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'EXPLODING' WEALTH FOR ALL

Towards better understanding of tax neutrality

GEORGE COPEMAN

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CENTRE FOR POLICY STUDIES

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The author

Dr George Copeman was a founder member of the Wider Share Ownership Council in 1958 -- the year that his first book on employee share ownership was published. He sat on the 1975-77 Howell Committee and contributed the initial paper which was the basis for developing the 1977 Green Paper on this subject. He is Deputy Chairman of the Wider Share Ownership Council, and as Chairman of its Employee Share Ownership Committee has submitted several legislative proposals to the Treasury. In 1977 he founded a management consultancy firm (from which he has lately retired), and was responsible for advising some 400 companies on employee share ownership.

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Summary

Britain's tax regime favours the creators of wealth who can invest for to-morrow's expansion out of today's income <u>before it is taxed</u>. Employees without equity in their workplace enjoy no such benefit in creating wealth for themselves. Tax neutrality, properly understood, demands that they should. The author, who is Deputy Chairman of the Wider Share Ownership Council makes recommendations for encouraging all companies to institute one of the various Revenue-approved schemes for employee share ownership.

1.
A capitalist confession

For all its virtues, capitalism has historic faults, too. The creeds of Communism and Socialism, which are now so discredited in so much of the world, were not born out of thin air. However misguided, they were serious attempts to put right a flaw perceived in capitalism, namely its high concentration of ownership in the hands of successful business families. The remedy proposed and put into effect by the communists was complete state ownership. This has had disastrous consequences for millions of people.

In Eastern Europe the reformers have admitted the hopelessness of their economic system, and called for democratic elections and a market economy. But many still claim to want a socialist market economy. We can hardly expect to convince them that this too is a mistake unless we are seen to be putting our own house in order.

Let us point out that not only was the communist remedy for curing capitalism a failure; the diagnosis was wrong too. Capitalism was accused of exploiting its employees. This was said to be the reason why some people became very rich.

The faults of capitalism have nothing to do with exploitation. A competitive economy generally has to pay market wage rates; and so cannot systematically exploit people.

Yet it is still necessary to explain why wealth became so concentrated as greatly to assist the rise of communism. Failure to do so would invite history to repeat itself under some newly named, but perhaps equally damaging ' ism'.

The fault in capitalism was much simpler than exploitation - more innocent and more easily cured. The history of companies shows that those who succeed in business are often surprised at the speed with which their fortunes can change from having very little to very substantial wealth indeed. This arises in many cases because they have developed a product or service just right for their customers, at a worthwhile level of costs, and there is an explosive growth in their market. Of course there are other ways of creating wealth. Nevertheless it seems appropriate to lay <u>fast</u> wealth creation at the door of what the author terms the 'Exploding Market Principle' -- in contrast to what may be equally well termed the 'Exploiting Labour Principle' of the communists. The former breathes hope and goodwill and leads to prosperity. The latter breathes despair and bad will and leads to poverty.

The 'Exploding Market Principle', presented later in detail, has three parts: first, the Spurt Factor, which explains how in a market economy successful businesses periodically have the possibility of growing very rapidly to meet customer demand; second, the Capital Multiplier, which explains how, when a firm has a fast growth period, its high rate of profitability enables it to grow at a geometric rate, not merely an arithmetic rate; third, the Up-front Cost Loading Factor explains how, when a firm is in a growth phase, many of the costs of supplying an increasing number of customers next month or next year can be and are charged as costs today, when they are incurred -- thus loading up-front a higher proportion of costs than are needed for meeting immediate customer demand. Hence taxable profits are reduced below what they would have been if the company was not growing; a tax situation further favouring growth.

The 'Exploding Market Principle' of business capital accumulation provides a way forward for a world taken by surprise at the speed of change in Eastern Europe. It lays the ghost of 'exploitation'; and allows the assertion that the half-way house called a socialist market is illusory.

No market economy can work properly other than within a clear framework of rights of personal ownership. Only so can the independent decision-making necessary for a market economy flourish. If property rights are blurred, power becomes centralised and there can be neither a real market economy nor sufficient dispersal of decisions to maintain durable political democracy.

The heart of an enterprise culture

The prospect of an exploding market leading to personal riches, and the fear of losses leading to bankruptcy, are the carrot and stick which chiefly motivate business entrepreneurs.

Once the Exploiting Labour Principle is replaced by an Exploding Market Principle, rejection of the idea of exploitation leads naturally to rejection of the idea of expropriation. If the capitalists do not exploit the workers, there is no case for expropriating their property. There is, however, as we shall see, a case deriving from the Exploding Market Principle, for sharing with employees the increase in capital wealth created.

The way forward to this sharing is through employee share ownership (though this is not the biggest element of popular capital formation, in financial terms). It is the way forward because it is directly motivational. Those who work for the successful wealth creators share directly in the wealth that they have helped to create.

Many people, such as public employees, are not in a position to do this; they nevertheless need personal capital too. The biggest elements in wealth creation, by employees as a whole, must essentially come through home ownership and through the building up of pension rights. The payments for these together dominate the capital market in Britain.

Thus in order to match the successful business firm's favourable tax position, it is proper to have tax-favourable facilities for employees to become shareholders too -- together with loan interest tax relief for home owners and tax deferment for pension plans, so that the whole workforce can build up assets on a more or less equitable basis.

