A piece of the action

employee ownership, equity pay and the rise of the knowledge economy

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A new kind of company

Summary

- This report is about the creation of a new kind of company, one that is both entrepreneurial and responsible, dynamic and inclusive, by using employee ownership and equity pay schemes.
- St Luke's, a London advertising agency, is one of the most striking examples of this new breed of business in the UK.
- The company is owned entirely by its employees and governed by an employee board called a Quest. All shareholders meet at the end of each month in a Flag Meeting to review recent performance.
- There are no executive offices, dedicated desks or personal computers. All the physical resources of the office are shared to promote collaboration and cooperation.
- The company is managed with little hierarchy and a free flow of information. Employees are involved in almost all decisions, including the setting of their own pay rises.
- St Luke's is an impressive model of how employee ownership has combined with open management and cooperative team working, to produce a highly innovative, knowledge creating company.
- Although some of the details of how St Luke's works are specific to advertising, most of its approach could be borrowed by other people based, knowledge businesses.

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Lucinda Chiesman is in full flow. She is making her 'Man of the Month' award to the male colleague who has helped her most by keeping the office tidy at St Luke's, the employee owned advertising agency. The atmosphere is riotous as Lucinda, the office administrator, reels off the shortcomings and good deeds of the staff, all 60 of whom are gathered around her. The award is a fun way to help Lucinda do her job. The staff, wine glasses and beer bottles in hand, scoffing from bowls of crisps and dips, hoot and howl as she delivers the award to a young account manager who volunteered to move some boxes.

The Man of the Month awards are just one item on the agenda of St Luke's innovative monthly staff meeting. Just before Lucinda made her awards a young member of staff had presented his 'Five Favourite Things' – a video of a Paul Gascoigne goal, an interview with the Beatles, a pop video, an advertisement and a piece of music. Each month a different staff member has to share with the rest of the company the ideas and impressions which have most influenced them. It's a way to encourage staff to share their most intimate ideas and thoughts in an atmosphere free from cynicism.

This gathering (known at St Luke's as a Flag Meeting) is no ordinary staff meeting: it is a monthly meeting of all shareholders. The Flag Meeting is the heart of one of the most dynamic and imaginative company cultures that has been created in Britain in the past decade. St Luke's is an extraordinary kind of company, but one we are likely to see more of. The agency is owned by its employees. At the Flag Meetings they review and celebrate their work over the previous month, discuss new business opportunities, make awards and have fun. Most importantly, the Flag Meeting has a voice on the big issues facing the company. In the spring of 1997, for example, St Luke's was growing so fast that the staff decided to ease the pressure by refusing to take on any new clients until the following autumn. They named this self-imposed pause the Summer of Love.

St Luke's is a knowledge business. Its output is largely intangible: ideas and images. Its most important skills are also weightless: creativity and imagination. Employee ownership is the foundation for an open, participatory management style and a creative, questioning approach to the way work is organised and the kind of advertising the company produces. In an industry known for the scale of its expense

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accounts and egos, St Luke's represents a revolutionary model of how an advertising agency should be owned and managed.

Yet the relevance of the St Luke's model goes well beyond advertising. Increasingly the competitiveness of most businesses in retailing and finance, manufacturing and tourism, depends on the knowledge, ideas and creativity of the people they employ. These are their most valuable assets. Our economies are shifting away from land, machinery and raw materials as the asset base of business to knowledge, ideas and creativity. That shift will require all businesses to ask fundamental questions about how they are owned and managed, how they pay and involve their employees. Andy Law, St Luke's managing director and guiding spirit, likes to remind his colleagues: 'Business must innovate or die, not just the products they make but their organisation, ownership and culture.' St Luke's has gone further than most in working out how companies will have to operate in the knowledge economy of the future.

St Luke's began life as the London office of the US advertising agency Chiat Day. In its time Chiat Day, which was set up in 1968, was revolutionary itself: it pioneered open plan offices and, in the 1990s, the 'virtual office' in which no employee had a dedicated desk. In 1992, two staff from Chiat Day's London office – Andy Law, who was then in charge of generating new business, and David Abraham, a young account director – joined a group made up of people from Chiat Day's international network who were charged with renewing the company's sense of purpose. They drafted a plan which argued that Chiat Day should become an ethical advertising company but it was thrown out by Jay Chiat, the founder.

Yet the experience of working in this group paid dividends for Law and Abraham. Back in London they introduced new ways of working in which the agency started cooperating more closely with clients. For the first time the Chiat Day London office started to attract new clients, such as Boots. Everything was going swimmingly. Until 30 January 1995. That evening Jay Chiat called Law to let him know the entire company, including the London office had just been sold to the media and advertising giant Omnicom. Law's job, according to Chiat, was to merge the London office with the operations of a rival agency, TBWA.

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However, Law, Abraham and the creative team of the London operation decided to make a stand. Law told Chiat that the London office had no assets other than its people. ‘People cannot be bought and sold like chattels,’ he told Chiat during heated trans-Atlantic negotiations. Law and Abraham quickly persuaded the other employees and the agency’s major clients that the London office could go it alone as a new company.

Soon afterwards Law and Abraham flew to New York for tense talks with their new owners. Omnicom, keen to avoid adverse publicity, agreed to an earn out in which Law and Abraham could buy the London operation for £1 and, in exchange, they agreed to pay Omnicom a share of their profits, worth £1.2 million, over seven years.

At that point, Law and Abraham could have kept the equity and become paper millionaires. But on the plane back over the Atlantic they realised they had a golden opportunity to create a new kind of company: employee owned, cooperative, open and creative. They wanted the company’s ownership to reflect everyone’s contribution to the business. It would be a company built on a set of relationships rather than a hierarchy. It would be managed openly, not through command and control.

Realising their ambitions was far easier said than done. Over the summer of 1995 a small group tried to devise various ownership structures. The company’s lawyers urged a traditional limited company. Law and Abraham toyed with the idea a craft guild. In one scheme the senior staff would have had larger stakes than everyone else. Another plan envisaged that no staff would own the company – ownership would be held in trust by a charity. Finally, the finance director stumbled over the idea of turning St Luke’s into an employee owned company using a little known statutory vehicle known as a Qualified Employee Share Ownership Trust.

The company was formally launched on St Luke’s day in October 1995. About 30 per cent of the shares in the company were distributed to employees in equal portions, regardless of salary, rank or length of service. Each year more shares will be transferred to employees but the plan is that the trust will always have a majority.

Employees have a huge influence over the company’s development. St Luke’s is governed week to week by a five person board known as the

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Quest. One of the board members is the company's lawyer, two are senior employees and two more are elected by a vote of the workforce. The Quest makes important decisions about issues such as maternity leave, sick leave, personnel matters and employment contracts. It meets about once every two weeks and any member of staff can attend as an observer.

The monthly Flag Meeting, which is open to all staff, reviews performance and recent work as well as future business prospects and strategic questions facing the company. The Flag Meeting rarely takes initiatives but it can veto a proposal from senior managers. In addition, the company has a Monday morning start-the-week meeting attended by all staff. This meeting is chaired by a different junior member of staff each week. The chair has to inform the rest of the company of major events that week, such as pitches for new business. This gives staff members the chance to find out about several different aspects of the business and to take responsibility for convening the meeting.

The management style gives employees freedom from supervision but in exchange demands that they take responsibility for decisions. David Abraham says: 'We wanted to take away that sense that the company was something else, some distant corporate entity … People feel relieved they do not have someone looking over their shoulder the whole time, but it also means they have to take more responsibility themselves. It cuts both ways. It is our company but that means we have to take responsibility for it.'

This inclusiveness extends to the way pay is set. Every employee's performance is appraised twice a year, by peer and colleague review. One of these reviews determines the employee's pay rise. The finance director uses the company's financial performance to establish parameters for how much the total pay bill can rise by. The employee is told of these broad guidelines and in the light of the performance review is asked to judge what sort of pay increase would be justified. The pay decision is reached by agreement with the staff member's immediate manager. These performance reviews are open and honest.

St Luke's inclusive and client centred style is reflected in the working environment. In most advertising agencies the largest offices are reserved for the most senior executives. At St Luke's the office is organised around the clients, each of whom have a themed, specially deco-

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rated ‘brand meeting room’ dedicated to them. Meetings about clients’ account take place in these rooms. Most of the rest of the building is made up of shared spaces which are a cross between a cafe and a library. Staff work at large common tables. They are not even allowed to colonise a regular place at these tables. Each evening at 5.30pm Lucinda comes around with ‘5.30 boxes’ to clear away work staff have left at the tables. These are stored in the basement next to the personal lockers.

All the physical resources are shared. Staff carry personalised mobile phones, which they pick up at reception every morning. A computer network means that no one needs their own computer. To unwind, staff can retreat to a womb, a round quiet room, decorated with plush red velvet, with computers connected to the Internet.

One of the most impressive aspects of St Luke’s recent performance is its output. Its employee ownership and participatory management are the basis for a creativity which has won the company a string of awards and plaudits in its first year. For most of its life as the Chiat Day outpost in London the office was in the doldrums. However, in the past two years it has doubled in size and is likely to carry on growing at a rapid rate. St Luke’s promotes itself as an ethical company: it makes advertising which is about more than selling products. It encourages clients to take a broader view of their social role as a way of unlocking hidden brand value. This year it expects to have a turnover of about £90 million, compared with about £50 million at the time of the buyout. St Luke’s is one of the fastest growing advertising agencies in London because its ownership and culture have made it one of the most creative.

Andy Law says his ambition is to create a new way of organising the advertising business. He explained: ‘Most advertising agencies are groups of entrepreneurial, self-employed people who get together to make themselves a million bucks. But if you create an agency designed to make you rich the same thing always happens. You put all your energy into years one, two and three. By year four, you’ve got lots of people working for you. Then they start having a few ideas themselves and start to ask for option schemes and shares. By years five and six you’re already thinking about how to get your money out. In years seven and eight you sell the business, destroying the thing you’ve

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created. We want to create something more durable than that, which isn't about ego and greed.'

St Luke's has made an impressive start but it is only a start. The open management style requires a lot of patience. In traditional organisations managers can issue instructions; at St Luke's everything has to be negotiated. St Luke's has yet to face a significant downturn which might require it to cut costs by reducing employment. Yet growth also presents a dilemma. If the company grows too fast it will find it more difficult to embrace employees in a common culture.

Yet St Luke's has developed a powerful blend of employee ownership, participatory management and a creative work culture. The lessons from St Luke's, and other employee ownership businesses profiled in this report, apply to any people based, service business which makes non-standard products. This new breed of company thrives because it does not have a top heavy management hierarchy. Information and responsibility is devolved to frontline employees. Employee ownership is the 'glue' that binds these loose, networked companies together. They all promote a high performance culture, in which employee ownership helps to provide a sense of membership and common purpose.

At their most radical, as in the case of St Luke's, this new breed of company is challenging the very idea of what a company is for and how it should be constructed. They are promoting the idea of a company as a community of interests, a set of relationships rather than a financial entity or a neatly bounded, organisational hierarchy.

The new model of ownership, management and compensation that these companies are creating may not apply as well to very large companies which operate in capital intensive industries. However the factors which make this new approach so potent – the importance of innovation and creativity, the emergence of more devolved and networked forms of organisation – will affect most companies in the next few years regardless of the sector they operate in.

All companies need knowledgeable, motivated employees who can take responsibility for solving problems and delivering services to the highest standards of quality. That applies to hotel and catering businesses as well as to biotechnology and multimedia companies. Knowledge is becoming the most valuable corporate resource. People

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are a company's most valuable asset. The organisations best able to make the most of people and their knowledge will be open and devolved. They will offer compensation that is as diverse as the contribution the employee makes – a wage, social benefits, an ownership stake, performance related equity awards, an individualised retirement package. Employee ownership and equity based pay will be vital to creating the networked, knowledge creating company of the future.

