MANIFESTO SUBMISSION BY JOB OWNERSHIP LIMITED [JOL]

PLEASE NOTE: JOL CHANGED ITS NAME TO EMPLOYEE OWNERSHIP ASSOCIATION IN DECEMBER 2006

The case for growing the UK's employee owned business sector

Introduction

This submission requests the Parties to make a firm commitment in their next Manifesto to achieving a significant growth in the size of the employee owned business sector of the UK economy.

The focus of this submission is on businesses which are wholly or majority owned by their workforce, including management, through trusts or individual shareholdings, or a combination of the two. As the association of employee owned businesses, **JOL** is the voice of employee owned business in the UK, but we also work with enterprises where there is a large and significant minority employee shareholding.

JOL argues in this submission that employee ownership of business in the UK has a formidable record of success, that a growth in the sector will benefit the economy in a number of ways, and that employee ownership of business fits well with the main Parties' policy approach.

It calls on the Parties to tackle a number of barriers to achieving that goal, and makes specific policy recommendations on how the objective can be achieved.

Fit with Parties policy

JOL acknowledges and welcomes the main Parties' long-standing support for wider employee financial participation in the companies they work for, and for actual employee ownership of businesses.

We believe that a commitment to a significant growth in the size of the employee owned business sector fits closely with the main Parties' objectives for business and the economy. Employee ownership of business:

- Reflects the Parties' commitment to a wide expansion in employee <u>financial participation</u>.
- Encourages an <u>entrepreneurial</u> attitude and commitment to business success among employees.
- Encourages the growth of <u>diversity</u> in the corporate sector.
- Exemplifies a constructive <u>partnership</u> approach to employment relations.

- Displays a high degree of corporate social responsibility, with a particularly strong record of building sustainable enterprises that have active community involvement.

- Tends to deploy 'high performance' employment practices that are rightly associated with increased competitiveness.

About JOL

Job Ownership Limited [JOL] is the association of employee owned and trust owned businesses.

Established in 1979, JOL's Member organisations now include major companies like John Lewis Partnership, other long established employee owned businesses such as Scott Bader and Swann-Morton, and small and medium sized enterprises from a wide range of sectors.

Although JOL strongly supports co-operative enterprise, JOL's focus is wider than the accepted definition of so-called 'worker co-ops' – instead centring on businesses that are profit driven, characterised by strong professional management structures, with a variety of direct or indirect ownership models.

In recent years, JOL helped to design the Private Members Bill that became the Employee Share Schemes Act 2002; instigated the Employee Share Alliance in 2001, with the objective of supporting Government legislation introducing the Share Incentive Plan [SIP]; participated in the Special Share Task Force and the HM Treasury Advisory Group that worked with the Inland Revenue to devise the SIP and the enterprise management incentives scheme.

Strengths of the employee owned business sector

Employee owned businesses and companies with a large and significant employee shareholding now account for well over £13 billion in annual turnover. This is no longer an insignificant part of Britain's economy and it is growing because it is an increasingly successful business model.

The critical strengths of the UK's employee owned business sector is that its leading examples:

- Have clear, professional management structures, with strong decision making authority that would be recognisable to any successful plc.

- Aim to make, and do make profits, but simply distribute them differently to non-employee owned businesses.

- Are quite capable of generating significant growth through internally or externally generated investment funds.

- Operate successfully in highly competitive markets, including international markets.

- Are exceptionally well equipped to handle innovation.

- Have a notably strong ability to recruit and retain highly committed, talented staff.

- Tend to have higher productivity than an average of comparable non-employee owned companies.

Economic benefits of the employee owned business sector

The growing number of employee owned businesses are making a disproportionately large contribution to the economy. The strengths which employee owned businesses tend to possess, summarised above, mean the sector provides a rich supply of role models for high performance enterprise, for these reasons:

- Independent research evidence suggests that a combination of widely distributed share ownership and employee participation delivers superior organisational performance, particularly in terms of productivity.

- Employee owned businesses [EOBs] represent some of the most highly developed forms of partnership working, and are a correspondingly more fruitful environment for high performance models of management and employee engagement.

- EOB's have achieved exemplary degrees of corporate social responsibility, including involvement with the communities they operate in, and strong commitments to sustainability.

- The employee owned sector represents a valuable extension to the diversity of corporate ownership models operating successfully in the economy, widening choice for employees, consumers, funders, job seekers, suppliers and purchasers.

- Employee owned business governance is characterised by high levels of integrity, transparency and accountability.

- EOBs offer a valuable additional model of enterprise by distributing responsibility, and encouraging a collective sense of business ownership, commitment to innovation, and workforce-wide awareness of financial imperatives.

- The factors above mean that employee owned intermediaries offer public service providers an attractive alternative source of service supply.

Barriers to wider employee ownership of business

Employee ownership of a business typically happens via a buy-out in either:

- Standard business succession, where the owners choose to sell to such a buy-out; or

- Other business transition situations such as actual or potential company insolvency, where the buy-out is selected as the preferred recovery option.

Although there are a few large employee owned businesses in the UK, which have achieved that status over time, the great majority of transfers to employee ownership affect small or medium sized enterprises [SMEs].

There are two major barriers limiting scope for growth in the employee owned business sector:

- A market failure which centres on awareness of the employee buy-out option in key areas of potential demand: SME company owners and their advisers; and

- Artificial constraints in the tax environment that discriminate against potential employee ownership of business.

The awareness problem

Employee buy-outs [EBOs] offer a sound, practical option for SME owners considering a sale. The EBO option has a number of advantages for prospective sellers:

- First, successive Governments have created a range of tax advantaged schemes, notably the Share Incentive Plan, which make structuring an employee buy-out feasible and rewarding for owner and employees alike.

