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A Share of the Spoils: Employee Financial Participation

P Reilly
J Cummings
S Bevan

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Published by:

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Mantell Building
Falmer
Brighton BN1 9RF
UK

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http://www.employment-studies.co.uk

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British Cataloguing-in-Publication Data

A catalogue record for this publication is available from the British Library

ISBN 1-85184-303-5

Printed in Great Britain

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Executive Summary

Employee financial participation schemes have been around for more than a hundred years. They offer the chance for employees to acquire a stake in the ownership of the company for which they work. This is either through some kind of share distribution/ grant of options, or participation in the growing wealth of the company through profit sharing in cash or shares. At various times and in different ways government has encouraged this process by offering tax relief on the money used, or in relation to the shares involved.

Why the interest?

Governments have promoted employee financial participation because it can offer a form of wage control (by limiting payouts to when the organisation is profitable). It can also improve industrial relations and provide better productivity, thereby increasing national competitiveness and allowing employment growth without fuelling inflation. Share schemes can also broaden share ownership and increase employee commitment to the success of the enterprise.

Employers have used employee financial participation as a means to:

- control costs
- take advantage of tax breaks
- attract or retain staff
- encourage a sense of mutuality between employer and employee.

The type of scheme adopted will be influenced by the above reasoning. Organisations wishing to maximise employee participation may prefer share to cash distribution, for example. Other companies will seek out the best tax advantages or find the mechanism that is most cost efficient. But there are other considerations that may come into play: the nature and structure of ownership, the size of the company and management structure. This means that some schemes are regarded as impractical (*eg* because there are no traded shares to be distributed) or too administratively burdensome.

How effective are schemes?

If employers seek to improve business performance or employee commitment to the organisation through employee financial participation, what is the evidence that it is effective?

Several major empirical studies have found a positive association between financial participation and business performance. This would not be surprising, given the growing body of recent research that demonstrates that a positively employee-centred approach is likely to deliver business benefits. There are, however, dissenting voices that have found no positive link between employee financial participation and profits, or only a limited and confused link. The problem in this situation is establishing cause and effect, and the direction of causality. It could be that successful companies are the ones that have the money to invest in employee financial participation, which then supports, not leads further business success. Or, it could be that employee financial participation plays a more leading role. Again though, this could be but one feature of a number of employee-centred aspects of the employment deal. Involvement, participation, and engagement of employees do seem to bring good results. Financial participation may be just part of a 'bundle' of this good practice.

Regarding the effect of employee financial participation on employee attitudes and behaviour, there is evidence that financial participation schemes are well regarded. Moreover, there is evidence from our research that financial participation schemes generate positive attitudes:

- 'it creates a better atmosphere'
- 'it makes people take a greater interest in profits and financial results'
- 'it makes people try to work more effectively so as to help the firm to be successful'.

Moreover, research suggests that some employee financial participation schemes, as well as encouraging a participative style of management, are more likely to lead to better organisational health, seen in lower absenteeism and staff turnover rates, and in an improved employee relations climate.

Problems

Whilst there are clearly benefits to be obtained from employee financial participation, there are also difficulties, as our research identified. For example, a centralised approach to reward, driven by corporate headquarters to meet its objectives, can seem remote from both employees and operational management.

Furthermore, some employee financial participation schemes can produce restricted management thinking if the targets or measures are narrow and short-term. This will encourage managers and employees to concentrate on these issues to the exclusion of other things.

Line managers may also be disinterested if they do not see the contribution of employee financial participation to improving the bottom line, or to increasing efficiency or productivity.

Financial participation may be used as a stick not a carrot. There is evidence that some firms have a history of making payment of shares conditional on 'acceptable behaviour'. On occasion, employers have threatened, or actually withheld, payment depending upon the behaviour of the workforce.

Employees and unions can be opposed because:

- employee financial participation can be seen as discriminatory if sections of the labour force are excluded
- setting up such schemes can give a false impression of employee involvement. Employees can do little to affect the share price or the company's profitability. They are merely

passive recipients of the shares or the money. It is simply a 'windfall'.

- employee financial participation is too often not negotiated with the unions. Rather it is a management-determined policy over which employees have little control.
- such schemes are too open to 'fiddling' by the employer. The payout formula can be changed to lower the size of the award. The size of 'profits' could be redefined using all sorts of adjustments, including the notorious 'extraordinary items'.
- if money is available to support employee financial participation, the same money could be distributed through increases in base pay. Why defer it?
- it puts too much pay at risk. Whilst financial flexibility might help employers adjust the paybill to suit business circumstances, the risk is transferred to the employee.
- employee financial participation also ties an employee too much into the fortunes of the firm. If the company is not successful, the individual risks losing not only a job and a source of income, but their savings as well.

Some of the above problems can be exaggerated or mitigated through the design of the scheme. The process of introduction can be inclusive to bring on board line managers and employee representatives, corporate and operational management. If implementation is done in an open and transparent way, it can eliminate bias and concerns over susceptibility to manipulation.

Prospects for the future

We believe employee financial participation will grow when:

- government encourages it through tax concessions and other signals; and/or
- labour market tightness means that in some sectors cash based profit or share schemes are needed for successful resourcing policies; or
- labour market slackness means that organisations can increase the proportion of variable pay to control costs better.

The current Labour government has set about supporting employee involvement and financial participation. In the

Chancellor's pre-budget speech in November 1998, Gordon Brown pledged to 'double the number of firms in which all employees have the opportunity to own shares'. This is to be achieved by a number of tax breaks in relation to specific share schemes.

In addition, there has been a trend in private sector firms towards more variable or contingent pay. Certainly, for executives it is now standard practice to link a significant part of the reward package to the success of the business, either through share options or shares/cash. This can also be true of particular occupations or sectors.

However, there are reasons why organisations may still not introduce employee financial participation schemes. We suggest on the basis of our research that the following may play a role.

- Complex administration is off-putting, especially as small amounts of bonus are not seen as worth the effort.
- Limited understanding by employees means limited value in introducing such schemes.
- Existing rewards are regarded as sufficient.
- Even if employee financial participation acts as an incentive (which some doubt), extrinsic motivation is of limited, short-term use.
- Organisational ownership structure prevents shareholding, or there are no profits to share!
- The volatility of share price means that if shares go up, morale goes up — 'for about a fortnight'. But if shares go down slightly, morale plunges.
- If it works too well, there can be an over-retention problem.
- When the better-paid become yet better off, a scheme may become divisive.

1. Financial Participation in Context

1.1 What is financial participation?

Financial participation concerns the involvement of employees in the financial success of the enterprise in which they work. It can take a whole host of forms, but most commonly, it refers to one of three types of basic scheme:

- firstly, profit sharing, in which a proportion of remuneration is tied to the profits of the organisation for the year
- secondly, employee share ownership, in which employees are rewarded with a number of shares in the employing company
- thirdly, share options, in which the employee is given the possibility of purchasing at a future date a set number of shares at an initially agreed price. Depending upon growth in the market value of the shares over the initial value, the option to purchase the shares may be exercised or not.

These schemes may be seen discretely or combined with each other, for example profit bonuses may be invested in company shares. Some schemes are applicable to all employees; others are restricted to particular groups, such as senior executives or directors.

Approved schemes

As we will see, financial participation schemes have been greatly influenced by the tax regime of the moment. At present (January 2001), there are various Inland Revenue approved share schemes. Approved Profit Sharing (APS) and Save-As-You-Earn (SAYE) are both all-employee arrangements. Company Share Option Plans (CSOPs) are discretionary, so may apply to the whole workforce, or only to selected groups. New schemes introduced in 2000 are the all-employee share plans and the enterprise management incentive programme.