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The traditional case for employee ownership

Summary

- The traditional case for employee ownership is that it will act as an antidote for the divisive, low-trust, 'them and us' culture of industrial capitalism.
- That case is still highly relevant. Reviews of studies into the effects of employee ownership on corporate performance shows that corporate performance can be transformed when employee ownership is combined with an open, participatory management style.
- The core of the traditional case for employee ownership is that it will help align the interests of workers, shareholders and managers to create the basis for a more cooperative, productive and flexible company. Appendix Four cites several cases where employee ownership and equity pay have helped to transform traditional manufacturing companies.
- The traditional case for employee ownership does not address the future as much as the past. The old case can be augmented and developed by a new case that employee ownership and equity pay will play a vital role in the knowledge intensive industries of the next century in which people, ideas and creativity will be the key assets.

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The case for employee ownership in the past was that it was an antidote to the shortcomings of the divisive, hierarchical industrial capitalism inherited from the nineteenth century. That case is still highly relevant, but it can be augmented. In the future, employee ownership will help companies and workers make the most of the knowledge intensive industries which will be the economic dynamos of the twenty first century. Employee ownership is not just a cooperative corrective for past failings, it can also underpin tomorrow's corporation.

The traditional case for employee ownership stems from a critique of the shortcomings of industrial capitalism. Industrial capitalism has created a 'them and us' world of waged workers and owners of capital. This produced an antagonistic, divisive and low productivity culture in much of industry. The management hierarchies of large industrial companies further reduced the autonomy and contribution of workers. Managers found it difficult to win employee cooperation. They had to use financial incentives or the power of their authority to get results. A company was usually owned by shareholders, whose only interest in its performance was financial and often short term. These financial pressures made it difficult to align the interests of shareholders, managers and workers cooperatively to create a successful business. It often seemed that the modern industrial corporation was built upon a barely concealed civil war of conflicting interests.

Employee ownership, it was argued, could remedy these problems by creating more common ground for managers, employees and shareholders. By gaining a stake in the business they work for, employees change their attitudes. As shareholders they start to understand the risks of ownership and the need for commercial management. As worker-owners they become more cooperative and voluntarily monitor their work effort, controlling costs and raising productivity. As workers become owners of capital the distribution of wealth becomes more equitable. Employee shareholders are more patient, knowledgeable shareholders, protecting the company from the short-term pressures of the stock market. Employee ownership creates a virtuous circle of long-termism, cooperation, higher productivity and quality as well as greater employment security and a fairer society.

Six main claims are made for employee ownership:

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Cooperation. Employee ownership reduces conflict between workers, managers and shareholders and promotes cooperation because they have shared interests.

Productivity. Workers with a stake in the business identify with it and voluntarily make an effort to cut costs, raise productivity and improve quality, in part by monitoring the work of their colleagues.

Patience. Employee shareowners are more knowledgeable about the company than outside shareholders and therefore more patient. This should help to protect the company from the short-term demands of the stock market.

Loyalty. Employees with a stake in the company are more committed. This is particularly important in sectors with high labour turnover and where it is difficult to retain skilled staff who are in short supply.

Flexibility. Worker-owners recognise the case for pay flexibility as the fortunes of the company fluctuate. Pay automatically becomes more flexible if more of it is linked directly to profits.

Risk taking. Employee owners come to understand the nature of the risks taken by owners of capital. This helps to underpin the legitimacy of share ownership.

Much of this case against the dominant model of the traditional industrial corporation is still persuasive. In the United States, for example, a number of manufacturing companies have been transformed by employee ownership. Some of these companies, such as Mayville Die and Tool and National Forge – are profiled in Appendix Four. Many companies would benefit from a more involved, cooperative relationship between workers, managers and shareholders.

Yet the traditional case for employee ownership has been lacking in several ways. First, it has been made in too simplistic a way. Some employee ownership advocates argued that employees would become more cooperative and productive simply by acquiring a stake in their company. But the links between employee ownership, employee moti-

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vation and corporate performance are much more complicated than this model implies.

US research into employee ownership's effect on corporate performance has broadly concluded that employee ownership on its own rarely has much impact on employee motivation, productivity or corporate performance. It can improve corporate performance but only when combined with 'participatory management' programmes (such as self-managing work teams, employee participation groups and employee advisory committees) which give employees a regular, meaningful input into decisions affecting their work. (For a detailed review of the economic studies of employee ownership and corporate performance see Appendix Two.)

Second, experience has shown that aspects of the case for employee ownership are weaker than its advocates have sometimes claimed. Employee owners are not necessarily more patient than external shareholders; sometimes they are as keen to reap financial returns as other investors – witness the sale of several of the British employee owned bus companies created by the Conservative government's privatisation programme. Giving managers and employees a large stake in a company might make them more committed; on the other hand if they are in control they might choose to relax more. This appears to have afflicted many employee owned businesses in the former Soviet Union.

Third, the traditional case for employee ownership primarily addresses the past – the poor industrial relations and productivity record of manufacturing industry. It has not addressed the future as confidently: how to create entrepreneurial, knowledge based companies in the growth industries of the twenty first century. Employee ownership and equity pay can play a vital creative role in shaping tomorrow's company. The traditional case for employee ownership, based on its capacity to correct the failings of the past, needs to be developed and augmented by a new case which addresses the future.

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The new case for employee ownership

Summary

- Employee ownership and equity pay will be particularly important as 'soft' assets become more important to competition and innovation.
- In most businesses knowledge, creativity and ideas are the most powerful and distinctive assets.
- Knowledge belongs to people, who cannot be owned. Therefore companies often will not own their most important assets. The most effective bridge between ownership of a company's financial assets and its real knowledge assets will be through employee ownership.
- Equity pay schemes, in which a significant proportion of total compensation is in the form of shares, share options or share purchase rights, will become more popular, especially among young, skilled knowledge workers.
- Equity pay and employee ownership will help to promote entrepreneurial, stakeholding companies which are built on a set of relationships between the company, its employees, suppliers and partners. These relationships need to be enshrined within the framework of shareholder rights.
- Companies are becoming increasingly networked with flatter organisations and more contracting out. Networked organisations, which have little management hierarchy, need a spine to provide a cohesive culture. Employee ownership is one of the best ways to combine the fluidity and flexibility of a networked organisation with a sense of membership and common purpose.

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- The neatly defined job is increasingly a thing of the past. With its demise will go the old fashioned 'wage-effort' bargain. Companies want a broader productivity from their employees: innovation, new ideas and problem solving. Rewarding this will require a completely different approach to pay.
- Work is becoming increasingly insecure. Employee ownership, through individualised savings plans, could help to combine security and flexibility for employees and companies.

The new case for employee ownership is about the future. Employee ownership will help companies and employees shape the forces which are changing the way we work and save, the way our companies are owned and managed. Employee ownership will help us make the most of flatter, networked organisations. Equity based pay will help define an employment contract to take the place of the traditional 'wage-effort' bargain. In an increasingly risk-laden, uncertain world, employee ownership can help to provide a sense of security at work, as well as contributing to a new approach to saving, education and pensions.

Owning the knowledge creating company

Knowledge, creativity and ideas are central to competitive advantage. Manufactured products are becoming more knowledge intensive, often combining several different technologies. There is more computing power in a top range BMW than on the Apollo craft which landed on the moon in 1968. The industries of the future – software, biotechnology, genetics, communications, nanotechnology, micro-robotics – will use scientific knowledge to create generations of global products. In retailing, a company needs to know as much as possible about its consumers to build a lasting relationship with them. Knowledge is becoming the most powerful and the most distinctive source of corporate competitive advantage across all industries, not just in high-tech sectors.

Knowledge can be created by institutions like schools and universities. It can be codified in handbooks and manuals. But knowledge belongs to people. The most creative forms of knowledge are often tacit and implicit, they are held in the heads and hands of skilled crafts-

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men, technicians, programmers, directors, authors, sales staff and engineers.

This presents companies with some difficulties. Their most important asset, knowledge, will not appear on their balance sheet. It will count as a cost – wages and salaries – rather than an investment. But once the staff have gone home and the office doors have shut, what assets does the average company have? For most companies the answer is: a few computers, some furniture and some real estate. Every company should ask itself: how much is this company worth without its staff? The next question is: if the knowledge of our employees is our most important resource, who owns it?

Not only is it difficult to own and account for this intangible, mobile asset, it is not ethical to do so. Knowledge resides in people. People cannot be owned. Therefore companies do not own their most valuable assets.

Companies will increasingly have to address this mismatch between the assets which make a business successful – people – and the financial ownership of the business. Employee ownership and equity pay are the most obvious way to create a community of interests between workers and other shareholders and to retain highly skilled, knowledgeable staff.

The knowledge creating economy

Employee ownership and equity pay can help to build an entrepreneurial, knowledge creating economy. When compensation is mainly in the form of wages and benefits, the tables are tilted in favour of larger, richer companies. Until recently, larger companies were usually able to offer more secure, better paid employment than smaller companies. They often attracted the brightest talent. The IBM model, which offered employment for life, regular wage increments and generous fringe benefits, was widely admired.

That model has been turned on its head by the knowledge entrepreneurs of the computer industry who have emerged from the US west coast. The companies these knowledge entrepreneurs founded, such as Microsoft, Netscape and Intel, have been built on a quite different employment culture of equity pay and employee ownership, in which all staff are paid in part through stock options and stock bonus

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programmes. This is a lesson other industries will have to learn as the phenomenon is unlikely to be confined to the computer industry.

With increasingly competitive global markets, large companies find it more difficult to make good their offers of employee security and stability. When equity pay becomes the currency of compensation, the balance is shifted towards smaller companies which can offer larger, potentially more lucrative, stock options. In Silicon Valley, experienced software writers often leave larger corporations to set up small creative companies, attracted by the prospect of owning a larger equity stake. This recycling of the talent base from larger, but not necessarily more stable, companies, into more entrepreneurial ones helps to promote a process of creative destruction which the economist Joseph Schumpeter argued is at the heart of an economy's dynamism.

Employee ownership does not guarantee a more entrepreneurial economy. But where employee ownership and equity pay are combined with competitive, dynamic product markets – as in the computer and software industry – the result can be a flowering of knowledge based entrepreneurship.

The stakeowning corporation

Is the point of a company solely to make profits? Is it governed by nothing other than the pursuit of shareholder value? These questions are being debated more fiercely now than for decades. There are two reasons for this. First, companies are being pressed to take on wider social responsibilities as the state recedes and the market becomes more pervasive. Second, it is increasingly recognised in business that a successful company relies on a set of relationships between the company, its suppliers, employees, customers and partners as well as shareholders. In the long run, giving undue weight to the shareholders undermines core relationships and the company's health.

One response to the growing debate over the wider social responsibilities of business is the idea of 'stakeholding', advanced by Will Hutton in his book *The state we're in* and John Kay in *The foundation of corporate success*. The stakeholding models most frequently used by Kay and Hutton are drawn from large, manufacturing companies in Japan and Germany. These models are not well suited to the more open,

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entrepreneurial and flexible British economy. The most effective way to create a dynamic and entrepreneurial form of 'stakeholding' is to adapt the shareholding structure, not to replace it with a different machinery of corporate governance.

Stakeholder interests have to be translated into specific and enforceable rights to influence the corporation. Adapting the existing shareholder structure is the best way to achieve this. Stakeholder interests will conflict. A development of the annual general meeting gives a mechanism for sorting out such conflicts.

Employee ownership is the most powerful way to give employees a direct, tangible stake in their company. Staff in employee owned companies can have far more influence over strategic decisions, such as acquisition and merger, than they would in a traditional company. This report make a number of proposals to adapt share ownership to include other stakeholders – suppliers and commercial partners for instance – in a stakeowner corporate structure.

The networked organisation

Employee ownership can underpin a new collaborative culture of work and management by helping companies to develop more dispersed, networked organisations which thrive without cumbersome management hierarchies. Companies are moving away from these neatly bounded hierarchies in which jobs are clearly defined and roles sharply demarcated. Large companies are increasingly contracting out services. Some companies have begun to experiment with virtual organisations, which have no physical core and little management structure. In delayering management structures more responsibility passes to frontline employees. Self-directed work teams are increasingly common.