In the Anglo-Saxon countries, with their funded pension plans, there is rapid growth in the proportion of listed company shares owned by pension and insurance funds. In Britain this proportion is already 62%. Opposition to employee share ownership in listed companies has been steadily dwindling, and the Investment Committees of the financial institutions which own the majority of shares in such companies operate guidelines for the rate at which shares are made available to employees. At the end of 1989 there were 4,199 approved executive share option plans, 879 approved profit sharing share ownership plans and 869 approved savings related share option plans (some of these latter two types both occurring in the same company).

One consequence of these developments is a change in the idea of tax neutrality. In the past, discussion of this has concentrated on getting rid of special tax exemptions such as relief on home mortgage loan interest, relief for pension plans and for employee share ownership. But this assumes -- wrongly -- that business firms have no tax reliefs for capital growth.

The 'Exploding Market Principle' of capital accumulation demonstrates that when a successful business is growing, it is in a specially favourable position to build capital on a tax-allowable basis. Hence those who propose that employees should forego tax reliefs on home ownership loan interest, pension provision and employee share ownership are, in effect, advocating that business owners should enjoy <u>more</u> favoured tax treatment than others.

Governments, however, simply <u>cannot</u> abolish the tax-favourable position of business firms when they are successful. Nor have governments wanted to do so, because growth is the basis of prosperity -- and also because the Revenue gains more from a firm which has grown than from one stifled by tax persecution.

This paper demonstrates how employee share ownership and tax neutrality as properly understood are keys to the creation of a durable market economy - and hence stable political democracy - right across Europe, east and west.

2.
The case for capital rewards

(a) The 'Spurt Factor'

At any given time, a competitive market economy will contain some business firms making low profits or losing money, some making moderate profits and a few doing very well indeed, making large profits and growing fast. If, however, one analyses the Growth Companies Register of the fastest growing 1000 unquoted companies, or the annual list of the fastest-growing 250 quoted companies compiled by Management Today, one finds that it is not the same firms which are continuously successful.

One reason is that these latter attract imitative competitors. Another reason: it is not easy to keep up, continuously serving customers with the right product or service.

So we must recognise the 'Spurt Factor', i.e. most successful companies have short spurts of success. And hence the motivational appeal of capital rewards.

If such spurts are seen only in successful businesses, it should not be deduced that in a stagnant economy the case fails for capital rewards. On the contrary, in such economies some firms grow and others decline -- so why not encourage growing companies by providing capital rewards for their employees?

The 'Spurt Factor' is seen in Julius Caesar:

There is a tide in the affairs of men,
Which, taken at the flood, leads on to fortune;
Omitted, all the voyage of their life
Is bound in shallows and in miseries.

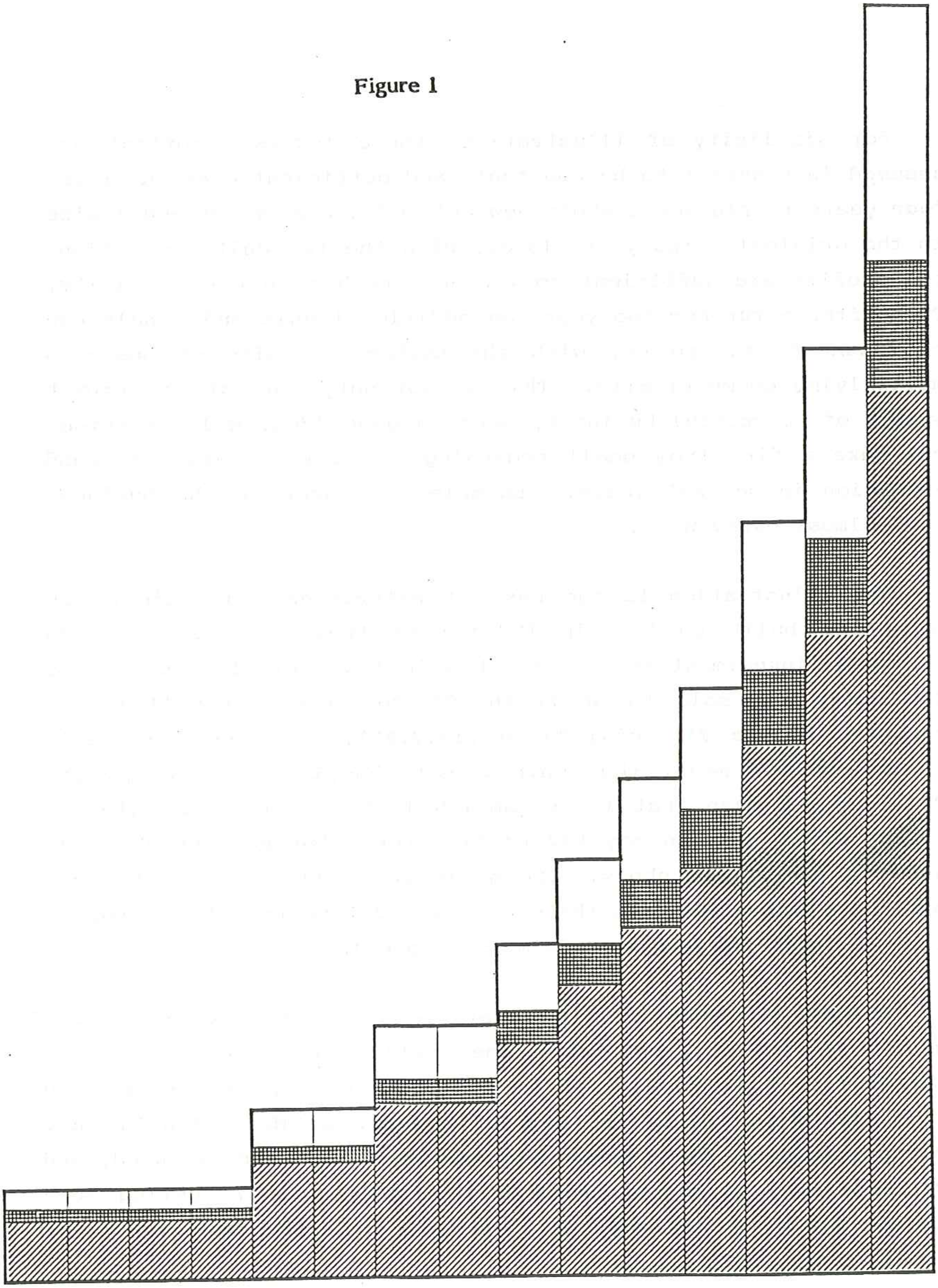
The principle of the 'Spurt Factor' tells us not to say, in response to a request for capital rewards, "wait until we get the profits up higher". That is too late. When the profits do become significantly higher, everyone is too busy to do anything about installing a share plan. Employees will have missed the tide and be "bound in shallows and in miseries".

