FINANCIAL PARTICIPATION FOR A NEW SOCIAL EUROPE

A BUILDING BLOCK APPROACH

Jens Lowitzsch et al.

With a preface by the President
of the European Parliament Hans-Gert Pöttering

Employee Stock Ownership Plans (ESOPs)
Employee Share Ownership
Profit-Sharing

EUROPEAN FEDERATION OF EMPLOYEE SHAREOWNERSHIP

IAFP

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Preface

The radical reforms of the legal and economic order in Europe that have occurred in the process of the EU's eastward enlargement, together with privatisation and globalisation, have led not only to economic progress but also to widening social fissures. To counter the growing discrepancy in some member states between the few who are rich and the many others whose economic existence is being rendered insecure, the concept of financial participation of employees in Europe is becoming increasingly significant.

This development derives partly from the recommendations in the 1993 White Paper *Growth, Competitiveness, Employment* advocating a productivity-related wage policy. In proposing moderate wage rises in conjunction with financial participation of employees, the Commission, under the presidency of Jacques Delors, anticipated one of the most important structural problems in reforming economic and social policy. Already in 1992 the European Council had issued a Council recommendation to the member states concerning the promotion of employee financial participation in profits and enterprise results and the European Parliament adopted various opinions on the subject.

These ideas are reflected in the resolutions of the European Parliament concerning the PEPPER (Promotion of Employee Participation in Profits and Enterprise Results) reports, as well as the EU strategy for growth and jobs, also known as the "Lisbon strategy". The 2003 report of the Committee on Employment and Social Affairs of the European Parliament on "asset formation" (rapporteur: Winfried Menrad) summarised these developments in response to the Commission communication "on a framework for the promotion of employee financial participation".

This book is a response to the above cited report of the European Parliament, which called on the Commission to undertake studies focusing on specific questions, e.g., the feasibility of financial participation in small and medium-sized enterprises, or the possibility of implementing share ownership schemes based on the British and Irish ESOP model (Employee Stock Ownership Plans) in other EU member states.

Preliminary results of the current PEPPER IV project, which is benchmarking financial participation of employees in all 27 EU member states, reveal a positive trend over the past 10 years. Against this background, by providing ample information and recommendations on how to implement and extend financial participation of employees, and thus on "asset formation" at a European level, this book makes an important contribution to the debate.

Of particular value is the flexible concept of a Building Block Approach to promoting a European platform for financial participation, based on the principle of voluntariness. I hope that the discussion of the advantages and disadvantages of the different national financial participation schemes will invigorate the search for feasible models at the European level.

Hans-Gert Pöttering

Note to the reader

The Vice-President of the European Commission, Günther Verheugen, stated in his foreword to the 2006 PEPPER III Report:

"Two years after the ten new Member States joined the European Union, it is clear that the enlargement has acted as a catalyst of economic dynamism and modernisation for the EU, helping the economies of old and new Member States to face better the challenges of globalisation, while the predicted major shocks or disruptive impacts have not taken place. However, important challenges remain for both old and new Member States, namely the ageing population and the strain it puts on public finances and the further increasing global competition. [...]

To address both challenges, we need to enhance the productivity and competitiveness of our economies, making the EU a more attractive place to invest and work in. The framework conditions set by legislators are an important factor enhancing innovation and entrepreneurial activity, productivity, and finally growth and jobs. The EU strategy for growth and jobs, which is also known as the 'Lisbon strategy', lays out an integrated framework to bring this about. [...]

[...] A stronger link between pay and performance can be one of the possible ways to reform the labour markets. Such performance pay schemes can come in many forms. Employee participation in profits and enterprise results (PEPPER) is one possibility to entice workers to be productive and adaptive to change.

The systematic approach followed in this PEPPER III Report will help to deepen our understanding of the pros and cons of financial participation schemes. The country specific analyses can serve as a tool for the exchange of best practice, and this report can be helpful in facilitating mutual learning among the Member States. I hope that the experiences with financial participation schemes in the new Member States and the candidate countries as presented in this PEPPER III Report will serve as a catalyst for new developments and dynamism in other EU countries and thus deliver a contribution to the success of the reviewed strategy for growth and jobs in the EU."

Thus Günther Verheugen, too, expressly endorses the idea of employee financial participation, especially in the context of the Lisbon Strategy. In view of the significant political initiatives currently underway at both European and national level, we believe that the conditions for further developing the financial participation of employees are now especially favourable.

Jens Lowitzsch

Foreword

More than fifteen years have elapsed since the Commission of the European Communities expressed an interest in promoting an EU instrument which would facilitate the implementation of financial participation of employees in enterprise results.[1] In the process of preparing such an instrument, the first PEPPER Report[2] was drawn up, reporting on EU countries' experience gained over the past few decades. The EU Commission's Recommendation on PEPPER was adopted by the European Council in July 1992[3], inviting Member States to facilitate the spreading of PEPPER schemes in practice. The PEPPER II Report, prepared in 1997, updated the information on the developments in the EU Members States that had taken place in the meantime[4], while the PEPPER III Report extended the assessment to the new member countries.[5] The most recent initiative regarding employee financial participation was undertaken by the European Commission[6] and the European Parliament, as reflected in the opinion of the Economic and Social Committee of February 26, 2003.

Today we are faced with a new reality of an European Union of 27 Member States, and the need to develop a common European concept on many issues, including those which concern a New Social Europe. In this undertaking, it would be important to share the rich experience gained with PEPPER schemes in the EU-15 with the new incoming Member States. In the new Member States from Central and Eastern Europe, for a variety of reasons, PEPPER schemes have not had a very long tradition and for the moment only some types of schemes have been implemented. This renders the task of diffusing information on the accumulated experience with financial participation in the EU over the last twenty years even more important.

A PEPPER instrument at EU level should facilitate financial participation of employees in their enterprise results, either through the participation in profits or in enterprise property. The nature of the instrument ought to be of such as to provide a wide range of possible alternatives, from which Member States may choose those they consider most appropriate in the context of their own specific national priorities and traditions. However, since the success of PEPPER schemes can depend on certain key features, it would seem advisable to take into account the experience acquired so far in the EU. The first PEPPER Report, recommended the adoption of PEPPER schemes having certain characteristics. These general characteristics of financial participation schemes recommended at that time are worth recalling , as they seem to have retained their validity:

— Regularity in application
— Calculation according to a predetermined formula

1 *See* Communication from the Commission concerning its Action Programme relating to the implementation of the Community Charter of Basic Social Rights for Workers, *COM (89) 569 final, Brussels, 29 November 1989.*

2 M. Uvalić, *The PEPPER Report – Promotion of Employee Participation in Profits and Enterprise Results (PEPPER is the resulting acronym).*

3 *Concerning the promotion of participation by employed persons in profits and enterprise results (including equity participation), 92/443/EEC, Official Journal L 245 , 26/08/1992 p. 53–55.*

4 *See* Commission of the EC, *Report from the Commission: PEPPER II – Promotion of participation by employed persons in profits and enterprise results (including equity participation) in Member States – 1996, COM (96) 697 final, Brussels, 8 January 1997.*

5 J. Lowitzsch, *The PEPPER III Report – Promotion of Employee Participation in Profits and Enterprise Results in the New Member and Candidate Countries of the European Union, Berlin 2006.*

6 *See the Commission's communication On a Framework for the Promotion of Employee Financial Participation; COM (2002) 364 Final.*

— As an addition to wages
— Providing variable employee benefits linked to enterprise performance
— All employees as beneficiaries
— All types of enterprises, both private and public
— In all enterprises irrespective of size
— Simplicity of schemes
— Employee information and education
— Voluntary nature of schemes.

In choosing the most appropriate schemes, there are clearly numerous options available, since PEPPER schemes can take many different forms. In a possible Common European Model of Employee Financial Participation, the following categories of schemes can be distinguished:
— Profit sharing (in cash or in shares)
— Employee ownership (employee shares or stock options)
— Employee Stock Ownership Plans, as a collective scheme.

These various types of PEPPER schemes could interact and be implemented simultaneously, depending on the specific needs and context, where enterprises ought to be able to choose those which they deem most suitable. With respect to the previous approach adopted in the PEPPER Report, a new category could be introduced, that of Employee Stock Ownership Plans (ESOP). Although ESOPs have been implemented in a limited number of EU countries so far, they could widen the range of possibilities open to enterprises for the application of PEPPER schemes in practice. Combining different types of schemes in a single model with alternative options leads to the Building Block Approach, with the different elements being mutually complementary.[7]

While the findings of the PEPPER Report suggested that there are not many legal obstacles to introducing financial participation schemes, the adoption of a framework law promoting financial participation, particularly in those Member States which have no legislation whatsoever on PEPPER, would be useful. Only if certain facilities in this regard are created could the voluntary introduction of PEPPER schemes be expected on a more substantial scale.

Milica Uvalić

7 *See* J. Lowitzsch, FINANCIAL PARTICIPATION FOR A NEW SOCIAL EUROPE (ED.), *in: "Faculty of Economics Split", Enterprise in Transition – Sixth International Conference, Split-Bol, May 2005, pp. 32–35; see also* Assemblée nationale, REPORT NR. 3304 *"sur la participation des salariés dans l'Union européenne", presented by F. Guillaume, 13 Sept. 2006, pp. 80–85.*

Financial Participation for a New Social Europe

A Building Block Approach

— I —
Introduction

If then, we regard economic freedom as a good, our objective must be thus to restore property. We must seek political and economic reforms which shall tend to distribute property more widely until the owners of sufficient means of production [...] are numerous enough to determine the character of society.

Hilaire Belloc, The Servile State, 1913

In every political system based on a market economy, the concept of property, and especially the legal institution of private property, plays a determining role. But privatisation, increasing concentration, unequal distribution and internationalisation of property have created economic, political and social problems, which so far have defied solution. The creation of a "New Social Europe" and the recent inclusion of no less than ten Eastern European states make the property question even more urgent. Financial participation (in the form of employee ownership as well as profit sharing) based on an appropriate legal framework addresses these problems at their source. Instead of eliminating private property and thereby destroying the market economy, wage dependant employees can be enabled to acquire productive property as shareholders in successful business corporations.

In the EU–15, more than 19% of employees in the private sector currently participate financially in the enterprise for which they work. These existing schemes constitute a pillar of the European Social Model. A generally favourable attitude within a given country has usually led to some supportive legislation for PEPPER schemes, which in turn has spread their practice. This suggests a clear link between national attitudes, legislation and diffusion. But the European Union still lacks a unified legal foundation on which to build a European system of financial participation.

A quite different situation obtains in the new EU member and candidate countries (see the PEPPER III Report). Very few laws specifically address employee financial participation, and these refer almost exclusively to employee share ownership; legislation on profit sharing is rare. Although employees were frequently offered privileged conditions for buying shares of their employer companies, the purpose was not to motivate employees to become more efficient and productive. Nor was there more than mild concern for social justice. Rather, this method was simply an expedient for privatising state-owned enterprises for which at the time there were no buyers. Essentially it was a decision made by default.

In the European Reform Treaty signed on 13 December 2007 in Lisbon, the EU for the first time expressly commits itself to the European Social Model as one of the pillars of its policy. Thus, Art. 3 III states that the Union "shall work for the sustainable development of Europe based on [...] a highly competitive social market economy, aiming at full employment and social progress" and that "[...] It shall combat social exclusion and discrimination, and shall promote social justice and protection [...]."

In 2006, in his foreword to the PEPPER III Report, the Commission's Vice-President Günther Verheugen postulated a stronger link between pay and performance as one of the possible ways to reform the labour markets. Further, in September 2007, Mrs. Christine Lagarde, the French Minister for Economy, Finances and Labour, announced that on assuming the Presidency of the European Union in July 2008, France wishes to launch a European Model of financial participation supported by the member countries.

This book sets forth both a policy and a detailed proposal for a European concept of employee ownership and profit sharing, one that provides a broad incentive system made up of diverse and flexible alternatives, which correspond to existing national systems. Our goal is a general scheme suitable for use throughout the European Union, derived from the best practises of national legislation and customs.

We would like to stress that we are particularly emphasising the development of Employee Stock Ownership Plans (ESOPs) and related schemes. Originating in the United States, ESOPs are – with the exception of Ireland the United Kingdom and Hungary – still little known in Europe. ESOPs are financial tools that, among other advantages, provide access to capital credit; they also tend to enhance the entrepreneurial commitment of both employers and employees.

— II —
Objective and Context

— II.A —
Socio-Economic Background

Both the European Commission and the European Parliament recently launched a new initiative, manifested in the opinion of the Economic and Social Committee of 26 February 2003,[8] on the Commission communication "on a framework for the promotion of employee financial participation".[9] Given this remarkable political initiative by the European policy-makers, we surmise that the conditions for improving the legal framework for financial participation of employees (and therefore for the transformation of non-owners into shareholders) are now especially favourable.

The European Parliament called on the Commission to submit studies on the issues raised in its Resolutionof 5 June 2003[10], including a study on setting up a European monitoring body. Our proposed European Concept ideally complies with the request for analysing and describing the overall framework of employee participation in general, and already existing financial participation schemes in particular. As an alternative to the creation of a European Recommendation or Directive on financial participation, we suggest the application of existing national Company Law rooted in the second Council Directive on Company Law.[11] Further, the amendment[12] of existing European Company Law, i.e., the European Company Statute[13] is considered. Advantages and disadvantages of financial participation schemes at the national level are discussed in support of the promotion of such schemes on a European level.

— II.A.1 —
The Function of Ownership[14]

Ownership of capital property is the material foundation of individual political and economic freedom. As the German Federal Constitutional Court has ruled: "The guarantee of ownership shall preserve – in the field of property rights – a free sphere for the bearer of fundamental rights, and thus it shall enable the individual to develop and self-responsibly conduct his life".[15] This reaffirms ownership as a fundamental constitutional right indispensable to individual freedom and economic opportunity.

8 *SOCI 115, Employee Financial Participation, CESE 284/2003.*

9 *COM (2002) 364 Final.*

10 *P5-TA (2003) 0253.*

11 *The Directive of 13 December 1976, 77/91/EEC allows various derogations designed to encourage the financial participation of employees in joint stock companies; see below IV B 3.*

12 *As proposed in the European Parliament Resolution of 5 June 2003 (P5-TA (2003) 0253), 31. IV. Similar to the Council Directive 2001/86/EC of 8 October 2001, "supplementing the Statute for a European company with regard to the involvement of employees", OJ, L 294/22, but with regard to financial participation.*

13 *Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European company (SE); OJ, L 294/1.*

14 *See* H. Roggemann, FUNCTIONAL CHANGE IN PROPERTY RIGHTS IN THE WELFARE STATE: LESSONS FROM THE FEDERAL REPUBLIC OF GERMANY, *in:* I. Collier, H. Roggemann, O. Scholz, H. Toman (Eds.), WELFARE STATES IN TRANSITION – EAST AND WEST, *St. Martins Press, New York 1999, pp. 25–40.*

15 *See the Federal Constitutional Court in the case concerning the possession of rented apartments of 26 May 1993, BVerfGE, Vol. 89, pp. 1, esp. p. 6; compare also BVerfGE, Vol. 24, pp. 267, esp. 389; Vol. 50, pp. 290, esp. 339; Vol. 53, pp. 257, esp. 289.*

The majority of citizens in industrial societies do not own any kind of productive property. Thus they are impeded from wider participation in civil society and from access to economic opportunity, as well as from the attainment of economic security and leisure. The challenge of the "New Social Europe" is to create a new proprietary society of functional owners, incorporating those who have so far been excluded by a closed system of ownership.

The Economic and Social Committee and the Commission both emphasised that broad forms of financial participation can greatly benefit the European business system by reducing conflict in industrial relations.[16] Both bodies believe that financial participation can help achieve the objective, laid down by the March 2000 Lisbon summit, of making the European economy "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion".[17]

— II.A.2 —
Capital Concentration Is Dysfunctional

The question of how much economic concentration and inequality of property distribution a democratic society can or even should tolerate remains to be answered. On the other hand, the thesis that democracy requires a wide distribution of wealth is widely accepted. Both social justice and free market distribution require a minimum standard of democratic equality in order to achieve social stability and maintain the market system. Present social policy has not yet responded to the growing concentration of wealth[18] and the resulting dramatic increase in "non-owners"; no regulations have come into force either on a national or a European level. Social attention so far has been focused on the growing wealth of the few (e.g., anti-monopoly legislation) without acknowledging the corresponding increase in the number of those who do not own. It needs to be recognised that the "society of owners" is simultaneously a "society of non-owners".[19]

What gives legitimacy to the current discussion of new forms of financial participation is the incontrovertible failure of the Marxist solution to the property problem. The problem of concentrated ownership cannot be solved by eliminating private property. The result is a dysfunctional economic system that, in abandoning a market economy, finds itself unable to satisfy either the basic human and consumer needs of its people or the basic requirements of democracy. Similar structural problems in Western Europe (e.g., Germany) have led to the legal and political conclusion that "the prevention of a dysfunc-

16 *See Opinion of the Economic and Social Committee of 26 February 2003, on the Commission communication "on a framework for the promotion of employee financial participation", SOCI 115, Employee Financial Participation, CESE 284/2003, p. 4.*

17 *See point 1.5 of the Presidency Conclusions of the Lisbon European Council (23–24 March 2000).*

18 *For Germany see* Die Zeit, *No. 40, 23 September 2004, Economy "Where do the rich stand?" and No. 34, August 2004, Economy "Only the rich get richer"; for emerging countries see* Le Monde, Dossier and Documents No. 334, *September 2004, "Les riches des pays émergents".*

19 *See* H. Roggemann, Functional Change in Property Rights in the Welfare State: Lessons from the Federal Republic of Germany, *in:* I. Collier, H. Roggemann, O. Scholz, H. Toman (Eds.), Welfare States in Transition – East and West, *St. Martins Press, New York 1999, pp. 25–40.*

20 *See* H. J. Papier *in* Maunz, Dürig, Herzog Commentary on the Basic (Constitutional) Law of Germany, *Article 14, No. 17; compare also the Resolution of the European Parliament (P5-TA (2003) 0253) on the Commission communication to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions "on a framework for the promotion of employee financial participation", COM (2002) 364, 2002/2243 (INI).*

21 *See* L. Kelso *and* P. H. Kelso, Democracy and Economic Power: Extending the ESOP Revolution through Binary Economics, *University Press of America, Lanham, Maryland, 1991.*

tional concentration of private property possibly not only requires legislation against concentration of economic property, but also an active public promotion of asset formation."[20]

The counter model representing the solution to this problem of property distribution was proposed as early as 1958 by the American lawyer and investment banker Louis Kelso.[21] It utilizes the existing financial infrastructure of a free market democracy. Kelso's alternative goes to the root of the problem: Instead of depriving owners of their private property, non-owners should be enabled to become owners through an effective opportunity to participate in the success of their firm not only as wage-earners but also as shareholders.

