held by a particular coalition (in this case, employees) and the degree to which the remaining shareholding is dispersed.\(^35\) The logic here is that in some cases, where there are no other individually significant shareholders, a collective employee stake of even five to ten per cent could exercise influence over the board. The proportion of shares that employees need to hold to represent a ‘significant’ stake, then, may be at least partially dependent on how other shareholdings in the company are distributed.

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34 Kaarsemaker et al. ‘Employee share ownership’, in OHPO.
**Financing:**
The question of who pays for the shares is obviously important in determining how much the scheme benefits the employees themselves, as well as having an effect on take-up rates. Contributory schemes are among the most common and one of the easiest for firms to implement, particularly if they are already a listed company.

If we want to encourage more broad-based schemes, however, contributory financing is not usually the most effective way at encouraging participation. Plans under which employees have to buy shares using their own incomes / savings, even when significant tax discounts are offered, tend to have lower participation rates. This is typically at around 30 per cent, as there is a risk that it is mainly higher income employees with the necessary savings who tend to take advantage of them. Often low income employees are understandably wary of putting their own limited capital at risk in the firm which they are already dependent on for their salary.

On the other hand, schemes which are financed entirely by the firm in the form of gifting shares to employees can be difficult for firms to finance, and there is a risk that this is used as a substitute for wages. For this reason in the UK schemes such as the Company Share Option Plan (CSOP) have greater attractions for companies and low paid employees alike.

A third option is to use a loan to finance a share distribution to employees via a trust. The trust uses its share of company profits each year to pay off the loan originally used to purchase them, before then giving the shares away to employees. This allows employees to acquire shares cheaply and easily and involves no direct cost or risk on their part. Such a mechanism has been widely used in the US under Employee Share Ownership Plans (ESOPs) and has been used in the UK. However changes in the 2003 Budget rendered this less attractive as companies could then run the risk of a double taxation charge. Changes to disguised remuneration rules in 2011 have also made the use of such mechanisms more complex.

**Holding:**
There is little evidence of much difference between individual or collective ownership when considering the benefits of employee ownership. One area where the choice can be significant, however, is in affecting the longevity of schemes. One of the reasons that the National Centre for Employee Ownership recommends the use
of ESOPs is because of their long term stability as an ownership structure. Direct employee ownership of individual shares is common, but only rarely is majority ownership achieved this way as share ownership tends to fragment over time as individuals sell on their shares.

In this sense individual share ownership may be more suitable for stock options and other short to medium term reward or savings plans, whereas collective ownership can provide a more convenient vehicle for long term majority ownership. This is the way in which John Lewis and many other worker cooperatives are run.

The other area in which collective shareholding might be more advantageous is in increasing employee voice in corporate governance. Depending on how it is structured, pooling the voting rights of employee-shareholders under the control of a single trustee can increase the shareholder power of employees by acting as a single, coherent bloc.

On the other hand employees have less chance to accumulate assets when shares are held collectively and arguably they feel less direct ownership compared to a situation where they actually own shares individually and can monitor the value of the shares.

**Rights / Restrictions**

In some cases special rules can also help to restrict the breakup of employee ownership, where the intention is to create a permanent employee owned organisation like John Lewis. Some models include mechanisms such as ‘golden shares’ which can be used to veto any attempt to sell an employee owned company to external owners. Alternatively, there can simply be rules which prohibit employees from selling shares to anyone outside the company.

Even in companies that are not aiming to create a permanent employee ownership structure, employees who hold onto their shares for a number of years are likely to lead to benefits of increased staff commitment and lower staff turnover. After all, if shares can be sold on again for a profit as soon as they are received, the source of any increased staff commitment may be diluted. One study found correlation between employee share ownership and increased staff turnover, which it attributed to a high proportion of stock option schemes among the sample:

“In a situation of high company profits and thus high stock prices, remarkable capital gains can be realized
by executing the stock options and selling the shares. Afterwards, employees (in particular management and professionals) are motivated to leave the company and look for new employers that again offer high leverage effects due to low stock prices and attractive stock options.”