The 'Spurt Factor' emphasises that employee share ownership plans provide a stake in the <u>increased</u> value of a business, not a share of the original capital. They do not involve confiscation of someone else's investment, but a capital reward for achievement.

(b) <u>The Capital Multiplier</u>

Figure 1 overleaf illustrates the Capital Multiplier. It is concerned with the fact that when a company has a high level of profitability, it can grow at a geometric rate. The column of revenue of the firm for each year is shown divided into current expenditure (at the bottom), then dividends, taxes and the cost of inflation adjustment (shown double-shaded), then revenue spent on growth (shown clear). This last item is the profit over and above the level which is necessary to pay dividends and taxes, and adjust for inflation.

Figure 1



For simplicity of illustration, these 'excess profits' are assumed in Figure 1 to be constant, and sufficient over the first four years to finance a whole new unit of activity, of equal size to the original. Two years later, with the two units in action, the profits are sufficient to finance another unit of activity. Then after a further two years an additional unit and a half can be financed, and so on, with the number of units of business multiplying geometrically. This is not untypical of the growth spurts of successful business, where a good idea, well executed, can take a firm from small beginnings to a multi-million pound valuation in several years. Examples are seen in the business news almost every week.

One illustration is the case of Waterstones, a chain of 30 bookshops built up by Tim Waterstone from a £16000, mostly borrowed, investment in one bookshop in 1982. Within seven years the chain was sold to WH Smith PLC for over £42 million. As reported in the Financial Times (19.7.89), "the costs of rapid expansion have meant that Waterstone's has been losing money". This did not mean that its established shops were unprofitable. Nobody would want to pay £42 million for a business which could not run profitable shops. It meant that all the profits and more were being spent on the costs of starting new shops. And no harm in that. The world needs more people like Waterstone.

Because a steady but high rate of profitability produces a geometric rate of growth when the profits are spent on growth, owners face a potential conflict if their employees are excluded from participation in the capital growth. At Waterstone's they did participate. But suppose the employees had been excluded, and demanded in lieu higher pay than the market rates? Meeting such demand could absorb all the high profits, and how would the growth come then?

To keep pay rates at market level leaves scope for financing growth out of profits and at the same time building a stronger business team by providing capital rewards for employees -- shares in the business. This has been shown to be well worth while for investors too. A 1987 study by D. Wallace Bell and Charles G. Hanson compared the performances of a sample of over 100 profit-sharing companies in Britain, most of them with employee share plans, with the performances of a similar number of companies that did not practise profit-sharing, during the eight-year period 1978-1985. It was found that in terms of total investor returns, putting together capital growth and dividends, the performance of the profit-sharers was over 78 per cent better than the performance of the non-profit sharers. There have been similarly favourable studies published in the United States.

(c) The Up-Front Cost Loading Factor

For people to assess the performance of their investments, time must be divided into accounting periods, normally of one year. If the profits are high enough to allow the firm to grow and some of this growth is being financed from profits, then some of the costs of growth will be immediately deductible when assessing profits for corporation tax, (even though the money has been spent on increasing the growth next year).

For example, a new branch may be opened and new staff recruited and trained, or extra money may be spent on advertising or research and development. There are many ways in which money can be spent now which increases revenue tomorrow -- but where the costs are chargeable today. If, for example, new machinery or equipment has to be bought with borrowed money, the interest on the money is immediately allowable for tax relief, in addition to depreciation on the machinery or equipment, yet the items purchased may not start earning revenue for another year or so. This understates the true rise in profitability, but this is not said in criticism of the system. It is a fact.[1]

It is in any case impossible for the tax authorities or the auditors to distinguish between some of the growth costs and the current costs. Nor indeed can the business manager, since nobody

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1. Likewise, in the opposite case, when a firm's market is declining, some costs, such as building maintenance, may be deferred to save cash; and this can understate the true fall in profitability.

knows whether growth will in fact take place. For example, a new employee may be recruited at substantial cost and later found to be an unnecessary addition.