- Second, selling to the workforce is a way for owners to preserve the integrity and continuity of the business they and the employees have built up, and to acknowledge the contribution of employees by allowing them, collectively, to take on ownership.

- Third, there is a strong case for asserting that employee buy-outs have a better record of sustainability than management buy-outs, so that the enterprise the owner created is more likely to survive.

- Fourth, employee buy-outs are very much less likely than a trade sale to result in closure of premises and production in localities whose communities may have come to rely on them for employment and commerce.

Mounting anecdotal evidence, however, including JOL's experience over two and a half decades, suggests that despite the advantages of selling to an employee buy-out, there is a serious market failure limiting the number of owners who select this option.

This failure amounts to a lack of awareness among company owners about the possibility of an employee buy-out option, let alone its feasibility and relative advantages. Compounding this lack of awareness, and probably the principal cause of it, very few of the business advisers relied on by SME owners appear to recommend or rate an employee buy-out option when asked to assist and advise on a business transfer. Another significant factor in the awareness 'gap' is the absence or 'invisibility' of adequate information about the EBO option in the range of Government and official information channels about business transfer.

Another dimension to this market failure is low awareness of, or lack of confidence in the EBO option among financial institutions. Such institutions may well have serious qualifications about the financial viability of EBOs, but JOL is aware of no reliable evidence that would justify such a judgement. It is more likely that financial institutions, like the advisers SME owners rely on, simply have little or no experience of EBOs, an imperfect understanding of the advantages and 'mechanics', and a misplaced preconception that more traditional options are more financially credible.

Despite all this, JOL's experience is that, once owners become aware of the EBO option and its relative advantages, a significant proportion favour it over the options of an MBO or trade sale.

The conclusion we draw from this is that if the barrier of low awareness was addressed, the number of EBOs would rise sharply – adding to the diversity of business models in the economy, utilizing the tax and share schemes created by Governments with employee financial participation in mind, widening participation in enterprise ownership, and offering a dynamic additional choice to SME owners facing a business transfer challenge.

A tax problem

There is also a tax-related barrier to successful business transfer via an employee buy-out. The decision to revoke the tax relief on company subventions into an employee benefit trust makes the process of an EBO more difficult and viability harder to achieve.

As a general rule, companies can get tax deductions when shares are awarded direct to employees. But the Finance Act 2003 overrides case law and prevents a company from getting a deduction for contributions to an employee benefit trust [EBT] which are used to buy shares held indefinitely in trust. Accounting rule changes may also prevent a company from recognizing an expense for contributions to an employee trust.

The negative effect of this change is to downgrade – wrongly – the importance of a collective shareholding in maintaining any long term employee ownership structure; and to increase the financial challenge on EBOs to find the necessary funding, because less money is needed from external funders if a company's own contribution to its EBT is tax deductible.

There are other tax concerns, including the adverse impact of the "loans to participators" tax regime on loans a company makes to its EBT.

Other barriers

JOL would also like to see action by Government to address other obstacles to a growth in the employee owned business sector.

It is often difficult for potential employee buy-outs to secure finance, or more specifically what is known as 'patient capital'. Banks will often be willing to lend to employee benefit trusts [EBTs], so long as any loan is backed by guarantee and security from the company itself. However, loans from the company are likely to incur a tax penalty on the company, while gifts from the company to the acquiring trust will frequently not be deductible for corporation tax. These factors discourage companies from providing finance for an employees' trust.

With a few exceptions, equity finance in the UK will often be regarded as incompatible with long term employee ownership, because:

- investors will be seeking to realise their investment within a timescale of three to five years, most commonly through arranging a sale of the whole company;

- there is a tendency amongst private equity houses to resist employee share ownership, which they see as too complicated and not the best use of scarce equity.

JOL is also concerned that public procurement procedures can tend to discriminate against workforce bids and bids from newly established employee owned companies. Our forthcoming report, funded by Co-operative Action, on the employee bid to win a contract to run the Dartford River Crossing enterprise argues that the current guidelines, and the interpretation of them by the Government agency concerned, unfairly discriminated against a legitimate workforce bid.

Manifesto policy recommendations

To recognize the value of the employee owned business sector, achieve the benefits of wider employee ownership of business, and remove barriers to its growth, JOL recommends that a future Government should:

1. Make a firm commitment to achieving a significant growth in the size of the employee owned business sector.

2. Initiate a programme of information and guidance about employee ownership and the employee buy-out option through all relevant official channels, in particular the websites of the Small Business Service, Companies House, Business Links, Regional Development Agencies, and the Inland Revenue.

3. Instigate a policy of encouraging companies to fund employee trusts to acquire and retain shares – including allowing a corporation tax deduction for such payments.

4. Work through the Treasury and DTI to increase awareness of employee owned business strengths and benefits among financial institutions; and give active consideration to measures to create new funding facilities for employee buy-outs.

5. Review the Enterprise Act 2002 with a view to creating preferential bidding rights and a tax advantage for employee buy-outs in potential insolvency situations, with the objective of securing local jobs, skills and enterprise.

6. Review public sector purchasing, and procurement guidelines, with the objective of significantly increasing the opportunity to bid, and the share of contracts won by incumbent workforces and the employee owned business sector.

7. Commission research into the extent and characteristics of the UK's employee owned business sector, the principal reasons for its growth, and constraints on further growth.

8. Include representation from the employee owned business sector on the DTI's Small Business Council.

NEW CONTACT DETAIL FOR EMPLOYEE OWNERSHIP ASSOCIATION:
info@employeeownership.co.uk