Networked organisations offer great advantages. They can be more flexible, agile and creative at a lower cost than more structured organisations which support a heavy management hierarchy. Yet reaping the gains of the networked organisation is not easy. It requires management by consent rather than command and control. The networked organisation must have a spine to hold it together. It needs to combine fluidity and flexibility with commitment and a shared culture. The spine of the traditional company is provided by the management hier-

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archy and demarcated office space. A networked organisation needs a different kind of corporate spine which employee ownership can provide.

The new employment contract

There is a vacuum at the heart of the modern employment contract. Although knowledge and people are the most important assets of modern business, in the United States and the UK at least there is no consistent way to give workers a voice in business. Trade unions are in decline, particularly among young workers and those in service industries. The sophisticated and benign 'human resource management' methods, such as employee involvement programmes, promised in the 1980s have rarely born fruit. Indeed the vogue for HRM was rapidly replaced by the brute force of downsizing and restructuring. Downsizing is not a recipe for creativity and growth – it has often left behind a demoralised workforce. Yet a regulated, European approach to employee relations, involving works councils and co-determination, would be inappropriate for the decentralised British economy. Employment relations have been left in limbo, without a guiding ethic for employee involvement. Union organisation, sophisticated paternalism, regulation and self-interest have failed as guiding ethics. This reflects a deeper shift in the character of work that is undermining the traditional employment contract.

The era in which jobs are clearly defined and workers are paid a wage in exchange for a specified amount of effort, is coming to an end. Companies are adopting a much broader notion of productivity based on customer satisfaction. They want employees to develop new products and solve complex problems. When work was 'routinised' in large offices and factories, a standard wage might have captured the limited relationship between employee and employer. In tomorrow's company the pay packet will have to look quite different, because it will reward a quite different kind of effort and worker. The employment contract for knowledge workers will resemble a rental contract on an asset or a financial option on their future time, rather than a wage. Leasing and renting, concepts associated with ownership, will become as relevant to pay as the wage and salary have been until now.

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Security with flexibility

Employee ownership could play a valuable role as people search for security in a much more competitive, uncertain world. Insecurity has become a pervasive feature of life for millions of people. Technological change can wipe out entire occupations in a few years. Established companies are facing competition from unexpected sources. Banks are facing a challenge from supermarkets. Manufacturers in the United States and Europe face a growing challenge from Asia. Even white-collar, middle class jobs are far less secure than they were. For many people the idea of a career lasting till retirement is a thing of the past. The anxiety about the insecurity of work has been compounded by the erosion of the traditional guarantees of the post-war welfare state.

Employee ownership can help to address the twin anxieties of job and welfare insecurity. A significant level of employee ownership – more than 20 per cent of a company – can provide employees with an influential voice over strategic decisions affecting a company. In the United States, proponents of Employee Share Ownership Plans (Esops) argue that employee ownership is the best way for small companies to stay independent in increasingly competitive markets dominated by international firms.

Another possibility is to use a modified version of the US individualised savings plans known as 401K plans, to create personalised funds for education, retraining and retirement. In the United States the employer contribution to these funds often takes the form of company stock. These 401K plans are the fastest growing part of the pensions industry in the United States and the fastest growing source of employee ownership. The workings of these funds is set out in detail in the following chapter. Proposals to create similar funds in the UK are set out in the recommendations at the end of the report.

Conclusions

The old case for employee ownership, that it would help to make good the divisive, low trust, ‘them-and-us’ culture of the hierarchical, industrial company, is still relevant. Many companies still suffer from a lack of trust between stakeholders. The old case can be built upon with a new case, that employee ownership will help us to shape the future. Far-reaching changes to the character of market economies, brought

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on by global competition and the rise of knowledge intensive, 'soft' industries, are forcing equally fundamental changes to the character of our corporations. Those changes will throw up questions about how companies should be owned and managed; how work should be organised and paid for; how workers should provide for their security and save for their retirement. Employee ownership and equity pay will help us to answer these questions in a cooperative and creative way.

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Lessons from the United States

Summary

- The United States is creating a diverse and deeply rooted culture of employee ownership, which is increasingly linked to so-called open-book, participatory management.
- Employee Share Ownership Plans are well established. They are now a current within the mainstream of US business, not on the margins.
- Esops are particularly useful in succession planning in small companies, where retiring founder-owners have been encouraged to sell their company to its employees.
- While Esops provide a solid base for the employee ownership movement, the most exciting and innovative developments are in equity pay schemes and individualised savings plans.
- One of the fastest growing forms of employee ownership in the United States is the 401K savings plan, in which shares are often used to match tax-free employee contributions.
- Equity pay, in which a large portion of employee compensation is in the form of stock options and bonuses, is becoming increasingly common in the United States, especially in younger industries and companies. It is playing a critical role in knowledge intensive businesses which will be the most dynamic in the next century.

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A visit to the equity compensation department at Adobe, the US software company, is like taking a trip to the future. All staff who join Adobe, which is based in San Jose, in the heart of California's Silicon Valley, are advised to get an accountant – with good reason. Within a few years of joining the company a large chunk of their pay will come not in the form of higher wages but in the shape of shares, profit sharing bonuses and stock options. For a majority of the staff at Adobe the traditional pay packet is just one component of their overall compensation. Adobe's equity pay approach is commonplace in Silicon Valley but still unusual in the rest of the United States. That is likely to change in the next few years as the products, working practices and culture of the Silicon Valley industries of software, communications and the Internet spread to other industries and regions.

Adobe, founded in 1982, has played a central role in the desktop publishing revolution, creating software to allow people to convey information through graphics and illustrations. Adobe went public in 1986 and now employs about 2,400 people. It is the world's third largest personal computer software company with revenues of $762 million last year.

Employee ownership and equity pay have been central to Adobe's growth. The company's two founders used stock options to reward staff when the company was small and cash was tight. Since then Adobe has developed an array of equity schemes to reward employees including: a stock options programme which includes all staff regardless of rank or pay; discretionary stock options and stock bonuses; a profit sharing bonus; a 401K savings plan involving company stock; and a generous employee stock purchase programme. Stock worth $156 million was issued under these employee stock programmes between 1993 and 1995. In that time 7.8 million options were granted to employees and 7.4 million were exercised.

All US employees are granted stock options when they join the company and staff are awarded additional stock options annually depending on their performance and competitive pressures in the labour market. In a typical year, half the staff receive selective stock options. The company also offers to sell shares to any employee at 85 per cent of the share price when an employee enters the stock purchase programme. An employee can buy shares at the discounted

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price, at any time during the two years after entering the scheme. For example, if the share price was $20 when the employee entered the scheme the discounted price at which they could buy shares would be $17. If the share price subsequently rose to $40 during the next 24 months, the employee could still buy the shares at $17. Should the share price fall below $20, the employee would be able to buy shares at 85 per cent of the lower price.

Real stock, rather than options, can be granted at management's discretion to help recruit or retain key staff. Recently, Adobe introduced team based rewards to recognise collaborative product development. At the start of a project, the team manager is given a pool of cash and stock which are awarded at his discretion to team members as they hit project milestones. Adobe also operates a corporate profit sharing scheme. Up to 10 per cent of base salary can be paid as a profit sharing bonus depending on corporate performance. If the company's performance is more than 15 per cent ahead of budget at the end of the year additional sums are paid into employees' individualised 401K retirement plans. In the past three years the company has contributed about $3.5 million to employees' 401K plans, much of it coming from its profit sharing plan.

To illustrate what these schemes can mean to an average employee, take the example of a software developer who joins the company on a salary of $70,000 a year. By the third year of employment it is quite possible this employee's pay will be made up of a wage of $85,000 and exerciseable options and bonuses worth in excess of $45,000. Half their remuneration might come in the form of equity pay.

Adobe is just one of many examples of how equity pay and employee ownership is driving the creativity of Silicon Valley, the narrow peninsula south of San Francisco which is one of the most dynamic regions in the world. Silicon Valley is home to about 6,000 high-tech companies, with annual sales last year of about $200 billion. Average pay in Silicon Valley was $43,510 last year but in the software industry it was $85,000. The Valley has been the home to some of America's most dynamic high-tech computer companies, including Sun Microsystems, Intel, Netscape, Oracle and Hewlett Packard. One fifth of the public companies based in Silicon Valley are 'gazelles' – small firms whose revenues have grown by 20 per cent in each of the last four years.

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Employee ownership has played a central role in the rise of Silicon Valley in four distinct but linked ways:

- Entrepreneurial employee ownership and equity based compensation have been the financial currency of Silicon Valley's creativity. Entrepreneurial employee ownership has helped to generate a high rate of start-ups and equity participation has helped to turn start-ups into high growth companies.
- Silicon Valley's success is built upon a network of small and large companies. These networks help companies to share information and risks as well as to generate ideas. Employee ownership has helped to create this corporate network.
- The founder-owners of a generation of entrepreneurial companies set up in the 1960s, during the early days of the Silicon Valley computer industry, are retiring. Many are selling their companies to their employees through an Esop.
- Large companies which were employee owned start-ups and which practice a culture of employee ownership are investing in entrepreneurial employee owned companies as a source of future ideas. For instance, Adobe has invested $60 million in 23 small companies to keep abreast with new technologies and markets and retain its competitive edge.

Companies such as Adobe and regions such as Silicon Valley are at the leading edge of the employee ownership and equity pay movement in the United States. Since the development of the Esop in California in the 1950s, US companies have pioneered equity-based compensation schemes. The schemes show how much further Britain could go to create a more diverse and deeply rooted culture of employee ownership.

The employee share ownership plan (Esop)

The most common form of employee ownership in the United States is the Employee Share Ownership Plan or Esop. The US Esop has its roots in deferred compensation schemes which provide employees with a retirement income. Since the nineteenth century, employers have put company stock into trusts as contributions to retirement funds for

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employees. After the Second World War, companies asked the tax authorities for the right to borrow money to buy stock for these plans. The Esop *per se* was created in the late 1950s by a San Francisco attorney, investment banker, economist and latter-day philosopher called Louis O Kelso. Kelso argued that wealth was increasingly concentrated in the hands of the owners of capital and so workers had to become part-owners of their businesses to avoid growing inequalities.

An Esop allows a company to use its profits to acquire its own shares on behalf of an employee benefit trust. This trust usually distributes the shares to employees. Usually, the employees can only sell the shares once they leave the company. Often a company will borrow money to buy the shares for the trust. Each year a contribution from profits pays off part of the loan. As the loan is paid off, the shares are distributed to employees. A detailed account of how Esops work in the United States and the UK is set out in Appendix One.

Esops began to have a significant impact in the 1970s when Senator Russell B Long, Chair of the Senate Finance Committee, took up their cause. Long used his position to give Esops statutory recognition, as well as to create powerful tax incentives to promote them. The most important of these tax incentives means that that the owner of a private company does not have to pay capital gains tax on the sale of his shares to an Esop, as long as it meets certain conditions, for example that the Esop should own at least 30 per cent of the company. Selling a private company to an Esop is much more tax advantageous than selling it to another company or to an outside investor.

As an example of how much these tax concessions can be worth take the case of HSQ, a San Francisco engineering firm which was set up with an investment of $200,000 by the owner Henry Hoge. Now it is worth at least $5 million. Had Hoge decided to sell the company to a trade buyer he would have paid tax worth 40 per cent of the capital gain, almost $2 million. By selling to an Esop he avoids this tax. Esops attract a range of other tax incentives which are detailed in Appendix One.

Long's tax incentives had a galvanising effect. The number of Esops grew from 5,000 in 1980 to about 10,000 in 1993 and the number of employees covered by Esops rose from about 4 million to more than 10 million. Esops are formed for all sorts of reasons by US companies. In

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large companies they have been used to get access to tax breaks on corporate borrowing. Some companies have created Esops to ward off the threat of a hostile takeover. In many companies an Esop is simply an alternative form of pension plan. But Esops are most common in private companies where a founder-owner wants to sell out. About 65 per cent of Esops have been created by an owner who wanted to sell the company to its employees.