However, once we charge to today's time period some of the costs which are hopefully going to bear fruit tomorrow, the business firm is seen to have an advantage, if it is successful, which its employees do not enjoy. They cannot increase tomorrow's income (and thus create future 'savings', i.e. capital), by spending money today and having it deductible for tax.[1]

Also it will be clear from Figure 2 and the notes accompanying it, that the tax authorities have no interest in pursuing a firm in a search to decide which items really do apply to this year, and which to next year. If the firm grows fast, then the Revenue gains far more tax from the firm than if it had not grown.

To avoid misunderstanding it needs to be emphasised that a successful businessman will be assessed for CGT on any gains when he sells shares (unless the precaution has been taken of becoming resident in a tax haven some considerable time before the sale -- a device becoming increasingly difficult). In Britain CGT is levied at the same rate as the taxpayer's marginal income tax, so those who succeed in business are likely to end up paying a fair amount of tax. The 'Exploding Market Principle', including the 'Upfront Cost Loading Factor', explains how the successful business firm accumulates capital rapidly, and is not meant to imply that government favours the individuals who own the business or allows them to avoid paying their full share of taxes in due course. The essential point is that a business firm has an advantage in wealth creation over those who work for it -- and this is the key to personal wealth, not exploitation of employees by paying them at less than market rates.

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1. They may receive future training and increase their 'human capital', but that opportunity is available on similar terms to all.

The author's own career has twice demonstrated the after-tax benefits to be gained from the 'Exploding Market Principle', as set out in the above three steps. At one point, an opportunity to take a £5 interest in a £100 company turned, in six years, into a five-figure sum when the business was sold. At another point a major interest in a £100 company turned into a sum which more than made up for great losses of pension rights arising from job changes.

Figure 2

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15	Annual Profit after 15 years if no growth	Taxable Profit Totals for 15 years	Taxable Profit Totals for 20 years
1. Sales revenue	100	120	144	173	207	249	299	358	430	516	619	743	892	1,070	1,284			
2. Operating costs at 70% of revenue	70	84	101	121	145	174	209	251	301	361	433	520	624	749	899			
3. Profit before costs of growth	30	36	43	52	62	75	90	107	129	145	186	223	268	321	385			
4. Direct costs of growth at 50% of next year's increased revenue	120 100 2/ 20 10	144 120 2/ 24 12	173 144 2/ 29 14	207 173 2/ 34 17	249 207 2/ 42 21	299 249 2/ 50 25	358 299 2/ 59 30	430 358 2/ 72 36	516 430 2/ 86 43	619 516 2/103 51	743 619 2/124 62	892 743 2/149 75	1,070 892 2/ 178 89	1,284 1,070 2/ 214 107	1,541 1,284 2/ 257 128			
5. Interest on loans for growth at 10% on loans of half revenue	5	6	7	9	10	12	15	18	21	26	31	37	45	54	64			
6. Total costs of growth	10 5 15	12 6 18	14 7 21	17 9 26	21 10 31	25 12 37	30 15 45	36 18 54	43 21 64	51 26 77	62 31 93	75 37 112	89 45 134	107 54 161	128 64 192			
7. Profit after costs of growth	30 15 15	36 18 18	43 21 22	52 26 26	62 31 31	75 37 38	90 45 45	107 54 53	129 64 65	145 77 78	186 93 93	223 112 111	268 134 134	321 161 160	385 192 193			
8. Profit if no growth	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	450	600
9. Profit if growth stops after 5 years	15	18	22	26	31	62	62	62	62	62	62	62	62	62	62	62	732	1,042
10. Profit if growth stops after 10 years	15	18	22	26	31	38	45	53	65	78	145	145	145	145	145	145	1,316	2,041
11. Profit if growth stops after 15 years	15	18	22	26	31	38	45	53	65	78	93	111	134	160	193	385	1,282	3,207

Notes to Figure 2

1. The first row shows sales revenue for a fast-growth business rising at 20 per cent per annum. This would indeed be very fast if continued over a long period, but is typical of the three to 10 year spurt of the firm which finds a winning product or service.

2. The second row shows operating costs assumed to be 70 per cent of sales revenue.

3. The third row shows the profit before the costs of growth. (All figures are rounded to the nearest whole number and 0.5 is alternately rounded up and down.)

4. The fourth row shows the direct costs of growth, in the way of preparatory costs, such as hiring and training staff, preparing additional premises and developing and promoting new products or services, which occur in the year before the increased business is operational. These preparatory costs are assumed to be 50 per cent of the increased revenue in the following year.

5. The fifth row shows interest at 10 per cent on loans to finance the growth, to the extent that it cannot be met out of taxed profits. Loans at any time are assumed to be half the current level of revenue. (10 per cent is a notional, long term figure because the example is spread over 20 years.)

6. The sixth row adds together rows 4 and 5 to show the total costs of growth.

7. The seventh row deducts the total costs of growth from the profit shown in row 3, to arrive at the profit after the costs of growth.

8. The eighth row shows the taxable profit if there had been no growth, i.e. a constant sum each year.

9. The ninth row shows the taxable profit if there had been growth for five years and then no further growth.

10. The tenth row shows the taxable profit if there had been growth for 10 years and then no further growth.

11. The eleventh row shows the taxable profit if there had been growth for 15 years and then no further growth.

12. It will be seen that everybody gains from growth, the company through higher profits, the employees through better job opportunities and the Inland Revenue through higher taxable profits. The column of total profits after 15 years appears to show that row 10, where growth stops after 10 years, is a better situation than row 11, where growth stops after 15 years, but in the latter case profits in the 16th year more than make up for the 15th year shortfall and the last column, showing total profits after 20 years, shows that the total for the company if it grew for 15 years, would be over 57 per cent greater than if it grew for only 10 years.