All of these comparisons between different types of ownership schemes should be treated tentatively. There is a lack of conclusive empirical research on distinguishing the effects of different models and a general air of confusion still exists in this area. “The Literature has not distinguished clearly between levels or types of ownership, nor indeed between types of complementary participation.”

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Overseas experience of employee ownership and share ownership

The United States
The USA has one of the widest experiences of employee ownership. Quite common are Employee Stock Purchase Plans (ESPPs) and stock option plans, which offer employees the opportunity to buy shares from the company at a discounted (usually by 15 per cent) or pre-fixed price. However, there are no real incentives for holding onto the stock for a long period of time, nor any restrictions on immediately selling it – so employees tend to acquire the shares, then sell them on. There is rarely a sufficient volume of these shares held by employees for them to exercise any kind of influence over the way the company is run, and they therefore function primarily as financial reward mechanisms.

In a number of other similar individual equity plans the employees never actually hold the shares at all; rather they simply receive a cash award based on the appreciation value of a certain amount of ‘phantom stock’ ultimately retained by the company. The only contributory plan that requires stock to be held by employees is the so called section 423 plan, which provides capital gains tax reduction if ESPP stock is held by the employee for two years before being sold.

However, there are more broad-based schemes that do provide long term ownership. By far the most common is an ESOP, or Employee Stock Ownership Plan (this is a specific government approved plan, not to be confused with the more generic international use of the term ‘ESOP’ to refer to any collective share ownership scheme). There are over 13 million participants in ESOPs in the United States - more than in any other type of share ownership scheme. Devised in the late 1970s, these allow shares to be acquired by a trust on behalf of employees. Shares are either gifted to the trust by the company, or the trust buys them with the resources of employees
or a loan, which can then be repaid by the company through tax-deductible contributions.

To qualify for such a plan, all employees over the age of 21 who work more than 1,000 hours per year must be included in the plan; it cannot be restricted to only those with the financial resources to afford to buy shares. The trust holds shares on behalf of all employees who meet these criteria, allocated relative to pay (up to a maximum of $245,000) and distributed when people retire, at which point the company must offer to buy back the stock. This method of financing allows the trust to acquire large stakes in the company, 100 per cent in a number of cases. ESOPs are often used in this way to buy the stakes of owners who wish to sell down their stake.

The voting power of the shares is held personally by the trustee of the ESOP trust. At least initially this can be a mechanism for the owner in practice to keep full control despite not having full economic interest. Whilst the position varies between states there are often tax advantages for the vendor as well, enabling them to transfer their assets into more liquid form without incurring a capital gains liability. Some consequently argue that the motivation for an ESOP is often driven by the interests of the vendor rather than employees.

After the first few years of a scheme, once shares have been fully allocated, employees can have the right to direct the trustee on how to vote on all issues in listed corporations, and on some key issues relating to closure or restructuring in private corporations. This provides a key route for employee participation and further fosters a culture of ownership and engagement.

The ESOP model also provides employees with significant retirement stakes. Similarly, so called 401(k) plans provide capital on retirement, in this case a more diversified investment portfolio where contributions are matched by the employer, often in the form of a combined ESOP.

The success of ESOP schemes shows how tax incentives can be extremely effective at encouraging adoption of a particular scheme. When done well and combined with participative management, it can offer a vehicle for a culture of real employee ownership that crucially offers workers an opportunity to participate without having to put forward their own savings to buy stock.
**European Union**

There has been a considerable increase in the number of employee share ownership schemes operating in almost all EU countries during the early 2000s, with the UK being a notable exception to this trend. The vast majority of these EU countries have at least some tax exemptions for companies that practise employee share ownership, with many of them operating multiple, parallel tax exempt schemes.