In the past fifteen years Esops have moved from the esoteric fringe of US corporate life to become a significant, though small, current within the business mainstream. Esops are supported by a well developed infrastructure of legal and accounting services. Most sectors of the economy in the United States have successful Esop role models. Many of the large Esops created in the 1980s have years to run – this should create an in-built momentum for employee ownership. In addition, Congress recently extended Esop provisions to so-called S-Class companies which cannot have more than 35 shareholders. In theory this could almost double the number of small companies which could use Esops, although the detail of the legislation excludes S-class companies from the tax concession available to other Esops.

These factors are likely to sustain Esops in the years to come. However several factors are working against them. Esops are too cumbersome for entrepreneurial, start-up companies which lack the profits needed to buy shares. Esop growth among large companies has probably peaked. In the 1980s, most Esops in publicly quoted companies were initiated by the corporate tax department. The abolition of tax concessions to banks makes them less attractive as a tool of corporate finance. This turn away from Esops among large companies means it is unlikely that the proportion of the US workforce covered by Esops will grow markedly.

The political support for Esops is not secure. Senator Russell Long retired in 1987 and no champion has emerged to replace him. Employee ownership has never figured prominently in New Democrat thinking. Critics on Capitol Hill, such as Californian Congresswoman Barbara Boxer, allege that Esops have provided lucrative tax breaks for banks and entrepreneurs at the expense of employees who have been given no choice but to rely on shares in their company as their main retirement income.

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In addition, Esops created a decade ago are facing problems in maturity. The motivational boost from creating an Esop often wears off. Some large, 100 per cent employee owned companies face large 'repurchase obligations' which threaten to make them uncompetitive. Senior, well paid employees who have been with the company for several years are retiring and want to sell the shares they own. The company has an obligation to buy them which will place a growing financial strain on the company. Esops generally benefit long serving, well paid, older workers close to retirement who regard their holdings as a pension plan. They have little appeal for younger, less well paid workers who may well change jobs several times in a career.

The Esop movement provides a base for employee ownership in the United States. As long as the main tax incentives are not abolished, Esops will remain a useful tool of corporate finance and management succession planning (passing a company from the owner to its employees) in small companies. This is the most useful role they could play in the UK. But Esops will not be the wave of the future that many claimed they would be in the 1980s. The fastest growing forms of employee ownership in the United States are individualised, flexible and linked to employee and corporate performance. It is to these new forms of employee ownership that we now turn.

Individualised savings plans

ELS Inc is a small, defence sub-contractor in Virginia on the outskirts of Washington DC which employs about 100 people. ELS, which was founded in 1976 as Engineering and Logistics Support, has a well developed Esop. But it has combined the Esop with other schemes designed to renew its employee ownership culture.

Mike Kelso, the president, set up an Esop in 1986 after persuading the founder-owner to sell the company to its employees. This gave the founder-owner an exit route from the company while providing continuity for the rest of the business. Initially the Esop galvanised the company. The workforce took voluntary actions to cut costs to help the company buy the shares.

However, the ESL Esop is now ten years old. It only has a minimal motivational impact for younger staff who are many years from retirement. In an attempt to respond to these shortcomings Kelso introduced

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a 401K saving plan, which was biased to favour younger, less well paid workers. The 401K plan has proved immensely popular with employees. The funds in the 401K plan, which only started in 1993, are already worth $1.4 million. A long-term employee at ELS who was reasonably highly paid and who had been in the Esop since 1986 would have a salary of $73,000, an Esop holding of $73,000 and about $42,000 in his 401K plan. A more recent, less well paid recruit, who had been with the company for four years would probably be paid $50,000, have an Esop holding worth just $6,500 but a 401K holding of $21,000.

The Esop and 401k plan are linked. If an employee has been in the Esop for ten years and is over 55 years old they can transfer 25 per cent of their shareholding into the 401K plan or a registered retirement account. For older employees the Esop has become a way to finance part of an independent pension. Kelso has plans to introduce a wide range of stock options and bonuses to give new impetus to the company's employee owned culture.

A 401K plan, named after the section of the tax code which defines it, is set up by a company to allow employees to save pre-tax earnings of up to about 15 per cent of salary. The employee's contribution is usually matched by the company but rarely at a dollar-for-dollar rate. The 401K fund is held in trust for the employee who can choose how it should be invested. Most companies offer six investment options, ranging from pooled equities to growth stocks and money market funds.

These 401K plans are attractive for companies because their administration costs are low. For employees they offer a mix of individual choice and flexibility, combined with shared security. Employee ownership plays a role in 401K plans in two main ways. In many plans the employee can invest in company stock and many employers make contributions to the plan in the form of stock.

According to Department of Labor figures there were 114,348 plans in 1992, with 21 million participants and total assets of $466 billion. There were 2,054 plans which involved employer stock, with 6 million participants and assets of $195 billion. About 39 per cent of these funds were invested in employer stock worth about $77 billion, that is about 16.5 per cent of all 401K funds.

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Since 1992, 401K plans have grown rapidly. The benefits consultancy Access Research valued the 1996 holdings of 401K plans at $690 billion. If the proportion invested in employer stock was 16.5 per cent that would mean employees owned employer stock worth about $114 billion. By the year 2000 the assets in 401K plans are expected to reach more than $1,200 billion, with almost $200 billion invested in employer stock. However, these figures may be an underestimate. The Institute of Administration and Management, which tracks 228 of these plans, calculates that about 40 per cent of their assets are in the form of employer stock. If that is correct it would mean these plans own about $276 billion of employer's stock in 1996.

These 401K plans do not necessarily give employees a sense of ownership. In large companies these plans usually own less than 1 per cent of the company. Yet their recent growth shows how popular they are with employees. We recommend that the 401K plan model should be developed in the UK not just to fund pensions but also training and education. It could be a mechanism for young people to acquire the assets needed for a deposit on their first house purchase. Proposals for using the 401K model to finance individualised career development funds are set out in the recommendations.

Equity pay

In a growing band of US companies, equity is increasingly used as a central component of employee compensation. According to the National Centre for Employee Ownership, companies offering stock options employ about 5 million people. Equity based compensation offers several advantages for companies: it can create a much stronger link between individual rewards and corporate performance; it is easier to tailor stock options and stock bonuses to the needs of a business strategy than it is to use an Esop; stock options can be powerful in retaining key staff because an employee usually has to wait three years before being able to exercise their options.

An outstanding example of how equity pay can work in practice is Science Applications International Corporation. Saic was set up by five scientists in San Diego in 1969 with a $150,000 research contract from the US Department of Defence. Last year Saic had sales of about $2.5 billion and 25,000 employees. The company is highly decentralised

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with employees working in about 500 teams in six or seven divisions handling about 4,000 research contracts a year. The teams are largely self-directed, working within broad financial parameters set by senior managers. Most of the budget planning for the business is done from the grass roots up with teams and divisions submitting estimates for their revenues and profits. Operational management is highly devolved. This decentralisation is combined with the entrepreneurial leadership of Saic's remaining founder, Dr Robert Beyster.

From the mid 1970s employee ownership and equity pay have been central to the company. They are an entitlement of those who contribute to the company, but the extent of that entitlement should be earned by performance. Saic's creativity thrives on combining a performance culture with a membership culture: it is a high performance club. Employees have several opportunities to become owners and to take part of their pay in equity. Profit sharing is the oldest ingredient in Saic's compensation package. It created a stock bonus plan in 1974 which was converted into an Esop in 1985. The company runs a range of performance based, equity pay schemes which began modestly in 1975. Since 1991 these schemes have become the largest non-wage component of compensation.

Equity pay schemes include: stock bonuses which are outright grants to the employee and which can be traded on a highly developed internal market; vesting stock bonuses which only become an employee's in stages over four years; stock options, which become an employee's over five years; and stock purchase rights, which are granted only as a performance award. See Appendix Four for a detailed case study of Saic.

Entrepreneurial employee ownership

The United States is undergoing an entrepreneurial renaissance in which equity ownership plays a central role. According to the Centre for Entrepreneurial Leadership in Kansas City, 750,000 new businesses were incorporated in the United States in 1995. About 600,000 businesses a year have been incorporated since 1990, compared with an annual rate of about 50,000 in the 1950s. This entrepreneurial upsurge is being driven in part by the downsizing of large companies. But it is also being driven by a culture of entrepreneurship and creativity in

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highly fluid, fast moving, industries. Traditional forms of employee ownership, such as the Esop, are ill-suited to entrepreneurial start-ups. Increasingly, start-up companies with limited cashflow are using large stock option grants in lieu of wages to attract staff. In one recent case a Silicon Valley start-up offered to pay staff a wage or to pay them entirely in the form of stock options for the first year. Many took the second option and subsequently became millionaires.

Conclusions

Employee ownership is extending its roots in the United States. Esops are an established part of the mainstream of business life. They have been used to great effect by a wide range of businesses facing different challenges. The UK can learn in particular from the way Esops have been used as a succession tool to pass control of a private company from its founder to its employees. The main growth in employee ownership in the United States, however, comes in different forms. Employee ownership is playing a role in the development of a more individualised welfare and pension system through 401K plans. Entrepreneurial employee ownership and equity based pay is a central ingredient in the knowledge based industries of the future. The United States is developing a diverse and hybrid culture of employee ownership from which Britain has much to learn.

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The UK's opportunity

Summary

- British employee ownership is relatively widespread, especially by European standards. About 10 per cent of the workforce own shares in the company they work for. Schemes for individual employee share ownership are popular. In many companies 95 per cent of the workforce participate.
- But there are weaknesses as well as strengths. Many of the personal share holders created in the 1980s did not hold onto their shares for very long. Individual share holding schemes often have little impact on corporate culture, management style and performance.
- Esops have had a great deal of legislative support but they have had a mixed record. Estimates of the number of UK Esops vary but the most optimistic is that there are at most 200.
- We recommend measures to make it easier and more attractive for Esops to be used in succession planning for small and medium sized businesses.
- The popularity of broadly based, individual share ownership schemes has been overshadowed by the furore over the large pay-outs from executive share option schemes. Share options are widely seen as a perk for management.
- The UK has the opportunity to create a distinctive corporate and economic model using employee ownership and equity pay. But that will require giving a fresh push to employee ownership with new policies which are broad based but also entrepreneurial and creative.

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The UK starts from a strong position in developing a twenty first century culture of employee ownership and equity pay. There is more legislative support for employee ownership in the UK than any other European country. Employee share ownership has been promoted by both Labour and Conservative governments since the late 1970s. Individual employee ownership was heavily promoted during the Conservative's privatisation programme which has transferred large swathes of the public sector into private ownership. The recent demutualisation of most large building societies has swelled the ranks of personal share holders. After the recession of the early 1980s, large businesses took up individual share ownership and profit related pay as part of employee involvement programmes. Some economists, such as Martin Weitzman, argued that profit sharing firms would create more jobs without fuelling inflation.

Yet despite this range of legislative, political and intellectual support, employee share ownership has only been a partial success in the UK. About 10 per cent of the workforce owns shares in the companies which employ them, a larger proportion than in most other European countries. When companies run schemes they are popular. In companies which run so-called free share schemes set up under 1978 legislation, about 95 per cent of employees take part. In those that run 1984 SAYE schemes, between approximately 30 and 40 per cent take part.

However, in most companies with employee ownership less than 2 per cent of the equity is owned by employees. Employee ownership has rarely led to the changes in management culture and style needed to significantly improve corporate performance.

Esops

According to the lobby group Job Ownership Ltd, the UK has some of the most supportive Esop legislation in the world. Details of UK Esops are set out in Appendix One. Yet despite this support, Esops have at best a mixed record in the UK. There are between 100 and 200 Esops in the UK, according to the Esop Centre, compared with about 10,000 in the United States. Some estimates suggest that there are no more than 50 Esops of which only ten, such as St Luke's, use the statutory Esop created in 1990. Some of these Esops are no more than tools of corpo-

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rate finance to allow a company to acquire shares for use in employee share schemes. In other cases Esops are paternalistic: they were created by an owner who believed in the principle of worker ownership. Some of the best known employee owned companies – The Baxi Partnership, Tullis Russell, John Lewis – fit into this category. The largest group of Esops were created by the privatisation of local and regional bus companies. At one time there were about 25 Esops in the bus industry. But many of these proved short-lived. They were often little more than a transitional device to allow employees to buy the company before selling out to a larger group. Some of the best known examples of employee owned companies have degenerated. The National Freight Corporation, once a symbol of employee ownership, is now less than 10 per cent employee owned.