Approved Profit-sharing (APS) and Employee Share Ownership Plans

APS schemes are share-based profit related pay schemes. They of a deferred rather than current distribution type. As such, the reward is not paid instantly but withheld for a period. The company makes tax-deductible payments to a trust, which buys shares in the company and appropriates them to scheme participants. All employees (including part-timers) with five years' service must be eligible to participate on similar terms, but most companies accept those with much shorter service. The shares must be left in trust for at least two years, and are free of income tax if left in trust for a further year. The employee pays Capital Gains Tax (CGT), if appropriate, on the difference between the sale price and the value of the shares when first awarded. Under the Finance Act 2000, these schemes are being phased out. The Inland Revenue will continue to approve schemes until 5 April 2001, and no further tax-free awards can be made after 31 December 2002.

APS is to be replaced by Employee Share Ownership Plans (ESOPs — not to be confused with Executive Share Options).

Save-As-You-Earn (SAYE)

These schemes are unaltered by the Finance Act 2000. Employees enter into a three- or five-year savings contract to save a fixed monthly sum of between £5 and £250. They receive a tax-free bonus at end of the savings period (with an additional bonus if the five-year savings are held on deposit for a further two years). Bonuses, equivalent to fixed-rate interest, are set by HM Treasury. Proceeds of savings and interest may be (but do not have to be) used to exercise options to purchase shares that were granted at start of contract. The option price can be set at a discount of up to 20 per cent below the market value. As with the APS scheme, all employees (including part-timers) with at least five years' service must be entitled to participate on similar terms. Most schemes accept those with much shorter service. The employee does not pay income tax on any increase in the share value over the life of the option, but may be liable to CGT when the shares are sold, based on the original price paid for the shares. Income tax *is* payable by participants within three years if the company is taken over or sold.

Company Share Option Plan (CSOP)

CSOPs were known up to 1995 as Executive Share Options (also known as ESOPs, but not to be confused with the new Employee Share Ownership Plans mentioned above). The company grants employees options to purchase shares at a future date at the market price of the shares at the time of grant. Each participant may be granted options over shares worth up to £30,000 at any one time. No income tax is charged on the increase in value of the shares between grant and exercise, provided the two main rules are observed: options must be held for at least three years, and there must be a gap of at least three years between each tax-relieved exercise. Employees are liable for CGT on gains made between option and purchase price, but the annual CGT exemption means that the effective tax rate is less than if income tax were paid. The scheme is discretionary: companies can select those employees or directors to whom they wish to grant options. The majority of current schemes are limited to board members and senior managers.

The two new tax approved schemes introduced last year will be dealt with on page 33.

Unapproved schemes

Of course, organisations do not need to be influenced by tax benefits; they can introduce schemes outside the Inland Revenue framework — creating unapproved schemes. Some in fact once had IR approval, since withdrawn; others were never covered. Unapproved schemes include those that pay out in cash as well as being share based.

Cash based profit-related pay

The payment of cash bonuses to employees, based upon the annual profits of the company, has long been a common form of employee financial participation. Interest grew in them during the 1980s and 1990s because of tax-breaks, but income tax relief on profit related pay is ended in 2000. Some organisations have, therefore, converted cash based profit-related pay schemes to all-employee share schemes. Others maintain non-approved schemes without any tax advantages accruing.

Profit related pay of this sort can either be restricted to certain groups of staff (usually determined by seniority) or open to all employees (though there may be a service threshold to pass). Rarely, a flat figure is paid to all staff. More commonly the payment is related to salary, or sometimes service, or a combination of salary and service. Payment is made with varying frequencies — anything from monthly to annually. Usually, a pre-determined formula determines the payout, based on a fixed percentage of net profits or on a sliding scale. On occasion, there is a threshold that has to be passed before payment is made. Ratios can also be employed to fix the size of the payment pot, *eg* return on capital employed. Sometimes the level of payment is at management discretion.

Profit-related pay of this sort may be combined with individual incentive schemes, either related to the extent to which the employee has met objectives, or delivered against business targets.

Gainsharing

This is not a widely practised or understood concept. According to a 1988 IRS survey, only three per cent of organisations had such a scheme. There is more interest in it in the USA, where a number of variants have developed (*eg* Scanlon and Rucker plans). However, the main principle is that employees share the financial gains enjoyed by an organisation as the result of improved performance. Performance can be determined in a variety of ways, and at different organisational levels — company wide, plant wide or by specific unit. Ratio of payroll to value added, sales or output is one type of measure used. Excess of product over standard is another form of calculation. Factors such as quality, customer satisfaction or cost reduction may also be included. Gainsharing is therefore broader and narrower in concept than profit related pay. It is broader in that a number of measures can be included, narrower in that it tends to concern itself only with those matters under the control of participants.

Thus, in its focus and aims, gainsharing is more about getting employees to understand the relationship between their activities and the immediate financial outcomes. Effort therefore goes into communicating on all aspects of the work process. Getting employees involved is a prime aim of such schemes.

Non-approved share based schemes

There is a whole variety of types of share option scheme designed for senior executives. Different measures are used *eg* earnings growth per share. Long-term incentive plans (LTIPs) emerged out of the Greenbury Committee report on executive remuneration. This approach favours the award of shares rather than the option to buy them. It also prefers benchmarked share performance against competitors, rather than the absolute increase in value.

There are still share purchase schemes in existence, though they are less common than in the past. Here employees buy shares in their company, possibly at a preferential rate, but certainly without the need to go through a broker and pay any charges. Sometimes a trust holds the shares on the employees' behalf whilst the individual pays for them via deductions from his/her salary.

1.2 Why employee financial participation?

This issue can be considered at the macro economic level, where government seeks to facilitate employee financial participation, and at the organisational level.

Government encouragement

Government aims in promoting financial participation are various. One driver relates to economic performance. The advantage of employee financial participation is that it is a form of *financial flexibility*. In other words, it allows employers to see their wage bill rise and fall in line with business activity. This means that the pay bill adjusts to suit the exigencies of the business situation. Wages can be contained during lean times, but rise on the back of profits, but in a controlled way. Labour costs thus become more flexible, just as they do if the numbers employed varies with work demand.

So for government, employee financial participation can act as a surrogate *incomes policy*: wages are related to corporate performance, only increasing when justified by profitability. Government also appears to hope that financial participation will boost enterprise and initiative. The theory is that employees, through having a stake in the profitability of their organisation, will strive harder to realise business success. They may even act as a goad to senior management to improve corporate performance. This was the view of Margaret Thatcher, who said in 1986:

> *'An employee should not only be working on the shop floor or in the office. He should also be present at the Annual General Meeting as a shareholder. He should be wanting to satisfy himself that management is efficient and that profits are as good as they could be.'*

Such interest in business results should also lead to better informed and co-operative pay bargaining. This result is especially important in a tight labour market, when employees could excessively bid up their share of the distribution of corporate income.

The benefits that can accrue at the macro economic level therefore include wage control, improved industrial relations and better productivity, thereby increasing national competitiveness and allowing employment growth without fuelling inflation.

There is a second, more philosophical, strand of thinking that has prompted government to promote employee financial participation. Under Conservative governments, there was the aim of broadening share distribution and popularising capitalism. This was explicitly seen as a means of creating a bulwark against socialism: the growth of the property- and share-owning classes being the principal form of defence. This argument goes back to the Heath government. Anthony Barber, as Chancellor of the Exchequer, said in 1973 when launching the precursor to SAYE: '*If we are to sustain the capitalist system, with all its advantages and the personal freedom it embodies, it must be built on a broader foundation*' (quoted in Reilly, 1978). The current Labour government believes that employee share schemes encourage greater employee involvement in the business activities of their employers. This not only has economic advantages, but also it fits with its 'stakeholder' philosophy that employees should be seen as key participants in the success of the enterprise. The Inland Revenue puts it thus:

> *'By building a community of interest between employers, employees and shareholders, you build that dynamic that will make the company much more successful and society benefits from that.'*

Employer interest in financial participation schemes

There is a similar split in organisational thinking to that found at government level. Some companies see financial participation in pragmatic terms. It can be a means to control costs, to take advantage of tax breaks from the regime in force, or to reward staff as a means of attraction, retention and motivation. Alternatively, others see it as part of a wider employment philosophy, that of encouraging a sense of mutuality between employer and employee.