— II.A.3 —
Insufficient Legal Foundations

The basic conception of civil society as a society of private property owners has not (yet) been sufficiently recognised in European law.[22] Since the adoption of the European Charter of Fundamental Rights (as part of the Treaty of Nice in 2001) ownership has been more precisely defined in Article 17 of the Charter.[23] But not until the ratification of the European Constitution and the inclusion of the European Charter of Fundamental Rights as part of it will the Charter become binding European Law.

So far the only explicit support for a framework for financial participation is to be found in the Council Recommendation of 27 July 1992[24] and in Part 7-II of the Action Programme for Implementing the Community Charter of the Fundamental Social Rights of Workers.[25] Title XI (Social Politics) of the additional protocol of the European Human Rights Convention of 1952, however, contains no recognition of the financial participation of employees. It merely states principles of protection of labour, equal opportunities and co-determination, although Article 139 (former 118b) ECT permits agreements between social partners on a community level. A rare exception to the general silence is the second Council Directive on Company Law.[26] In summary, the community law appears deficient in regard to employee participation in general, and financial participation in particular.

22 *One reason is that Article 295 (former 222) of the Treaty of Amsterdam excludes private property as a legal institution from the law of European contracts. But de facto the treaties do deal with the subject of private property, especially by regulating derived rights and related areas.*

23 *Nevertheless the Charter as a mere list of policies is not genuine jus cogens and thus has no res judicata effect.*

24 *Concerning the promotion of participation by employed persons in profits and enterprise results (including equity participation), 92/443/EEC, Official Journal L 245 , 26/08/1992 pp. 53–55.*

25 *The Charter of 9 December 1989, which was also signed by the United Kingdom in 1998, is neither a binding legal act nor is it a treaty among the signatory states. It is merely a solemn declaration which should nonetheless serve as an aid to the interpretation of the provisions of the EC Treaty, since it reflects views and traditions common to the Member States and represents a declaration of basic principles which the EU and its Member States intend to respect. Together with the Action Programme, which has also been approved by the Heads of State or Government, it is therefore used by the Commission as a basis for justifying many of the Directives it proposes.*

26 *See Art. 19 para. 3, 23 para. 2, 41, para. 1 and 2 of the Directive, 77/91/EEC, dating back to 13 December 1976 which allow derogations from the European legal framework for Joint Stock Companies designed to encourage the financial participation of employees (see below IV. B.3.)*

— II.B —
European Initiatives

— II.B.1 —
The PEPPER Reports

The foregoing problems were previously discussed at the European level and addressed by several measures in the early '90s, including:

— the European Commission PEPPER I Report (Promotion of Employee Participation in Profits and Enterprise Results) in 1991;[27]
— the Recommendation of the Council of the Union of 27 July 1992,[28] concerning the promotion of employee participation in profits and enterprise results; and
— the Resolution of the European Parliament of 9 April 1992, concerning the proposition of the European Commission for the aforementioned recommendation of the Council of the Union.[29]

Despite these initiatives, however, the PEPPER II Report of 1997[30] found no major changes in national policies in respect to the promotion of employee financial participation schemes. Large differences between the countries – especially in respect to the role of the state in the development of PEPPER systems – still exist. A systematic information exchange on a larger scale has generally not succeeded beyond perhaps a few narrow studies. With the exception of Great Britain and France, the variety of incentive systems offered was rather small.[31]

This assessment was extended to the new Member and Candidate countries in 2006 with the PEPPER III Report.[32]In both the non-transition countries and the former socialist states, the few laws enabling forms of employee financial participation refer almost exclusively to employee share ownership, while in the latter they are mainly linked to privatisation. There have been only a few cases of legislation on profit sharing. The general attitude of governments and social partners shows the lack of concrete policy measures supporting PEPPER schemes by policy makers, and limited interest both by trade unions and employers organisations.

In 2008 the PEPPER IV Report[33] for the first time provides an overview on employee participation in its entirety in all member and candidate countries of the European Union. Furthermore, it offers comprehensive empirical data on employee participation in the 27 EU member and two candidate countries, its significance in economic practise; legal obstacles, and future possibilities.

27 *By M. Uvalić, published in Attachment 3/91 of the brochure* SOCIAL EUROPE.

28 *92/443/EEC, OJ, L 254 of 26 August 1992, p. 53.*

29 *OJ, C 245 of 20 September 1991.*

30 *The report was designed to give a review of the effects of the previously mentioned recommendation of the Council of the European Union 92/443/EEC in the Member States; see PEPPER II Report, 1997, KOM(96)0697 C4-0019/97.*

31 *With preference generally given to profit-sharing models in France and share ownership models in Great Britain.*

32 J. Lowitzsch et al., *The PEPPER III Report – Promotion of Employee Participation in Profits and Enterprise Results in the New Member and Candidate Countries of the European Union, Berlin 2006, distributed by the European Foundation for the Improvement of Living and Working Conditions.*

33 *The Commission funded project, led by the author of this book, closes the gap between PEPPER I/II (1991 EU12 / 1997, EU15) and PEPPER III (2006 10 New Member and 4 Candidate Countries) that currently prevent a full profiling of financial participation policy and practice and rolls out the benchmarking indicators developed by the European Foundation for the Improvement of Living and Working Conditions.*

The Report consists of three complementary basic components that build on each other:

— Description of the legal environment, fiscal or other incentives and social partners attitudes in country profiles;
— Benchmarking financial participation, i.e., the scope and nature of financial participation schemes against the background of the country profiles;
— Comparative Analysis of the national policies and characteristics that affect the environment for financial participation, providing a contextual frame of reference for each single profile.

The PEPPER Reports analysed schemes promoted by the European Union. These were all company level, broad-based plans dependent on company performance (at the same time not excluding participation in company assets). Thus gain-sharing, irregular cash-based profit sharing, share option schemes not broadly based and executive stock option schemes were excluded.

— II.B.2 —
Finding Solutions for a "New Social Europe"

A variety of concepts have been established in the Member States, where the executive and legislative branches and the social partners have made great efforts to advance "employee participation in productive property".[34] This is not only true of countries led by social-democratic governments. In Germany the conservative government, before being voted out of office on 27 September 1998, had accepted a draft for a "Third Act of Property Participation"[35] and the current "Große Koalition" under Chancellor Merkel is presently considering a law on financial participation.[36] This suggests that the debate has transcended the classical political battlefields of left and right. Furthermore, it seems that the dogmatic frontiers between employers and employees – at least in the area of financial participation – are starting to erode.

Within the European Union as a whole, reinforcing the integrational function of ownership by making ownership more broadly accessible requires a legal foundation for the implementation and support of financial participation schemes. This involves two main goals:

— Firstly, to develop regulations concerning financial participation at the Directive level, providing for a broader incentive system in order to support financial participation more actively and to overcome national differences in taxation policy;

34 *For details see PEPPER II Report, 1997, KOM(96)0697 C4-0019/97.*

35 *BGBl I/1998, No. 61, p. 2647, on which the Committee for Labour and Social Policy of the German Bundestag had conducted a hearing of experts.*

36 *See the interview with German President Horst Köhler, Der Stern, 29 December 2005; the Christian Democratic Party (CDU) established a specific expert group dealing with the issue.*

— and secondly, to attain a general inclusion of the principle of financial participation of employees in the legal framework of the European Social Constitution.[37]

— II.B.3 —

Summary of the Postulate of the European Policy-Makers

The Commission communication seeking a "framework for the promotion of employee financial participation"[38] sets forth the following *essential principles* for financial participation schemes:

— Participation must be voluntary for both enterprises and employees.
— Access to financial participation schemes should in principle be open to all employees (no discrimination against part-time workers or women).
— They should be set up and managed in a clear and comprehensible manner with emphasis on transparency for employees.
— Share ownership schemes especially will almost inevitably involve a certain complexity, and in this case it is important to provide adequate training for employees so as to enable them to assess the nature and particulars of the scheme in question.
— Rules on financial participation in companies should be based on a predefined formula clearly linked to enterprise results.
— Unreasonable risks for employees must be avoided or, at the very least, employees must be warned of the risks of financial participation arising from fluctuations in income or from limited diversification of investments.
— The scheme must be a complement to, not a substitute for, existing pay systems.
— Financial participation schemes should be developed in a way that is compatible with worker mobility both internationally and between enterprises.

Financial participation involves not only opportunities but also risks and difficulties, in particular:

— The dual risk that employee shareholders might lose both their jobs and the value of their shares in the event of the company's bankruptcy.
— Organisational and other obstacles, e.g., in the areas of taxation law, social security law and labour law in transnational enterprises.
— In small and medium sized enterprises (SMEs) both the cost and the administrative problems may be considered prohibitive.

37 *EU Treaties in the actual form of the Nice Treaty. See Title XI, Article pp. 136; Title XVII, Article pp. 158.*

38 *COM (2002) 364 Final, 5 July 2002.*

The Commission and Parliament further identified the following transnational obstacles to both the development of a European model and to cross-border plans for financial participation:[39]

- Differences in taxation systems can give rise to double taxation issues. This is primarily a problem of determining the optimal time to tax share options depending on when they are exercised.
- Differences in fiscal systems can also entail substantial administrative costs for enterprises wishing to introduce multi-national financial participation schemes.
- Social security contributions on income from financial participation and investment holdings are assessed in various ways.
- Legal questions arise from differences in the laws on securities and prospectuses and in labour as well as social security laws.
- In an international context, the general lack of mutual recognition usually impedes offering these schemes to employees in other countries.
- Blocking periods restrict the time when employees may dispose of their shares.
- Cultural presumptions regarding the social partnership vary widely.

Except for share-holding schemes in the context of the ongoing privatisation processes, almost none of the new member countries provide either a legal or fiscal framework for employee participation.[40] According to the Commission communication, a number of specific obstacles exist in Central and Eastern Europe:

- Employee-owned enterprises often face severe financial difficulties, especially in cases where employee ownership emerged by default rather than by design.
- Interest in employee share ownership on the part of employees tends to be limited, as evidenced by employees very often preferring to sell their shares almost immediately.
- With the completion of privatisation, favourable tax arrangements offered by some countries for the purposes of employee buy-outs are expiring.
- Techniques for increasing the awareness of employee participation need development in countries where private ownership is a relatively new concept.

39 *See High Level Group of Independent Experts, Report on cross-border obstacles to financial participation of employees for companies having a transnational dimension, Brussels, December 2003, pp. 17.*

40 *See* J. Lowitzsch et al., *The PEPPER III Report – Promotion of Employee Participation in Profits and Enterprise Results in the New Member and Candidate Countries of the European Union, Berlin 2006.*

— II.C —
The Current Reform Process

— II.C.1 —
Actual Tendencies of Property Development – A Challenge for Social Policy

The current development of the legal system of ownership in Europe can be described as bearing the following tendencies:

— Concentration of ownership, which reached new extremes in the 1990s, is continuing in several European countries.[41]

— In some Western European countries (e.g., Germany, France, Italy, Austria) the privatisation of big companies (especially in the infrastructure, energy and telecommunication sectors) although leading to a diversification of ownership to some extent, only slowed down but did not reverse the process of concentration of ownership.[42]

— In the course of the post-socialist (re-)privatisation in Eastern and Central Europe, unusual forms of financial participation have been developed as a result of social privatisation methods.[43] They have, however, been carried out with only varying success. In Eastern Germany, forms of participation have been limited to the management buy-out.[44]

— In Central and Eastern Europe, as well as in Eastern Germany, the (re-)privatisation of economic assets previously held by the state, by society or by co-operatives at first appeared to broaden ownership. But this process did not, despite legislative intentions, lead to progressively more equality in ownership distribution, but promoted new ownership concentration.

— II.C.2 —
Status Quo

In the EU–15, more than 19% of employees in the private sector currently participate financially in their employer firms through profit sharing or share ownership.[45] These existing schemes constitute a pillar of the European social model based on partnership and seeking to overcome the rivalry between capital and labour. So far only participation in decision-making has been incorporated in the legal framework of the EU treaties.[46] The Commission's PEPPER II Report (1997) concluded that there is more diversity than uniformity in models of finan-

41 *E.g., for Germany see* Die Zeit, *No. 40, 23 September 2004, Economy "Where do the rich stand?".*

42 *See* J. Winiecki *in* Rzeczpospolita, *16 August 2004, Economy "Kapitalistyczna karawana idzie dalej" (The capitalist caravan is moving on), comparing the share of public property and privatization in* OECD *countries.*

43 *See* J. Lowitzsch, Privatisierung und Beteiligung in Mittelosteuropa – Am Beispiel des polnischen, slowakischen und tschechischen Modells *(Privatisation and Capital Participation in Central Eastern Europe – The Example of the Polish, the Czech and the Slovak Model), Berlin Verlag, 2002.*

44 *See* F. Barjak, G. Heimpold, et al., Management Buy-Out in Ostdeutschland, *Halle, 1996.*

45 A5-0150/2003, Report of the Committee on Employment and Social Affairs of the European Parliament *on the Commission communication "on a framework for the promotion of employee financial participation", COM (2002) 364, 2002/2243 (INI), p. 12.*

46 *E.g., in the context of the European Company Statute in the Council Directive 2001/86/EC of 8 October 2001, "supplementing the Statute for a European company with respect to the involvement of employees", OJ, L 294/22.*

cial participation. The analysis of the legislative framework in the ten new EU members and the four candidate countries[47] (PEPPER III, 2006) has shown that there are practically very few laws specifically dedicated to employee financial participation. Because no specific legal foundation yet exists, there is no European framework for financial participation until now.

There is a need, however, for co-ordination of current practices through the development of guidelines and agreements on general principles. These should maintain the flexibility of individual countries' policies to ensure compatibility so as not to impede workers' mobility, particularly across national borders. Solutions must be found on a community-wide basis to the issues of taxation of share ownership and to the valuation of shares for social security purposes. Management may be induced to introduce share ownership or profit sharing for several reasons[48]:

— to make employees more motivated and productive;
— to make enterprises more competitive through improved capital structure, better liquidity for the company (i.e., to enhance working capital), and easier access to external capital.

Yet a significant breakthrough can probably be achieved only with the help of government incentives, i.e. tax concessions. All these considerations must be incorporated into the development of a specific legal framework for the financial participation of European employees in the enterprises for which they work.

— II.C.3 —
Recent Studies

In order to formulate a more focused strategy, a number of studies have recently been undertaken, including:

— the working document of the European Parliament Secretariat, "Employee Participation in Profits and Ownership: A Review of the Issues and Evidence";[49]
— studies by the European Foundation for the Improvement of Living and Working Conditions on the subject of employee financial participation;[50] and
— the report of the Committee on Employment and Social Affairs and the opinions respectively of the Committee on Economic and Monetary Affairs, the Committee on Industry, External Trade, Research and Energy, and the Committee on Women's Rights and Equal Opportunities.[51]

47 *Cyprus, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Malta, Poland, Slovakia and Slovenia as countries that joined the European Union on May 1st 2004 and Croatia, Bulgaria, Romania and Turkey as Candidate Countries.*

48 *For a recent, comprehensive overview of the positive economic evidence (esp. for ESOPs) see J. R. Blasi, D. Kruse, A. Bernstein, "In the Company of Owners", Basic Books, New York 2003; they find an average increase of productivity level by about 4%, of total shareholder returns by about 2% and of profit levels by about 14% compared to firms without PEPPER schemes.*

49 *SOCI 109, European Parliament, Directorate-General for Research, Luxembourg, 2002.*

50 *Employee Share Ownership and Profit-Sharing in the European Union, 2001 and Recent Trends in Financial Participation in the European Union, 2001; Financial participation in the EU: Indicators for benchmarking, 2004 Financial participation for small and medium-sized enterprises: Barriers and potential solutions, 2004, and Financial participation: The role of governments and social partners, 2004.*

51 *Of 5 May 2003 (FINAL A5-0150/2003), Rapporteur: Winfried Menrad.*

Based on these studies, the European Parliament reiterated its proposal that "employee share ownership, which creates jobs, is more deserving of state support than profit sharing handed out in cash to employees". Triggered by a motion of the Committee on Employment and Social Affairs in its Resolution of 5 June 2003,[52] the European Parliament advocates, in addition to fiscal solutions, savings bonuses to encourage personal asset formation on the grounds that savings bonuses benefit workers who pay little or no tax while bonus systems are easier to reconcile in transnational participation models. The Resolution's proposal for increasing employee ownership starts from the premise that the value added by an enterprise is created by all the factors of production working together. Therefore the European Parliament proposes that stock options should not be restricted to management and calls for studies on the feasibility of making share options available to all employees and, if this is practicable, what forms of options would allow employees to share in the growing value of the companies for which they work.