France has practised a widespread approach to employee share ownership and profit sharing. In total around six million employees, or 23% of the workforce, are members of a share ownership scheme – which is over three times that of the UK. They are the only European country where all companies of 50 or more employees are legally obliged to set up a profit sharing plan for all employees. Whilst no specific share ownership plans are widespread, the mandatory profit sharing plans generally operate by dispensing shares rather than cash.

The ‘Plan Epargne d’Enterprise’ is an employee savings plan under which employers match employee contributions and is often used as a vehicle for employees owning shares. There are numerous tax benefits, such as contributions being exempt from income and payroll taxes, and a capital gains tax discount on any profits. Savings are locked in for a minimum of five years, resulting in a relatively high degree of continuous ownership. Where the savings are in the form of shares, the chairman of the trust must be an employee representative by law. If employees own over three per cent of the shares of any listed company, then they are also entitled to elect at least one employee representative to sit on the company board. Employee share ownership is therefore legally tied in with employee participation, which as has already been shown is an important factor in making it effective.

Germany, meanwhile, may score highly on measures of employee participation, but it has a very low incidence of employee share ownership. This is generally attributed to “the complexity of German law and the high degree of formalization of workplace industrial relations”, “the strong position of unions”, and “a lack of government support”.  

Spain has a legal system which, as well as encompassing various standard share ownership schemes, defines a special set of ‘Workers 

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Chart 2: Employee share ownership by firm size 1999

Chart 3: Employee share ownership by firm size 2005

Source: PEPPER IV Report, Inter-University Centre Split/Berlin, Institute for Eastern European Studies, Free University of Berlin (2008)
Companies’ (Sociedades Laborales) that must have at least 51 per cent employee share ownership and mandatory employee decision making rights. If, in addition, they reserve 25 per cent of their profits to a special fund for the compensation of losses, then they are exempt from a wide raft of taxation, including capital transfer taxes, tax of capital formation and notary fees.

This is significantly more than is the case with standard share ownership schemes and shows that a dual system can promote both limited employee share ownership in listed companies and more comprehensive cooperatives for those firms that wish to go down that route. In 2007 there were estimated to be approximately 20,000 of these ‘Workers Companies’, employing over 125,000 workers, and the growth of these schemes has been steady and continuous over the last decade, surpassing that of other types of companies.

The most famous of these Spanish cooperatives is the Mondragon group, set up around 1960 with the support of the Spanish state. It has since grown and prospered to such a degree that it has become an icon for many advocates of the cooperative movement. They acquire capital both from their members and from the Mondragon cooperative savings bank Caja Laboral Popular, which also amasses reserve funds from years of profit to cover the firms in years of loss. They limit their pre-tax pay differentials between the highest and lowest paid to three to one.

One particular success is avoiding the tendency of some cooperatives to disintegrate when retiring members keep their capital and control by banning members from holding individual shares that can be bought or sold; rather, all present worker-members have their own share of the capital and an equal vote - immediately cashed in and terminated on their retirement from the company.

In the course of the 1980s there were two interesting innovations in Italy and Spain which enabled the employees of companies which would have otherwise gone out of business to capitalise their unemployment benefit to finance the co-operative. In Italy this was known as Marcora’s Law and enabled workers to capitalise three years of unemployment benefit. By 1992 40 million euros had been invested in 89 co-operatives which employed 3100 people. In Spain the ‘Sociedades Laborales’ in the 1980s became the standard way to deal with insolvency. However in both Italy and Spain these approaches were abandoned in the mid 1990s, in part because of concerns that under EU law this would represent state aid and so be illegal.
9 Proposals on how to promote employee share ownership and employee ownership in the UK

In this section we examine what measures could be implemented to boost employee share ownership and employee ownership. Our policy proposals are in the following areas:

1) Promotion by government of the case for employee ownership and share ownership and co-ordinating action to ensure that there are no unnecessary barriers to such ownership.

2) “Technical” measures which could be taken to make employee share ownership and employee ownership more attractive.