One purpose of employee financial participation is to allow employers to increase and decrease wages in line with business performance, be it productivity or profitability. This can be seen with profit-related pay, distributed either in cash or in shares, and in gainsharing schemes where the level of payment is determined by some other measure of successful performance (often productivity of some kind). Variable pay can be a means of controlling costs, but also may be intended to orient staff towards the profitability of the enterprise, or some other measure of success. It helps people to focus on key results.

There is a lot of evidence to suggest that organisations adopted profit related pay merely to enjoy the benefit of tax relief. This enabled them to be more tax efficient in their wage distribution, thereby saving money. This was certainly the Treasury's view, and in 1996 the government began to withdraw tax relief from cash based schemes. Since it appears that few firms have retained their current schemes once tax relief is ended, the government's position seems vindicated.

The waxing and waning of executive share options has also followed the pattern of taxation change. Some have been designed specifically to avoid certain tax rules, and then altered to respond to the closing of loopholes.

Some organisations explicitly use employee financial participation as part of their reward package. This might be to attract employees in a competitive market. Giving shares or share options to new recruits might be particularly attractive to new firms or those with limited resources, as up-front cash is substituted by the possibility of future gain. Similarly, financial participation schemes may be designed for retention purposes. This may be to lock in staff who are given a significant number of share options. This seems to apply to senior executives and long-serving workers especially. It may be done as a part of a competitive positioning to retain highly marketable young graduates or specialist staff. Finally, financial participation may be used as a reward or incentive. Company wide schemes may reward employees if the company does well. If the grant of shares or options to purchase shares, or the distribution of cash is given to individual employees, rewards can be directed to high performers — thus signalling approbation or giving a tangible benefit. Thus, employee financial participation can be used for motivational purposes as part of a wider approach to performance related pay.

Other organisations see financial participation as part of a wider form of employee involvement. The argument is that the more employees are tied into the success of the firm, the more likely they are to contribute to its success. Giving shares or share options to new recruits might be taken as a signal that the company wishes to involve them in the success of the firm. In inclusive share based schemes, giving an employee a stake in the firm both enables the employee to benefit from its success but also to identify with the interests of shareholders. It means seeing issues from the vantage point of an owner, not just as a recipient of a pay check. As one IES respondent explained, share schemes help employees accept change; when the share price is seen to be down, they understand something has to be done.

A partnership philosophy entails:

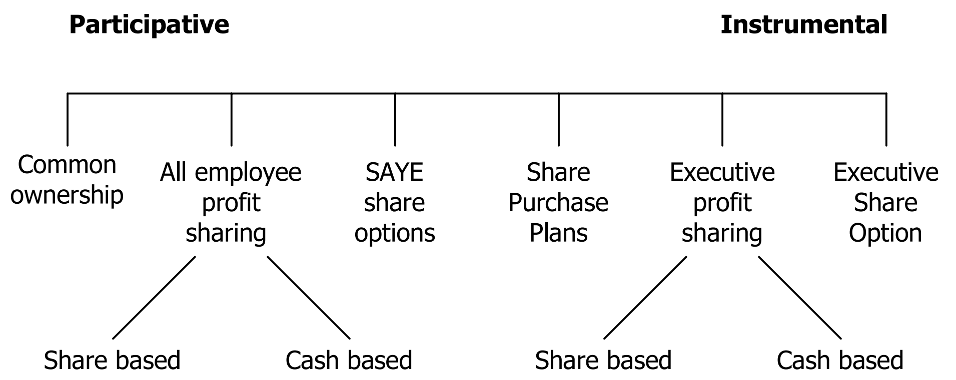
- keeping employees well informed of business decisions
- consulting them on changes to, for example, employment strategy
- involving them in decision making on work organisation at the unit or team level

- sharing in the ownership of the organisation (through some form of share scheme)
- sharing in the results of their labours (through profit related pay of some kind).

There is considerable variation on how deep employee participation goes. At the one extreme are employee owned firms, like the John Lewis Partnership, through organisations that emphasise partnership and mutuality, like Birds Eye Walls, to companies where employee involvement is merely another means of maximising productivity. In other words, the spectrum moves from those that are philosophically attracted to participation as part of their value system to those organisations that are instrumentally driven.

Thus, one might characterise employee financial participation schemes on the basis of their objectives. Figure 1 shows that schemes can be, to varying degrees, participative or instrumental in intent. Participative schemes tend to be inclusive, in terms of involving all employees in their operation, and set up with the aim of increasing employee identification. In design, they are likely to be very transparent and supported by high levels of communication. Instrumental schemes, by contrast, tend to be restricted to specific groups, *eg* senior executives, with more limited objectives (often incentivisation); details of such schemes may not be widely published.

Figure 1: Employee financial participation schemes, characterised by objectives



Source: Adapted from Reilly (1978)

Necessarily, in practice, these distinctions may be blurred, and intentions and effects muddled.

1.1 Choice of scheme

Decisions about what employee financial participation scheme(s) to adopt will be influenced by the above reasoning. Some organisations will wish to maximise employee participation, others will seek out the best tax advantages. However, there are other considerations. There is the nature and structure of ownership, the size, and management structure. This means that some schemes are regarded as impractical (*eg* because they are no traded shares to be distributed) or more attractive, depending upon the type of organisation, for example. Larger companies can cope with administration that would be beyond the small firm.

We take the tax-approved schemes first. SAYE schemes are less costly to set up than approved profit share arrangements. Model rules are provided, and since rewards are paid out as options, companies do not have to spend money buying their own shares. The latter point, and the need to set up a trust, will be a disincentive to smaller companies to establish APS schemes. However, since the latter relate to profitability, they tend to be more involving of employee interest than SAYE schemes. Saving schemes that rely on a growing share price may produce a more passive response on the part of employees. The variation in the share price may be seen as outside the control of individuals in a way that profit is not. CSOPs have some of the advantages of SAYE schemes in that no company shares have to be provided at the outset, but, as they rely on the company to finance them, they may be seen as more involving than SAYE.

Unapproved schemes have the major benefit of being entirely within the control of the organisation. No rules have to be followed. Importantly, cash as well as shares can be distributed. Payouts can be at the time of the organisation's choosing. Gratification can thus be immediate rather than deferred, thereby leading to greater incentivisation. There is free choice too in deciding on who should be the recipients — all employees, only senior managers or directors. The only downside is the lack of tax benefit.

Certainly, the cost and administrative complexity of setting up an approved scheme is off-putting, especially for small firms. The inflexibility of Inland Revenue criteria is an additional drawback. In APS schemes, for example, in order to be equitable, common criteria must be set (such as length of service) applicable to all staff. This prevents rewards being tailored to individual performance or targeted groups. Large or small firms might wish to use the grant of shares as an incentive, reward or means of retention. CSOPs offer targeting; APS schemes do not.

Furthermore, smaller organisations may be reluctant to have to pay out in shares rather than cash, and thereby dilute their equity. They may also be concerned about liquidity problems, as they have to pay the shares to be put into the trust in an APS scheme; this is less of a problem for CSOPs. Small firms often do not understand the schemes well, and do not realise, for instance, that private companies do not need to have tradable shares to qualify. Indeed, a deferred share option plan as offered by a CSOP can be seen as particularly useful for small companies, who cannot compete with larger firms in high current salaries, but may instead offer employees future rewards as the business builds.

1.2 How have the types of financial participation changed and grown?

Profit sharing in the UK is not new. The first recorded scheme was in 1829 and, by 1919, 380 schemes had been started. These early schemes were mostly in the gas, engineering and chemical sectors. A Ministry of Labour survey in 1954 showed that limited progress had been made in the inter-war years. By this time only 310 schemes operated in 297 companies, involving nearly 350,000 employees. However, there were some household names with schemes such as Vauxhall Motors, ICI and the John Lewis Partnership, with its distinctive ownership structure.