The European Parliament would also welcome studies on the forms of financial participation that now exist or would be appropriate for small and medium sized enterprises (SMEs).[53] It further recommends that studies be conducted on the suitability of trusteed programmes such as Employee Stock Ownership Plans (ESOPs) and Employee Stock Ownership Trusts (ESOTs) (which operate in Ireland and Great Britain), on funds which combine several SMEs, as well as on existing workers' cooperative models.[54]

52 *P5-TA (2003) 0253.*

53 P. Maillard, *Rapport sur la Participation dans les Entreprises de mois de 50 Salariés, Report to Prime Minister Dominique de Villepin, April 2007; compare also Final Report of the MAP 2002 Project, European Commission Enterprise Directorate-General, "Transfer of Businesses – Continuity Through a New Beginning", 2003.*

54 *In this context the question of employee involvement is mentioned. As the study Recent Trends in Financial Participation in the European Union, Dublin, 2001 by* E. Poutsma, *showed, there is a clear connection between successful employee financial participation and participative structures in the enterprise; see pp. 42–45.*

55 *COM (2002) 364 Final, 5 July 2002, p. 3, 10.*

—— II.D ——

The Path to a European Regulation

The American experience in institutionalising techniques for broadening the ownership of capital, valid in all of the 50 American states, provides a model for such a trans-jurisdictional framework. In its communication the Commission refers to this experience by stressing the "important impact financial participation can have in terms of economic growth, fostering industrial change and making sure that all workers participate in this growing prosperity". Furthermore, the Commission states that "especially when compared to the experiences in the U.S., there exists still a huge, largely unused potential for the further development of financial participation as part of an overall strategy aimed towards stimulating the growth of new, dynamic companies".[55] Two relevant issues are currently under consideration in the European Union:

— Can broadened ownership of capital through ESOPs or similar vehicles help EU companies become more competitive in the world market? One field of action already identified in this context, in the Council Recommendation of 7 December 1994,[56] are transfers of businesses to employees as a way to facilitate business succession in SMEs.[57]
— Assuming that broadened ownership of capital is desirable from a social and economic standpoint, what is the best way to amend legal structures in the EU so as to create a legal foundation for employee share ownership as part of property rights legislation, and thus the "acquis communautaire" itself?

— II.D.1 —
Focus: Legislating Financial Participation Schemes

Although tax incentives are the most common way of encouraging financial participation schemes, a common European legal framework imposing such tax incentives would collide with the national legislative sovereignty over taxation. Under the European Union each member state retains exclusive power over all matters involving taxation; any Directive involving taxation requires the unanimous consent of the Member States. Therefore a European approach to the problem must provide a broad incentive system going beyond the classical instruments of tax legislation. Establishing such schemes through legislation is of primary importance, as it gives companies a distinct legal entity and provides them with a clear framework for company decisions and actions. At the same time, establishing a legal framework delineates what is possible for companies without inviting sanctions from regulatory, legal or taxation authorities.[58]

— II.D.2 —
Unanimous Decision vs. Majority Vote

Diverse national approaches to both financial participation and participation in decision-making constitute further impediments to change. For obvious reasons, it is very difficult to reach a unanimous supranational compromise either in the Commission or in the Council. The law of European Treaties in general permits majority vote decisions in a limited number of cases, recently extended by the Treaty of Nice.[59] No less than 27 provisions have been changed completely or partly from unanimity to qualified majority voting, among them measures

56 *On the transfer of small and medium-sized enterprises, 94/1069/EEC, with explanatory note,* Official Journal No. C 400, 31 December 1994, *p. 1.*

57 *One of the key areas defined in the Final Report of the MAP 2002 Project, European Commission Enterprise Directorate-General,* Transfer of Businesses – Continuity Through a New Beginning, *2003.*

58 *See* A. Pendleton, et al., Employee Share Ownership and Profit-Sharing in the European Union, *European Foundation for the Improvement of Living and Working Conditions, 2001, p. 9.*

59 *The Treaty of Nice has extended the scope of co-decision. This procedure will be applicable to seven provisions which change over from unanimity to qualified majority voting (Articles 13, 62, 63, 65, 157, 159 and 191; for Article 161, the Treaty stipulates assent). Accordingly, most of the legislative measures which, after the Treaty of Nice, require a decision from the Council acting by qualified majority will be decided via the co-decision procedure.*

to facilitate freedom of movement for the citizens of the Union (Article 18 ECT) and industrial policy (Article 157 ECT). As to taxation (Articles 93, 94 and 175 ECT), however, the requirement of unanimity for all measures is maintained across the board. In the field of social policy (Articles 42 and 137 ECT), despite maintenance of the status quo, the Council, acting in unanimity, can make the co-decision procedure[60] applicable to those areas of social policy which are currently still subject to the rule of unanimity.[61] Therefore the search for a legal foundation at the Directive level has to focus on those "majority vote" regulations if it is to be successful. This is further true because the position of the governments in relation to the social partners, their role in society, and their relation to each other varies significantly in the different member countries.[62]

— II.D.3 —

Different Contexts, Different Approaches – The Building Block Approach

A strict distinction concerning suitable options and legal procedure to create solutions at the European level has to be made between participation in decision-making and financial participation. Participation in decision-making, whatever its form at the national level, is as a rule obligatory for enterprises in the given country.[63] Since community law would be equally binding, a supranational compromise can encompass only the smallest common features of the diverse national regulations.[64] Financial participation on the other hand is traditionally an optional instrument for improving company performance and corporate governance; enterprises are therefore free to introduce PEPPER schemes.[65] Thus, provided that they are granted voluntarily on the national level, a supranational concept can offer a variety of incentives from which to choose.

A European Regulation should thus encompass a broad incentive system which provides different and flexible solutions, compatible with those already established in the Member States. An adaptable scheme can provide for a solution suitable for use throughout the European Union, comprising best practises of national legislation and customs.[66] Combining them in a single program with alternative options leads to a "Building Block Approach", with the different elements being mutually complementary.

These building blocks consist of the following three basic elements:

— Profit Sharing (cash-based, deferred and share-based);

— Individual Employee Shareholding (stock options and employee shares);

— Employee Stock Ownership Plans (ESOPs) as collective schemes.

60 *See Annex II.*

61 *This "bridge" cannot, however, be used for social security.*

62 *E.g., the consensual continental contrasts with the Anglo-American confrontational model; likewise the strong position of the state in France contrasts with the powerful role of the German "Tarifpartner" (collective bargaining parties, such as trade unions and employer associations). See* A. Pendleton, E. Poutsma, FINANCIAL PARTICIPATION: THE ROLE OF GOVERNMENTS AND SOCIAL PARTNERS, *European Foundation for the Improvement of Living and Working Conditions, Dublin 2004.*

63 *As, for example, the German "Mitbestimmung" and the Works Councils in France and the Netherlands.*

64 *This problem is well illustrated by the prolonged controversy over the so called European Workers Council, and as a consequence the rather minimal compromise of the regulation in the European Company Statute.*

65 *A rare exception exists in France where enterprises with more than 50 employees are required to establish a participation fund. See "PEPPER II Report", 1997; KOM(96)0697, C4-0019/97, pp. 19–20.*

66 *Compare* White *and* Case, *THE EUROPEAN COMPANY STATUTE, 2001, p. 4.*

67 *For Ireland, see* J. Shanahan *and* L. Hennessy, *UNDERPINNING PARTNERSHIP AT THE WORKPLACE – AN MSF GUIDE TO PROFIT SHARING, ESOPS AND EQUITY PARTICIPATION, Dublin, 1998, p. 9.*

68 *One of the key areas defined in the Final Report of the MAP 2002 Project, European Commission Enterprise Directorate-General, TRANSFER OF BUSINESSES – CONTINUITY THROUGH A NEW BEGINNING, 2003.*

While profit-sharing schemes, stock options and employee shares are relatively widespread in the European Union, Employee Stock Ownership Plans (ESOPs) are predominantly to be found in countries with an Anglo-American tradition, e.g., the United Kingdom and Ireland.[67] Originated in the United States as a technique of corporate finance, the ESOP, using borrowed funds on a leveraged basis, has the capacity to create substantial employee ownership and can be used to finance ownership succession plans, an important feature, especially for European SMEs.[68] Furthermore, it can be used to refinance outstanding debt, to repurchase shares from departing plan participants, or to finance the acquisition of productive assets.[69] The last two functions are also both possible on an unleveraged basis. In the unleveraged case, of course, less stock can be acquired in any given transaction.

— III —
The Current Situation in Europe

— III.A —
Policy Issues

With the advent of a new European Constitution, the structural problems described above have led to the postulate that in addition to legislation discouraging concentration of economic property, an active public promotion of asset formation[70] is required on a European scale. Nevertheless, up to now no appropriate conclusions have been drawn from the fact that the social groups of owners and non-owners are drifting apart dramatically. No regulations actively supporting the implementation of a European concept for employee financial participation have been enacted at the national level or at the European level. At the end of the 1990s, in the countries of the EU–15, no major changes in the national policies were to be observed, and up to now large differences between the countries exist. In the new Member Countries of Central and Eastern Europe, local approaches embracing different forms of mass privatisation and employee shareholding (not contemplated in (Eastern) Germany[71] or in other Western European states) were undertaken with varying degrees of success.[72]

The influence of private property on the political system,[73] especially the observation that widely diffused private property may have a decentralising, power-sharing and power-limiting effect, leads to the conclusion that "[…] ownership, being by nature autocratic, becomes republican when it is implanted into a political society".[74] The arbitrary intrusion on private ownership reduces

69 *From an entrepreneurial point of view, see* D. Ackermann, How to Cash Out Tax-Free, Yet Keep Your Business … ESOPs – A Practical Guide for Business Owners and Their Advisors, *Conference Paper for the National Center for Employee Ownership, San Francisco, California, 2002.*

70 *See* H. J. Papier, Maunz, Dürig, Herzog, Commentary on the Basic Law of Germany, *Article 14, No. 17.*

71 *East Germany has confined itself almost solely to forms of management buy-out. See* F. Barjak, G. Heimpold, et al., Management Buy-Out in Ostdeutschland, *Halle, 1996.*

72 *In some cases it has become obvious that these local approaches to greater equality in the distribution of property may lead to a renewal of socialistic structures of ownership and bureaucratic hindrance of market economy structures (e.g., Czech Republic, Slovakia, Russia, Croatia and Bulgaria). With regard to the voucher privatisation in the Czech Republic, see* J. Lowitzsch, Restructuring Strategy and Insider Ownership as Determinants of Privatisation Models in Poland and the Czech Republic, *Conference Paper, Enterprise in Transition, Split, Croatia, 2001. As to problems of privatisation in Slovakia, see* I. Mikloš *(former Minister of Privatisation),* Corruption Risks in the Privatisation Process, *Klub Windsor Paper, Bratislava, 1995.*

73 *"Speaking one's mind declines when property holding declines, and with it those who are free of necessity disappear from sight",* Sebastian de Grazia, Of Time, Work and Leisure, *The Twentieth Century Fund, New York, 1962.*

74 *For the power-limiting and "peace-making" function of private property see also* H. J. Papier, *loc. cit., Nos. 4 and 5.*

the confidence of the citizen in the state. Thus a reasonably stable but also fair system of property plays an important part in political peace. This link between the political system and the property system makes the current but not always successful privatisation process in the postsocialist transformation states a touchstone for real (as opposed to only formal) system transformation.

The concentration of the most important property assets in the hands of only a few individuals or in the hands of the state is a threat to any democratic pluralistic society, especially to the emerging social system and civil society in Central and Eastern Europe. Nevertheless, legal and political priorities differ considerably between East and West, since changing the socialist economic system through privatisation and re-privatisation is the first priority of postsocialist legislators.[75]

—— III.B ——

Problems Related to the Legal Framework and Transnational Obstacles

As previously mentioned, as of now the only explicit support of financial participation is to be found in the Council Recommendation of 27 July 1992[76] and in Part 7-II of the Action Programme for implementing the Community Charter of the Fundamental Social Rights of Workers. The Charter of 9 December 1989, also signed by the United Kingdom in 1998, is neither a binding legal act nor a treaty among the signatory states.[77] Together with the action programme, which has also been approved by the Heads of State or Government, it is used by the Commission as a basis for justifying many of the Directives it proposes. Overall, the community law seems to be deficient in respect to employee participation in general, and financial participation in particular.

A second deficiency is that the development of financial participation schemes across the European Union is strongly influenced by national policies, in particular by the availability of an appropriate legal framework, tax incentives and other financial advantages.[78] As a result, different laws, and sometimes mandatory rules, in the different countries often require specific forms of financial participation, forcing companies to tailor the design of an international plan accordingly.[79] At the end of 2003, a High Level Group of Independent Experts[80] classified the barriers to cross-border plans for financial participation into seven broad categories:

Existing legal framework Legal obstacles embrace such different issues as for example employee involvement in the introduction of plans; legal

75 *See* H. Roggemann, *Functional Changes of Property Rights in East and West – Comparative Remarks to Post-Socialist Transformation in Eastern and Western Europe, Working Paper, Prague CERGE EI, Charles University, 1997;* the same, *On the Relation between Ownership and Privatization in the Post-Socialist Countries, in:* University of Split, Faculty of Economics (ed.), *Enterprise in Transition II, Split 1997, pp. 193;* the same and J. Lowitzsch (ed.), *Privatisierungsinstitutionen in Mittel- und Osteuropa, Berlin 2002.*

76 *Concerning the promotion of participation by employed persons in profits and enterprise results (including equity participation), 92/443/EEC, Official Journal L 245 , 26/08/1992 pp. 53–55.*

77 *It is merely a solemn declaration which should nonetheless be used as an aid to the interpretation of the provisions of the EC Treaty since it reflects views and traditions common to the Member States and represents a declaration of basic principles which the EU and its Member States intend to respect.*

78 *In some countries, however, financial participation schemes have developed without specific tax incentives or when incentives have been reduced (Germany, Italy, the Netherlands, Canada). See* V. Pérotin, *Employee Participation in Profit and Ownership: A Review of the Issues and Evidence, Working Paper, Social Affairs Series, European Parliament, SOCI 109 EN, 01–2003.*

79 *Ibid., pp. 22–27.*

80 *High Level Group of Independent Experts, Report on cross-border obstacles to financial participation of employees for companies having a transnational dimension, Brussels, December 2003, pp. 17.*

statute of companies or groups; plan coverage; limits, thresholds and criteria for calculation; eligibility criteria; fixing of withholding or retention periods as well as rules and vehicles for investment and administration of funds.

Taxation and social security issues Diverse tax treatment of the various types of financial participation plans across the EU, linked to general differences in taxation systems, represent another very important barrier to the implementation and spread of plans. Combined with the existence or absence of tax-favoured plans, the differences most importantly concern incidence and timing of taxation, uncertainty and/or complexity of fiscal treatment, and differences in tax treatment and social security contributions for employers and/or employees as well as double taxation or double exemption.

Securities laws Different securities laws can impose substantially different obligations on enterprises to provide information to employees when offering shares in different Member States.

Labour or employment laws In some countries labour or employment laws foresee the necessity of consulting with employee representatives, trade unions or Works Councils and negotiating plans with them at the company level as well as of providing information to employees. Likewise the definition of pay, the impact of plans on pension rights, the existence of "acquired rights" and employee data protection are often regulated differently at the national level.

Financial market regulations Member countries have different requirements regarding stock exchange disclosure rules, levels of compliance and shareholder and regulatory approval, as well as the entitlement of the employees' legal representatives to information.

Social and cultural traditions Differences in industrial relations practice as well as cultural differences relating to savings patterns and risk aversion, which affect the willingness of employees to invest in their employer firm.

Introduction and operating costs Installation and maintenance costs may be high when financial design and company appraisal, employee communications, legal and tax advice, compliance obligations and annual administration must comply with different national requirements under one plan.

—— III.C ——
The National Level

The Old Member States of the EU

Country	General Attitude [a] Social Partners [b] Government	Legislation and Fiscal or other Incentives	Schemes and their Incidence CRANET: Offered in Firms >200 Empl. EWCS: Take-up Rate of Employees
Belgium	[a] **TU** opposed, but relatively more support for profit sharing; **EA** in favour. [b] Since 1982, legislation for **ESO**; amendment 1991; since 1999 legislation for stock options; since 2001 new law on **ESO** and **PS**.	**All plans**: EmpC max. 20% of after tax profit/year; max. 10% of total gross salary. **ESO**: NCL – discounted ES in JSC, financing by firm possible; in capital increases: max. 20% of equity capital, ES discount limit 20%; NTL – (restricted stock grant) value reduced by 16.7%, taxation deferred if 2 years not transferable, 15% tax on benefit, no SSC; (stock purchase plan) benefit tax base 83.33% of fair market value. **SO**: NTL – since 1999 taxed at grant on a lump sum basis, no SSC. **PS**: NTL – tax 15% for PS in an investment savings plan, 25% for other plans.	2005 CRANET: **ESO** 21%, **PS** 3.7%. 2005 EWCS: **ESO** 4.3%, **PS** 5.9%. firms involved mainly from financial sector, large firms and multinationals. **SO** 2005 CRANET: 2%; EU-Report 2003: 75,000 employees benefit; most of 20 largest Belgian firms operate plans; 40% of firms with more than 50 employees.
Denmark	[a] **TU** indifferent to FP; **EA** opposed to any extension of employee participation. [b] Employee Funds discussed in 70s/80s, PS popular; later support for **ESO** and **SO**; in 2000s Government support for share-based schemes.	**ESO**: NCL – ES in JSC: discounted, max. 10% of salary/year, 7 year holding period, free max. 8,000 DKK/year; financing by firm possible if qualified plan; in capital increases deviation from subscription/pre-emption rights possible; NTL – deferred taxation of benefit; EmplC: discount tax deductible. **PS**: NCL – SPS; NTL – max. 10% of annual salary. **SO**: NTL – broad-based max. DKK 8,000, 5 year holding period; individual max. 10% of annual salary or max. 15% difference exercise price/market price.	2005 CRANET: **ESO** 36%, **PS** 7.3%. 2005 EWCS: **ESO** 2.4%, **PS** 6.4%. **SO** 2005 CRANET: 2%; EU-Report 2003: 20% of 500 largest firms by 1999, 1/3 of quoted firms 2000.
Germany	[a] **TU** sceptical/partly hostile because of "double risk"; **EA** support individual firms. [b] Traditional focus on savings plans (total capital higher than that of ES-firm plans); FP since 2006 on political agenda of all parties.	**ESO**: NCL – discounted ES in JSC, financing by firm possible; state savings bonus of 18% of max. 400 Euro (72 Euro/year) invested in employer stock; no tax/SSC on max. 135 Euro/year employer matching contribution. **PS**: None **SO**: NCL – in capital increase, nominal amount restricted to 10%, that of increase to 50% of equity capital.	2005 CRANET: **ESO** 11%; **PS** 45%. 2005 EWCS: **ESO** 0.7%, **PS** 5.3%. 2005 IAB: **ESO** 3%, **PS** 12%; 2003 WSI: **PS** in 1/3 of firms; **ESO**: 2006 AGP, 3,000 firms, 2,3 mln. empl., 19 bln. Euro; **SO**: EU-Report 2003, in over 2/3 of DAX-listed firms;
Greece	[a] **TU** moved from scepticism to support in 1980s; **EA** indifferent, low priority not a current topic. [b] Some regulations on **CPS** (1984) and **ESO** (1987); since 1999 more attention on **SO**; not a current issue.	**ESO**: NCL – ES in JSC discounted or free; within capital increase for 3 years not transferable, up to 20% of annual profit; NTL – no PIT/SSC on benefit. **SO**: NCL – free/discounted; NTL – taxable at exercise; tax exempt if qualified plan. **PS**: NTL – max 15% of company profits, 25% of employees' gross salary; no PIT, but SSC.	2005 CRANET: **ESO** 23.6%; **PS** 9.4%. 2005 EWCS: **ESO** 1%, **PS** 2.8%. **SO**: 2005 CRANET 2%. **SO** EU-Report 2003: only a limited number of firms.
Spain	[a] Low priority: **TU** oppose income flexibility; **EA** ambivalent, fear information disclosure requirements. [b] Long tradition of social economy: COOPs (new law 1997) and **EBO**; **PS** supported in 1994 then shift to **ESO/SO**; active support.	**ESO**: NCL – ES/SO in JSC, financing by firm possible; NTL – tax benefits on PIT after 3 year holding period; **PS**: NLL. **SO**: NTL – after 2 year holding period 40% reduction of taxed plan benefit. **EBO**: "Workers Companies" with more than 51% ESO, 10–25% of profits in Reserve Fund; NTL – if 25% reserve, tax exempt from capital transfer tax; tax on formation/capital increase, notary fees.	2005 CRANET: **ESO** 5.7%, **PS** 17%. 2005 EWCS: **ESO** 0.5%, **PS** 6.4%. **ESO**: 2003 CNMV 20% of large firms with share purchase plans. **SO**: 2005 CRANET: 19%; EU-Report 2003: plans in 40 firms of which 1/2 in IBEX 35. **EBO**: 2003 Heissmann, appr. 15,000 "Workers Companies".