3) Transformational measures which government could take to promote employee ownership.

In respect of the first two of these areas there is little that we are proposing which has not been proposed on many occasions by others. However it remains important, as to date it has not been acted upon by government.

Promotion of employee ownership and employee share ownership

Promotional and research bodies such as the Employee Ownership Association, ESOP Centre, Co-ops UK, ifs ProShare and Mutuo argue that government should promote the cause of employee ownership and share ownership by pursuing a more consistent, coherent approach across government and seeking to work with the private sector. This view was also supported by the All Party Parliamentary Group on Employee Ownership in its report in May 2008.

There is much that government can do, without legislation, to promote particular causes within the wider economy. The case for doing this in relation to employee ownership and share ownership is
Employee ownership

clear – it will help to promote growth, a fairer distribution of income and wealth, and a more stable economy. In particular we propose that a minister should have specific responsibility for mutuals and employee ownership. Such a minister would:

- Ensure that all current and proposed government legislation (both tax and more general) considers the needs of EO companies and co-operatives, so that there is a level playing field.

- Be a champion of the case for employee ownership and share ownership within government and in the wider economy. For example there is a lot of concern that professional advisers give little regard to the potential for employee ownership when advising on corporate transactions. A government minister pushing this agenda with professional bodies, business schools etc could have a significant role in securing change.

- Promote this agenda amongst companies which do not yet have significant employee share ownership and participation, in the same way as government ministers, for example, have promoted a fairer approach to interns in order to promote social mobility.

- Work with banks and other financial institutions to identify any gaps where government intervention might be required, and to ensure that they properly meet the needs of employee owned companies and co-operatives, eg through having single contact points and dedicated teams with experience of working with this sector.

- Facilitate greater co-operation between different parts of the sector eg between mutual financial institutions and co-operative and employee owned businesses. For a sector which stresses the benefits of co-operation there is more that could be done to promote their common interests.

**Technical changes needed to boost employee ownership and share ownership**

There is a fair degree of consensus amongst advocates of employee ownership and share ownership on a number of technical measures which government might take to promote greater use of employee ownership and share ownership. Indeed, the fact that relatively small changes could make a quite substantial difference illustrates why a single minister with a specific remit for employee owned firms and mutuals is important. The Office of Tax Simplification
has recently (March 2012) published a report on tax advantaged employee share schemes. Some of the measures outlined in the box are also amongst their proposed changes.

### Tax advantaged employee share schemes

- **Change in the law to enable private equity owned companies to have HMRC tax advantaged employee share schemes.** Currently this means that three million employees are unable to benefit from tax advantaged schemes. Indeed when companies with share schemes are taken over by private equity, eg Boots, they have to cancel their employee share schemes.

- **Change in the tax legislation so that employees of companies taken over during the first three years of a Share Incentive Plan by an unlisted company for cash are not subject to a tax charge.**

- **Making it easier to transfer funds from employee shareholding into a pension fund at retirement.** In the case of employee owned or co-owned firms, where shares are individually held, there will often be requirements that employees sell their shares back to the employee benefit trust at retirement. If the value of the shares is greater than the annual Capital Gains Tax allowance (currently £10,100pa) this would incur a tax charge. Whilst this can be avoided through careful tax planning it would be better if this were done without the risk of a tax charge being incurred.

- **Consideration of an extension of entrepreneurs’ relief under CGT to EMI schemes where an employee owns less than 5% of the company’s equity.** If this were to be the case it would need to apply to all employees.

### Employee ownership more widely

- **A reduction in the time period during which SIPs have to be held from five to three years to make them consistent with other HMRC schemes.**

- **Currently individual SIP, SAYE and CSOP schemes have to be individually pre-approved by HMRC whilst EMI schemes do not.** Given current resource constraints within HMRC, a similar approach to that used for EMI could be considered for other schemes.