Growth came in the 1970s facilitated by tax incentives and by the interest in employee participation generally. The 1973 Finance Act introduced the SAYE concept. The 1978 Finance Act gave tax relief for share-based profit-sharing schemes. As for employee participation more generally, this was the time of the Bullock report and discussion of employee representation mechanisms, including at board level.

The four high street banks started schemes during this period—National Westminster and Barclays (1974), Lloyds (1977) and Midland (1978). Some retailers and manufacturers, *eg* Bentalls and Owen Owen (1974) and Wedgewood (1975) took the same decision around the same time.

Further tax breaks came for savings-related share option schemes (SAYE) approved under the Finance Act 1980, and discretionary executive share option (ESO) schemes approved under the Finance Act 1984.

Table 1 opposite shows how the picture changed over this period, with the effect of the introduction of the three tax-approved types of scheme.

Later Acts gave tax benefits to two further types of scheme. A form of tax-approved cash-based (rather than share-based) profit sharing was brought in by the Finance Act 1987, and Employee Share Ownership Plans (ESOPs) by the Finance Act 1989.

By 1992, a majority of workplaces (56 per cent) operated a profit related pay or share ownership scheme. Of those that operated a scheme at all, 52.5 per cent operated just one, whereas most of the rest operated two or more schemes together (Third British Workplace Industrial Relations Survey [WIRS3], see Poole and Whitfield, 1994).

The relative popularity of the five schemes is shown in Table 2 on page 14.

Bringing matters up to date, before they were phased out, approved cash-based profit-sharing schemes involved around 4.5 million people, with pay-outs of £800 at maximum. Table 3 on page 14 shows where the remaining tax-approved schemes stood in February 1999.

1.3 What types of organisation use employee financial participation?

It is clear that larger companies tend to use share schemes. Almost all the FTSE 100 companies operate SAYE and CSOP schemes, and two-thirds APS schemes (IDS *Management Pay Review* 216, February 1999). The percentages are lower for the

Table 1: Financial Participation Rates in UK, 1979-1992

Year	Approved profit sharing (Finance Act 1978)			Share option schemes (Finance Act 1980)			Discretionary share options (Finance Act 1984)		
	Schemes approved	Employees (000s)	Average £ value per employee	Schemes approved	Employees (000s)	Average £ value per employee	Schemes approved	Employees (000s)	Average £ value per employee
1979-80	117	225	220						
1980-81	93	350	190	22	11	16,000			
1981-82	68	300	210	115	89	1,700			
1982-83	63	285	260	78	95	1,800			
1983-84	49	300	260	73	105	1,800			
1984-85	70	580	290	114	225	2,500	208	50	16
1985-86	68	360	500	114	200	2,300	1,259	50	17
1986-87	105	780	350	103	290	1,800	772	55	21
1987-88	108	600	450	90	440	2,200	746	90	20
1988-89	66	850	410	101	370	2,000	855	90	18
1989-90	94	900	480	84	460	2,200	549	105	18
1990-91	77	890	470	81	550	2,600	395	65	22
1991-92	37	730	450	83	480	2,900	305	80	18
Total	*1,015*			*1,058*			*5,089*		

Source: Poole and Whitfield 1994

Table 2: Workplaces possessing profit-related payment and employee share ownership schemes, 1990

	% of total workplaces
Profit-related payment or bonus scheme	40.2
Save as you earn share option	25.8
Discretionary/Executive share option	18.2
Deferred profit sharing	9.3
Other type of share ownership	6.7

Source: WIRS3, in Poole and Whitfield (1994)

Table 3: Extent of Financial Participation, 1999

	Approved Profit-Sharing (APS)	Save-As-You-Earn (SAYE)	Company Share Option Plan (CSOP)
Number of participants	1.25 million	1.25 million	300,000
Number of companies	859	1,201	3,769
Average value/grant of shares per employee	£680 (value)	£2,700 (grant)	£5,700 (grant)
Tax cost	£150m	£380m	£100m

Source: IDS Management Pay Review 216, (Feb 1999)

FTSE 250, especially APS schemes where only a quarter of companies has them. The proportion of share schemes further declines with size. Unlisted companies are less likely than listed companies to have approved schemes, especially APS or SAYE. Discretionary schemes are, however, popular in all companies.

Unapproved share schemes are also to be found more in publicly listed companies. According to a ProShare Survey in 1997, 60 per cent of plcs had an unapproved scheme, usually for senior executives, compared with just 21 per cent of limited companies.

The location of company ownership is also a significant factor. Share ownership schemes are much more common in UK than foreign owned UK companies (ProShare, 1997). Among UK owned companies, SAYE is more common than profit sharing;

Table 4: Adoption of ESO schemes by sector

Employee Share Ownership Schemes	Total	Consumer goods	Financials	General Manu-facturing	Mineral Extraction	Services	Utilities	Other
Bases	*528/660*	*83*	*35*	*131*	*10*	*109*	*9*	*151*
	%	%	%	%	%	%	%	%
Executive Share Option Scheme	48-53	55	57	41	40	38	77	32
SAYE	37-46	40	34	27	40	25	100	39
PSS (Both types)	23-28	33	37	21	30	23	77	27
CSOP	7-16	18	26	12	20	12	22	34
Unapproved Arrangements	43-44	49	51	33	60	39	44	31
Overseas Arrangements	18	23	11	2	30	17	33	30

Source: ProShare 1997

the reverse is the case for foreign owned companies. Discretionary schemes, operated by 84 per cent of UK listed companies, are much less popular among foreign owned companies. The most common scheme among foreign owned companies is unapproved, but still well below the UK owned rate of 64 per cent (ProShare, 1997).

By sector, there has been a higher take up of all schemes in banking and insurance companies, and of ESO schemes in the privatised public utilities (presumably because the grant of shares to employees was a feature of their privatisation). The wholesale/retail and communications sectors are second to finance in their use of share schemes. Unsurprisingly, there has been less employee financial participation in the public sector.

Table 4 shows the adoption of ESO schemes by sector, in 1997.

As Table 5 shows, the take up by occupation of financial participation varies by type of scheme. For ESOs, 31 per cent of companies in Great Britain use a scheme for mangers, but only 17

Table 5: Employee share ownership and profit sharing by employee group (per cent)

	Management	Professional/ Technical	Clerical/ Admin.	Manual
Employee share ownership	30.5	21.4	19.1	16.6
Profit sharing	26.1	22.1	21.0	18.0

N=1283 for GB.

Source: Festing et al. 1999

per cent for manual workers. The difference is less marked for profit-sharing schemes, where 26 per cent of companies operate a scheme for managers, and 18 per cent one for manual workers.

Take-up of profit sharing and ESO schemes appears higher in young and growing companies (Festing *et al.*, 1999). A culture based on increased co-operation, interaction and responsibility, rather than specialised, routine tasks, is also associated with higher use of employee financial participation (Fitzroy and Kraft, 1987), as is an emphasis on product quality (Friedrich *et al.*, 1998).

Cash based profit related pay, certainly whilst it was tax-approved, was to be found relatively widely across all sectors and types of organisation. Thus schemes were common in the manufacturing and construction sectors, where share based schemes are less prevalent (Poole and Whitfield, 1994).

2. Effectiveness of FP Schemes

One can measure the effectiveness of employee financial participation on the basis of its direct effects on profitability and productivity, or one can look at indirect measures of success, such as employee attitude and commitment. Often the latter cannot be so easily measured, and so proxy means, such as sickness absence, wastage, absenteeism, or dispute levels, can be used.

In this section, we will examine the different types of evidence. We will then go on to look at areas of difficulty experienced in employee financial participation.

2.1 Does financial participation have an impact on business performance?

If employers wish to pursue employee financial participation for its organisational performance gains, in terms of profitability or productivity, then it is as well to see whether this position is supported on the basis of the research evidence.

Evidence on profitability and productivity

Several major empirical studies have found a positive association between financial participation and business performance. These are set out below.