13. The costs of growth shown in rows 4 and 5 of Figure 2 are allowable for corporation tax and to this extent the company has enjoyed tax-free growth -- an opportunity which its employees do <u>not</u> enjoy unless the company has an employee share ownership plan, with appropriate tax relief.

Tax Neutrality

The tax advantages of successful business firms alone justify assisting employees to become shareholders, via changes in the tax system. Facilities for employees are the equivalent of the relief which the business gains through being able to set down many of the costs of growth in this year's accounts, even if they do not result in growth until the following year.

U Arrangements for employee participation in ownership of capital growth cause an automatic trickle-down of wealth creation -- from the successful entrepreneur to his employees, and hence to the population generally. Without such arrangements ownership of business can remain in too few hands, and the 'Enterprise Culture' be confined to a small minority.

A indirect form of trickle-down is also provided via the pensions industry. In the middle of this century British pension funds for employees began buying company shares in large quantities and where the companies which were invested in grew in value, employees benefited. (But it also enabled the companies themselves to benefit via a contribution holiday.) Yet are pension funds buying company shares really an adequate way of providing employees with a stake in business? Consider how expensive this is in terms of cash flow; how it gives no direct motivation to work well; how it inhibits the job mobility which an enterprise culture needs.

To make the pension fund secure, diversification of investments is necessary, but parallel to such pension provision there could be provision for employees to participate directly in ownership of the companies in which they work. There could, in other words, be provision for capital rewards for employees, as has now begun, indeed, in some countries, particularly the United States, Britain and France.

How comprehensive is the 'Exploding Market Principle'?

An obvious query relates to the comprehensiveness of the 'Exploding Market Principle'. Does it describe all wealth creation? What about dealers who get rich buying, stripping and selling other people's businesses? A competitive economy where some people win also contains some who lose and lick their wounds, hoping to fight another day. Some takeovers are reminiscent of the regrouping of an army after defeat in battle, to form new units which can continue fighting. Other takeovers are directly creative, putting together units which have not been defeated but will form part of a new marketing strategy.

So the 'Exploding Market Principle' is comprehensive if one regards it as the core of the ambition of every entrepreneur. But alas the predominance of pension fund and similar investment in British business discourages managements from operating the principle. Fund managers are inevitably judged on short-term results. Their eye to their careers makes them reluctant critics of management, since -- who knows? -- their next job application might be to the management of a fund they had criticised.

Pension funds are nevertheless a central feature of popular capitalism, and a way must be found of giving their managers the longer view of business investment. One possibility, worthy of close inspection, is to remove the capital gains tax rollover relief for sales of shares involving change of control of a business, whilst retaining it for other, day-to-day transactions of the pension fund.

It cannot be repeated often enough that democracy, liberty and prosperity are dependent on the market economy, and hence on the dispersal of capital ownership. The more widely that capital is dispersed (especially by means of a continuing, 'earned' process) the stronger the safeguard of the parliamentary system, the rule of law to protect individual liberty and personal and business property, and the free market.

Reconciliation of reward levels

The successful entrepreneur builds capital worth typically between

100 and 1,000 times his or her pay (e.g. someone with a salary of £100,000 may build a business worth between £10 million and £100 million). At least 80 per cent of this capital must be regarded as a tool of the trade, not as spending money. It is however strange that many people who accept the enterprise culture, as motivated by the enlightened self-interest of the business owner, and who also accept that employees in general should have shares in the business where they work, are hostile to the idea of senior managers having substantially more shares than other employees.

The calculations of Professor Peter Moore of the London Business School[1] show that an average employee working in a reasonably successful firm (typically averaging 8 per cent real return on capital) can expect over his working life to build up capital worth about four times pay, or roughly equal to the value of his house, if the employer operates share facilities within the Investment Committee guideline limits (see below). Since the managers of the business are principally responsible for its success, it does not seem unjustifiable that they should build up more capital in relation to their pay than this factor of four. If one accepts that the entrepreneur can and should build up 100 or more times pay, why not have the key managers at some point on the scale between 100 and four?

To put this in perspective, the capital value of a pension of two-thirds of final pay is typically about seven times pay. Employees change jobs and it has been established by Danby Bloch in a Sunday Times article (23.4.89) that somebody changing jobs after 20 years' service is likely to be able to transfer to the new employer only six or seven years' pension value. This is a great loss, which most people do not appreciate in their eagerness to obtain a better, or at least a different job. The loss arises from the professional routine by which actuaries calculate the preserved, transferable value without assuming any upgrading of the future income of the person changing jobs. (This

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1. Shared Ownership, Ch.10 & appendices 4 & 5.

affects the redundant and early-retired as well as those changing jobs voluntarily. Indeed, a recession can substantially reduce a company's pension commitments.)

Many people -- particularly those in business -- change jobs or are made redundant more than once in their working life. Thus they can lose so much pension value that they may need the money derived from share ownership in a successful business to make up for their lost pension value. It is easy, through job changes, to lose half or more of full pension value, in spite of government legislation of recent years. Personal pensions have proved very attractive to employees not previously covered, but they have had all too little impact on the vast bulk of company pension schemes. Very few people except those key managers who are specially topped up, earn a full two-thirds-of-pay pension in the business sector. Hence share ownership is seen as one way in which people who change jobs can, through the success of their businesses, make up for lost pension value.