- **Action to remove the adverse tax consequences for**
companies which wish to transfer shares to Employee Benefit Trusts caused by the provisions in the Finance Act 2003. Whilst introduced to stop the use of Employee Benefit Trusts (EBTs) to avoid tax this had the unintended consequence of introducing what is arguably a double taxation charge on transfers to EBTs by companies seeking to become employee owned or co-owned. This issue was considered in some detail by the All Party Parliamentary Group on Employee Ownership in 2008 and we support the suggestions made and do not repeat them here.\(^{39}\)

The problems caused for EBTs have, if anything, been made worse by the introduction of measures to tackle disguised remuneration in 2011. We also consider in the next section whether there might be merit in building on the concept of an EBT to have a more formal legal structure akin to ESOPs in the US.

A Co-operatives and Societies Consolidation Act to simplify and bring together current legislation (a proposal along these lines was announced by the prime minister in January 2012)

Some lobby groups have also called for increases in the limits for SAYE and CSOP schemes of the amount that can be invested per month or the amount of shares over which options can be granted. We are not convinced of the need for this given the potential adverse distributional consequences.

**How do we get a big change in employee ownership and share ownership?**

The above measures will undoubtedly have a significant impact in making employee ownership and share ownership more prevalent. In this section we investigate additional measures which might be adopted to give this form of company an even greater boost within the private sector. We have deliberately not considered measures which could make employee ownership more prevalent in provision of services to the public sector as this is an area where the government is already active through its mutuals initiative, run out of the Cabinet Office.

\(^{39}\) ‘Share value: how employee ownership is changing the face of business’m APPG on Employee Ownership, May 2008.
We have primarily focused on two questions. What can be done to boost employee share ownership and employee influence within companies where there is currently a low proportion of equity held by employees? And what can be done to make employee ownership and co-ownership models be considered more actively by business owners?

To answer these we look at whether there are any ‘nudge’ measures which might be used to ensure that business owners consider the transfer of all or part of a business to employees and what fiscal incentives might be used.

The deputy prime minister in his Mansion House speech mooted the idea of introducing a ‘right to request’ to boost the prevalence of employee ownership and share ownership without specifying any details. It is this concept which we turn to first. A ‘right to request’ was introduced by the last government in relation to some public services such as community health services (subsequently strengthened by the current government to a ‘right to provide’). Of course government outlining a ‘right to request’ for workers to take over a currently publicly owned service (with a presumption that as long as the terms are acceptable it will accede to the request) is rather different from government giving a right to request taking over an entity from a third party (the existing company owner).

There are several ways in which a ‘right to request’ could work. The first would be for employees to have the right to request to take a majority or 100% stake in any business. The second, at the other extreme, would be the right for employees to request an employee share scheme in their company. A third would be a right for employees to request a minority but significant stake in any business. A variant of each of the above would be for employees to have a right to request any of the above but only at a point of business transfer.

What would a right to request entail? At one extreme it could be meaningless in the sense that employees could at any time request it. As long as there is no obligation on the employer to say yes then it might mean nothing. For a right to request to be meaningful there must be an obligation on the business owner to consider the request seriously and to respond by setting out the terms on which they would accede to the request. There might then be the potential for the employees to appeal if they believe the terms to be unreasonable.

There would also need to be a trigger of a certain percentage of employees making the request. We suggest a similar trigger to
that set out in the Information and Consultation Regulations 2004 of 10% of employees. Whilst in the case of the ICER 2004 this 10% threshold has been considered to be a significant hurdle, in our view it is more appropriate that such a significant proportion of the workforce should be required to request employee share ownership as it represents a more significant structural change in the business than simply establishing information and consultation procedures. The limited use that employees have made of their rights under the ICER due to lack of awareness offers a lesson for a ‘right to request’ employee share ownership as well. It will need to be highly publicised to make sure that employees are made aware of their new rights and how to exercise them.