ProShare (1999) plotted share prices for the UK Employee Ownership Index against the FTSE All Share Index for the years 1992-1998, and found that the former consistently outperformed the latter. Starting from a common index point of 100 in 1992, there was by 1998 a 200 point gap between the two.

Bell and Hanson (1989), compared 458 firms across ten sectors, over eight years from 1977/78 to 1984/85. They were all fully quoted on the Stock Exchange and those with profit-sharing schemes had operated them for at least four years. They used nine measures of business performance, and found that the profit-sharing companies outperformed the non-profit sharers on all nine measures, especially during recessions. The measures of profit were: return on equity, return on capital employed, earnings per share, and return on sales. Measures of growth were for sales, equity and profit. Investor returns were measured as dividends per share and total annual returns.

Conyon and Freeman (reported in Freeman, 2001) looked at 299 companies listed on the stock exchange and examined the effects on employee productivity and the presence of employee financial participation schemes, over the period 1995 to 1998. Value added per worker increased by 17 per cent with the introduction of approved profit-sharing schemes and this was associated with increased consultation and communication with staff. Executive share option schemes also showed better productivity, but were not characterised by more employee involvement. Profit-related pay and SAYE schemes were associated with a greater degree of employee consultation and communication but with limited or no productivity benefits. Their analysis of the Workplace Employment Relations Survey (WERS) produced similar results. Business performance seemed to be better where employee financial participation schemes were present and employee involvement was higher. Finally, this team looked at the share price of companies using forms of share-based remuneration compared with the FTSE index. The former outperformed the latter nearly threefold over the period 1992-2000.

Poole and Jenkins (1990), in a large-scale survey for the Department of Employment, concluded that there is:

> *'almost certainly a positive relationship between company profitability and profit sharing, but the direction of causality is unclear.'*

This is because it is often high profitability firms that begin schemes. The effect is mediated by employees' identification with, and commitment to, the organisation:

> *'a positive commitment to share-based schemes was found to be associated with an emphasis on the employee feeling fully part of the company and with relationships of trust between management and workforce'.*

However,

> *'while the relationship is in the expected direction, it is not strong enough to support the argument that attitudes to work can be radically transformed by the adoption of profit-sharing and share ownership schemes'.*

The perception of the financial success of schemes is central to the positive assessment of profit sharing and share ownership schemes.

> *'Although the links are weaker, a positive attitude toward profit sharing and share ownership does indicate a positive view on the effects of the introduction of schemes on productive effort. Positive views on schemes are positively associated with further favourable attitudes to financial and productive performance of firms, employee participation and a perceived co-operative atmosphere between management and the workforce.'*

Similarly, Festing *et al.* (1999) found that both employee share ownership and profit sharing are positively related to profits. Festing *et al.* concluded that, whilst it may be debatable which phenomenon causes which, it is clear that, if one is searching for best practice, the highest performing companies demonstrate a use of employee financial participation.

Some research suggests that clusters of high-commitment work practices are associated with employee productivity and business success. These practices include, in our context, encouraging employee ownership and adopting employee participation practices (Pfeffer, 1994; Ostroff, 1992; and Huselid, 1995).

Neumark and Cappelli (1999), testing Huselid's ideas, conducted a longitudinal study using a nationally representative sample of firms in the USA. They found that, whilst employees benefit from higher wages, productivity improves, so that there is no net loss of competitiveness for the employer.

There are, however, dissenting voices that have found no positive link between employee financial participation and profits (*eg* Brooks *et al.*, 1984), or only a limited and confused link. Bryson and Millward reported in 1997 that share ownership had no significant effect on company performance. Poole and Whitfield (1994), looking at several measures of economic performance, found that there is no discernible relation between any financial participation schemes and gross return on capital. However, financial performance relative to others in the same industry *was* positively related to all four schemes examined (profit-related bonuses, deferred profit-sharing schemes, SAYE and ESOPs). Labour productivity was negatively related to three of the schemes (but not ESOPs). Explanations for this finding may be that schemes are more common in firms with product market dominance (which allows some slack), or because the schemes are less common in foreign owned companies, which tend to have higher productivity than UK owned firms.

A study in the USA by the General Accounting Office also came to the conclusion on share ownership that:

> *'in general, they have not been used to promote capital formation, have not improved productivity or profitability of the sponsoring firms, and have not led to a high degree of control over or participation in corporate management'* (GAO, 1987).

Conclusion

In one sense, it would not be surprising if the evidence supported the notion that employee financial participation was positively correlated with higher profitability or productivity. This is because there is a growing body of recent research that demonstrates that a positively employee-centred approach is likely to deliver business benefits. The problem is always in this situation establishing cause and effect, and the direction of causality. It could be that successful companies are the ones that have the money to invest in employee financial participation, which then supports, not leads, further business success. Alternatively, it could be that employee financial participation plays a more leading role. Again though, this could be but one feature of a number of employee-centred aspects of the employment deal. Involvement, participation, engagement of employees does seem to bring good results. Financial participation may be just part of a 'bundle' (Huselid, 1995) of this good practice. Pendleton (1997), for example, found that 'employee representation and participation in decisions goes hand in hand with financial participation'.

It is this connection between employees participation in financial aspects of the firm and their participation in decision making that makes analysis difficult. Getting the hard evidence is difficult enough, especially with the number of variables affecting share price and levels of profitability. Trying to distinguish the effects of the individual elements of a participative approach is well nigh impossible. Maybe the answer is to accept that the integrative nature of mutually reinforcing policies on reward, work organisation and consultative decision making, is a total package, and that individual parts will not work as well as the sum of the whole. This indeed is the view not just of Huselid (1995), but also the conclusion of a multi-national study by the European Foundation for the Improvement of Living and Working Conditions (EFILWC, 1997).

2.2 Does financial participation affect employee attitudes, motivation and commitment?

Before looking at the evidence of whether employee financial participation has positive benefits to organisations in terms of employee attitudes, it is worth emphasising that there are certain circumstances in which higher commitment is likely to be observed (see Salancik, 1977, quoted in Mowday, Porter and Steers, 1982). These points are relevant to how employee share schemes or profit sharing operate.

Behaviours that increase attitudinal commitment must be:

- explicit (unequivocal and observable to others)
- difficult to revoke or change
- public—known to others
- freely engaged in; *ie* a positive choice from several options, without pressure to choose one rather than another.

A virtuous (or indeed vicious) cycle may develop whether attitudes change to justify the choice of action and this then affects behaviour. The longer the behaviour continues, the more the attitudes become fixed and reinforced.

Regarding motivation, a key distinction is between intrinsic and extrinsic motivation. The former relates to self-generated factors that influence people, whereas the latter concerns externally produced effects on people. Employee financial participation as a reward is clearly intended to be an extrinsic motivator. This can be either because the extra money produced is a goal in itself or because achieving a successful result (higher profits, raised share price) is recognised in a tangible way as a desirable outcome. However, those who see financial participation as part of a wider philosophy of involvement are hoping that employees will respond to a climate in which self actualisation is encouraged.

For employee financial participation to work as a motivator, summarising a complex theoretical picture, one might say that any scheme should have the following characteristics:

- the goal to be achieved must be clear and deemed to be obtainable — a clear line of sight
- the individual should be able to see that their efforts will have an effect on achieving that goal
- employees are more likely to be positively disposed to the scheme, if they helped in its design
- the process of allocating awards must be seen as fair, equitable and consistent
- the reward should be seen as worth having.

Evidence

To begin with, there is evidence that financial participation schemes are well regarded. A large-scale UK survey representative of the private sector, carried out between 1983 and 1984 (Bell and Hanson 1989), found that 70 per cent strongly supported profit sharing in general, and 64 per cent strongly supported the profit-sharing scheme in their own firm. A further 21 per cent and 24 per cent respectively gave moderate support. Outright opposition was too negligible to record.

This survey also suggested that financial participation schemes generate positive attitudes:

- *'it creates a better atmosphere'* (65 per cent agreement)
- *'it makes people take a greater interest in profits and financial results'* (76 per cent)
- *'it makes people try to work more effectively so as to help the firm to be successful'* (51 per cent).