The unique British Investment Committee guideline limits on the issue of shares to employees -- the prudent limits up to which the issue is considered good value on the grounds of motivation to employees, but beyond which allocation of shares to employees could be regarded as dilution of the equity -- may be claimed to derive from the work of J H von Thunen, the German mathematician and economist, 1783-1850. He developed on his own estates in Prussia a system of employee capital reward based on the prosperity of the estate, which built up funds for employee retirement. His formula for this is on his tombstone at Mecklenberg.[1]

The author's own interpretation of this formula, translated into modern conditions -- notably the development of the joint stock company and of the stock exchange -- is that the prudent guideline limit would be 1.4 per cent per annum of the issued share capital of the company. This, in a business owner's full

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1. $\sqrt{AP}$, where A is the subsistence wage and P is the added value per employee.

working life of 50 years, could mean sharing his capital 50 : 50 with those who work for him, assuming these unlikely circumstances: that the business will be successful every year for fifty years, that the employees will stay with the firm throughout their working life and that they will never sell any shares -- neither will the main owner. Some such artificial assumptions are necessary if one is to study the full range of possibilities for the business-builder who wants to provide capital rewards for employees.

The British Investment Committees for the pension funds and insurance companies have adopted a more flexible figure than a precise 1.4 per cent per annum. They have preferred a limit of 1 per cent per annum on the issue of new shares under approved employee share plans. In addition, however, up to 5 per cent of profits may be used in a profit-sharing share plan and if the shares for this are purchased in the market instead of being new issue shares, the purchased shares do not count within the 1 per cent per annum limit for new issue shares.

Most important about the institutional guidelines, however, is that they allow a maximum of half the total available shares to be allocated to management on a discretionary basis. The remainder, if allocated, must go to all service-eligible employees on a 'similar terms' basis, such as proportional to pay, and the 'service-eligible' must include all who have at least five years' full-time service.

But how, in blunt terms, does one 'harness greed to creed'? It is important to seek ways of reconciling enlightened self-interest with belief in teamwork. A Financial Times survey in 1975 by Professor E. Victor Morgan showed that in Britain only 3.8 per cent of people of working age and above were direct shareholders in their own right. Now the proportion is 27 per cent. Most of the increase is due to privatisation -- a once-for-all operation. The proportion of employees who have shares in their place of work has so far risen only to 9 per cent. It is raising this latter figure -- which has motivation inherent in it, and which involves a continuing process while businesses are successful -- that creates the reconciliation between capital and labour so much needed, both in the areas of the world which enjoy free enterprise and those which have suffered communism.

A serious neglected matter

It may be argued that Britain now has the most comprehensive and well thought out employee share ownership legislation in the world. One reason is the consistency of policy in this area, (in contrast to the horse-trading, for example, to be seen in the US Congress). The Appendix to this paper describes briefly the four basic types of approved employee share ownership plan. It should not be thought, however, that the British legislation is complete. The 1989 additions need some tidying. Also there is a serious omission which needs urgent attention, as discussed in detail in the next section.

What could possibly be missing, when government has given so much attention, in 10 of the last 12 budgets, to the design of the actual share employee arrangements as described in the Appendix? To repeat; only 9 per cent of employees at present participate. The missing ingredient is a specific inducement to companies to start a share plan.

One cause of this omission has been the priority given to privatisation. No quarrel with this, except that privatisation's once-for-all effectiveness in increasing the number of shareholders is in sharp contrast to the ongoing benefits of employee share ownership. Also, privatisation leads to high sales costs in the case of very small investors. Again, by contrast, an important advantage of employee share ownership is that it solves the problem of the high cost of handling small bargains. Ten years of experience show that employees are generally slow sellers of shares in their own company; and when they do sell the employer can achieve economies for them by bulking the small deals.

These, however, are administrative advantages. The core of the argument of this paper is that employee share ownership plans are important because:

a) The 'Exploding Market Principle' demonstrates them to be just.

b) Study of company performance shows them to be worthwhile to investors because of the better motivation of employees.

c) Available evidence on pension plans shows employee share ownership to be an important means for making up deficiencies in provision, arising from job changes, redundancies and early retirements.

The proposal in the next section, therefore, concentrates on encouraging managements to set up employee share ownership plans.

3.
Future growth of employee share ownership

Summary

Experience has shown how important it is to 'harness greed to creed'. The enterprise culture is based on enlightened self-interest. The desire of management to earn substantially greater rewards by serving customers more effectively can be harnessed to encouraging the provision of share ownership facilities for all employees.

There are at present in Britain over three times as many companies who have share plans for executives as have them for all employees -- and the former are growing faster than the latter. This imbalance could probably be corrected if the 20 per cent discount on share price available to all-employee share option plans was extended to executive share option plans, conditional on the company operating both types of plan.

The details

The Wider Share Ownership Council has long argued that tax legislation favourable to executive share options should apply only to those companies which also have share plans for all employees. But the Treasury has raised objections each time a specific tax, such as corporation tax, was proposed as an instrument for favourable tax treatment of companies with all-employee share plans.

The problem, then, was to discover a tax-neutral way of achieving the desired objective which did not involve any direct tax payment or relief. Hence the following proposal:

In 1989 in Britain the discount for shares issued in savings-related share option plans was increased from 10 to 20 per cent. This increased their popularity.