We do not consider that a blanket ‘right to request’ a majority or 100% stake in a business would be sensible – not least as it would risk infringing the property rights of the owners. On the other hand we consider that there is a strong case for a right to request to have an employee share scheme in all firms above a certain size. For example in France all firms employing more than 50 employees have a legal duty to have a profit sharing scheme – which in many cases is an employee share scheme. In the UK a right to request should, at least initially, require a similar size to the Information and Consultation Regulations 2004, applying to all firms with more than 250 employees.

Whilst over 80% of the largest listed companies have tax advantaged employee share schemes, less than 50% have all employee schemes - so introducing such a right to request would be worthwhile. Furthermore, for listed companies outside the FTSE 250, figures from 2003 indicate that only 35% have any such scheme, and presumably fewer have all employee schemes. More than twice as many people work in the unquoted sector (12 million) than in public companies (5 million) so there are still many companies where a right to request employee share ownership would be worthwhile.

There is also a case, in our view, for there to be a right to request for employees to seek a significant, but less than majority, stake in a firm. We have given careful consideration to what such a ‘significant’ stake might be, and what measures might be taken to facilitate this, both for business owners and employees. Our judgement is that a ‘right to request’ a 5% stake in the business would not be unreasonable and under company law, if exercised collectively, gives certain additional rights.

Clearly for some capital intensive businesses it is unlikely that a combination of HMRC tax advantaged schemes or even straight
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purchases of shares would make this attainable. However for many businesses it would be attainable. Analysis of FTSE 100 companies by market capitalisation and number of employees indicates that this implies 30 companies would have a per employee shareholding of less than £10,000, over 40 would have a shareholding of less than £20,000, and for three quarters of the FTSE 100 this would imply a shareholding of less than £50,000. Moreover the more capital intensive companies are the most likely to be in the FTSE 100 given their need for external capital. Hence such an employee stake is likely to be more attainable for smaller companies. In those companies where a 5% employee shareholding is unrealistic, it would still be possible to give them 5% of voting influence through use of different classes of shares.

We set out in more detail in the box how this might work and possible mechanisms which might be put in place to facilitate this. In particular we moot the possibility of an “acceleration” of the tax benefits of a SIP or SAYE scheme both for employees and employers to make this more attractive. We also suggest consideration of a temporary corporation tax benefit to incentivise such arrangements.

A further benefit of such a scheme is that 5% employee ownership is of such a size that having a director nominated by employees on the Board becomes more tenable. As noted earlier if shareholding is widely dispersed a shareholding of 5% can give significant influence. One of the traditional objections to employees having a seat on the Board is that this would infringe the fundamental aspect of Anglo-American capitalism that it is only owners who should have the right to choose who is on the board. We argued in ‘Employee empowerment: towards greater workplace democracy’ that we do not accept the validity of this argument. This would be a way of giving employees a say without infringing this view about the Anglo-American capitalist model. Note that in France if employees have a 3% shareholding in a company they have a legal right to a seat on the board.

There are already several large listed companies which are at or near the 5% level for employee share ownership and around 20 LSE listed companies that have over 10% employee stakes, so we consider that 5% is realistically attainable in many, though clearly not all, cases. Even if a formal right to request 5% of shares is not granted, we suggest that this should be a target that the government promotes amongst companies.

The second question is how we can get business owners to consider more actively employee ownership or co-ownership when
a change in ownership of the business is being contemplated. It is in these circumstances that there may be greater validity in a ‘right to request’ employee ownership or co-ownership, as in these cases one cannot say that this is a challenge to the ownership rights of the existing owner.

In the US it is at this point of ownership change that ESOPs have played a significant role by providing a fiscal incentive for owners to transfer shares to an ESOP. Something similar to this should be considered in the UK – probably by some discount on Capital Gains Tax. This would both provide a direct incentive for owners but also ensure that the option were more actively considered by professional advisers to owners. The other two circumstances in which transfers happen are when corporates consider sales of subsidiaries and insolvencies.