Country	General Attitude [a] Social Partners [b] Government	Legislation and Fiscal or other Incentives	Schemes and their Incidence CRANET: Offered in Firms >200 Empl. EWCS: Take-up Rate of Employees
France	**[a] TU** show mixed attitudes: sceptical but actively involved, favour if not substitute to pay; **EA** generally in favour, esp. if voluntary; **[b] PS/ESO** strong continuous support since 1959; also in privatisations; climate FP friendly, focused policy;	**ESO**: PrivL – 5% ES-reserve, max. 20% discount; NCL – discounted ES in JSC, financing by firm possible, also capital increase; Save-as-you-earn schemes; NTL – flat rate tax of 7,6% and 10% on returns, no SSC. **SO**: NCL – capital increase; NTL – tax on exercise gain 26–30% after 4 year holding period. **ESOP/EBO**: Law on Trusteeship 2007; NCL – special reserve for EBO possible. **PS**: DPS compulsory/CPS voluntary; NTL – flat rate tax 7,6–10% if paid to firm savings-scheme/fund after 5 year holding period.	2005 CRANET: **ESO** 34%, **PS** 92%. 2005EWCS: **ESO** 5.3%, **PS** 12%. 2004 FONDACT: DPS covered 53% of non-agriculture private sector firms employees (i.e. 6.3 million). **SO**: 2005 CRANET 3%. **SO** EU-Report 2003: approx. 50% of quoted firms and 28% of limited companies, total approx. 30,000 employees.
Ireland	**[a] EA** strong support; **TU** support if financial and intrinsic reward to employees; managers/employees pragmatically motivated; Lobby groups/Institutions e.g. banks for **ESO**. **[b]** Support in privatisation; improvements in 1995 and 1997; promoting voluntary adoption of SPS, e.g. Approved Profit-Sharing Scheme (APSS).	**ESO**: PrivL – 14.9% ESOT-stock paid for by loan/by state; NCL – ES/SPS in JSC, financing by firm possible; NTL – New Shares: limited PIT tax base deduction for Empl., no SSC. **SO**: Savings-Plan: bonus/interest on savings tax free, no PIT on grant/exercise, no SSC; Approved-Plan: no PIT at exercise, no SSC. **ESOP**: Trust Act – taxed 15% interest/10% investment; NTL – ESOT: tax incentives as for APSS if ESOT part of APSS. **PS**: NTL – APSS: at transfer no PIT, no SSC up to limit, salary foregone – up to 7.5% of gross salary deductible.	1999 CRANET: **ESO** 14%, **PS** 15%. 2005 EWCS: **ESO** 5.3%, **PS** 9.2%. **SO**: 2002 IBEC: 90 firms with SAYE schemes, 15 firms with Approved Share Option Schemes. **PS**: 2002 IBEC: 400 firms with APPS. **ESOP**: n.a.
Italy	**[a] TU** mixed attitudes, recently interested in topic/**EA** mostly supportive. **[b]** Trilateral agreement 1993 supported **PS**; then shift to support **ESO/SO**; recently discussed on political agenda.	**ESO**: CivC – discounted ES in JSC, financing by firm possible; in capital increases deviation from pre-emption rights and preferential "ES" possible; NTL – PIT exemption up to max 2,065 Euro after 3 year holding period. **PS**: NCL – no SSC on max. 5% of total pay. **SO**: NTL – PIT exemption up to max. 2,065 Euro after 3 year holding period.	2005 CRANET: **ESO** 13,7%, **PS** 6.2%. 2005 EWCS: **ESO** 1.4%, **PS** 3.1%. **SO**: 2005 CRANET 1%; EU-Report 2003, approx. 6% of employees involved.
Luxemburg	**[a] TU/EA** growing interest in 1990s, not supportive of share schemes; **EA** support profit sharing. **[b]** FP not a current issue.	**ESO**: NCL – ES in JSC, financing by firm possible. **SO**: NTL – "Tradable Option Plans" reduced tax burden. **PS**: None.	2005 EWCS: **ESO** 3.7%, **PS** 13.5%. **PS**: PEPPER II, 1995 CPS in 25% of firms, mainly banks. **SO**: EU-Report 2003, estimates 25% of firms – mainly financial sector. **ESO**: n.a.
Netherlands	**[a] TU/EA** generally in favour; **TU** support if supplement to pay, prefer PS to ESO. **[b]** Traditional focus on savings plans; support for **SO** in 2003.	**ESO**: NCL – ES in JSC, financing by firm possible; NTL – up to Euro 1,226 from pre-tax salary after 4 years in a savings plan 15% flat tax, no SSC. **PS**: NTL – up to Euro 613 from pre-tax salary after 4 years in a savings plan 15% flat tax, no SSC. **SO**: NTL – specific tax incentives abolished. **IEnt**: Qualified Savings Funds.	2005 CRANET: **ESO** 20%, **PS** 44.8%. 2005 EWCS: **ESO** 1.5%, **PS** 13.8%. **PS**: 3 Mln. participants in 2000. **SO**: 2005 CRANET 4%; EU-Report 2003, more than 80% of all listed firms.

Country	General Attitude [a] Social Partners [b] Government	Legislation and Fiscal or other Incentives	Schemes and their Incidence CRANET: Offered in Firms >200 Empl. EWCS: Take-up Rate of Employees
Austria	**[a] TU/EA** currently support FP and cooperate; different views about participation in decision-making. **[b]** Legislation since 1974; first tax incentives since 1993; more active support since 2001.	**ESO**: NCL – discounted ES in JSC; financing by firm possible; NTL – PIT/SSC allowance for benefit; CGT or 1/2 PIT for dividends; tax exemption for share sale gain. **IEnt**: NCL – Empl.Foundation: EmpC buys own stock, sheltered in IEnt, dividends paid out; NTL – EmpC: contribution to IEnt, setting-up/operation cost deductible; IEnt: tax allowance on contributions; Empl.: CGT on dividends. **SO**: NCL – capital increase: nominal amount max. 10%, increase max. 50% of equity capital; max. 20% of equity capital for total amount of shares receivable; NTL – 10% of benefit/year, but max. 50% of total benefit tax free and carry forward of taxation for the remaining amount. **PS**: None	2005 CRANET: **ESO** 12%, **PS** 32.8%. 2005 EWCS: **ESO** 1.2%, **PS** 5.4%. 2005 WKÖ/BAK: **ESO** 8%, **PS** 25%. **SO**: 2005 CRANET: 2%; 2005 WKÖ/BAK: 1%.
Portugal	**[a] TU/EA** Indifferent, low priority: **TU** prefer PS to SO. **[b] ESO** mainly supported in Privatisation, esp. around 1997; not on the Agenda; FP is generally ignored.	**ESO**: PrivL – discounted ES; NCL – ES in JSC, financing by firm possible; in capital increase: suspension of preemptive right of shareholders for “social reasons” possible. **PS**: NLL – not remuneration, no SSC. **SO**: NTL – 1/2 of share sale gain liable to PIT.	2008 PEPPER IV: **ESO** 5.3%, **PS** 28%. 2005 EWCS: **ESO** 0.9%, **PS** 1.9%. **SO**: EU-Report 2003, from 60 firms listed at Euronext Lisbon Stock Exchange, about 22% have implemented SO.
Finland	**[a] TU/EA** generally support FP, especially desire to improve the environment for personnel funds; other forms not discussed. **[b]** Discussions on FP since the 1970s; 1989 law on Personnel Funds (the major form until now).	**ESO**: NTL – discount tax free, no SSC; tax relief for dividends. **SO**: None. **PS**: Cash-based none; NCL – share-based “Personnel funds”: in firms with more than 30 employees, if all participate, registration with Ministry of Labour, after 5 year blocking period up to 15%/year can be withdrawn; NTL – 20% of payments to employee tax free; earnings of fund tax free.	2005 CRANET: **ESO** 14%, **PS** 66%. 2005 EWCS: **ESO** 0.7%, **PS** 11%. **PS**: 2007 54 Personnel Funds with 126,000 members. **SO**: 2005 CRANET 5%; 2003 EU-Report: 84% of companies listed at Helsinki Stock Exchange.
Sweden	**[a] TU** neutral/opposed, advocated Wage Earners’ Funds; **EA** favour PS for wage flexibility, but no active support. **[b]** From 1992–1997 tax incentives for **PS** in firms; since then no support.	**ESO**: NCL – ES in JSC, financing by firm possible; in capital increase suspension of pre-emptive right of shareholders possible. **PS**: Cash-based none; NCL – share-based “Profit-Sharing Foundations”: 1/3 of employees on similar terms, after dissolution assets to be distributed; NTL – for the employer 24.26% payroll tax instead of 32.28% SSC. **SO**: None	2005 CRANET: **ESO** 16%, **PS** 26%. 2005 EWCS: **ESO** 1.6%, **PS** 15%. **PS**: 2003 Heissmann: 15%. Wage Earners’ Funds created in 1983 were abolished in 1991.
United Kingdom	**[a]** Climate FP friendly and supportive; **TU** involved, but reservations: prefer SO to PS; **EA** positive, favour flexibility with regard to form of schemes; employees interested. **[b]** Long tradition of FP, esp. **ESO** and **ESOP**; now more active support for **SO** i.e. SAYE and Sharesave; 2000 new of Enterprise Management Incentives EMI; very little participation in decision-making.	**ESO**: NTL – Share Incentive Plan (SIP) discounted: no PIT/SSC; no dividend tax if dividends reinvested in shares, generally no SSC; no CGT if sale immediately after taking shares out of the plan. **SO**: NTL – Savings-Related SO-Plan, Firm SO-Plan: generally no PIT at grant or exercise, no SSC; SAYE: tax bonus on savings; EMI: no PIT, no SSC at grant or exercise; (NCL – Empl. Benefit Trust used). **ESOP**: NCL – max. £ 125/month shares for pre-tax salary in Trust, EmpC max. 2 matching shares/share worth max. £ 3,000/year; NTL – shares exempt from income tax and SSC after 5years; EmpC contribution to trust tax deductible. **PS**: NTL – approved PS; tax benefits abolished in 2002.	2005 CRANET: **ESO** 19%, **PS** 13%. 2005 EWCS: **ESO** 1.9%, **PS** 6.4%. 2006 ifsProShare: **ESO/SO** approved plans in 5,000 firms, some with **ESOP**s; SIP in 830 firms; SPS: 2002 1Mln. empl. under approved schemes , average/head less than £ 700. **SO**: 2005 CRANET: 2%; 2006 ifsProShare: Savings-Related Plans in 1,300 firms, 2,6 mln. empl.; Company Plans in 3,000 firms; EMI in 3,000 firms.

The New Member and Candidate Countries

Country	General Attitude [a] Social Partners [b] Government	Legislation and Fiscal or other Incentives	Schemes and their Incidence CRANET: Offered in Firms >200 Empl. EWCS: Take-up Rate of Employees
Bulgaria	[a] **TU** open to FP, **EA** indifferent; not a current topic on either of their agendas. [b] **ESO** strong support 1997–2000 since then ignored; in 2002 PrivL incentives abolished; FP generally ignored.	**ESO**: None; NTL – Uniform 7% dividend tax. **PS**: None; NTL – SPS personal income tax exempt.	2005 CRANET: **ESO** 38%, **PS** 5%. 2005 EWCS: **ESO** 1.8%, **PS** 6.3%. **ESO**: 10% Mass-Priv, 4–5% Cash-Priv; low, decreasing. **MEBO**: 1,436, 28% privatisations; managers took over most. **PS**: AI, few cases survey evidence. **SO**: 2005 CRANET 14%.
Cyprus	[a] FP not an issue on **TU/EA** agendas. [b] FP so far ignored.	**ESO**: NCL – discounted ES in JSC; financing ES by firm possible; NTL – dividends/gains from share sale tax free. **PS**: None	2005 CRANET: **ESO** 10%, **PS** 7.7%. 2005 EWCS: **ESO** 1.2%, **PS** 2.7%. **SO**: 2005 CRANET:4%. **ESO/PS**: AI, insignificant.
Czech Republic	[a] **TU/EA** indifferent to FP, not a current topic on their agendas. [b] **ESOP** discussed in 1990; FP ignored after introduction of Voucher concept.	**ESO**: NCL – discounted ES/SPS in JSC; not considered public offering; ES discount limit: 5% of equity capital, financing by firm possible; NTL – uniform 15% dividend tax. **PS**: NCL – CPS/SPS in JSC; NLL: negotiable in collective bargaining agreements.	2005 CRANET: **ESO** 14%, **PS** 27%. 2005 EWCS: **ESO** 1.6%, **PS** 11%. **SO:** 2005 CRANET: 3%. **ESO**: Insignificant; 0.31% of the privatised assets. **PS**: AI, insignificant.
Estonia	[a] **TU** indifferent to FP, **EA** opposed to any extension of employee participation. [b] PrivL supported **ESO** until 1992; after 1993 FP ignored.	**ESO**: NCL rights attached to shares issued before 1 Sept. 1995 remain valid; no public prospectus for ES needed; NTL Emp.: no income tax on dividends from resident firms; EmpC: 22% on distributed profit, only “bonus issue” in capital increase exempt. **PS**: None	2005 CRANET: **ESO** 9.6%, **PS** 11%. 2005 EWCS: **ESO** 2%, **PS** 11%. **ESO**: 2005 2% (1995 after privatisation 20%) of firms majority employee owned, 20% minority. **PS**: AI, survey evidence, very few cases.
Hungary	[a] FP for managers means to avoid external control, for employees to preserve work-place; **TU** lobbied **ES/ESO** in privatisation, recently passive; **EA** indifferent. [b] **ESOP/ES** strong support in PrivL until 1996; climate FP friendly but lack of concrete economic policy decisions.	**ESO**: PrivL – preferential sale; discount max. 10% firms assets and 150% of annual min. pay, instalments; Decree “Egzisztencia” Credit; NCL – specific “ES” in JSC, discounted/free, max. 15% of equity capital, financing by firm possible; since 2003 tax-qualified stock plans, first 1/2 mln. HUF free, then 20% tax, 3 year holding period. **SO**: NTL – PIT base is value at exercise. **ESOP**: ESOP-Law 1992; preferential credit; corporate tax exempt until end 1996; contribution to Plan max. 20% tax deductible; tax base lowered. **PS**: None	2005 CRANET: **ESO** 15%, **PS** 15%. 2005 EWCS: **ESO** 1%, **PS** 3%. **ESO**: 1998 1% of assets privatised; preferential privatisation in 540 firms; CS strong decline; now AI, 30% of firms (70% SO, 30% ES), mostly foreign. **ESOP**: initially 287 employing 80,000, in 2005 151 left; 1.2% of employment by private firms. **PS**: AI, 20% of firms, mostly foreign, only 10% of entitled receive profit. **SO**: 2005CRANET 27%.
Latvia	[a] **TU/EA** indifferent to FP, not a current topic on their agendas. [b] Little support for **ESO** in PrivL; FP so far ignored.	**ESO**: PrivL – max. 20% ES; specific “ES” in state/public firms; NCL – preferential ES in JSC free/discounted, in capital increases max. 10% of equity capital non-voting stock. **PS**: None	2005 EWCS: **ESO** 0.6%, **PS** 8.5%. **ESO**: PrivL 110.6mln. vouchers to 2.5 mln. people; AI, 1999 16% of 915 firms dominant ESO but falling over time. **PS**: AI, 7% of firms; mostly IT, consulting, real estate.
Lithuania	[a] Climate FP friendly; **TU** interested, lack of actions; EA support individual firms. [b] **ESOP/ES** strong support in PrivL until 1996; now FP not on political agenda of Parliament and Government.	**ESO**: PrivL – 5%ES deferred paym. max. 5 years; NCL – in corporations ES for 3 years non transferable/non voting, financing by firm possible; NTL – uniform 15% dividend tax; after holding period profits from sale of shares not taxed. **PS**: None	2008 PEPPER IV: **ESO** 4%, **PS** 36%. 2005 EWCS: **ESO** 0.9%, **PS** 4%. **ESO**: low and decreasing; AI, 2000 36% (1995 92%) privatised firms dominant ESO, falling over time. **PS**: AI; CPS mostly foreign (IT, consulting, advertising, etc); DPS few cases 2005 linked to employee savings plan.
Malta	[a] **TU** support schemes in practice; FP not a current topic in national tripartite dialogue. [b] FP collateral effect of nationalisation (80’s) and privatisation (90’s) not a current issue.	**ESO**: NCL – ES in corporations, exempt from prospectus/investment rules; max. 10% discount, financing by firm possible; NTL – SO only taxable at exercise. **ESOP**: Trust Act refers to FP; taxed 15% interest/10% investment. **PS**: mentioned in NLL.	2005 EWCS: **ESO** 0.7%, **PS** 3.9%. **ESO**: AI; banking sector: ES, SAYE scheme, SO. **ESOP**: AI, Trust Funds in Bank of Valetta/ Malta Telecom. **PS**: AI; 2004 public sector (Shipyard 1,761 empl.); private (foreign) firms, mostly reserved for management.