The simplest way to encourage the side-by-side establishment of both executive share plans and all-employee share plans would be, as suggested above, to allow a similar 20 per cent discount on shares for executive share option plans, under Finance Act 1984 rules, but make the discount conditional, as follows:

1. Subject to 2 below, the discount would only apply to discretionary grants under the FA84 rules if, in the same tax year, the number of shares made available for discretionary grant under FA84 rules was at least matched by the number of shares made available and so far as possible allocated on an all-employee, similar terms basis, under (a) the profit sharing FA78 rules and/or (b) the savings related FA80 rules.

2. The matching required in 1 above would only apply up to a total of all-employee share allocations per annum equal to one half of one per cent of the company's issued ordinary shares. Beyond this number no further matching would be required and neither of these total share allocations would be controlled in relation to the other. Nor would there be any legal limit on individual discretionary grants of share options, though all grants would remain subject to shareholder control.

3. A further requirement for the 20 per cent discount might be that the normal period before exercising a discretionary option would be four years, not three, thus encouraging a longer term view of business achievement.

   Companies could be allowed to choose whether to operate the FA84 rules on a three-year-wait basis, as at present, without a discount, or on a four-year-wait basis with a 20 per cent discount and with parallel all-employee share allocations.

This proposal would involve no net cost to the Revenue; indeed the Revenue would in due course collect more Capital Gains Tax, because of the lower share issue price.

The system would be self-policing if the auditors of a company were required (a) to countersign the company's annual return on share plan operation and (b) to ensure that it was submitted on time.

Some questions and answers

Q. Would the financial institutions who are now the major shareholders of listed British companies object to a 20 per cent discount on shares for top management?

A. They have no reason to do so, for they have the power to impose incentive triggers, requiring top management to earn their discount by improved company performance. A typical trigger would be that to receive a 20 per cent discount management would, before exercising their options, be required to achieve a 20 per cent increase in earnings per share and maintain this for two consecutive years.

Q Should not triggers be put into the legislation?

A That would be too inflexible. It is not the business of government to intervene, in such detail, between shareholders and management. In any case the law already allows the Inland Revenue to refuse approval to a share plan with unreasonably high trigger targets, for these could deny to participants the 'opportunity to acquire shares' which the legislation is designed to provide. There is no need for a legal battle with the Revenue, as Burton have recently had, if a trigger target is expressed as (say) a 20% increase in the two-year moving average of immediate past earnings per share. This formula, though fixed in advance, is flexible. It encourages both continuous growth and recovery from a recession.

Q Why is it proposed that there should be no restriction on executive share allocations, once a certain minimum level of all-employee share allocations has been achieved?

A The ending of restrictions is intended to apply both to individual and to total share allocations, because the nature of work and of the labour market is continually changing. This is so at management levels, as well as for the workforce generally. Provided the shareholders agree, a company's management should be free to reward performance with such allocations of shares or options on shares, in excess of the present limits, as it thinks fit.

Q How would these proposals affect the harmonisation of European legislation on employee share ownership?

A They would assist harmonisation because they do not involve loss of tax revenue -- which naturally appeals to governments. Capital gains tax could eventually be charged on the 20 per cent discount, unless the share price fell. Any government adopting these proposals would remain free to put the rate of CGT at whatever level it chose. The fact that the rate differed from one country to another and from time to time would not affect the harmonisation which could be achieved in method of operating employee share plans.

Q Surely any arrangements for encouraging all-employee share ownership should exempt small firms?

A It is not necessary to impose a dividing line between large and small firms. A small firm can now, if it wishes, grant options to one or two key managers without benefit of a discount on the share price. When the firm grows, however, to a size where it has a number of managers interested in obtaining a 20 per cent discount on the share price, it is probably ready to introduce an all-employee share plan.

Q Is there any advantage in a company operating two all-employee share plans?

A Yes, because a profit sharing plan operates well when profits are high and an option plan provides a special incentive to increase the profits when they are low. So, with two share plans, a year-by-year need to allocate shares or options in order that managers may qualify for a 20 percent discount, can be most economically met.

Q Do employee share ownership plans have any relevance to the battle against inflation?

A Yes, because money reinvested in a business, instead of being taken out for personal consumption, is an increase in saving.

APPENDIX

Present situation on UK-approved employee share plans

Profit sharing share plans
(introduced in the Finance Act 1978)

A profit sharing share plan operates on the basis of an annual allocation of a portion of the company's pre-tax profits, to be used by trustees to acquire shares which are then allocated to eligible employees. The amount of profit used can be governed by a formula relating it to the performance of the company or it may be entirely at the discretion of the board of directors. The trustees may use the money either to purchase ordinary shares from existing shareholders or to subscribe new issue ordinary shares at market price, or both. The money so applied is allowable for corporation tax relief.

The shares acquired must be 'appropriated' to eligible employees on 'similar terms'; this generally means that the allocation may be either the same for all employees, or in proportion to earnings, or weighted in favour of those having longer service, or by some other acceptable, objective criterion. Differences explicitly based on status or on board discretion are not permitted. All full-time employees (usually those contracted to work at least 25 hours per week) with five years' service or more must be eligible to participate; inclusion of part-timers and the setting of a shorter period of service for qualification are at the discretion of the company.

Shares, once appropriated are, as the word implies, the beneficial property of the participant and cannot be taken away except in bankruptcy proceedings against the individual. The participant must, however, contract to leave the shares in the hands of the trustees for at least two years (though they are released in the compassionate circumstances of death, redundancy, reaching statutory retirement age or ceasing employment through injury or disability) and if held for a further three years they are free of income tax.