In the case of insolvencies, as noted earlier, there were provisions in Italy under Marcora’s Law and in Spain which helped workers to fund buyouts. However this ceased because of concerns that it would contravene European state aid rules. Unless this were to change we do not consider that this is a viable option in the UK.

Jensen outlines some other potential routes which could be explored but we do not consider that this is likely to lead to substantial growth in employee ownership. Indeed, there is likely to be a relatively high failure rate of buyouts from insolvencies and hence it may not be sensible for government to incentivise this route.

In the case of sales of subsidiaries, as long as the sale process is open then there is always the possibility for employees to mount a bid anyway even if the timescales involved might make this difficult. One option would be to require the workforce to be notified if there is to be a sale which then would enable them to consider mounting a bid.

Proposal

Employees would have a right to request 5% of the share capital of the company.

**Why 5%?**

1) It is a small enough percentage for employees (in most cases) to have a realistic prospect of acquiring or being gifted the shares under HMRC tax advantaged schemes. For 30 of the FTSE 100, a 5% share stake would be less than £10,000 per employee, 43 would be less than £20,000 per employee and 76 would be less than £50,000 per employee. There are some companies where the cost per employee of a 5% stake would be unrealistic.

2) It is within Association of British Insurers (ABI) guideline restrictions on dilution of equity by employee schemes.

3) 5% shareholding (if exercised collectively) gives certain rights under the Companies Act such as the right to have an item placed on the agenda at an AGM and the right to call a general meeting.

4) Depending on the dispersion of equity holdings 5% can be significant enough to give real influence (assuming voting rights are in some way combined). In France if employees have 3% of the share capital of a company they have the right by law to a seat on the board.

5) There are several academic studies which indicate that employee share ownership can have on firm performance by around 5%. This could be used as a justification for gifting the shares (though gifting would not be a requirement).

**Should the 5% be gifted or bought?**

This should be left open to the company in responding to employees’ request. It would be unfair to require gifting as clearly this could lead to a substantial windfall for employees of companies with a high share capitalisation/employee ratio.

**How would the 5% be financed?**

If the problems caused by the 2003 Budget changes for loans by companies to employee benefit trusts (EBTs) could be resolved, then one route would be for corporates to lend the money to EBTs. There has recently been considerable
attention given to the large cash piles held by corporates in the UK, US and Europe with an unwillingness to invest given current uncertainty. One way in which many corporates are investing this cash is in share buy backs. An alternative therefore might be for them to be encouraged to lend the money to an EBT to acquire shares. Alternatively, banks could lend to the EBT to finance the purchase.

An additional mechanism might be to enable EBTs to ‘accelerate’ tax benefits from a SIP. Currently employees can acquire up to £1500 of shares out of gross income in a SIP or be gifted up to £3000 worth per annum, and then be required to hold them for five years. Consideration could be given to allow individuals/firms to accelerate five years benefits into a single year. If not universally available, such an ability could be triggered by a change in ownership. In such a case the target company putting cash into the SIP to help finance the buy out could then be encouraged to accelerate the distribution of shares to employees.

These mechanisms would be a pull factor to incentivise employees. A push factor to incentivise employers could be tax discounts of some sort. Employers could be permitted to accelerate the deduction of a number of years gifted shares for corporation tax purposes (mirroring the acceleration provisions for employees). Another option might be to reduce the corporation tax rate for companies who set up such an arrangement immediately to 23% (which the government has announced will be the corporation tax rate from 2014). This would give a small incentive but one which by its nature would be time limited. Other potential fiscal incentives might include a more permanent discount on the corporation tax rate or perhaps on employers’ NI contributions.

**Details to be worked out**

Whether shares would be always held by the trust or by the employees individually.

How employees would exercise their voting rights. Our preference would be that it can generally be done collectively so that they have real influence.
There are two other measures which should be investigated which could facilitate the growth of employee ownership and share ownership.