Country	General Attitude [a] Social Partners [b] Government	Legislation and Fiscal or other Incentives	Schemes and their Incidence CRANET: Offered in Firms >200 Empl. EWCS: Take-up Rate of Employees
Romania	[a] **TU** support indiv. cases; **EA** avoid topic; Tripartite council tackled FP sporadically. [b] **ESO** supported until 1997 esp. **MEBO**; then support declined; current government gives little support and has other priorities.	**ESO**: PrivL – aim 30% of privatised assets Vouchers/ES; Vouchers free; 10% discount ES; NCL – ES in JSC, financing by firm possible; NTL – 10% dividend tax. **ESOP**: PrivL on Empl. Associations; leveraged transaction, preferential credit, max. interest rate 10%. **PS**: Ordinance – CPS compulsory in State/Municipal firms.	2008 PEPPER IV: **ESO** 6%, **PS** 42%. 2005 EWCS: **ESO** 1.6%, **PS** 5%. **ESO**: ES 10% of shares issued at privatisation, decreasing. **ESOP**: 1998 1/3 priv., most frequently used single method 2000: 2632 firms, average 65% ESO, 1652 majority ESO. **PS**: estimated 1.2 mln. empl. in public sector covered.
Poland	[a] **TU/EA** indifferent to FP; managers/ employees pragmatically motivated; Lobby groups/Institutions e.g. banks for ESO. [b] FP Supported in early privatisation period; **ESO** in most privatisations, since mid-90's more and more ignored; **PS** increased emphasis in the context of collective bargaining agreements.	**ESO**: PrivL – 15% ES for free, 2 years non transferable, max. value 18 month min. pay, National Investment Funds 1995 (NIF), shares for symbolic fee; NCL – ES/SPS in JSC, financing by firm possible; NTL – uniform 15% dividend tax. **EBO**: PrivL – Leverage Lease Buy-Out (LLBO), anticipated ownership transfer possible; interest 50% of refinance rate; interest part of lease payments are costs; Insolvency Law – buy-out right. **PS**: NCL – CPS/SPS in JSC.	2008 PEPPER IV: **ESO** 40%, **PS** 26%. 2005 EWCS: **ESO** 0.7%, **PS** 5%. **ESO**: low and declining; AI in privatised firms, 2000 ca. 11.4% (1998 12.7%); NIF adult citizens 1 share in 15 funds. **EBO**: LLBO 2002 1/3 of privatisations, most frequently used single method, 1,335 firms employing 162,000, 14% over 250 empl. **PS**: AI, limited to management.
Slovak Republic	[a] **TU/EA** indifferent to FP, not a current topic on their agendas. [b] **ESOP** discussed in 1990; **EBO** concept failed 1995; FP now generally ignored.	**ESO**: NCL – discounted ES and SPS in JSC; max. 70% discount/financing by firm possible. **PS**: NCL – CPS/SPS in JSC.	2005 CRANET: **ESO** 12.7%, **PS** 17%. 2005 EWCS: **ESO** 2.3%, **PS** 28%. **SO**: 2005 CRANET 10%. **ESO**: Insignificant; AI, banking sector/ new privatisations. **EBO**: AI, in privatisation, usually management-led.
Slovenia	[a] **TU/EA** very supportive to FP; Employee Ownership Ass. lobbies legislation; active support by Works Councils/Managers Ass. [b] Strong political support to FP; draft laws 1997/2005 in parliament rejected; new Law on FP in 2008.	**All Schemes**: Since 2008 70% tax relief for PS and ESO with 1-year holding period (100% relief with > 3-year); max. 20% profits or 10% total salaries/year and max. 5,000 EUR/employee. **ESO**: PrivL – max. 20% ES for Vouchers; Vouchers free, shares for overdue claims; NCL – ES/SPS in corporations; discount/ financing by firm possible. **EBO**: max. 40%, shares 4 years non transferable; Worker association proxy organisation under Takeover Law. **PS**: PrivL – SPS in internal buy-out.	2005 CRANET: **ESO** 14%, **PS** 20%. 2005 EWCS: **ESO** 2.6%, **PS** 18%. **ESO/EBO**: 90% of privatised firms; CS 1998 60% majority ESO while only 23% of capital (2004 18% strong decline). **PS**: CS, in statutes of 32% of firms, but unexploited in 22%; for board members 20% of listed firms. **SO**: 2005 CRANET 4%.
Croatia	[a] **TU** recently promote **ESO** in revision of privatisation; **EA** indifferent to FP; long tradition of Self-management. [b] **ESO** supported until 1995, since then FP ignored; **ESOP** planned in new PrivL.	**ESO**: NCL – ES in JSC financing by firm possible; NTL – Dividends tax exempt; profits from sale of shares not taxed. **ESOP**: General rules of NCL apply. **PS**: None	2008 PEPPER IV: **ESO** 34%, **PS** 29%. **ESO**: 2005 more than 10% of value of privatised firms (1996 20%); 2004 12% firms with majority ESO. **ESOP**: Survey evidence, ESOP elements in 9,4% of firms (52 out of 552), completed ESOP approx. in 1/4 of them. **PS**: AI
Turkey	[a] Climate FP friendly; **TU** supportive, **EA** undecided, split; employees interested. [b] FP issue 1968 in Tax Reform Commission; some attention in individual privatisations; 2002 program, lack of concrete measures.	**ESO**: PrivL decrees for individual firms; discount/instalments; NTL – after 1 year share-sale profits not taxed; for SO limited tax on dividends/profits from sale. **IntE**: NCL/CivC "welfare/mutual assistance funds" of firms; financing by firm profits/ contributions. **PS**: NCL/CivC both CPS and SPS; max. 10%, prior reserve.	2005 EWCS: **ESO** 1.3%, **PS** 2.4%. 2005 CRANET: **ESO** 4.4%, **PS** 8.9%, **SO**, 1%. **ESO**: AI, PrivL 12 cases 9–37% ESO, 1 case majority, up to 15% discount; SO/ESO private firms mostly foreign (26 registered 35 applications) 2007 survey evidence: 3–4% of publicly traded companies. **IntE**: n.a. **PS**: AI, retained profits as dividends wide-spread; CS 38 out of 50 listed firms; 2007 survey evidence: 20% of publicly traded companies.

Source: *PEPPER I-IV and: CNMV 2003; CRANET 2005/1999 (firms with more than 200 empl.); EU Stock Options Report 2003; EWCS 2005 (take-up rate); FONDACT 2004; Heissmann 2003; IAB 2005; IBEC 2002; ifsProShare 2006; WKÖ/BAK 2005; WSI 2003; please note that the country data of the different surveys is incoherent due to inconsistencies in methodology and definitions. Excluded from studies: Management Buy-out, General Savings Plans, Consumer and Housing Cooperatives.* **Abbreviations:** *AI = Anecdotal Information only; CGT = Capital Gains Tax; CivC = Civil Code; CPS = Cash-based Profit-sharing; CS = Case Studies; DPS = Deferred Profit-sharing; EA = Employer Associations; EBO = Employee Buy-out; EmpC = Employer Company; ES = Employee Shares; ESO = Employee Share Ownership; ESOP = Employee Share Ownership Plan; FP = Financial Participation; IEnt = Intermediary Entities; JSC = Joint Stock Companies; MEBO = Management-Employee Buy-out; NCL = National Company Law; NLL = National Labour Legislation; NTL = National Tax Legislation; PIT = Personal Income Tax; PrivL = Privatisation Legislation; PS = Profit-sharing; SO = Stock Options; SPS = Share-based Profit-sharing; SSC = Social Security Contributions; TU = Trade Unions.*

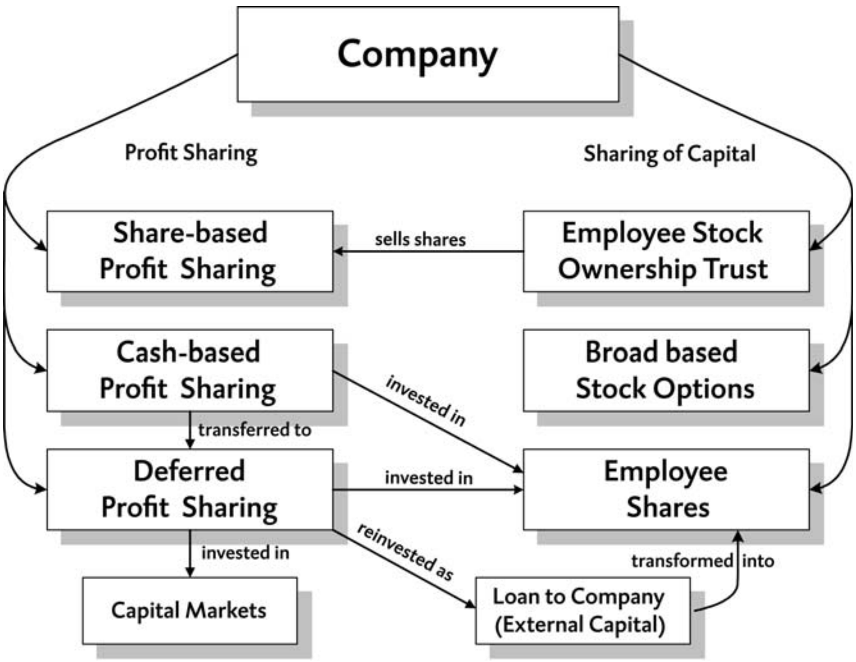
— IV —
Towards a European Concept of Financial Participation

— IV.A —
Choosing a Building Block Approach

Regardless of the form profit sharing takes, the resulting funds may be used to create employee share ownership, as in the case of share-based deferred profit sharing practised in various other combinations in France, the United Kingdom and Ireland. The existing variety of national profit-sharing schemes (often involving an institutional infrastructure) would be compatible with a supranational concept resting basically on the two forms of employee share ownership: individually held or held through a trust.

Therefore the building blocks should consist of the three basic PEPPER elements:[81]

— Profit Sharing (Cash-based, Deferred and Share-based);
— Employee Share-holding (Stock Options and Employee Shares);
— Employee Stock Ownership Plans as Collective Schemes.



Referring to the catalogue of minimum requirements (e.g., being transparent, broad-based, etc.) the scheme reflects the existing postulates of the European policy-makers (see above in Section II-B3) and neither relies on nor excludes

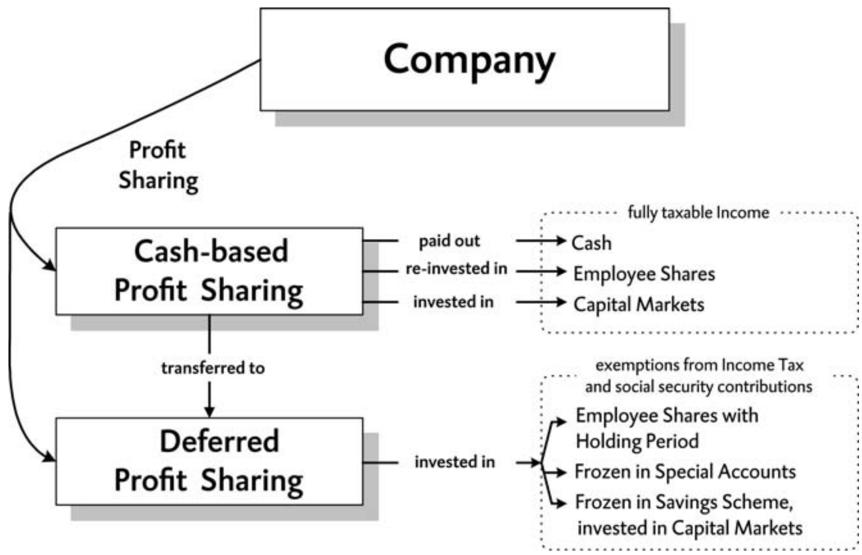
81 *For a detailed technical description of the different mechanisms and schemes see Annex III and* M. Uvalić, *PEPPER I Report, 1991; see also* K. P. O'Kelly, A. Pendleton, *Common elements of an adaptable Model Plan for Financial Participation in the European Union*, IAFP *working paper, December 2005.*

tax incentives. All of the different elements are voluntary for both enterprises and employees. They can be put together in any combination with the different building blocks tailored to the specific needs of the given enterprise.

— IV.A.1 —

Module One: Profit Sharing (Cash-Based and Deferred)

In Cash-based Profit Sharing (CPS) and Deferred Profit-sharing Schemes (DPS), part of an employee's remuneration is directly linked to the profits of the enterprise. In contrast to individual incentives, this concept involves a collective scheme which generally applies to all employees. The formula may include profits, productivity and return on investment. Bonuses are normally paid in addition to a basic fixed wage and provide a variable source of income. They may be paid out in cash or on a deferred basis into a company saving scheme, and can be invested in the capital markets or the company's shares.



A considerable body of evidence suggests that the introduction of profit sharing correlates with a rise in the level of productivity in a company.[82] The consistency of the findings on the incentive effect on profitability is remarkable. Profit sharing is associated with higher productivity levels in every case regardless of the methods, model specification, or data used.[83] Although profit-sharing schemes operate successfully even without tax or social security exemptions (e.g., in Germany), a disadvantage of these schemes in the context of a European

82 *See* D. L. Kruse *and* J. R. Blasi, Employee Ownership, Employee Attitudes, and Firm Performance: *A Review of the Evidence*, *NBER Working Paper, Series 5277, Cambridge, MA, 1995;* D.C. Jones *and* T. Kato, The Productivity Effects of Employee Stock Ownership Plans and Bonuses: Evidence from Japanese Panel Data, *in: "The American Economic Review", June 1995, pp. 391–414.*

83 *Summarizing OECD, 1995, and* M. Uvalić, PEPPER I Report, *1991, the experience to date suggests that cash-based schemes have had significantly greater incentive effects than share-based schemes.*

Concept is their dependency on the necessary administrative infrastructure. A further downside in cross-border plans is the fact that they are typically based on individual firm rather than on controlled group profits.[84]

Financial participation schemes and in particular profit-sharing bonuses which are paid in cash should also have the effect of making total remuneration more flexible and therefore more responsive to macroeconomic shocks. This wage flexibility is seen as a means of reducing the risk of unemployment in periods of recession and therefore promoting greater employment stability.[85] In some Western countries recent findings have confirmed this effect while, in contrast, other studies suggest no relationship, or question the methods and outcome due to the periods of investigation.[86]

—— IV.A.2 ——

Module Two: Employee Share-Holding (Employee Shares and Broad-Based Stock Options)

In share ownership plans, shares may be distributed for free or may be sold at the market price or under preferential conditions. The latter may include sale at a discount rate (Discounted Stock Purchase Plan), sale at a lower price through forms of delayed payment (usually within a capital increase), or by giving priority in public offerings to all or a group of employees. To defer the valuation problem in unlisted SMEs[87], capital participation may initially take the form of an employee loan to the company, creating corporate debt (external capital) subsequently converted into company shares.[88] Valuation of the shares designated for acquisition through the loan can be postponed until the moment of the actual conversion into shares (debt-to-equity) without impeding the implementation of the scheme.

Employee stock options,[89] unlike executive stock options granted to reward individual performance, are broad-based. The company grants employees options which entitle them to acquire shares in the company at a later date, but at a per share price fixed at the time the option is granted. Potential gain from rising stock values is the primary reward conferred by options. Unlike conventional options, employee stock options as a rule cannot be traded, and the holder cannot usually hedge against the risk of a decline in value. Furthermore, employee stock options are normally subject to forfeiture prior to vesting should the employee voluntarily leave the firm.