The biggest weakness in the UK approach to Esops is that they are rarely used in private companies to ease the transfer of a company from a founder-owner to its employees. In the UK, founders usually sell out to a larger company or an outside investor, or else simply close the business down. In the United States, Esops are a widely accepted tool for small business succession. UK legislation should be focused on making the Esops far easier to use in succession planning among small and medium sized businesses. According to a recent EU report about 300,000 jobs a year are lost in the EU when profitable small and medium sized enterprises are liquidated by owners who have no other way to realise the value of the business. Many of these people will find other jobs. But a succession mechanism which allowed them to own the companies that they work for would help to reduce unnecessary disruption and friction within the economy.

Share schemes

Individualised employee ownership schemes have proved far more popular than Esops. The first was the Approved Deferred Shared Trust (ADST) scheme – called the Free Share Scheme – introduced in 1978. Companies can use a part of their profits to buy shares which are then distributed to employees. If the employees hold onto the shares for a specified period they pay no income tax and are likely to be exempt from capital gains tax on the proceeds from the eventual sale.

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The other broad employee ownership scheme is the SAYE share option scheme, introduced by Mrs Thatcher's government in 1980. In this scheme employees take out an option to buy shares at some point in the future, but usually at 80 per cent of the share price when the option is granted. Employees save to buy their shares through a payroll deduction. Their gain on the option once it is exercised is free from income tax although they may be subject to capital gains tax.

These schemes have proved popular. According to official statistics between 1979 and 1995-96 about 1,201 ADST style profit sharing schemes were approved. At their height in the late 1980s about 900,000 people a year were participating in these schemes. The average amount paid per participant has risen from £220 in 1979 to about £550 a year in 1996. Since 1979 these schemes have appropriated shares worth about £3.8 billion. About 1,517 SAYE schemes have been set up since 1980, involving shares worth about £12.4 billion. The average value of shares per participant rose from £1,600 in 1979 to about £2,900 in 1995. Since 1990 the number of people participating in such schemes has fluctuated between 480,000 and 590,000.

These schemes suffer from several shortcomings. The link between individual performance, business strategy and share price is often tenuous. The shares owned through these schemes are usually a small proportion both of the company's equity and the employee's savings: in most schemes the employees own less than 2 per cent of the company's equity. These schemes are not usually accompanied by deep seated changes to management style or corporate governance of the kind needed to improve corporate performance.

The most controversial employee share ownership schemes have been those targeted at senior executives under legislation introduced in 1984. By 1996 about 6,515 executive schemes had been approved and 4,339 were still active. These schemes involved shares worth more than £16.5 billion but for most of their life have only covered 50,000 to 90,000 people. The average value of these schemes per employee reached a peak of £25,000 in 1994. They were widely criticised for contributing to a 'fat cat' pay culture among senior managers as they have often proved an easy way for senior managers to make large returns, at little risk, by meeting only vague performance targets. As a result of the furore over these schemes, some of the tax benefits were

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scaled back sharply in 1995 and stock options are now widely regarded as a perk for senior managers.

Conclusions

Employee ownership in Britain has strengths and weaknesses but, most importantly, it also has great potential. Share ownership is more widely spread and more strongly rooted than in any other EU state. There are some outstanding examples of employee owned companies, such as the John Lewis Partnership, as well as other companies where employee ownership has played a significant role in revitalising the corporate culture – the supermarket group Asda, for instance.

Yet there are also weaknesses. British individual share ownership is relatively shallow and weak. Many share owners created in the 1980s sold they shares soon after they bought them. Employee ownership has only occasionally created lasting corporate models. The all-employee share ownership schemes have been overshadowed by the furore over large pay outs from executive share option schemes, which have reinforced rather than replaced a 'them-and-us' culture.

Yet there is still great scope for the UK to develop a deeper, broader culture of employee ownership and equity pay which could help create a new culture of employee involvement and empowerment. The Conservative government's trade union legislation reformed industrial relations without putting in place a new model to give employees a voice in enterprise. The European works council model does not command widespread support. The Japanese model of lifetime employment is unworkable. Employee ownership and equity pay offers Britain the best chance of creating a viable alternative, and with it a distinctive kind of entrepreneurial, stakeholding company. This should be one of the main aims of public policy in this field.

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Creating a new culture of ownership

Summary

- Britain has the opportunity to learn from the United States by creating a distinctive corporate culture and type of market economy in which employee ownership and equity help to create entrepreneurial and dynamic companies which are inclusive and socially responsible.
- Employee ownership could also play a useful role in new individualised savings plans to help employees save for retraining, self-employment and retirement.
- Equity pay will play a vital role in creating a successor to the traditional and outdated 'wage-effort' bargain.
- Tax reliefs for Esops should be focused on promoting their role in small and medium sized businesses to make sure more of these companies are sold to their employees when the founder retires.
- The DTI should create an Employee Ownership Development Unit to work with small companies in particular and to promote the use of equity pay in networks of companies in younger, emerging industries such as biotechnology and genetics.
- The government should promote a stock options for all culture in which all employees have an opportunity to benefit from the wealth that their ideas and knowledge has helped to create.
- Employees should be given tax incentives to take up to 20 per cent of their pay in the form of equity.
- A new wider share ownership culture should be promoted by encouraging the use of stock-options to underpin corporate rela-

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tionships with suppliers and partners as well as the community at large and even schools.
- The government should promote the use of wider share ownership in further privatisations. We recommend it create consumer owned health services and examine the possibility of employee buyouts at some Universities.

Four fundamental questions provide the starting point for a new policy approach to employee ownership and equity pay.

What kind of market economy do we want ?

A market economy can be organised in many different ways. Britain has yet to develop its own successful, distinctive model. Critics of individualistic, laissez-faire policies praise the long-termism of the regulated economies of Germany and Japan. Yet these centralised, industrialised economies are unlikely to be good models for a UK economy which is service and software based, entrepreneurial and decentralised. A far more promising model is California, which is strong in the knowledge intensive industries which will be the dynamos of growth in the next century. Employee ownership and equity pay both play a vital role in these industries.

What kinds of company do we want?

We want companies which are dynamic and entrepreneurial, and yet socially responsible and inclusive. The best way to include a wide range of stakeholder interests within a company is to adapt the existing structure of shareholder rights, not to replace it. Spreading ownership, in part through equity pay schemes, will be the most effective way to create responsible and entrepreneurial companies.

How we compensate employees in a world without neatly defined jobs?

Modern business is leaving behind the old fashioned idea of a neatly defined 'job'. The old wage-effort bargain needs to be replaced by something more open and fluid. Knowledge workers recognise that their skills and creativity are the main source of wealth creation: they want a piece of the action. Employers want workers who are committed and creative, able to solve complex problems for consumers and come up

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with new ideas. Unlocking that kind of creativity goes well beyond old fashioned notions of productivity improvement and will require a new kind of compensation culture.

How can individuals feel more secure in an increasingly uncertain world?

Insecurity and anxiety are pervasive features of life. Jobs are rarely for life anymore and the safety net of the post-war welfare state has been weakened. Savings schemes using employee ownership offer a new approach to individualised savings which could fund continuing education and training, small business creation and retirement income.

A fresh push to deepen the roots of employee ownership in the UK needs to learn from US successes with employee ownership as well as from the shortcomings of past policies in the UK. A new equity ownership policy should promote:

- entrepreneurial employee ownership so that more new companies are employee owned
- equity pay schemes which allow employees to be paid in part with shares
- employee ownership in succession planning in the small business sector, to make sure more retiring owners sell their companies to their employees
- the use of employee ownership to create more participatory management and reform corporate governance.

Different kinds of employee ownership schemes can all play a role meeting these four objectives.

Esops

In Britain the most common exit route for a retiring owner of a private company is either to liquidate the company or to sell it to a larger competitor. This often reduces competition, eliminates independent, local producers and creates unnecessary upheaval in the economy as staff are laid off. Esops could play a much larger role as a succession tool for small business. We recommend several measures:

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- Reduce tax reliefs on executive only share schemes to create a new tax relief for employees borrowing to raise funds for a succession Esop in companies with fewer than 100 employees.
- An owner selling shares to an Esop gets tax relief on the transaction. These reliefs should be targeted on the small business sector to make them more effective.
- Create an Employee Ownership Development Unit within the DTI to promote the use of Esops among small companies planning their succession to give them access to know-how and services.

An individualised savings plan

One of the fastest growing and most flexible forms of employee ownership in the United States is the 401K plan. We recommend a similar plan, called a Individualised Savings Plan, for the UK which has several innovations:

- Employees should be able to contribute up to 15 per cent of pre-tax earnings into an Individualised Savings Plan.
- The employer contribution to an Individualised Savings Plan should be limited to 6 per cent of salary and should be tax deductible.
- The employee should be offered at least six investment options, each with a differing degree of risk. One of these options could be employer stock, but there should be a limit on how much an employee has to invest in employer stock, for example, the first £1,500 of the fund.
- The employee should be able to draw a sum from the fund every seven years to pay for a designated training or education scheme. The Individualised Savings Plan should be the basis for a lifelong learning account.
- First time home buyers should be able to use the fund as collateral for a mortgage.
- An employee should be able to rollover a portion of the fund into a small business venture: the Individualised Savings Plan could be the basis for a move into self-employment in mid-career.

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- The fund's main purpose should be to finance retirement income. It should be handled by a registered financial adviser appointed by the employee with the company's approval.

Equity pay and stock options for all

Equity pay schemes in which employees receive a large portion of their total compensation in the form of stock options, share bonuses and share purchases at discounted prices is the currency of the new knowledge based industries. If Britain is to create an environment favourable to the growth of these industries, it needs to facilitate the spread of equity pay schemes.

- Equity pay schemes should be open to all employees not just executives. The rallying cry for these schemes should be 'Stock options for all'.
- The DTI should work with the Association of British Insurers and other interested parties to make it easier for small companies to grant share options. British biotechnology companies recently had to lobby the ABI for the right to offer larger options to recruit highly paid marketing executives from larger companies. There is no such constraint in the United States.
- The government should examine the case for a tax relief to encourage equity based pay schemes for non-executives. Tax concessions would apply only to staff who are not executives and who take more than 20 per cent of their compensation in the form of shares, share options or share purchase rights. The policy should create a 'stock options for all' culture, in which any employee can take part in a stock option scheme.
- A simpler but more radical measure would be to amend employment law to require an employer to give new all employees the choice of taking part of their pay – for instance between 5 and 10 per cent – in the form of stock options. For this scheme to apply to subsidiaries of large companies, reliefs would have to apply to so-called phantom share options which can be tailored more closely to the performance of unquoted divisions of publicly quoted companies.

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The new wider share ownership

The impulse behind the 1980s ideas of wider share ownership and popular capitalism – that everyone should have a stake in the economy – is still appealing. A new policy should put wider share ownership on a different footing by linking it to reforms in corporate governance.

Stock options could be used to underpin relationships between the company and its stakeholders. This would give them a say over policy and the opportunity to benefit from the wealth they help to create. This could involve policies to:

- Encourage the use of stock options to recognise employees who carry out charity and community work.
- Provide tax relief for School Stock Option Plans to underpin corporate links with the education system. For instance, a large company with a strong presence in a particular area might grant long-term stock options to local schools from which the company gets a large part of its workforce. The options might only be exerciseable if the school improves its performance in basic tests of literacy and numeracy.
- Provide tax relief for Community Stock Option Schemes. A company with a strong presence in a locality could grant stock options to community groups – residents groups, the local council, churches and local social entrepreneurs. These options might be tied to performance targets in terms of job creation or crime reduction which would improve the environment around the company. It would be a way for a company to make a joint investment in the area with other organisations in the community.
- Allow Consumer Stock Option Plans. Leading companies are increasingly using loyalty schemes to underpin so-called 'relationship marketing'. Loyalty cards and frequent flyer Air Miles schemes are almost another form of currency. Stock options could play a role in loyalty schemes by giving customers a chance to benefit from the wealth their buying power creates. Clearly such consumer loyalty schemes should take account of possible competition policy concerns.