The first would be to examine the case for a formal legal structure for the holding of employee shares. Generally they are held in an employee benefit trust, using trust law provisions. However the advice needed to set up and structure a trust in such a way so as to minimise tax costs can be expensive. We have also heard how the uncertainty caused by the inadvertent effects of tax changes can be a deterrent (see case study below). There may well be merit in a more formal ‘off the shelf’ structure, perhaps along the lines of a US ESOP structure. Such a structure should enable shares to be held both collectively but also individually.

**Case study**

Company X was founded ten years ago and operates in the media sector. It has had compound annual growth in recent years of 50% pa and now has sales approaching £10M pa and profits before income and tax of £3m. There are 50 staff. Its two founders each own 25% of the company and there are nearly 100 shareholders in total comprising business angels, employees and suppliers. The company is estimated to be worth in excess of £30m.

Until changes to capital gains tax taper relief employee shareholders would face a tax rate of 10%. Whilst entrepreneur’s tax relief was introduced at a rate of 10% on a lifetime gain of £10m this only applies if the shareholder owns more than 5% of the company. As individual employees are unlikely to be offered a 5% stake this is a significant disincentive to attracting and rewarding key employees with shares in the company.

The two founders are starting to think about business succession – probably within a 5 year timeframe. Having built up the company with the help of their employees and other stakeholders, the founders would potentially be interested in transferring their business to employees, potentially through a loan to the employees to purchase the shares, repaid out of dividends – an arrangement similar to a US ESOP. Two factors are deterring them. The first is the complexity (and cost) of the structuring required. The second is the concern that tax changes (particularly ones with a
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The retrospective effect introduced for other reasons) could adversely affect the arrangement. By contrast a trade sale would be simpler to execute and the tax and other impacts would be known. A clear structure, enabling employees to increase their stake in the business, would make this a more attractive proposition.

The second would be to examine the need for new financing institutions to help this sector. There are two different financing needs. One is the financing of employees purchasing significant stakes in the firms in which they work. In the US there are well-established arrangements for financial institutions to lend to ESOPs, on the security of the shares in the ESOP and to be repaid out of dividends. We understand that there have been similar loan agreements in the UK but this is far less common.

The other financing need concerns the normal financing requirements of a company which is primarily or totally employee owned. In this case some in the sector claim that there is a significant degree of ignorance about such firms amongst banks and financing institutions. Furthermore, where the firm is entirely employee owned, that the inability to attract external equity frustrates the development and growth of such firms.

There is some basis for this concern but we are instinctively sceptical of suggestions that the government should set up a state owned bank to foster this sector. Cooperative and Community Finance has been instrumental in several employee ownership transitions and provides a useful service. However, the lending limits are low at £150,000 and an overall fund of £4m is not able to help larger businesses. There would be merit in considering an expansion of this organisation, perhaps through accessing some further finance through Big Society Capital. There are also various financial mutuals such as the Co-op Bank and Unity Trust Bank which ought to be much more receptive to the needs of this sector.

In general, the financial services industry typically shows a high degree of financial innovation when the need arises. For example HCT (the community transport company which is a social enterprise) recently raised a “social loan” through Bridges Ventures which, whilst a loan, has equity characteristics. Very often such financing instruments will develop when the demand arises.
There is sometimes a role that government can play as a catalyst and co-funder. Investigation of whether this is a key inhibitor should be a matter for early action by the minister with responsibility for employee ownership.

Clearly some of the proposals outlined would have short term costs – mainly in tax revenue foregone. However to the extent that they lead to improved company performance and hence improved economic growth there would be compensating tax benefits. An alternative would be to restrict some of the tax benefits within non-all employee share schemes, ie CSOP and EMI, where the tax relief per beneficiary far exceeds that for SAYE and SIP schemes. However the aims of the EMI scheme are at least as much to do with promoting small entrepreneurial firms as boosting employee share ownership, so we would advise against restricting relief on CSOP and EMI schemes.