84 *See High Level Group of Independent Experts,* Report on cross-border obstacles to financial participation of employees for companies having a transnational dimension, *Brussels, December 2003, p. 7.*

85 *J. Vanek was the first to argue that profit sharing could have a positive macroeconomic effect on employment; see* Workers' Profit Participation, Unemployment, and the Keynesian Equilibrium, *in: "Weltwirtschaftliches Archiv", No. 2, 1965.*

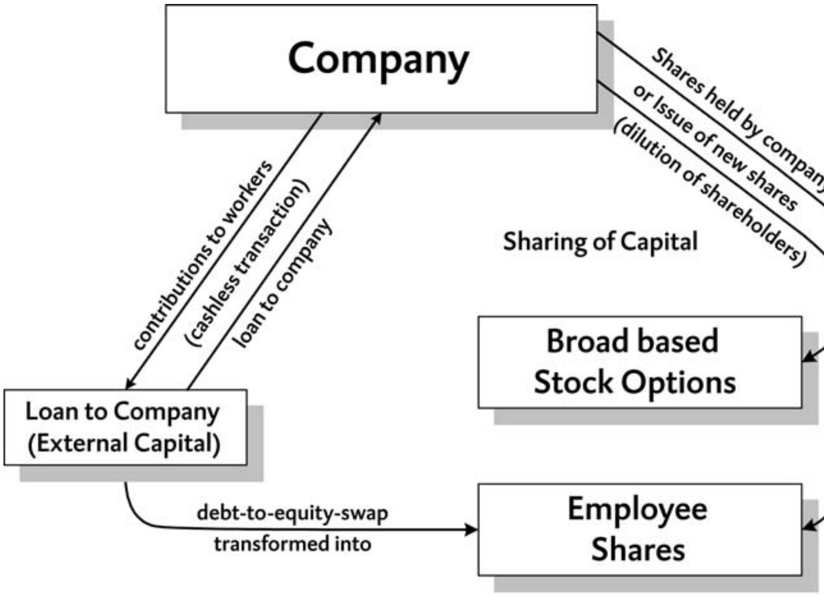
86 *Positive:* D. Vaughan-Whitehead, Interessement, Participation, Actionariat – Impacts Economiques dans L'Éntreprise, *in: "Economica", Paris, 1992;* D. Kruse, Profit-Sharing and Employment Variability: Micro-economic Evidence on the Weitzman Theory, *in: "Industrial and Labour Relations Review", Vol. 44, April 1991.*

Negative: S. Whadhwani *and* M. Wall, The Effects of Profit Sharing on Employment, Wages, Stock Returns and Productivity: Evidence from UK Micro-Data, *in: "Economic Journal", 1990, 100 (399), pp. 1–17.*

87 *The valuation of the shares prior to the acquisition may create unreasonable costs particularly in a small firm. This problem is exacerbated when the valuation is repeatedly necessary for different share acquisitions not occurring simultaneously.*

88 *See the* Annex of the Committee on Employment and Social Affairs Report on the Commission communication, On a framework for the promotion of employee financial participation, COM(2002)364, 2002/2243(INI); *"Models for Employee Participation in SMEs", PE 316.420.*

89 A. Pendleton, J. Blasi, D. Kruse, et al., Theoretical Study on Stock Options in Small and Medium Enterprises, *Study for the European Commission, Manchester;* Employee Stock Options in the EU and the U.S.A., *Pricewaterhouse Coopers, London, 2002.*



When a company contributes newly issued stock to its employees, the current stockholders suffer a dilution in equity per share. Theoretically, this dilution can be compensated for by increased productivity and profitability as a result of higher employee motivation and increased working capital, which increases the value of all company shares. Although some studies[90] confirm this result, the issue remains widely disputed (except in 100% ESOPs or in buy-outs where no newly issued shares are involved).

Sceptics voice concern that share ownership subjects employees to an additional risk. Since they are encouraged to put a part of their wealth into the shares of their own companies, rather than other companies, risk is concentrated rather than diversified.[91] The advocates of share ownership maintain that reasonable investment in shares of their own companies represents a good portfolio allocation, since shares these are positively correlated with the return on their most valuable asset, their own work. On the whole this theoretical debate has not yet produced decisive results. It seems that collective investment funds operating on a branch level,[92] or investment and credit insurance backed by the government,[93] could spread the risk and thus compensate for the "double-risk". However, the risks are very limited if the scheme only involves a benefit in addition to the basic wages.

90 S. Chang, *Employee Stock Ownership Plans and Shareholder Wealth: An Empirical Investigation*, *in: "Financial Management", Spring 1990, pp. 48–58.*; D.C. Jones *and* T. Kato, *The Productivity Effects of Employee Stock Ownership Plans and Bonuses: Evidence from Japanese Panel Data*, *in: "The American Economic Review", June 1995, pp. 391–414*; H. E. Meihuizen, *Productivity Effects of Employee Stock Ownership and Employee Stock Option Plans in Firms Listed on the Amsterdam Stock Exchanges: An Empirical Analysis*, *Paper for the 10th Conference of the IAFEP, Trento, 6–8 July 2000*; J. Sesil, et al., *Sharing Ownership Via Employee Stock Ownership*, *World Institute for Development Economics Research (WIDER) Discussion Paper 2001/25, United Nations University, 2000.*

91 *An argument commonly used by German trade unions. See* H. Tofaute, *Arbeitnehmerbeteiligung am Produktivkapital – Fortschreibung einer unendlichen Geschichte*, *in: "WSI Mitteilungen", 6/1998, pp. 376.*; D. Lipton *and* J. Sachs, *Privatization in Eastern Europe: The Case of Poland*, *in: "Brookings Papers on Economic Activity 2", 1990.*

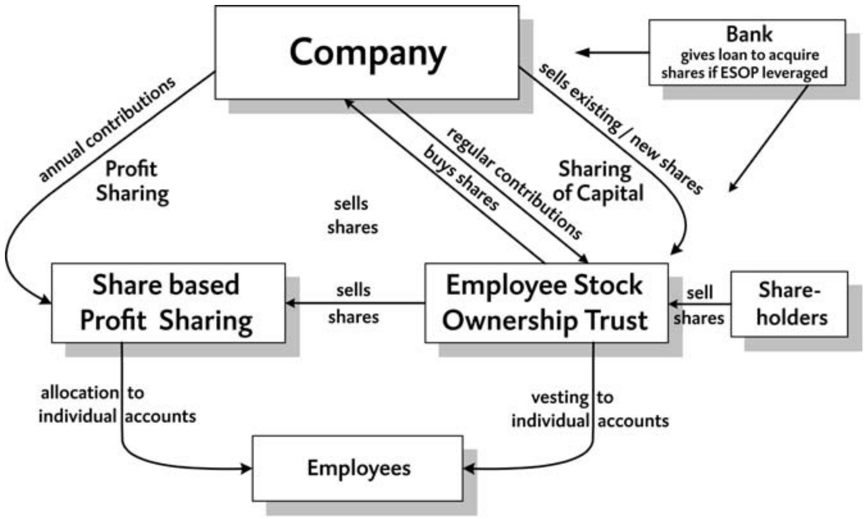
92 *In Germany the possibility of linking these "Tariffonds" with the reform of the social security system was widely discussed. See Die Zeit, 10 December 1998.*

93 *As proposed for American ESOPs, see* L. Kelso *and* P. H. Kelso, *Democracy and Economic Power: Extending the ESOP Revolution through Binary Economics*, *University Press of America, Lanham, Maryland, 1991.*

—— IV.A.3 ——

Module Three: Employee Stock Ownership Plans (ESOPs) and Share-Based Profit Sharing

Share-based Profit Sharing (SPS) is a form of deferred profit sharing with the profit share being paid in shares of the company, which are usually frozen in a fund for a certain period of time after which workers are allowed to dispose of them. Similarly, Employee Stock Ownership Plans (ESOPs) are funded by the company either contributing shares to the plan, contributing cash that the plan uses to buy shares, or by having the plan borrow money to buy new or existing shares. The schemes may be combined, resulting in the following essential structure:[94]



94 *As defined in* J. Shannahan *and* L. Hennessy, UNDERPINNING PARTNERSHIP AT THE WORKPLACE – AN MSF GUIDE TO PROFIT SHARING, ESOPs AND EQUITY PARTICIPATION, *Dublin, 1998, p. 9.*

— The company establishes an Employee Share Ownership Trust (ESOT) in favour of its employees.
— The trust is usually financed by a combination of company contributions and borrowings. Company contributions often are part of a profit-sharing agreement with the employees. The trust may borrow money directly from a bank or from the company, which in turn may take a loan from a bank or other lender. Shares are either acquired directly from the existing shareholders or by means of a new share issue. The trust loan is usually guaranteed by the company, but in some cases it is without recourse to the company.
— The shares are held collectively in the trust, and are only allocated to individual employees accounts, or distributed, after a particular holding period. This holding period may be either a matter for the trustees to determine, or it may be driven by the need to repay borrowings before

distributing shares, or it may be driven by tax holding periods before the shares can be distributed free of income tax. Most commonly, it is a combination of all three.

— When a share-based profit-sharing scheme is used to distribute the shares, the shares are usually transferred by the ESOT to the profit-sharing scheme without the profit-sharing scheme being required to pay for them. Alternatively the company can make a payment to the profit-sharing scheme to allow the scheme to acquire the shares from the trust. In either case, the shares will be vested in individual employees once they are transferred to the profit-sharing scheme.
— The loan may be repaid by direct cash contributions from the company to the trust, monies received from sale of shares to the share-based profit-sharing scheme, or dividends on the shares held in the trust.

95 *If the P/E ratio is 5 and the interest rate is as low as 5%, a standard 7 year level-principal loan amortisation schedule would require P/7 + P x .05 or almost a 20% dividend in year one to service the loan.*

— IV.A.4 —
Specific Features of Employee Stock Ownership Plans

Unlike a pension plan, which as a rule requires diversification, an ESOP is specifically designed to hold employer securities. An ESOP can be used by a company which does not have a listing for its shares to create an internal market for the employees to buy and sell the company's shares. This can be done if the ESOP both distributes shares to the employees, and also operates a market whereby employees can sell their shares and acquire further ones. Usually, a process such as a bi-annual share auction is used. The ESOP can provide liquidity to this internal market if it is also a buyer of shares in this internal market. The shares which the ESOP buys will then be distributed to employees in subsequent distributions. The creation of a market for the shares of an otherwise illiquid company makes the ESOP a financial tool which benefits both employees and the employer company.

In this context an important feature of an ESOP is that it can be leveraged by taking out an external loan to buy shares in the employer company. This leverage potential is most important because it can accommodate large transactions for the company and its shareholders while creating particularly sizeable capital ownership in employee accounts. The ESOP debt is funded by appropriately timed contributions from the company to the ESOT. Of course any dividends earned by the stock may also help to pay off the loan, but this is more of a complementary element.[95] As with any other bank loan, ESOP loans must be repaid regardless of whether the dividends on the stock are sufficient to pay off the loan. By making the loan payments tax deductible to the corporation, as, e.g., in the U.S., the loan is repaid with tax-free income, in contrast to a conventional re-capitalisation loan that must be paid back with after-tax income.[96]

Utilizing corporate credit to guarantee the loan which funds the acquisition of employee shares by the ESOT and writing off loan repayments as expenses deductible from taxable corporate income substantially reduces the financing costs.[97] Given the additional advantage that the shares are not sold to outsiders, thus eliminating the risk of loss of control, the ESOP solution in most cases will be preferable to a conventional bank loan. Of course any of the objectives of an ESOP, resulting in any percentage of shareholding from 1% to 100%, can be achieved on an unleveraged basis over time.

An ESOP, considered only as an umbrella term to cover a trust set up by a company to put shares in the hand of its employees, is similar in many ways to a share-based profit-sharing scheme but most importantly is not as limited. While the latter has only one source of funds (i.e., direct contributions from the employer company), the ESOP can be financed from such different sources as:

— A loan from the employer company, from a selling shareholder or from a financial institution such as a bank;
— Dividend earnings;
— Sale of shares to its related share-based profit-sharing scheme;
— Contributions from the employer company.

Share-based profit-sharing schemes, while providing the company with a vehicle to deliver shares to the employees, offer a very limited market for those shares. The ESOP not only provides a new source of shares which can be sold to a profit-sharing scheme, it has the advantage of providing workers with an internal market to which they can sell their shares, which at the same time recycles shares for the accounts of future employees. This internal market is of major importance in unlisted SMEs for which no other source of liquidity exists.

Leveraged employee share ownership, on the other hand, as in the case of ESOPs, involves an additional element of risk. Whereas profit-sharing plans represent a variable financial burden, leveraged schemes require fixed loan amortisation payments regardless of the company's financial performance – a condition similar to taking on debt. In fact, such loans are treated as a liability if the company guarantees the loan or commits to future contributions to service it. Thus, if a company is not growing or becomes unprofitable, the repayment obligation can threaten its ability to survive. Furthermore, closely-held companies may be obliged to purchase the shares of departing plan participants

96 *For the U.S.A., see* C. Bachman *and* K. Butcher, *ESOP* Financing, *National Center for Employee Ownership Conference Paper, San Francisco, 2002.*

97 *In a variation of the described loan structure the lender often prefers to make the loan directly to the company, followed by a second "mirror loan" from the company to the trust. The tax results will be the same as in the case of a direct loan to the trust. The principal repayments will still be deductible because the company has to make annual deductible payments to the trust in amounts sufficient to amortise the internal loan from the company to the trust. The amounts paid by the ESOP trustee to the company to amortise the internal loan will usually constitute tax-free loan repayments and can be used by the company to amortise the external bank loan. The "mirror loan" structure provides the lender with a stronger security interest in the assets pledged to secure the loan. In the case of default the lender will be in a better position to defend against claims of fraudulent conveyance if it has taken collateral directly from the borrower rather than from a guarantor of the loan.*

because of the absence of a public market for their stock.[98] In such a case the repurchase liability in a successful company generally increases over time as the appraised value of the company's stock rises, although it does not usually increase as a percentage of the company's free cash flow.[99] If a company does not plan adequately to meet this liability, it may be forced to make a public offering of its stock to eliminate the repurchase obligation, an expedient which is not only very expensive but also involves a loss of control and independence and the loss of opportunity to future employees.[100] A better alternative is the creation of a "sinking fund", although in small companies it may be difficult to develop accurate actuarial assumptions.[101] Where a relatively large portion of the repurchase liability is attributed to a few plan participants, the use of life insurance may be appropriate.[102]

Finally, the costs of designing and implementing a financial participation scheme can be considerable. To these must be added the ongoing costs for administration, legal services and employee communication. An additional expense for closely-held companies arises from the need for an annual appraisal of the company's value by an outside expert. For a medium-sized U.S. ESOP company, the installation costs are approximately USD 40,000 with the annual administration costs, including appraisal, ranging to about USD 15,000.[103] Generally speaking, unless a company is medium-sized, these costs may outweigh possible tax advantages.[104]

— IV.B —
Options for Creating the Legal Foundations of a European Concept

— IV.B.1 —
Recommendation According to Article 249, Paragraph I, 1 ECT

The European Concept could be framed as a Recommendation according to Article 249, paragraph I, 1 ECT. The downside of such a solution, however, is that Recommendations according to Article 249, sentence 5, ECT are not legally binding and thus implementation in the Member States would be far from certain. On the other hand, legislation of such schemes in any form whatsoever is a major step forward, as it sets up a distinct legal entity for companies to refer to and provides a framework for company decisions and actions in those countries that approve the European Concept.

98 *If local company law, as in the U.S., or bylaws of the company requires this. In Ireland, for example, departing employees have no right to be bought out at market value.*

99 *The percentage of a company's free cash flow which will be required to service the repurchase liability on average over a period of years is fairly constant unless the multiple of the company's earnings (price/earnings ratio) alters dramatically. The average company will require cash equivalent to 7.5% of the value of the allocated stock in the trust for repurchase liability purposes each year. This is equivalent to a 7.5% dividend on the stock, but only on the stock already allocated to employee accounts in the trust. See* L. Lyon, THE REPURCHASE LIABILITY OR THE PHANTOM OF THE ESOP, *Menke & Associates, Inc., San Francisco, California, 1989, pp. 4.*

100 *Thus the ESOP transaction should be modelled in advance to ascertain that the company can afford this amount of "dividend". Otherwise, there should be a limit on how large a percentage of the company's total stock may be acquired by the ESOP. A growing company may require almost all of its free cash flow to fund future growth, but a company growing this fast may well want to go public.*

101 *For U.S. ESOPs, see* D. Ackermann, HOW TO CASH OUT TAX-FREE, YET KEEP YOUR BUSINESS … ESOPS – A PRACTICAL GUIDE FOR BUSINESS OWNERS AND THEIR ADVISORS, *Conference Paper, National Center for Employee Ownership, San Francisco, California, 2002.*

102 *See* R. C. Bye, THE CASE FOR COLI (CORPORATE OWNED LIFE INSURANCE) – FUNDING THE REPURCHASE OBLIGATION, *Conference Paper, National Center for Employee Ownership, San Francisco, California, 2002.*

103 *Information provided by Menke & Associates, Inc., San Francisco, California. Costs are generally lower for smaller companies where the ongoing annual appraisals are generally around USD 5,000.*

One possible solution to the problem of national implementation would be a recognition procedure by Member States for financial participation similar to that proposed by the High Level Group of Independent Experts.[105] As a result of this procedure, single Member States would recognise single elements from the European Concept drawn up in the Recommendation as equivalent to a plan drawn up under its own laws and provide equivalent benefits. In this way they would provide companies operating under their legislation with a legal framework that delineates what is possible without invoking sanctions from regulatory, legal and taxation authorities. Recognition is nonetheless a major step and would require considerable co-operation between the Member States and the Commission.

— IV.B.2 —
Directive Level: Amending Existing European Company Law

Considering the difficulties in passing and implementing European Directives, especially in sensitive areas where unanimous decisions may be required, it seems preferable to amend existing European legislation. Since employee share ownership fits into the framework of company law, rules to implement it could be proposed as an amendment of the "European Company" legislation. Like the European Company Statute[106] (ECS), which provides an option for forming a supranational company, there could be an amendment to the ECS permitting such companies to create "European Employee Shareholding" as an option.[107] This option could be easily extended to other companies which do not fall under the ECS, provided that national legislation would then be adapted to the requirements of the supranational statute.

The EU Member States would have an incentive to implement legal rules pertaining to the "European Employee Shareholding Statute" as an amendment to the ECS, choosing from a variety of incentives, possibly including tax breaks as well as other preferential treatment:

— Unlike the supplementary rules to the ECS concerning participation in decision-making, those on "European Employee Shareholding" would be totally voluntary; they would apply only if the company decides to adopt one of the existing models of financial participation.
— As in the case of the supplementary rules to the ECS on participation in decision-making,[108] the scheme would be, at first hand, proposed by the employers to their employees; in other words, a negotiated proposition.

104 *See* E. Poutsma *and* Van den Tillaart *(1996); set-up expenses are, however, usually tax deductible as, e.g., in Ireland. See* J. Shannahan *and* L. Hennessy, Underpinning Partnership at the Workplace – An MSF Guide to Profit Sharing, ESOPs and Equity Participation, *Dublin, 1998, p. 33.*

105 High Level Group of Independent Experts, Report on cross-border obstacles to financial participation of employees for companies having a transnational dimension, *Brussels, December 2003, pp. 52.*

106 *Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European company (SE); OJ, L 294/1.*

107 *As proposed in the report of the Committee on Employment and Social Affairs of 5 May 2003 (FINAL A5-0150/2003), p. 11 and 14 and expressed in the European Parliament Resolution of 5 June 2003 (P5-TA (2003) 0253), 31. IV; like the Council Directive 2001/86/EC of 8 October 2001, "supplementing the Statute for a European company with regard to the involvement of employees" but with regard to financial participation.*

108 *Here it is the result of negotiations between employer and employee representatives.*

If the proposed scheme does not correspond to a catalogue of minimum requirements, or the parties so decide, a statutory set of standard rules would apply as a "safe harbour".