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- Promote Partnership Share Option Plans. Companies are increasingly interdependent as part of complex and extended supplier networks. Reciprocal share options would be one way to underpin these networks.

Entrepreneurial employee ownership

One of the strengths of employee ownership in the United States is its entrepreneurial component. This is largely lacking in the UK. The government could take several measures to correct that shortcoming.

- A first step would be to relax laws governing the creation of partnerships. Partners in designated professions can get tax relief on their borrowing to buy a stake in the partnership. These concessions are not available to ordinary employees. This relief targeted at the professions should be extended to all employees who wish to invest in a partnership.
- An Employee Ownership Development Unit at the DTI should focus on creating self-sustaining cultures of employee ownership and equity pay among networks of companies in the same field. This would help to promote equity pay as the norm in some emerging sectors of the economy such as biotechnology and genetics.

Privatisation

The privatisation programme created millions of new employee shareholders. For many it was a short-lived experience. Yet there is still scope to promote lasting employee ownership through a privatisation programme designed to create a more diverse and innovative public sector. Many of the state's activities are akin to the people-based, information processing, service businesses in which employee ownership has flourished in the private sector.

There are opportunities to create employee owned services in education and welfare provision, as well as in civil aviation and even perhaps the police. We make two recommendations below, in part to illustrate the potential for employee ownership in the new public sector.

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- *A University* is a classic 'people business'. Apart from a few physical assets such as playing fields and halls of residence, which universities are not necessarily skilled at running, the main assets of a university are human and intellectual. A university's brand and reputation is built upon the quality of its teaching and research. In its response to the review of higher education by Sir Ron Dearing, the government should examine the possibility of allowing universities to become at least partially owned by their employees and funded by Esops.
- *Health.* One way to create a stakeowner health service would be to create Consumer Share Ownership Schemes, which would allow patients more of a say over how the profits of a health practice should be used. One model for direct ownership of health services has been developed at the Bromley-By-Bow centre in London's East End, where members of a community centre have set up a development trust which has raised money to fund a new health centre. Through their votes as members of the development trust, the patients have a say over how the centre's profits are used. This is one example of how wider ownership could be used to create a consumer owned health service.

Conclusions

While the individualistic, free-market policies of wider share ownership and popular capitalism in the 1980s have passed their peak, the case for employee ownership has not. On the contrary, employee ownership and equity pay can play a central role in creating a distinctive and successful market economy in Britain, as well as opening up opportunities to reform the welfare system, modernise the employment contract and change the way companies are governed.

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Appendix one. A basic guide to employee ownership schemes

The employee share ownership plan

The Esop was created in the United States in the late 1950s by Louis O Kelso. Under an Esop, an employee trust buys shares in the company for its employees. The trust's purchases of the shares are usually, but not always, funded by a contribution from the company's profits. In a leveraged Esop the trust takes out a loan, usually from a bank but sometimes from the company itself, to buy a block of shares for the employees. The loan is paid off over time as the company makes contributions to the trust, usually from its profits or retained earnings. As the loan is paid off, the trust distributes the shares to employees. In a non-leveraged Esop, the trust buys shares with money from the company, without having to borrow. An Esop is governed by a board of trustees which can have an influence over strategic issues, such as acquisitions and mergers.

British Esops come in two legal forms. The first are so-called 'case law' Esops, created in the 1980s by lawyers working with companies and ratified on a case-by-case basis by the Inland Revenue. Usually, an employee benefit trust is established to buy equity on behalf of employees using a bank loan, a gift from the company in the form of a profit share or company loan.

During the 1980s, the companies that developed these case law Esops became concerned that there was no statutory underpinning for the tax reliefs granted to them. So in 1990 the government created a statutory Esop know as a Quest (Qualifying Employee Share Trust). The Quest offers several tax advantages, such as providing capital gains tax relief for owners of companies that sell to an Esop. Statutory Esops can get access to these tax reliefs only if they pass all their equity to their employees within twenty years and if 50 per cent of the trustees, excluding a statutory independent trustee, are employees elected by the workforce.

In the US Esops attract a range of tax concessions. The main concession is to the owner of a closely held private company who does not have to pay capital gains tax on the sale of their shares as long as they sell to an Esop. In addition, US Esops have the following tax advantages:

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corporate contributions to an Esop are tax deductible up to a limit of 25 per cent of total payroll costs; dividends paid by a normal corporation are not tax deductible but they are for an Esop; lending institutions have been allowed to deduct from their tax bill 50 per cent of the income they earn on a loan to an Esop providing the plan meets certain conditions such as owning more than 50 per cent of the stock. Typically the lenders passed on some of the savings to the Esop in the form of lower interest rates. However, this tax concession for banks has been recently abolished for new Esops.

Share purchase plans

These schemes allow employees to buy shares in the company directly as individuals and usually at a discount. A corporation is allowed to sell shares to its employees at 85 per cent of the prevailing market price. This is akin to the British SAYE scheme.

Profit sharing linked schemes

In these schemes employees are paid a profit sharing bonus in the form of company shares. In the UK these Approved Deferred Share Trust schemes were created by the last Labour government in 1978. These are known as the Free Share Schemes. They are among the most popular forms of employee ownership in the UK.

Share option plans

A share option is a contract between an employee and their company which gives the employee the right to buy shares in the future at a price set when the options are granted. For example, an employee might be granted an option in 1997 to buy shares two years later at £5. If by 1999 the share price has risen to £10 the employee would be able to buy the shares at the option price, £5, and sell them at the market price, making a profit of £5 per share. Usually it takes time for the options to be fully vested with an employee, that is, to become their property. For instance, an employee may be granted 100 share options in 1997 but they may only vest at the rate of 33 a year. The employee would then be given two to ten years to exercise the options by buying and selling the shares.

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Share bonus plans

In these schemes shares are given to employees as a bonus.

Share appreciation rights

These are usually performance bonuses akin to share options. The company agrees to pay the employee a sum equivalent to the rise in the company's share price over a period. This allows the company to avoid having to issue new shares for the options or buying shares on the open market.

Phantom stock and quasi stock

Sometimes companies cannot use shares to reward employees. In this case they can award the cash equivalent to the value of the shares. These schemes are particularly relevant to large, multi-division companies, where only the overall holding company has a quoted share price. Rather than award stock options linked to the overall share price, the company could grant phantom options linked to a notional share price for subsidiary or division.

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Appendix two. The strengths and weaknesses of employee ownership

Collective vs Individual

In some employee ownership schemes, shares are owned jointly by the employees through an employee trust. This is the approach taken by the John Lewis partnership. Individual employees have no right to dispose of the shares. In other schemes – stock purchase plans for example – the employee owns the shares and can decide what to do with them. An Esop is usually an intermediate approach. The shares are purchased by a share trust on behalf of the employees and usually distributed to individual accounts.

Direct vs Indirect

When shares are owned on an employee's behalf by a trust, employee ownership is indirect. Share purchase plans and share bonus schemes are direct: the individual has control over the shares. The cost of indirect forms of ownership is that it is arms length: employees often feel little direct sense of ownership. The cost of more direct forms of shareholding is that employees are free to sell their shares, sometimes to outside investors. This can lead to a dilution of the employee's stake.

Immediate vs Delayed

Some schemes give employees immediate ownership over shares. For instance, a share bonus programme allows an employee to sell the shares immediately. However in many schemes employees have to wait before they exercise control over the shares they have been granted. In most Esops employees have shares vested in their accounts over five to ten years. They can sell the shares only when they leave the company or retire. If they leave before their account is fully vested, they can only realise part of their notional holding. Many share option schemes are linked to a vesting schedule to help to tie employees to a company.

Passive vs Active

A criticism made against Esops and bonus schemes is that they are relatively passive forms of ownership. An employee does not have to make a decision to purchase shares, they are bought for him and distributed

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to his account by the employer or by an employee trust. If an employee chooses to buy shares this is a decision to invest in the company. If the shares are given to the employee by a trust they are more like an entitlement or an employee benefit.

Open vs Selective

All employee share schemes have eligibility criteria that might exclude some employees. For instance most employees can only join an Esop if they work more than a certain number of hours in a year. Many share option schemes and bonus plans in both the UK and the United States are designed as incentives only for top executives or skilled staff who are difficult to recruit and retain. However most Esops, stock purchase plans and British SAYE option schemes are open to all employees.

Selling in vs Selling out

An important distinguishing feature of employee ownership schemes is how employees are allowed to dispose of their shares. In most share schemes in publicly quoted companies employees are allowed to sell their shares in an open market. However employee owned companies and private companies often find it difficult to create a liquid market for their shares. If an employee owned company allows employee owners to sellout to external investors, for instance through a stock market flotation, employee ownership will be diluted and the company may lose one of its most distinctive characteristics. But employees must be able to realise the value of their shareholdings, otherwise the notion of ownership is meaningless. Employee owned companies often have to create an internal market for their shares. This can be helpful in providing shares for new employees but the company may have to take on potentially large 'repurchase obligations' to buy back shares from departing employees. Also, internal stock markets are complicated to run as it is often difficult to match supply with demand. In many Esops, the employee owners can only sell their shares when they retire. If a cohort of long serving employees with large holdings retires in the same year, the Esop will have to buy back a large number of shares.

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Appendix three. The economic evidence

Advocates of employee ownership argue that employee owned companies should perform better than non-employee owned companies because when employees become owners they have more of a stake in the success of the company. That changes their attitudes and makes them more cooperative and productive which in turn makes the corporation more profitable. However, US research into employee share ownership has found that this instrumental model is too simplistic. Workers' attitudes towards their company rarely change significantly simply by becoming shareholders. Employee ownership is beneficial only when it is combined with a more participatory approach to management. The studies summarised below mainly examined the impact of Esops on measurable aspects of performance such as productivity, sales and profitability. However, several also looked at the use of self-directed team working, quality circles, suggestion schemes and employee advisory groups to gauge the impact of participatory management. This review is substantially drawn from Michael Quarrey and Corey Rosen's *Employee ownership and corporate performance* published by the US National Centre for Employee Ownership in Oakland, California.

Michael Quarrey: employee ownership and corporate performance, 1986

This study compared the performance of 45 employee owned companies five years before and five years after they became employee owned. Each company was compared with five close competitors for sales and employment. Quarrey found that employee owned companies did better than their competitors before becoming employee owned and did better still after becoming employee owned. Sales growth was 1.89 per cent higher than competitors before the employee ownership plan but 5.3 per cent higher afterwards. Employment growth was 1.21 per cent higher before the plan, but 5.05 per cent higher afterwards. Quarrey isolated those companies with participatory management techniques and found their performance improved by between 8 and 11 per cent after the plans were introduced.

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Michael Conte: employee stock ownership in public companies, 1989

This small survey of eighteen Esops and 27 matched companies found that Esops in large companies had no measurable effect on performance. Esops in large companies typically own between 5 and 15 per cent of the company and they are usually instituted by the corporate finance department to reduce taxes or to help ward off a takeover threat. A second study in 1992 on the stock price performance of public companies with significant employee ownership found that a stock index for companies with employee ownership of more than 10 per cent consistently outperformed other stock indices. Setting all the indices at 100 in 1992, the employee owned index had risen to 131 by the end of the third quarter of 1994, compared with the Dow Jones at 118 and the S&P at 115.

Gorm Winther et al : studies on employee ownership, 1993

This study looked at 28 companies for three years before and after becoming an Esop. They were compared with 112 non-Esop firms. This is a small sample but the results were in line with Quarrey's 1986 survey. Winther found that employee ownership companies had a 3.8 per cent improvement in employment growth after the Esop. In participative, employee owned companies the gain was 10.5 per cent. In ordinary Esops, sales growth declined after employee ownership was introduced, but in participative, employee owned companies sales grew by 6 per cent a year. The participative Esop companies also performed better than companies which had participatory management but were not employee owned.