In this latter period the employee can obtain possession of the shares or direct the trustees to sell them, but will be taxed according to a scale related to how long the shares have been held. At death, a participant's shares are immediately free of income tax. In the other compassionate circumstances mentioned above, the relevant income tax liability is immediately halved. There is no relief from capital gains tax liability when the shares are sold, though the first £5000 of capital gains from all sources in any year are at present tax-free.

Savings-related share option plans
(introduced in the Finance Act 1980)

A participant in a savings related share option plan must enter into a Save-As-You-Earn contract with a building society or the Department of National Savings, agreeing to save a regular sum (currently between £10 and £150 a month) for five years. At the end of this period he receives a bonus equal to twelve monthly payments (at the time of writing) and, if he leaves the savings in the account for a further two years, a second bonus of the same amount, both bonuses being tax-free.

Upon entering into the SAYE contract, he is granted an option to subscribe for ordinary shares of the company. The price per share is fixed at the discretion of the board, subject to a lower limit (20 per cent less than the current market price). The aggregate option price is equal to either the sum which the participant will have saved or to that sum plus the bonuses earned after five years or after seven years, the period depending on his own savings contract decision at the outset.

The statutory conditions determining which employees must be eligible to participate, if the plan is to be approved by the

Inland Revenue, are identical to those for a profit sharing share plan.

An option can be exercised only to the extent of the money which has actually been accumulated in the SAYE account up to that time. To obtain income tax relief on gains in value of the shares when the market price exceeds the option price, the option cannot be exercised (except in circumstances of death) during the first three years after date of grant. The option lapses, if not exercised, six months after the end of the contracted saving and holding period of five or seven years, as the case may be. Capital gains made on the exercise of options are chargeable to capital gains tax, but subject to the annual exemption limit.

The right to exercise an option is protected if an employee dies or leaves employment by reason of injury, disability, redundancy or retirement, or if he continues working after reaching statutory retirement date. If an employee leaves the company in other circumstances during the first three years after grant of an option, it lapses.

Approved share options
(introduced in the Finance Act 1984)

Participation in an approved share option plan is entirely at the discretion of the board of the company, both as to eligibility and as to the extent of participation (subject to the statutory limits and mindful of Investment Committee guidelines). The options granted, if they are to qualify for tax relief, are exercisable not less than three years after the date of grant (to avoid suspicion that participants are taking advantage of inside information) but not more than ten years after the date of grant. So there is a seven-year 'window' when they can be exercised. Options cannot be granted below the market price of the shares. Moreover, they cannot be exercised at intervals of less than three years, if there is to be tax relief.

Whilst the plan can provide that an option lapses if the employee leaves to take another job elsewhere, the right to exercise it can be protected if the employee dies or leaves employment by reason of injury, disability, redundancy or retirement. The tax relief relevant to an approved option plan is that there is no income tax on any capital gains up to the date of exercise, but capital gains tax is chargeable on the difference between the option grant price and the current market price when the shares are sold, if the latter is higher.

US-type leveraged employee share ownership plans
(introduced in the Finance Act 1989)

The Finance Act 1989 introduced US-type arrangements for financing employee share ownership through loan funds or profits made available to qualifying employee share trusts (QUESTs). These arrangements make it possible to fund, in one go, more than one year's allocation of shares to employees. Payments by a company to a QUEST set up to acquire and distribute shares to its employees qualify for corporation tax relief, provided certain conditions are met. Key features of the qualifying conditions are that shares must be distributed to employees within a maximum of seven years from their acquisition by the trust, and such distributions must be open to all employees on similar terms. In practice, to obtain employee income tax relief, a QUEST operates in conjunction with an approved employee share plan under the Finance Act 1978.

A QUEST may borrow externally to acquire shares rather than relying entirely on funds provided by the company. In the case of unquoted companies it may wish to provide a market in the company's shares for the benefit of employees and other shareholders, on a performance-related valuation basis. Also it may wish to distribute larger amounts of shares to employees than is possible under 1978 plans.

A QUEST which meets the qualifying conditions does not qualify for any special tax reliefs other than corporation tax. It is liable to income tax and capital gains tax in the normal way and employees receiving shares are liable to income tax if they pay less than market value for them. As already mentioned, a QUEST may, however, operate in conjunction with a profit-sharing plan trust set up under the 1978 legislation and distribute shares to employees through it. Provided the necessary conditions are met, the employees will then not be liable to income tax on any shares given to them.

A majority of the trustees of a QUEST must be independent of the company and of those who have, or have had, a material interest in it.

The purpose of this legislation, as with the other three employee share plans which qualify for tax relief, is to encourage arrangements which result in individual employees directly owning shares in the businesses in which they work.

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All these types of approved share plan except the QUEST now fall within Sections 185 to 197 and Schedules 9 and 10 of the Income and Corporation Taxes Act 1988, also Sections 34 to 63 of the Finance Act 1989, whilst 'unapproved' employee share plans, mainly of use in independent private companies and in subsidiary companies, come within Sections 77 to 89 and Schedule 14 of the Finance Act 1988 and QUESTs fall within Sections 64 to 71 and Schedule 5 to the Finance Act 1989. Arrangements for the fair valuation of employee shares in unlisted companies come under Sections 138 and 139 of the Income and Corporation Taxes Act 1988.

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