This view is borne out in research conducted by Pendleton, Wilson and Wright (1998). They found that feelings of ownership are significantly associated with higher levels of employee commitment and satisfaction. A 'sense of ownership', they discovered, is generated more by opportunities for participation in decision-making than by actual ownership itself. Nevertheless, it supports the employee involvement thesis.

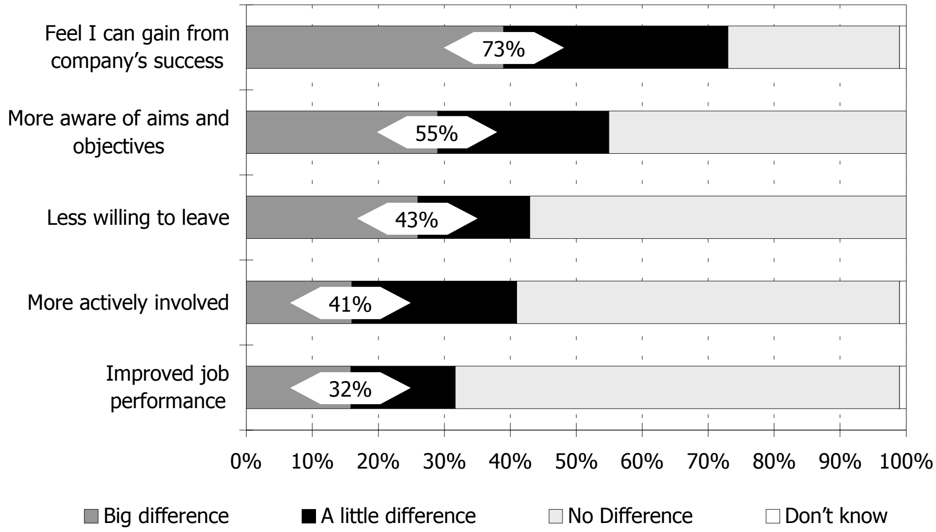
Poole and Jenkins (1990) found companies that had profit related pay schemes, as well as a participative style of management, were more likely to have a better organisational health. This was seen in a lower absenteeism rate and a better strike record. These benefits seem to be associated with high employee commitment and identification, which in turn is related to lower staff turnover.

Profit sharing reduces staff turnover and absenteeism (Festing *et al.*, 1999). Outcomes of financial participation were studied in Great Britain, Germany, France and Sweden by Festing *et al.* (1999). Comparing firms that do not use financial participation with those that do, they found that profit sharing significantly reduces staff turnover and absenteeism. Employee share ownership, whilst also reducing absenteeism, was found to be associated with *higher* staff turnover (a result they found theoretically hard to explain). There is a more mixed picture from research by Poole and Whitfield (1994). They found that absenteeism improved significantly only with discretionary ESOPs, and that voluntary turnover improved only in association with SAYE and ESOPs, but not significantly with profit-related bonuses or deferred profit sharing.

Confirmatory evidence of the above research comes from a ProShare survey in 1998. This looked at the views and behaviours of a representative sample of 300 employees who currently own shares in their company. Directors and senior managers were excluded from the sample.

Employees were asked whether owning shares made a big difference, a little difference or no difference at all to their attitudes to the company and work. Nearly three-quarters felt that they could gain from their company's success. A little over half said that they were more aware of the company's aims and objectives. There was evidence too that they were less likely to leave the organisation. Interestingly, their responses were less

Figure 2: Impact on Employee Attitudes

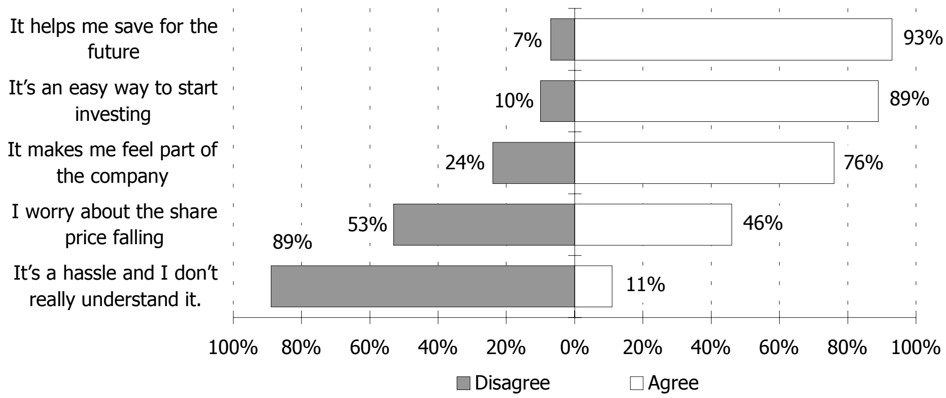


Source: ProShare 1998

positive on making them feel more actively involved and particularly, improving their performance (see Figure 2.)

Employees were asked whether they agreed or disagreed with a series of attitude statements. The results, in Figure 3, show that employees identify with the positive more than the negative aspects of shareholding.

Figure 3: Attitudes to owning company shares



Source: ProShare 1998

There is also supporting evidence from outside the UK.

Brown, Fakhfakh and Sessions (1999), in a study of 127 French firms, found that both profit sharing and employee share ownership are associated with significant reductions in absenteeism.

Employees in a US firm who felt that they had more influence and had a greater financial stake in an Employee Stock Ownership Program, were more satisfied with the program, more committed to the organisation, and had both a lower intention to leave the company, and lower turnover in practice (Wilson and Peel 1991; Buchko 1992).

Profit sharing is an important determinant of organisational commitment, which is not moderated by job satisfaction (Florkowski and Schuster, 1992).

Employee financial participation can improve industrial relations. The Poole and Whitfield (1994) study, reported earlier, found all four schemes they examined were strongly associated with freedom from any strike, work to rule, lockout or other industrial action in the previous 12 months. Poole and Whitfield argue that trade unions will encourage schemes so long as the arrangements do not challenge traditional collective bargaining. Indeed, some unions, such as the old EETPU, negotiated profit-sharing schemes in return for no-strike deals.

However, in the strikes in BT in 1987, during which the profit-sharing scheme was withheld, there was no distinction in militancy between employee shareholders and non-holders.

Conclusion

On balance, employee financial participation is seen to encourage strongly both intrinsic employee commitment (stemming from participation, security, job satisfaction) and extrinsic commitment (stemming from pay and other instrumental rewards). The effects are never direct, however, and are strongly influenced by environmental factors.

2.3 Problems and issues with employee financial participation

A corporatist approach to reward

One objection levelled at employee financial participation is that it is a centralised approach to reward. The corporate headquarters see it as a good idea and operate for their own purposes. It is remote from both employees and operational management. For share based schemes, organisations have little choice but to run them corporately. Cash based schemes, however, can be decentralised, unless the company quotes only one profit figure and wishes to use this as its measure of success. Other companies have broken down profit figures to subsidiary, divisional or operating unit level to encourage the link between local effort and reward (Florkowski and Schuster, 1992; Corkerton and Bevan, 1998). Alternatively, other measures than profitability may be used such as volume measures (*eg* production or sales) or other performance indicators (*eg* the broadly based 'balanced scorecard' that looks at customer, employee and process results as well as financial ones).

Short-term horizons in management thinking

By contrast, employee financial participation might work too well. How can this be a problem? It is back to the measures. If they are narrow and short-term, then it will encourage managers and employees alike to concentrate on these issues, to the exclusion of other things. For example, annual profit may be the only target. This may mean that scheme participants do all they can to maximise this figure. The result may be under investment in long-term factors such as research and development or physical infrastructure. If the measure of success is share price, decisions may be overly influenced by what will please the market. Chasing short-term sales volume might be pursued at the expense of medium-term customer retention.