The mechanism of the "default standard rules" concerning participation in decision-making, foreseen in the ECS for resolving potential conflict while at the same time not imposing a solution, would even be suitable in the field of financial participation:

— As for the "standard rules" for private and/or unlisted SMEs, an ESOP-trust would be feasible since it may provide a relatively non-controversial solution to the question of employee voting rights and may buffer potential risk more easily, while at the same time solving the problem of business succession.

— As for the "standard rules" for quoted medium sized and large enterprises, a restricted broad-based employee stock option or stock purchase scheme (as practised in the United Kingdom) seems to be feasible since there has already been substantial development in European harmonisation on the one hand (see below), and a remarkable initiative put forward by the Enterprise Directorate-General on the other.[109]

109 European Commission Enterprise Directorate-General, *Employee Stock Options: The Legal and Administrative Environment for Employee Stock Options in the EU*, 2003.

— IV.B.3 —
National Level: Building on Existing National Company Law

Given the above described difficulties in arriving at a supranational compromise either in the Commission or in the Council, in order to reach a regulation at the Supranational level, the simplest solution is to build on existing national legislation originating in the Acquis Communautaire. A rare example of such legal "common ground" are some of the national rules on listed and unlisted joint stock companies originating in the implementation of European Law i.e., the second Council Directive on Company Law 77/91/EEC, dating back to 13 December 1976. Arts. 19 para. 3, 23 para. 2 and 41, para. 1 and 2 of the Directive allow Member States to deviate from the European legal framework of Joint Stock Companies in order to encourage employee financial participation. Although primarily referring to share ownership schemes these – optional – regulations also leave room for combination with profit-sharing schemes.

Art. 19 para. 3 allows Member States to deviate from the restrictive rules governing exemptions from the general prohibition against a company acquir-

ing its own stock. When the shares acquired by the company are earmarked for distribution to that company's employees or to the employees of an associate company, a general shareholders assembly decision is not obligatory although such shares must be distributed within 12 months of acquisition.[110]
Member States may lift the limit of the nominal value of the acquired shares of 10% of the subscribed capital (including shares previously acquired by the company and held by it, and shares acquired by a person acting in his own name but on the company's behalf) though, according to Art. 41 para. 1.

As an exception to the general prohibition against a company leveraging the acquisition of its own shares, Art. 23 para. 2 allows Member States to permit companies to advance funds, make loans, and provide security (financial assistance), with the intention of selling these shares to company employees. Art. 41 para. 1 further allows for deviations from general rules and restrictions to encourage employee financial participation during the process of raising additional capital. An example is the financing of the share issue from the companies' own funds or through a profit-sharing scheme. Finally, the opening clause of Art. 41 para. 2 of the Directive providing for the possibility of suspension of Arts. 30, 31, 36, 37, 38 and 39 for companies under a special law issuing collectively held workers' shares, has not been used except in the case of France.[111]

As the table illustrates, a surprisingly large majority of Member States have adopted national legislation permitting a company to acquire its own shares in order to transfer them to its employees (implemented in 17, possible in 25), and to facilitate this acquisition by financial assistance (implemented in 23). Despite the fact that this legislation has rarely been used in some countries, the existence of corresponding regulations across the EU may serve as a foundation for a European concept.

110 *The general rules that 1) require that the acquisitions may not have the effect of reducing the net assets below the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes and 2) require that only fully paid-up shares may be included in the transaction still apply across the board.*

111 *See Art. L.225–259 to L.225–270 of the French Commercial Code: Employee shares collectively owned by paid personnel in a workers' commercial co-operative.*

Implementation of the 2nd Council Directive 77/91/EEC

Country	Art. 19 III Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 I Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
EU-15				
Belgium	Without decision of General Assembly.	Value of financial assistance within distributable reserves; net assets mustn't become less than subscribed capital; also firms founded by employees who hold more than 50% of voting rights.	5 years not transferable, limit: 20% of equity capital; max. 20% discount.	No
Denmark	Limit: equity capital exceeds distributional dividend; share capital less own shares held must amount to not less than DKK 500,000.	If qualified stock purchase plan; also acquisition from employees; to extent that shareholders' equity in firm exceeds amount of not distributable dividends.	According to Articles of Association issue of new/bonus shares; also subsidiary employees; authorisation up to 5 years each; also other than by cash payment.	Deviation from subscription/pre-emption rights by decision of General Assembly (2/3 of votes and equity capital) for benefit of employees.
Germany	Without decision of General Assembly; also (former) employees or of affiliated firms; reserve fund necessary without reducing equity capital or reserve funds.	Yes	Stock options for firms/affiliated firms employees; General Assembly decision; nominal amount of options restricted to 10%, that of increase to 50% of equity capital.	In firms with individual share certificates number of shares to be increased to the same extent as equity capital is increased.
Greece	Also personnel of ancillary firms.	No	Shares/stock options, free/discounted; 3 years not transferable without General Assembly approval.	No
Spain	Also for stock options.	Yes	No	No
France	In context of share-based profit-sharing scheme, share savings plan or stock option scheme.	Also in subsidiaries or companies included in a group savings scheme.	For all schemes; General Assembly decision required; no public offering.	Employee stock options; Share-based deferred profit sharing; Save-as-you-earn schemes.
Ireland	Not specific for employees, generally possible.	Firm/group firm; provision of money/loans under share scheme; present/former employees and members of families.	No	Finance Acts: Share-based profit-sharing; Save-as-you-earn/Share purchase schemes.
Italy	No	Value of financial assistance within distributable reserves.	Pre-emptive right of shareholders can be suspended for up to 25% of new shares with majority General Assembly vote; more than 25% require majority of capital held.	Special "Employees shares" can be issued in capital increase with specific rules for form, tradability and rights.

Country	Art. 19 III Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 I Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
Luxembourg	As minimum requirements of Directive.	Limit: net assets of firm not lower than amount of subscribed capital plus reserves.	No	No
Netherlands	Also employees of group firm; without decision of General Assembly, if Articles provide; equity capital reduced by acquisition price not less than amount paid for shares plus reserve funds.	Yes (but restrictions for closed JSC).	No	No
Austria	Also employees of affiliated firms; reserve fund for own shares to be established without reducing of equity capital or other reserve funds; Stock options without decision of General Assembly, but consent of supervisory board.	No	Stock options for firms/affiliated firms employees; General Assembly decision; nominal amount of options restricted to 10%, that of increase to 50% of equity capital; limit of 20% of equity capital for total amount of shares receivable.	In firms with individual share certificates the number of shares has to be increased to the same extent as equity capital is increased.
Portugal	Not specific for employees, generally possible, if partnership contract does not provide for anything else.	Also to employees of affiliated firms; liquid assets mustn't become less than subscribed capital plus not distributable reserves.	General Assembly may limit/ abolish pre-emptive right of shareholders for "social reasons".	No
Finland	Not specific for employees, generally possible.	Yes, if interest rate is less than the reference interest rate, difference is taxable benefit and subject to social tax.	No special regulation with a view to employees.	Act on Personnel Funds.
Sweden	Not specific for employees, generally possible.	employees of firm/group firm; total value limited; min. 1/2 of firms employees covered; advance/loan to be repaid within 5 years.	General Assembly can suspend shareholders pre-emptive right of; also group firm; also wife/ husband/children.	No
United Kingdom	Not specific for employees, generally possible.	Firm/group firm; provision of money/loans under share scheme; present/former employees/family members; net assets mustn't become less than subscribed capital; value of financial assistance within distributable reserves.	No	Finance Acts: Share-based profit-sharing; Save-as-you-earn/Share purchase schemes.

Country	Art. 19 III Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 I Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
New Member Countries				
Bulgaria	Not specific for employees, generally possible.	No	No	No
Cyprus	Without decision of General Assembly.	Advance funds and make loans to employees.	No	No
Czech Republic	Without General Assembly decision provided for reserve.	In accordance with Articles of Association.	Financing from company profits or profit sharing; not considered public offering.	Discount limit: 5% of equity capital, covered by firms own resources.
Estonia	Not specific for employees, generally possible.	No	No	No
Hungary	Not specific for employees, generally possible.	Also employees of controlled firms or organisations founded by employees.	Both, free/discounted special "Employee Shares", not considered public offering.	Spec. Free/discounted "Employee Shares"; limit: 15% equity capital; not transferable; obligation to sell back.
Latvia	Firm may fully pay up stock, not transferable; for max. 6 months.	No	Non-voting shares, max 10% of equity capital, covered by firms profit; no public offering.	"Employee shares" in municipal/ state firms; not transferable; obligation to sell back.
Lithuania	Not specific for employees, generally possible.	Advance funds or loan paid back by deductions from employees' salary.	Non-voting shares for max. 3-year period in which share sale only to other employees.	No
Malta	Without decision of General Assembly.	For employees of firm/group firm; provided it does not endanger firms own funds.	No	Free/discounted shares of mother firm for employees; no prospectus needed.
Poland	Also retired employees/ affiliated firms; reserve needed.	Reserve needed, also employees of affiliated companies.	Financing from firms' profits/ profit sharing; not considered public offering.	No
Romania	Financed by profits and/or distributable reserves.	Yes	No	No
Slovak Republic	In accordance with Articles of Association.	Provided it does not endanger company's own funds.	By General Assembly decision.	Discounted share offers, discount max. 70% covered by firms' own resources.
Slovenia	Also retired employees and of associate firms.	Also employees of associate companies.	Financing from profit sharing possible.	No
Candidate Countries				
Croatia	Also employees of associated firms; reserve from profits needed.	Reserve needed; must not endanger equity capital.	Among others to fulfill employees' claims to acquire shares.	No
Turkey	Not specific for employees, generally possible.	No	No	No

— V —
Conclusions and Summary

— V.A —
Compliance with the Postulates of the European Policy-Makers

— V.A.1 —
Achieving Competitiveness While Maintaining Diversity

Financial participation of employees is closely linked to the objectives of the Lisbon summit for making the European economy "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion".[112] Our proposed European Concept refers – as does the Commission – particularly to the experience in the U.S. that demonstrates the impact such a model can have "in terms of economic growth, fostering industrial change and making sure that all workers participate in this growing prosperity".[113] Therefore, in order to harness the potential – still largely unexploited in Europe – of the further development of financial participation as part of an overall strategy for stimulating the growth of new, dynamic companies as the Commission requires, we advocate the development of ESOPs.

Although the thesis that democracy requires a broad distribution of wealth is widely accepted, present social policy has not yet responded to the growing concentration of wealth; no regulations have come into force either at a national or a European level. Social attention so far has been focused on the growing wealth of the few (e.g., anti-monopoly legislation). Given this context, an open, modular concept ideally responds to the need for developing regulations at the supranational level in order to support financial participation more actively and to overcome national differences in taxation policy. At the same time, such a legal framework, while providing a broader incentive system, delineates what companies may do without inviting sanctions from regulatory, legal and taxation authorities.

A legal foundation at the European level has to focus on "majority vote" regulations if it is to be successful. Thus it should encompass a broad incentive system which provides different and flexible solutions compatible with those already established in the Member States:

112 *See point 1.5 of the Presidency Conclusions of the Lisbon European Council, 23–24 March 2000.*

113 *Commission communication seeking "a framework for the promotion of employee financial participation", COM(2002)364 Final, 5 July 2002, pp. 3 and 10.*

— Relatively widespread in the European Union are profit-sharing schemes, stock options and employee shares.
— In countries with an Anglo-American tradition, e.g., the United Kingdom and Ireland, ESOPs are also to be found;
— Central and Eastern European countries have developed share ownership systems (rather than profit-sharing schemes) with shares being distributed for free or sold at the market price or under preferential conditions.

The apparent difference in legal and political priorities between East and West is due to the fact that the first priority of postsocialist legislators is to change the socialist economic system through privatisation and re-privatisation. Therefore the development of these schemes does not necessarily constitute a progressive evolution of their pay system or their work organisation process.

The Building Block Approach reflects this diversity, while opening national practise to new forms of financial participation.

— V.A.2 —
The Building Block Approach: Meeting Essential Principles ...

The proposed Building Block Approach fully complies with the essential principles of financial participation schemes which the Commission sets forth in the cited communication:
— All elements of the building blocks are voluntary for both enterprises and employees (this does not, however, conflict with the French compulsory regulations at the national level).
— The building blocks can be put together in any combination depending on the specific needs of the given enterprise so as to produce individually tailored, clear and comprehensible plans.
— Discrimination, e.g., against part-time workers or women, would exclude any national company scheme from being integrated into the supranational European Concept.
— The proposed share ownership schemes that have been established in the United States and the United Kingdom for decades include adequate training programs and educational materials which allow employees to assess the nature and details of the schemes.
— Unreasonable risks for employees are buffered by the diversity of the concept. The dissemination practices for employee information aim at,

among other objectives, raising the awareness of the risks of financial participation resulting from fluctuations in income or from limited diversification of investments.

— By collecting the best practise of national legislation and customs, the rules on financial participation at the company level are based on a predefined formula clearly linked to enterprise results.
— Each building block is a complement to, not a substitute for, existing pay systems.
— It is the explicit aim of the Building Block Approach to be used throughout the European Union and as such to be compatible with worker mobility both internationally and between enterprises.

— V.A.3 —
… and Overcoming Transnational Obstacles

At the same time, the Building Block Approach seeks to address transnational obstacles identified by the Commission and Parliament[114] as imposing barriers to the development of a European model and to cross-border plans for financial participation:

— By providing a broad incentive system going beyond the classical instruments of tax legislation, the modular approach neither relies on nor excludes tax incentives.
— In spite of the difficulty of implementing tax incentives, these still remain a powerful tool for enhancing and broadening financial participation. They could be voluntarily granted by countries singly or in groups, creating in the process an increasingly favourable environment. The pro-activism of countries with an advanced tradition like France or the United Kingdom would at the same time encourage others to emulate them.
— The benchmarking project we are currently undertaking[115] across the EU the first ever complete provides overview employee participation in all member and candidate countries of the European Union and thus facilitates the avoidance of transnational obstacles, e.g., blocking periods when employees may not dispose of their shares.
— Our project, by providing information in a systematic way with reference to the experience of the EU–15, is also helping to overcome the cultural differences in the social partnership as well as raising the new member countries' awareness of employees.

114 *Report of the High Level Group of Independent Experts on cross-border obstacles to financial participation of employees for companies having a transnational dimension, Brussels, December 2003, pp. 17.*

115 *The Commission funded project, led by the author of this book, offers comprehensive empirical data on employee participation throughout the EU, including its significance in economic practise, legal obstacles, and future possibilities; the PEPPER IV Report is published in 2008.*

— V.B —

Employee Stock Ownership Plans (ESOPs): A Thrust for Innovation

In addition to well known forms of financial participation (e.g., employee shares and profit sharing), the Building Block Approach introduces a lesser known but flexible form of collective share ownership: the ESOP. While, for example, share-based profit-sharing schemes have only one source of funds (i.e., direct contributions from the employer company), the ESOP can obtain financing from such different sources as:

— A loan from the employer company, a selling shareholder or from a financial institution such as a bank;

— Dividend earnings;

— Sale of shares to its related share-based profit-sharing scheme;

— Contributions from the employer company.

A full or partial ESOP buy-out provides an ideal vehicle to facilitate transitions in ownership and management of closely-held companies. This field of action has been highlighted as one of the main objectives of the Council Recommendation of 7 December 1994[116] and recently by the European Commission, explicitly stressing the importance of ownership transfers to employees as a specific measure for facilitating business succession in SMEs.[117] The ESOP creates a market for retiring shareholders' shares, which is of major importance to unlisted SMEs having no other ready source of liquidity.

While share ownership generally involves additional risk for employees, the ESOP avoids this consequence. Although employees, as in other share ownership schemes, are encouraged to allot part of their wealth into the shares of their own companies rather than those of other companies, resulting in concentrated rather than diversified risk, there is this fundamental difference: ESOP debt is funded by appropriately timed contributions from the company to the ESOT. Thus the scheme provides an additional benefit to basic wages. The employee's salary remains unaffected. There is an additional advantage to the company: shares are not sold to outsiders; thus there is no risk of loss of control and the company remains local.

Finally, ESOPs make employees more motivated and productive while at the same time making enterprises more competitive.[118]

116 *On the transfer of small and medium-sized enterprises, 94/1069/EEC, with explanatory note, Official Journal No C 400, 31 December 1994, p. 1; reiterated in the communication from the Commission on the transfer of small and medium-sized enterprises, OJ C 93, 28 March 1998.*

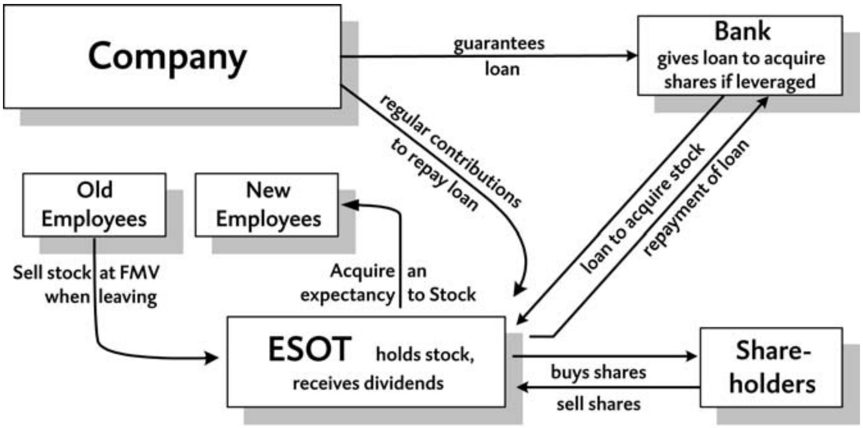
117 *One of the key areas defined in the Final Report of the MAP 2002 Project,* European Commission Enterprise Directorate-General, Transfer of Businesses – Continuity Through a New Beginning, 2003.