Northeast Ohio Employee Ownership Centre: study of employee ownership in Ohio, 1993

This survey of all Esop companies in Ohio found that 41 per cent of employee owned companies had increased employment, 22 per cent had cut it and 37 per cent had kept it level since 1986. Compared with their peers, the employee owned companies were doing better than 49 per cent, as well as 50 per cent and worse than 1 per cent. The survey found that employee owned companies were far more likely to have introduced participatory management techniques. All employee owned companies said they shared financial information with employ-

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ees. The incidence of self-directed teams and joint and problem solving groups had more than doubled in employee owned companies.

Donald Collat: public company Esops and corporate performance, 1995

Collat examined the role of Esops in takeovers by studying 91 companies that created Esops between 1988 and 1990. Fifteen had set up their plans in response to the threat of hostile takeovers. The study found that an Esop might be an effective device to ward off a takeover but it is unlikely to improve performance and may in fact worsen it. Collat found that Esop companies which were not threatened by a takeover performed 2.1 per cent better than the industry norm. But companies which set up Esops to ward off a takeover performed worse than their industry norms.

Michael Conte and Rama Jamapani: financial returns of Esops, 1995

This study examined rates of return in employee owned companies compared to diversified employee benefit plans between 1981 and 1990. It compared data for more than 80,000 diversified benefit plans with financial information from more than 4,000 employee owned companies. The Esops tended to yield higher returns than diversified savings plans, but Conte and Jamapani estimated that the higher returns did not offset the higher risk of investing in one's own employer. Once the risk of non-diversification was factored in, they estimated the returns from leveraged private Esops were 4.24 per cent lower than diversified plans. Overall, private Esops did 2.4 per cent worse as an investment. However the study also showed that only 0.8 per cent of all the Esops that terminated in the ten years covered by the study did so because the company went bankrupt. Most Esops ended because the company was taken over or because tax changes made it less attractive. The study suggests that the value of private Esop companies might be reduced by taking on high levels of debt and by repurchase obligations to departing employees. It also suggests that Esops should not serve as the main pension for employees.

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Mary Ducy et al: 'a re-examination of the effects of Esops on the operating performance of publicly traded companies', 1996

This examined the financial performance of 75 quoted companies of which at least 10 per cent is owned by an Esop, comparing cash flow and market value three years before and after the companies introduced their Esops. The study found that cash flow relative to sales, employees and market value declined by between 0.2 per cent and 2.1 per cent. It found little evidence that publicly quoted companies tried to create a participatory culture to accompany the Esop.

Conclusions

Three general conclusions can be drawn from this review of research into employee ownership.

- When employee ownership is combined with participatory management techniques such as self-directed work teams they can transform a company and dramatically improve performance. But on their own they have little impact.
- In some circumstances employee ownership can be detrimental to economic performance. Esops seem to have little impact in large publicly quoted companies and are often associated with deteriorating performance when they are used as an anti-takeover device.
- It would be unwise for employee ownership to be used as a primary form of savings for employees because investments in employee owned stock are often riskier than diversified holdings.

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Appendix four. Case studies

Science Applications International Corporation
Location: San Diego, California headquarters
Business field: Scientific research
Type of scheme: Esop and variety of equity pay and profit sharing plans
Number of employees: 2,500

History
Science Applications International was set up by five scientists in San Diego in 1969 with a $150,000 research contract from the US Department of Defence. It its first year it had sales of $350,000. Last year Saic had sales of about $2.5 billion and 25,000 employees. One of its founders, Dr Robert Beyster, recognised that it was impossible to control scientific inquiry and that scientific knowledge was largely in the heads of scientists. He set out to create an environment in which scientists could thrive and decided that ownership should be given to those who create knowledge. Dr Beyster owns less than 2 per cent of the company.

Employees have several opportunities to become owners and to take part of their pay in equity through stock bonus, stock purchase and profit sharing programmes. Most of the employee owners are better paid staff. In 1991, officers and directors owned 26.3 per cent of the company, other employees owned 19.3 per cent, outsiders (primarily retirees and consultants) owned 11.7 per cent, current consultants owned 2.7 per cent and various retirement plans, including an Esop, owned 40 per cent. About 52 per cent of employees owned stock in the company by the early 1990s.

The company sets individual goals for stock ownership as a proportion of salary so that by the time an employee is a senior executive they should own stock worth about nine times their annual salary. A senior manager is expected to own stock worth six times their salary and the top 10 per cent of employees are expected to own stock twice the value of their annual salary. Most scientific staff are expected to own stock worth their annual salary after five years with the company.

Saic says it wants to use its equity pay schemes, which often have vesting schedules of about six years, to glue employees to the organi-

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sation, to motivate them, to reward them according to merit and to fuel corporate growth. Saic runs several non-wage compensation schemes of which most are equity based. It also operates a highly sophisticated internal stock market to allow employees to trade their shares.

Profit sharing. The benefits of the plan vest over six years. Until 1982 it was the largest component of non-salary compensation. The proceeds of the profit sharing plan are invested in a range of schemes by external institutions.

Esop. A stock bonus plan created in 1974 was converted into an Esop in 1985. The company has contributed about 2 per cent of its payroll costs to the Esop, which has primarily invested in Saic stock.

Performance based equity pay. The company runs a range of schemes which began modestly in 1975. Since 1991, these schemes have become the largest non-wage component of compensation.

Each division, group and team within the company is awarded a pool of stock and options each year to award to employees on merit. The size of the pool is determined in part by past performance. Senior executives decide how much stock should be allocated for bonuses to each division and division chiefs decide how much to allocate to each team. Team leaders decide how much each employee in their team should receive. These schemes include:

- Stock bonuses, which are outright grants to the employee and can be traded on the internal market.
- Vesting stock bonuses, which become an employee's gradually over four years. These bonuses are forfeited on leaving the company.
- Stock options, which are fully vested over five years and exerciseable over a similar time span.
- Stock purchase rights are granted only as a performance award. Since 1975, employees have been allowed to purchase stock outright if approved by senior executives. The stock can be bought

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during quarterly trades managed by the company's wholly owned broker, Bull Inc.

Employees can join a regular stock purchase plan by withholding between 3 and 10 per cent of their salary to buy shares which are offered at a 5 per cent discount. Employees can contribute up to 10 per cent of their pre-tax salary to a 401K retirement fund, with the first $2,000 matched by a 30 per cent contribution from the company. Additional amounts are matched with a company contribution of 15 per cent. The first $2,000 in an employee account is automatically invested in Saic stock. The employee can choose to invest the remainder in one of seven funds.

Bull Inc, the internal stock broker, trades in Saic stock once a quarter. About 10 per cent of the workforce take part in these trades. Employees are told what price the shares will be sold at and, after reviewing all requests to buy stock, formal offers to buy are made to an approved list of employees. Employees cannot buy and sell in the same quarter. The Esop and the retirement plan acquire their stock through these trades.

Saic's employee ownership system does not mean it is a perfect, employee friendly company. Internal surveys in the late 1980s found that many employees thought the company prized competitiveness rather than cooperation. There was widespread disillusion with the paucity of training. The company faces significant challenges. Dr Beyster, its guiding force, is 73 years old and managing an effective succession will be difficult. The acquisition of Bell Corp, a telecommunication group, will involve a difficult merger of two strong corporate cultures. Saic took on its first major long-term debt to fund the acquisition, which will make its financial performance less impressive. Its equity pay system has been successful because its share price has never fallen. As it enters more commercial markets its finances, including those of its employee owners, may become more volatile. Yet by any standards Saic is a remarkable company which has been very successful by traditional financial standards by using completely non-traditional methods of pay and ownership.

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Starbucks Coffee Company
Location: Founded in Seattle
Business field: Speciality coffee retailer
Type of scheme: Broad based stock options
Number of employees: 1,500

History
The success of Starbucks, the speciality coffee retailer, shows how equity pay can be applied even to a retailing business with high labour turnover among a mainly part-time workforce. Starbucks was founded in Seattle in 1971. Howard Schultz, its current chief executive, joined the company in 1982 as head of marketing. During a visit to Italy, Schultz was struck by the central role that coffee shops play in Italian social life. He decided to try to create a US version of the Italian coffee shop, selling gourmet coffees. He formed his own company in 1985 and in 1987 he bought Starbucks for $3.8 million. Starbucks has grown exponentially since 1991. In 1987, it had just eleven stores and 100 partners. Now it has more than 800 stores and 15,000 partners. By the millennium it aims to have 2,000 stores. Sales in the fiscal year 1995 were $465.2 million

Schultz realised that his ambition to create an upmarket coffee house depended on delivering high standards of service by employing young, often part-time, staff. He decided that to achieve this he had to encourage them to participate in the company's equity by treating them as partners rather than as employees. Starbucks employees, called partners, receive a significant benefits package by the standards of the retailing industry. In addition to stock ownership, the package includes health, dental and vision insurance, as well as career counselling, paid vacations and product discounts. The company also runs an extensive training programme and holds quarterly open forums for partners as well as 'connection' meetings at which consumers can express their views.

Starbucks introduced its stock option plan in 1991 and a stock purchase plan in 1995. About half the workforce participate in one or both of these programmes. Stock options are available to any partner who is employed from 1 April till the end of the fiscal year, works at least 500 hours and is still employed when options are distributed in

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January. Partners are awarded options as a proportion of their wage. The target is for each partner to get options worth 10 per cent of their wage in the previous year. The distributions have always been higher than the target due to the company's strong profitability. The options are granted at the stock price at the start of the fiscal year and are fully vested in five years. Any partner can participate in the stock purchase plan after working at least 20 hours per week for 90 days and can purchase stock at a 15 per cent discount through a payroll deduction.

FI Group

Location: Hemel Hempstead
Business field: Software
Type of scheme: Esop linked to individual share option schemes
Number of employees: 1,148

History

A workforce buyout at FI Group in 1991 helped to propel it into a period of strong growth. Employees were encouraged to become owners of the business through two trusts – a qualified employee share ownership trust and a FI Group shareholders' trust – as well as direct shareholdings. Through these trust, the employees owned about 54 per cent of the company prior to flotation. By the mid 1990s, it became clear that the group needed additional capital to expand and that the best way to achieve this was through a stock market listing. However, the senior executives – some of whom stood to become paper millionaires through the flotation – also thought it was essential that the group should maintain its employee owned structure and culture. A taskforce set up by the board recommended combining the flotation with the introduction of two employee share schemes.

With the flotation in April 1996, FI Group introduced a profit sharing scheme, which is paid in the form of shares, and a linked share option scheme. Both schemes are open to all employees. The company also wanted employee ownership schemes which could provide employees with a meaningful stake that could be built up as the company hit performance targets. The profit sharing scheme gives employees shares worth up to 10 per cent of their salary or £8,000 depending on corporate performance. An employee can take cash for

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half the value of the shares and must pledge to hold on to the remainder for three years. The stock options cannot be exercised for three years and in addition the employee has to pledge to keep hold of a matching amount of FI Group stock for that period. Options can only be exercised if FI Group's earnings per share rise 2 per cent points above the retail price index.

All employees participated in the first profit sharing scheme distribution in July 1996 and 89 per cent of those participating elected to take shares which they must hold until 1999. About half the workforce took part in the first share option scheme offering in August 1996. The flotation has provided FI Group with the capital it needed without obviously endangering its employee ownership culture, which has been strengthened by the introduction of new individualised and direct equity pay schemes linked to performance.

CMG

Location: London
Business field: Computer services
Type of scheme: Share purchase schemes
Number of employees: approximately 2,000

History

Cornelius Stutterheim, the chairman of CMG, sums up his corporate philosophy thus: 'Our most important asset is our most mobile asset and it is not recorded on our balance sheet: it's our people ... The awareness of that means you have to treat people in the way that you would like to be treated yourself.'

In the early days, CMG styled itself as a progressive but paternalistic company. It promoted an open culture of reward according to merit but most of the share capital was held by the founders until the mid 1980s. When the founders decided to sell their stakes the current management took the opportunity to create a broadly based employee ownership culture through an employee buyout.

Employee ownership is combined with a free flow of information and open decision making. For instance, all personnel files are open, including salaries and bonuses. If someone wants to challenge another employee's salary, executives are obliged to respond to the query.