Line management lack of interest

A series of case studies by Marchington *et al.* (1992) found that some middle managers and supervisors have reservations about the resources and training provided for employee involvement, or do not see it as important because they are not evaluated or appraised on encouraging employee involvement. This experience can be replicated on other aspects of people management. Whether it extends to financial participation is not known. In one sense, this would be surprising since line managers themselves rarely play a role in designing schemes or implementing them. However, a negative attitude to employee participation may hinder the organisation from deriving full benefit from all its initiatives. If there is a 'bundle' (see page 20) of good HR practice, then undermining one element may undermine the whole.

This is especially so given the critical role that first line management and supervision play in employee attitudes and commitment. IES research (Barber *et al.*, 1999) found clear evidence of the positive effect of front-line supervision on employee attitudes. This involved managers supporting staff, valuing them as people, giving and receiving information and feedback, and allowing them to grow and develop. The attitude of managers generated a culture that fostered both employee commitment and better business performance (in this case, sales).

Financial participation as stick not carrot

Throughout this report, we have tended to assume that employee financial participation is employed for positive reasons — philanthropic or instrumental — with the aim of attracting, retaining or motivating staff. It has been used as a carrot to induce greater commitment, higher productivity, lower absence or turnover. There are, however, examples where organisations have used financial participation schemes as a stick rather than a carrot.

There is evidence that some firms have a history of making payment of shares conditional on 'acceptable behaviour'. Many schemes may well have some link between their performance management process and share or profit scheme. Thus, poor performers or those with a substandard absence or disciplinary record might be excluded. However, if the stick rather than the carrot is used more as a collective and coercive tool, then the issue is more serious. The approach clearly runs counter to any aim of increasing employee involvement or identification with the company. It merely becomes another bargaining item in an adversarial relationship. The employer can offer or withhold payment depending upon the behaviour of the workforce.

There is evidence to suggest that firms that attempt to tie profit sharing to pay reduction are less likely to be successful (Florkowski and Schuster, 1992). In a study of three profit-sharing companies, Florkowski and Schuster found that participants in the schemes are much more likely to support the schemes if the extra rewards they receive are proportional, firstly to the extra efforts and responsibilities asked of them and, secondly, to the improvements in the firm's profitability. Consequently, any attempt to tie profit sharing to a cut in basic pay is likely to be perceived as inequitable, and to be less successful.

Employee and union opposition

There is a number of dimensions to employee or union objection to employee financial participation.

- It can be discriminatory if large sections of the labour force are excluded, *eg* public sector employees, those on short-term contracts, or new recruits who have not worked a qualifying period.
- It produces short-term thinking. Employees, if they are influenced by the presence of a scheme, will tend to support actions that improve their chances of a good reward. This is likely to mean support for short-term actions, and opposition to long-term ones. Thus, investment in physical and human capital might be opposed if it risks diluting rewards. Moreover, this selfish thinking may produce unco-operative behaviour (exclusion of disabled, disadvantaged workers) if this leads to higher rewards.
- It gives a false impression of employee involvement. Employees in general, it is argued, can do little to affect the share price or the company's profitability. They are merely passive recipients of the shares or the money. It is simply a 'windfall'. In theory, being a shareholder entitles employees to attend the AGM and to gain access to certain types of company information. In practice, employees have little influence in most large quoted companies, as limitations on the size of share schemes mean that they are heavily outnumbered by institutional investors.
- It is too often not negotiated with the unions. Rather, it is a management-determined policy over which employees have little control.

- It is too open to 'fiddling' by the employer. Every year the payout formula could be changed to lower the size of the payout. The size of 'profits' could be redefined using all sorts of adjustments, including the notorious 'extraordinary items'.
- It is deferred pay that should be paid now. If money is available to support employee financial participation, the same money could be distributed through increases in base pay.
- It puts too much pay at risk. Whilst financial flexibility might help employers adjust the paybill to suit business circumstances, the risk is transferred to the employee. If the company does not do well, incomes fall. Whilst this might make perfect economic sense, it makes it hard for employees to plan their own finances.
- It also ties an employee too much into the fortunes of the firm. It is all well and good if the company is successful; if it is not, the individual risks loses not only a job and a source of income, but their savings as well.
- SAYE schemes require employees to save. This, it seems, can be a significant deterrent to participation. Hay Management consultants estimate that participation can range from 22 per cent to 88 per cent of the workforce, with the median running at just over half (IDS *Management Pay Review*, 216, February 1999).

Conclusion

Some of the above problems can be exaggerated or mitigated through design choices. This is especially true in the selection of criteria. A well-designed reward scheme will balance short-term and long-term considerations, and the different measures of performance. The process of design can be inclusive in bringing on board line managers and employee representatives, corporate and operational management. If this is executed in an open and transparent way, it can eliminate bias and concerns over susceptibility to manipulation.

3. The Future Development of Employee Financial Participation

3.1 Where does employee financial participation sit?

Is financial participation a passive or active employment process? Proponents who see it as part of a participatory process would wish to see active engagement of employees in the business enterprise. Those who regard employee financial participation as a motivational tool would want to see increased effort or contribution. However, in practice, do employees actually play a passive role, seeing any reward as being a *windfall*? Similarly, is there a real link between *financial* participation and other forms of participation? Is it integrated into an holistic framework of employment relations? Or again, do employees accept their bounty without seeing any requirement for greater interest in business affairs?

In the ProShare survey of 1998, it was found that two-thirds of respondents check the share price once a week or more; 18 per cent check it once a month, eight per cent twice a year, two per cent less than twice a year, and six per cent never. Those who check most often tend to be those who acquired shares both through own purchase or employer grant (76 per cent once a week or more) and employees aged over 45 (75 per cent once a week or more).

This suggests that shareholding does indeed gain the attention of some of those holding shares. Poole and Jenkins (1990) claim, on the basis of their research, that employee shareholders have a desire for greater influence over decision-making at firm, department and job levels.

There are those, however, who find such share schemes as overly complicated. Bell and Hanson (1989) found that 40 per cent of the respondents of their survey were unaware of, or had not read, or could not understand, the literature about it provided by their company. Nonetheless, sixty-eight per cent watched the share price; of those who had held shares for more than two years, 85 per cent intended to hold on to them more or less permanently Bell and Hanson (1989). However, there is also evidence that shares tend to be cashed in as soon they are available. This suggests that, whilst employees may take an interest in corporate affairs, it is only so as to secure pecuniary gain. Looking at the share price is akin to looking at the lottery numbers. The comparison is not over-done: one IES respondent said that the workforce in the lower grades tends to see the share scheme as a lottery because they are so remote from how it moves. There is a similar position for cash based schemes — employees are happy to receive the award but frequently do not see a relationship between their efforts and company profitability.

Poole and Jenkins (1990) found that attitudes to the share scheme were linked to views of the firm. If they had a positive attitude towards their company, they were more likely to take note of its share price.

The evidence then is that there are those who gain or, perhaps more accurately, sustain affiliation with their employers through employee financial participation schemes, but that these individuals are in a minority. Some may be incentivised to improve their performance, but probably only where there is a clear link between effort and outcome, *eg* in sales. Elsewhere, participation is more likely to be passive. Neither employees nor their representatives are likely to take profit sharing into account in terms of their attitudes to pay increases. In the 1989 Bell and Hanson survey, for example, 96 per cent agreed that profit sharing should not be seen as a substitute for an adequate wage or salary. Forms of financial flexibility that allow employers to trade wages for jobs are rare in the UK. In that sense, it appears that fiscal incentives have not succeeded in changing the pay culture of British companies. Poole and Jenkins conclusion is that share ownership is welcomed, but it has not breached the 'employee consciousness' that creates the 'them and us' divide. It is not yet at a level to shift fundamental work attitudes.

3.2 Prospects for growth

Theory

There are three competing theories about the development of employee financial participation schemes.

- The 'evolutionary' theory holds that in the long term, developments in technology and rising expectations among a property owning democracy will lead to ever-increasing incidence.
- 'Cyclic' theorists hold that advances are most likely in periods of 'control crisis'. In a tighter labour market, 'softer' managerial techniques (including profit sharing and employee shareholding) are required because the power balance has shifted in favour of employees.
- Thirdly, a 'favourable conjuncture' approach sees historical developments as discontinuous, and dependent upon the conjunction of a variety of factors.