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Stutterheim believes an open flow of information is vital to create an environment in which people take responsibility for their actions with minimal interference from executives. He explained: 'People will tell you the truth and argue with you and hopefully they will also correct mistakes of their own accord. If people know why they are doing things they will do things better. If they are told the results of their actions that is better still. But ideally they should also have a stake in the outcome through employee ownership as well. Then the results are more rewarding still.' As well as being open, the company prides itself on being entrepreneurial and meritocratic. Pay is set by an annual open review of employee performance. Managers are demoted as well as promoted.

In October 1995, when the company was listed on the stock market, about 1,000 directors and employees and about 850 ex-employees and their relatives, together with employee trusts and pension schemes owned about 90 per cent of the company. The shareholding of current employees has been reduced to about 30 per cent. One of the reasons for the listing was to create an external market for employee shareholders to sell their holdings. CMG had run an annual, internal stock market but it proved too illiquid to match all buyers and sellers.

The top 70 executives are required to own CMG shares worth one year's salary. The next 170 managers are required to hold shares worth six month's salary. The company runs a share option scheme open to all employees which is funded by payroll deductions. This share option scheme is extremely popular. In the last offering almost 60 per cent of employees elected to take part. One indication of CMG's success has been its share price, which has risen from 290p per share at the time of the flotation to about 1,175p in May 1997. Pre-tax profits rose from £11.2 million in 1993 to £20.1 million in 1995 on revenues that grew from £128 million to £196 million.

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McKay Nurseries
Location: Waterloo, Wisconsin
Business field: Nursery, landscape gardening
Type of scheme: Widespread employee ownership through Esop
Number of employees: About 100, mainly migrant, labourers

History
McKay was founded in 1897 and prides itself on continuity in its values and management style. The founder, William G McKay, had a strong business philosophy: profit should be re-invested; promises should be kept; product quality should exceed the offer made to the customer. McKay retired in 1957 to be replaced by Karl Jeninger. In 1961, he introduced the first profit sharing plan in the nursery industry which helped to underpin a culture of partnership at the company. By the late 1970s the leading executives and shareholders were nearing retirement. The prospect of selling the company or bringing in an outside investor did not appeal to the top management and so the company decided to form an Esop which was set up in 1984. It was funded in part from funds built up in profit sharing accounts as well as bank borrowing. McKay terminated a defined benefit pension plan and used funds from this to invest in the Esop. The company is now entirely owned through the Esop.

The company's president, Griff Mason, says employee ownership has been the best way to build a lasting relationship with a very fluid workforce. More than half McKay's workforce are seasonal, migrant Mexican labourers from Texas. Most are employed for only three months a year. About 90 per cent of the workforce are members of the Esop. Many have been with McKay for fifteen years. All seasonal employees qualify to join the Esop as long as they have worked more than 1,000 hours. There are about 62 seasonal employee owners. The company also works with about 60 partners as independent sales distributors who are on a profit sharing plan which helps to build their relationship with the company. The average contribution to the Esop each year by the company is between 20 per cent and 25 per cent of the salary bill.

The company has an advisory council of sales representatives at which managers are invited as guests to answer questions. Each month senior executives talk in-depth with a group of between nine and

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twelve employees to build trust. If a committee meets it has to publish its minutes which are put in every payroll envelope. The pay structure is entirely merit based, depending on the recommendation of team leaders. First time home buyers can use their Esop account as collateral for a mortgage.

Mayville Die and Tool

Location: Mayville, Wisconsin.
Business field: Diemaker for large manufacturing companies
Type of scheme: Esop
Number of employees: 30

History

Six years ago Mayville Die and Tool had lost money for each of the previous four years. It had large debts, its key customers in the defence and aerospace industries were experiencing a steep downturn and there wasn't a computer in the plant. The only consistent feature of Mayville's employment policy was recurring layoffs. The owners of the company decided to sell and, after a planned management buyout failed, an Esop supported by the Machinist's Union won through.

The purchase price was $1.6 million. The workforce had to raise 10 per cent of the asking price, so each was asked to put in $5,000. Only with that pledge was the government's Small Business Administration prepared to back the deal. The Machinists' Union guaranteed the bank loan which got the deal going and the Wisconsin Department of Development also put money into the purchase. The workers raised a loan of $1.5 million, with $100,000 put in directly by the workforce. The original loan had a seven year life but since the creation of the Esop, the company has done so well it plans to pay it off after five years.

In 1997, the average employee had $4,800 in his Esop account, which is 40 per cent vested over 5 years. The workforce took a 12 per cent cut in benefits to underpin the deal but they have made good those cuts with the stock distributed from the Esop and yearly bonuses they have earned since the plan started. The early days after the Esop was created were hair-raising. There was no job in the shop for two months. Since then employment has risen from 20 to 30. In year one,

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sales were $1.6 million. In 1997, sales were projected to be $3 million. The Esop has allowed Mayville to invest in new machinery which has improved productivity and quality by 50 per cent. It has met an on-time delivery pledge, whereas in the past it used to be six weeks late on most jobs. There is virtually no management hierarchy and no foremen and even financial administration is outsourced.

National Forge

Location: Urban, rural Pennsylvania.
Business field: Engineered steel products
Type of scheme: Esop
Number of employees: 700

History

National Forge, founded in 1915, has sales of about $90 million a year. It is based in Urban, a small town on the edge of the Appalachians. It is a closed community – many workers at National Forge are the third generation of their family to work for the company. It is a fully integrated manufacturing plant which makes engineered steel products such as crankshafts for railway locomotives, tubes for periscopes and shell casings. In 1993, owner Robert O Wilder announced he wanted to sell. He had been mainly an absentee owner. Management at the plant had been lax and absenteeism was at high levels. In the spring of 1994 Wilder said he would give employees the first shot at a buyout. Roger Clarke, the new president, set about creating a cooperative approach to the buyout by bringing together employees and managers in a company plagued by high levels of distrust and hostility. It took six months before the board was capable of the cooperation needed to push forward the plan in detail. They decided on a leveraged Esop which included a five year labour contract and a 10 per cent benefits sacrifice (1 per cent wages and 9 per cent other benefits) followed by five year wage freeze. About 80 per cent of workforce voted in favour of the plan and the deal was signed in June 1995.

Every employee went to a day long Esop training session. More disciplined work rules were introduced and a new performance appraisal system for salaries was introduced. Each employee can earn 100 points a year. In five years 500 points are available. The only way to get a wage

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increase when the wage freeze comes into force in 1999 will be by earning points in the interim. Clarke introduced written goals for top management, linked to performance based pay. He is trying to drive decision making down into the organisation but is encountering deep hostility from older workers. About nineteen inter-disciplinary teams have been established to reduce errors and improve quality. These are generating cost cutting ideas from operators. On some product lines costs have been cut by 22 per cent just by improvements in tool management and better maintenance.

In June 1996 National Forge's sales were 3 per cent ahead of plan, its operating profit was 5 per cent ahead and pre-tax profit 10 per cent ahead. The company paid cashflow bonuses worth 6 per cent of average pay. In 1997, pre-tax profits are 96 per cent up on the previous year. Much larger cashflow bonuses have been paid. These have more than made up for the benefits sacrificed to get the deal going. At National Forge the Esop has been a route to new management and strategy as well as a more cooperative atmosphere to revitalise a company which had been drifting.

Bureau of National Affairs

Location: Washington DC
Business field: Specialist magazine publisher
Type of scheme: Employee owned company
Number of employees: 2,000 of whom 1,600 are shareholders

History

The Bureau of National Affairs is an unlikely name for a corporate revolutionary but BNA is one of the oldest employee owned companies in the United States. In its time it was as revolutionary as any company recently created in Silicon Valley. Many of the problems it is facing could confront other employee owned companies as they mature.

BNA began life as part of US News and World Report, an entrepreneurial magazine publishing group. The Bureau publishes a range of specialist magazines and newsletters which provide detailed analysis and information from Washington DC, for instance on changing labour regulations, supreme court decisions, patents judgments and environmental regulations. Its newsletters and magazines are hand

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delivered overnight to executives and businesses around the country. It is a subscription business with a 90 per cent renewal rate. For 45 years it has been a very stable business facing little competition. It developed a comfortable employee owned culture. Now it faces growing competition. More information can be distributed electronically now and large international publishers are moving into its market.

BNA is known as a company that dares to be dull. The work atmosphere is sober and subdued. It has 200 employees, many of them specialists. In 1996, it had revenues of $240 million. BNA is employee owned but not an Esop. Ownership is open to any employee who wants to buy stock. Stock is sold twice a year and bought via payroll deductions. Employees lodge offers to buy with an internal broker who buys and sells to create an internal market. About 6,400 shares are made available in two offerings each year. Some employees have got rich. One of the largest shareholders, an aggressive buyer of stock who died recently, was a former staff writer with more than 200,000 shares worth between $6 million and $7 million. Some other shareholders have 100,000 shares worth $3 million. Payroll deduction provides a flow of cash to buy shares from people as they want to sell them back to the broker. Employees can sell shares at any time but they can only buy shares twice a year. The board sets the stock price – currently $28.50 – using a valuation based on earnings, competitive industry data and corporate financial performance. In 50 years, the shares have never gone down in price. But now that the industry is becoming more competitive the outlook is less certain.

BNA senior executives are frank about the costs of employee ownership. The employee benefits at BNA are very good. Employees get a defined benefits pension plan, which after 30 years with the company is worth approximately 35 per cent of salary. Company health insurance is available for retirees, which is very expensive but employee shareholders have insisted it is maintained. However in many ways employee owners are like any other shareholders. In 1997, senior managers started to take a hardline over wage costs which have been rising at twice the rate of the rest of the industry. Employee owners largely accept the case for pay restraint. Employee ownership has kept together a talent base and produced great employee loyalty to the

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company but executives worry that it has made the company less entrepreneurial and more risk averse. The culture of employee ownership needs constant renewal to make it dynamic. BNA's pay structure is highly egalitarian and the company does not offers stock options. But senior executives recognise that this will make it harder for the company to compete with younger electronic publishing companies which are fuelled by equity pay awards.

Other case study companies

California Eastern Labs, based in Silicon Valley, is the exclusive distributor of components made by Japanese electronics group NEC. The company was sold by founder Al White to a leveraged Esop in the early 1980s. All the stock is now distributed to 175 employees. In most years, much of CEL's contributions to the Esop fund go into other investments, not company stock.

Hunter Labs is the story of a disillusioned Esop. Based in Virginia, Hunter Labs makes colour processing equipment. The company became employee owned in 1976. The Esop owns about 40 per cent of the company but the company has made no contributions to the Esop for the past five years. Half the participants in the Esop no longer work for company. The current president, Phil Hunter, says the direct benefits for the company are very limited. The Esop costs a lot in legal and accounting fees and has helped to entrench a complacent culture among the 135 strong workforce. Hunter said: 'The Esop has helped to create a culture of longevity and loyalty but the downside is that people can get too stuck in their ways and complacent … Today, with competitive markets and labour turnover, the long-term relationships implicit in an Esop make less sense than they used to.'

Compass Components is an electronic components maker and distributor based in Fremont, California. Their Esop was created by the departing founder-owner to allow him to realise his stake without breaking up the company. It has had very little impact on corporate governance or management style. Executives say they are disappointed it has had no impact on productivity nor created a more cooperative work atmos-

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phere. Indeed it raised expectations of involvement among the workforce which have been dashed.

Synetics is a Virginia based information technology defence contractor. It created its Esop in 1984 to ease succession. The Esop owns 55 per cent of the company, which has about 150 employees and sales of $20 million. The founder, James Altman,+ says the Esop has great latent power in framing the way that management can behave because it ultimately underpins the legitimacy of the board through its voting strength. He says there is little evidence of the Esop making a difference to employee morale or motivation. Altman is considering stock options and bonuses for managers and staff who are difficult to recruit but warned: 'An Esop can amplify the good but it can also amplify the bad. Whatever outrage people feel in closely held companies about inequalities of earnings it is certain that those feelings of outrage are intensified by having an Esop which generates an expectation that everyone is in it together. That is difficult to square with a culture which gives much larger rewards to managers and key staff.'

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