Poole and Whitfield (1994) compared these theories with the empirical evidence within UK in the 1980s and early 1990s. They give detailed figures for the take-up following the four main pieces of legislation referred to earlier. The evolutionary theory is not sustained. There is some evidence for a cyclical theory. Interest in profit schemes was marked in the late 1970s, when existing schemes were converted to approved ones. The recession in the early 1980s led to a slowdown in growth, followed by an expansion around the 1986-88 boom, and a subsequent decline during the recession of the early 1990s. Allowances have to be made for time lags, and the success of earlier schemes may inhibit the take up of later ones. Poole (1988) comments that the boom in financial participation in the 1980s started before the economic recovery and was thus historically unusual. It took place against a background of high unemployment and low industrial unrest. It can be concluded therefore that legislative changes clearly helped, and the weak labour market and unions meant that managers could impose their choice of schemes. So employee financial participation flourished, not because of pressure to attract/retain employees, but to make employment costs more variable and to follow the ideological climate of the day.

This suggests that the third theory is closer to the mark. Employee financial participation will grow when:

- government encourages it through tax concessions and other signals, and/or
- labour market tightness means that in some sectors, cash based profit or share schemes are needed for successful resourcing policies, or
- labour market slackness means that organisations can increase the proportion of variable pay to control costs better.

We will next look at whether government encouragement will lead to increased employee participation and whether trends in reward will encourage variable pay.

Government positioning

The Labour government has set about changes to the ground rules of how tax relief will operate. This is against a background of supporting employee involvement and financial participation. In the Chancellor's pre-budget speech in November 1998, Gordon Brown pledged to: *'double the number of firms in which all employees have the opportunity to own shares'*. Set out below are the proposed means of doing this, as laid down in the Finance Act 2000, which received the royal assent in July that year.

New all-employee 'Partnership Share' scheme

- Employers will be able to give workers free shares up to a maximum value of £3,000 without tax liability. These can be performance related.
- Shares, known as 'Partnership shares' can also be bought by employees with pre-tax pay; employers will be allowed to match these by up to two free shares.
- A tapered tax charge is applied the salary used to buy shares when the employee takes possession of them. The tax liability on disposal of these shares at will depend upon how long they are held.

- For the purposes of income tax and National Insurance, the value of the shares when disposed of is taken to be their market value when first acquired. Any capital gains will be tax free, as will dividends, provided these are used to purchase more shares.

New 'Enterprise Management Incentive' (EMI)

In his budget statement of 9 March 1999, Chancellor Gordon Brown outlined the features of the EMI.

- The scheme will be available only to companies meeting set criteria, likely to be those carrying on a qualifying trade and with gross assets of £15 million pounds or less.
- Only 15 employees in each company will be able to take advantage of the scheme to the value of £100,000, equal to £1.5 million worth of options. These workers need not be managers, but they must be able 'to make a critical contribution to the company's success'.
- Tax will be due on shares only at the time of their disposal.
- The employer may deduct, for the purpose of corporation tax, the value of shares allocated, as well as costs of setting up and running the scheme.

Further possible changes to EMI were announced in the Chancellor's pre-budget statement in November 2000. This proposed removing the restriction in the number of individuals who could receive options, but retaining a limit on the total value of options issued at a higher figure — a maximum of £2.5 million. As of January 2001, these proposals are open to consultation, with a decision expected early in the year (www.inlandrevenue.gov.uk/shareschemes and *Financial Times*, 11 November 2000).

Between July, when the first EMI scheme was launched, and November 2000, about 111 companies had set up programmes. The government expected 1,100 companies to launch schemes in the first year (*Financial Times*, 10 November 2000).

It is always hard to assess the take up of new initiatives in tax relief. The *Enterprise Management Incentive* is designed for small firms, and the government has claimed that the advantage of this new scheme is that it allows 'more discretion and flexibility than is possible under the existing approved schemes'. One cannot fault the logic of this view, but whether the theory will develop into practice is more doubtful. One can imagine that only certain companies will be sufficiently aware or interested to take up the offer. Even amongst those that see value in employee shareholding, the restriction in the number of participants will be a disincentive to many. Certainly, those organisations that position employee financial participation as part of a wider participatory approach were unlikely to be attracted to a scheme that is so discriminatory in its application. By contrast, those that regard financial participation schemes as a means of incentivisation of employees may well welcome this new tax break. This is especially true for those organisations that use share options as an alternative to base salary in a highly competitive market. Small companies may not have the cash to pay high wages; share options can get round the problem. Having said that, recipients need to be confident that the share price will rise — not a feature of dot.com companies, especially since March 2000. Individuals also have to be able to cash in their options if they are to realise a benefit and this can be difficult in unquoted companies. A tax accountant has calculated that only around half of share option schemes result in a payout (Collinson, 2000).

As to the Partnership Share scheme, it has several advantages compared with the current (tax) Approved Profit-sharing scheme, which it is replacing. The new arrangement distributes shares immediately rather than in a deferred fashion. There is no need to have a Trust involved. No CGT or income tax is payable if the shares are held for the requisite period. However, whether it does anything more for employee participation or involvement in the organisation's business is more doubtful. Employees can passively receive shares unrelated to business performance, and make a tax gain if they follow the rules. There is an incentive to hold on to them and to see the share price rise, but again in a passive way. The ability to purchase shares would get staff more involved, but it will be interesting to see the level of take-up of this offer.

Variable reward

There has been a trend towards more variable or contingent pay. Certainly, for executives it is now standard practice to link a significant part of the reward package to the success of the business, either through share options or shares/cash.

This type of remuneration is found in the workforce more generally in certain pockets — particular occupations (sales or IT?) or sectors (dot.com companies?). This seems to be both supply led — individuals seek flexible remuneration packages and means of sharing in the business success — and demand led — organisations wishing either to incentivise or control payroll costs.

Our expectation is that these trends will continue, but that employee financial participation as expressed through variable pay will remain concentrated in certain employee groups and will not become widespread.

3.3 Why might financial participation not develop?

So why is it that organisations may not introduce schemes? IES experience suggests the following may play a role.

- Complex administration is off-putting, especially as small amounts of bonus are not seen as worth the effort.
- Limited understanding by employees means limited value in introducing such schemes.
- Existing rewards are sufficient.
- Employee financial participation does not work as an incentive: so why do it?
- Organisational ownership structure prevents shareholding.
- There are no profits to share!
- Extrinsic motivation is of limited short-term use.
- There is too indirect an effect on intrinsic motivation.
- Volatility of share price — if shares go up, morale goes up — 'for about a fortnight'. But if shares go down slightly, morale plunges.
- If it works too well, there can be an over-retention problem.
- Where different schemes operate in different units, mobility is reduced.

- When the better paid become yet better off, a scheme may become divisive.
- Since share price is not necessarily linked to profit, there can be a disjunction between expectation and performance.
- Employees at the 'coalface', who are in the best position to affect customer satisfaction and business outcomes, often cannot afford to buy many shares.
- If the share value remains low, this may demotivate.
- Team-based schemes depend on the team continuity. The danger is that employees may be in shifting, virtual or project based teams, thereby either changing teams frequently or having multiple membership of several teams.
- It is difficult to measure the effectiveness of employee financial participation — is it introduced on faith?

The above reminds us though the government is keen to encourage employee financial participation, there are difficulties to overcome. Some of these, as we have remarked before, can be ironed out through good design. Others are not so simply dispensed with. In some respects, introducing a profit-sharing or share ownership scheme is done as a matter of faith. Trying to use them to incentivise workers directly may be over-ambitious, given the problems of achieving a line of sight between effort and reward. However, if employee financial participation is used as one element in a 'bundle' of HR practice, it may have a role in supporting wider aspirations towards employee involvement and partnership.

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