118 *For a recent, comprehensive overview of the positive economic evidence (esp. for ESOPs) see* J. R. Blasi, D. Kruse, A. Bernstein, In the Company of Owners, *Basic Books, New York, 2003; they find an average increase of productivity level by about 4%, of total shareholder returns by about 2% and of profit levels by about 14% compared to firms without PEPPER schemes.*

— V.B.1 —

ESOP as a Vehicle for Business Succession

ESOPs may easily buy-out one or more shareholders while permitting other shareholders to retain their equity position. This is one of its major advantages from the shareholders' perspective. At the same time, ESOPs give business owners the opportunity to diversify their investment portfolios without the costly process of going public.[119] Furthermore, there is no dilution in equity per share of current stockholders since no new shares are issued and all shares are bought at fair market value.[120]



As stated above, if the ESOT borrows money to buy shares, the company repays the loan by combining any dividend income of the trust with its own tax-deductible contributions to the plan. As the loan is repaid, a number of shares equal to the percentage of the loan repaid that year is allocated to employee accounts, usually on the basis of relative compensation. In this way the ESOP creates a market for retiring shareholders' shares at a price acceptable to the owner – a market which otherwise might not exist. At the same time, when a change of control is appropriate, ownership is transferred to motivated employees who have a vital interest in the company's long-term success.

Thus the ESOP may be an attractive alternative to selling the business to outsiders, especially when there is a desire to keep control of the business within a family or a key-employee group.[121] As a trusteed plan, the ESOP is designed to separate control over the shares in the trust from the "beneficial owners." The trustee exercises the voting rights while the employees are the financial beneficiaries of the trust. The trustee may, in fact, be the very person who has just sold some or all of his shares to the trust. For smaller firms especially, it is much easier to contemplate a gradual transfer of ownership by creating a mar-

119 *For American ESOPs, see* D. Ackermann, *How to Cash Out Tax-Free, Yet Keep Your Business … ESOPs – A Practical Guide for Business Owners and their Advisors, Conference Paper, National Center for Employee Ownership, San Francisco, California, 2002.*

120 *Theoretically, there is a temporary loss in the potential of the company caused by the obligation of the loan, since the borrowed funds used for the buy-out otherwise might be used to finance further growth. It is unlikely, however, that a trade sale to an outsider, if at all possible, would trigger the same increase in productivity and profitability as a result of higher employee motivation.*

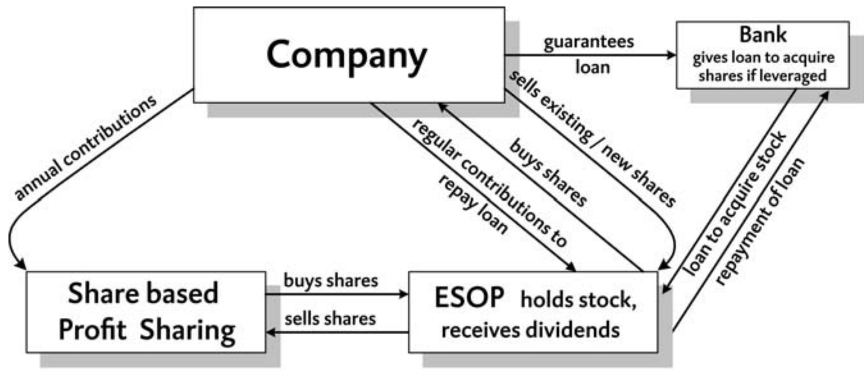
121 *The ESOP may also be used to buy out dissident shareholders.*

ket for the shares of those who wish to sell at the present moment, while enabling those who wish to hold their shares to retain their equity interest permanently or at least until some later date. The result is the opportunity of gradually cashing out without giving up immediate control.[122]

The virtue of an ESOP is that it can easily accomplish a 100% buy-out over time without subjecting the company at any given moment to 100% leverage.[123]

— V.B.2 —
ESOP Enhancing Cash Flow

The ESOP may also be used to enhance working capital or for other legitimate corporate purpose. This involves the issuance of new shares or the sale of existing stock held in the company treasury. Besides creating employee share-holding, the employer company, under certain circumstances, by selling shares at full market value to the trust, receives an equity injection. This is the case when tax advantages are available for paying off leveraged principal with tax-deductible plan contributions. It also occurs when the company acquires cash from the employees directly. However, even without these conditions, the company, through its contributions, fully funds the "equity".



Usually the dilution of the current stockholders is partly offset by any available tax advantages. It can further be compensated for by increased productivity and profitability of the company as a result of higher employee motivation, which in the process raises the value of its stock. An increase in working capital can occur if the ESOP is replacing some other program which would have diverted cash out of the company (e.g., a pension or profit-sharing plan invested in non-employer securities). The same is true if, in the absence of an ESOP, the company has to purchase shares from a departing founding shareholder with after-tax income rather than pre-tax income.

122 *Once the loan is paid off, of course, most companies make some arrangement for the presence of employee representatives on the plan committee.*

123 *One hundred percent buy-outs are very difficult for most companies to finance without a significant part of capital from lenders who demand a very high rate of return (35–40%). The costs for arranging the financing can amount to millions of Euros, which is certainly beyond the range of SMEs.*

— V.B.3 —

The Private Equity Buy-Out vs. the ESOP

A recent Commission Communication from 2006[124] stated that with the aging of Europe's population, "one third of EU entrepreneurs, mainly those running family enterprises, will withdraw within the next ten years". This portends an enormous increase in business transfer activity which could affect up to 690,000 small and medium-sized enterprises and 2.8 million jobs *every year*.[125] It is anticipated that as a consequence of the new forms of business finance now coming into use, transfers within the family will decrease, while sales to outside buyers will rise. The entrance of international investors into what used to be primarily domestic markets will broaden the range of potential buyers for European small and medium-sized enterprises. But these enterprises are the backbone of Europe's national economies, cultures and traditions. Their sale to impersonal Private Equity funds[126] and strategic investors will affect not only the working lives of Europeans, but also their material well-being and the quality of their communities. This process is likely to threaten the successful regional structure of European (family-owned) businesses[127] and will profoundly affect the European Community itself – its values, its vision and its effectiveness.

The growing number of Private Equity firms targeting Europe's small and medium-sized enterprises[128] makes a comparison of an alternate leveraged buy-out tool of immediate strategic importance. This alternate vehicle is the Employee Stock Ownership Plan. Although the ESOP and the Private Equity fund have some features in common[129], the two markedly differ in one crucial respect: they benefit different constituencies and have different economic and social effects. The Private Equity buy-out concentrates ownership of productive enterprises and the income it produces, while the ESOP broadens both the economy's ownership base and the distribution of income. The Private Equity buy-out increases the wealth of its own narrow constituency, while the ESOP improves the material well-being and economic security of working people and their families. The Private Equity buy-out is a short-term transaction aiming at restructuring and selling the target company to a third party – that, in turn, may be just another Private Equity Fund. The ESOP is a long-term commitment which ensures the continuity of the enterprise.

Quick profits for a few investment consortiums, whose participants are already well-capitalised, or incomes rising over time for employees motivated by the ESOP to make their enterprises more profitable and competitive? This is the choice confronting the EU as it prepares for a massive transformation of ownership of the business enterprises that generate its economic prosperity.

124 *Implementing the Lisbon Community Programme for Growth and Jobs, on the Transfer of Businesses – Continuity through a new beginning, from 14 March 2006 COM(2006) 117 final.*

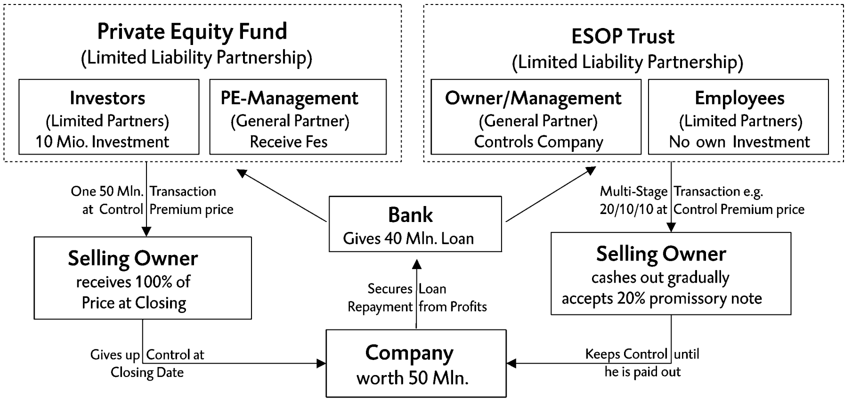
125 *Calculated by Extrapolations from the final report of the BEST-project on the transfer of small and medium-sized enterprises, 2002, which estimated that the annual transfer potential for the EU-15 was 610,000 businesses. E.g., the Transfer volume of enterprises is estimated for Germany around 354,000 over the next five years (Institut für Mittelstandsforschung, Bonn, 2005), for France around 600,000 for the next decade (Vilain, La transmission des PME artisanales, commerciales, industrielles et de services, avis et rapport du conseil économique et social, 2004).*

126 *The Volume of Private Equity transactions in Europe has been rising over the last years with 126 billion Euro in 2005 and a new peak of 178 billion Euro in 2007; source: Incisive Financial Publishing, 2007.*

127 Deutsche Bank Research, DEUTSCHER MITTELSTAND VOM AUSSTERBEN BEDROHT? UNTERNEHMENSNACHFOLGE IM FOKUS *(Germany's Mittelstand – an endangered species? Focus on Business Succession), current topics 387, 29 May 2007, p. 1, (download at www.dbresearch.de). See also PES* PRIORITIES FOR THE EU POLICY AGENDA *2008, adopted at the Party of European Socialists Leaders' meeting 21 June 2007, p. 3.*

128 *The part of LBOs in the total funds raised in Europe reached over 68% in 2005. In contrast the amount of venture capital investments only represents 5%. See* HEDGE FUNDS AND PRIVATE EQUITY – A CRITICAL ANALYSIS*, PSE Socialist Group in the European Parliament, 2007, p. 69.*

129 *The ESOP, invented in 1956, is the prototype leveraged buy-out; the Private Equity form originated in the seventies to utilize tax advantages which the U.S. Congress had passed to encourage the ESOP.*



The leveraged buy-out (LBO) exploits the fact that productive capital repays its formation or acquisition costs out of its own future earnings, i.e., it is self-financing. But this vehicle has two forms, either of which may be used to transfer small and medium-sized enterprises to new owners. In both cases the owner sells at fair market value with the control premium.[130] As has already been noted, however, the two forms serve different purposes with radically different economic and social effects.

Although both kinds of LBOs employ debt-financing up to 80%[131] of the purchase price to acquire partial or total ownership of the target company, the time horizon is entirely different. The goal of the private equity firm is generally short-term profit gained from restructuring or "down-sizing" the company for resale; therefore retaining control of the company at closing is a prerequisite. The ESOP by comparison is a multi-stage, long-term transaction extending over a period of five to seven years during which the buy-out loan enables the selling owner to cash-out gradually without giving up control immediately.

The flexibility of the ESOP can greatly benefit owners of SMEs who do not want totally to sever their connection with an enterprise which perhaps has been family-owned for generations and to which they may be bound by sentimental as well as economic ties. Selling their company to the ESOP in instalments, they may delegate some management functions while retaining a vital role in the control of the company until they wish to completely to retire. This option involves sharing any risks with the bank which financed the acquisition loan; employees themselves incur no additional risk.

The exit-strategy of Private Equity funds of restructuring and then selling the enterprise may lead to a management buy-out, initial public offering, secondary sale, buy back, trade sale or, even a write-off. Ideally the whole cycle is no longer than five years.[132] The ESOP trust by contrast "warehouses" shares, thus creating an in-house market in non-listed companies which can be used to buy shares from retiring employees while offering shares to new employees.

130 *Nevertheless, in the case of the ESOP he may receive a little less due to the loss in interest caused by the duration of the multi-stage transaction.*

131 *In this example in the case of the ESOP the selling owner accepts 20% of the price as a promissory note, while the Private Equity Fund raises 20% by investment of the limited partners.*

132 *A Standard & Poors analysis of the big LBOs found that in 2004 they got 64% of their invested capital back just after 29 months engagement in the target company, in 2005 27% in just 20 months and in the first half of 2006 86% in just 24 months. See* PSE Socialist Group in the European Parliament, *Hedge Funds and Private Equity – a Critical Analysis, 2007, p. 18.*

Private equity transactions may increase liquidity in capital markets; they also create wealth for the limited partners, investment bankers, outside investors and senior managers who structure and participate in this type of buy-out.[133] But middle managers and lower-echelon employees may lose their jobs during the restructuring process; the home community may lose consumers and taxpayers. Production, under globalisation, may be relocated elsewhere or even "off-shored" to another country.

The ESOP leveraged buy-out offers continuity and stability. If "modernization" or restructuring is necessary, as is usually the case with an old established business in need of new technology and methods, the enterprise will still remain in the community. It will be owned by local residents, consumers and taxpayers. More of the income it produces will remain in the community as well.

Studies over the years have found that firms in which employees have an ownership stake are more profitable, create more jobs and are better taxpayers than their counterparts with no employee ownership. These findings suggest that the ESOP leveraged buy-out could be an important tool for implementing the goal of the Lisbon Agenda, namely making European SMEs more competitive.

133 *Nevertheless, the average investor often obtains poor returns from investments in private equity funds, potentially because of excessive fees. For a detailed analysis see* L. Phalippou, INVESTING IN PRIVATE EQUITY FUNDS: A SURVEY, *The Research Foundation of CFA Institute, 2007.*

— Annex I —

The U.S. ESOP as an Example of an Advanced Model

By John D. Menke and Stefan Hanisch

— A —

Historical Background

For the first 100 years after the founding of the American republic, the U.S. was in fact a "society of owners." Ownership of a farm, ranch or small business was the norm rather than the exception. During the next 100 years, however, this situation changed radically with the coming of the industrial revolution and the eventual emergence and success of big business.

During the mid 1800s there was a legislative attempt to reverse the increasing tendency toward concentration of ownership through the enactment of the Homestead Act, which gave ownership of 160 acres of public land to any citizen who "homesteaded" the land and made it productive through his own toil. By 1929, however, the concentration of corporate wealth and power again overpowered all other forms of ownership, leading to the Great Depression of 1929. During the next decade, the federal government attempted to restore purchasing power through massive measures of redistribution. These measures alleviated the symptoms, but did not cure the disease. Purchasing power was not fully restored until World War II created a whole new industry of defence contractors and small manufacturers.

After World War II, the U.S. economy enjoyed two decades of prosperity before crashing again in 1974. In 1974, as in 1929, the U.S. economy was again characterised by a high degree of concentration of ownership, by an abysmal lack of purchasing power, by extremely low rates of productivity, by violent confrontations between labour and management, and by a lack of capital for growth and expansion. Interest rates were at an all time high, and few banks were willing to lend in any event. The stock market was at its lowest since 1929, and public offerings were non-existent.

Although stock bonus plans and profit-sharing plans that invest primarily in shares of company stock have existed since 1926, the first ESOP did not come into existence in the U.S. until San Francisco attorney Louis Kelso designed a leveraged ESOP to buy out the founders of Peninsula Newspapers, Inc. in 1956. Between 1956 and 1986 the Kelso law firm went on to design ESOP buy outs for another 500 or so privately-held companies. The ESOP concept was first codified[134] into law in the Employee Retirement Income Security Act of 1974 (ERISA).[135]

— A.1 —
Foundations of the U.S. Employee Stock Ownership Plan

The European policy makers' postulates are in line with the fundamental principles of the Employee Stock Ownership Plans developed by the Kelso's in the United States, many of which have been legislatively implemented. The basic Kelso thesis is that every nation's capital assets must and can be broadly owned by its own citizens not collectively, but as the private property of individuals. Universal capital ownership is necessary because in a technologically advanced economy it is increasingly difficult and even impossible to attain a high standard of living solely through jobs and employment. People must supplement their wages and salaries with capital sourced income – i.e., interest and dividends – in order for everyone to participate in and enjoy the fruits of our private property, free market system.

ESOPs are retirement-type plans that qualify for special tax treatment. They operate through trusts established by the company to hold stock and other investments for the employees until the employee leaves the company. In return for significant tax benefits, companies must comply with a variety of rules to assure equitable treatment for plan participants. The benefits for the company include increased cash flow, tax savings, and increased productivity from highly motivated workers. The main benefit for the employees is the ability to share in the company's success. Due to the tax benefits, the administration of ESOPs is regulated, and under government supervision.

In an ESOP, the company, not the employee, funds the plans. Companies can fund these plans by contributing shares to the plans, contributing cash that the plans use to buy shares, or by having the plan borrow money to buy new or existing shares. If the plan borrows money to buy shares, the company repays the loan by making tax-deductible contributions to the plan to enable it to repay the loan. As the loan is repaid, a number of shares equal to the percentage of the loan repaid that year is released to employee accounts. If the plan does not borrow money, then as shares or cash are contributed to the plan, the shares are allocated to individual employee accounts, usually based on relative compensation.

134 *Since the tax code already authorised stock bonus plans and profit sharing plans that were primarily invested in shares of company stock, Congress was persuaded to authorize leveraged ESOPs on the grounds that leveraging the plan would allow the employees to acquire much larger equity stakes in their employers than they could otherwise acquire by buying stock on a year-by-year basis.*

135 *Prior to 1974 there was no explicit statutory authorization for ESOPs. They were simply approved on a case-by-case basis by the Internal Revenue Service, based on certain existing regulations and revenue rulings that applied to stock bonus plans and profit sharing plans.*

The ESOP is designed to build capital ownership into employees of a business in the course of efficiently financing its growth or other worthwhile corporate objectives, without touching employee pay-checks or savings. As to employees, the ESOP is that constitutionally mandated missing link that gives them access to capital credit to buy the employer's capital stock and, without personal risk or liability, to pay for it from the pre-tax earnings of the assets underlying that stock. In other words, the ESOP equal their access to capital credit with that of the already rich.

— A.2 —
Structural Changes Needed to Implement ESOPs and Profit-Sharing Schemes

When the ESOP was proposed and adopted as part of the Employee Retirement Income Security Act of 1974 (ERISA), it was not proposed and adopted as part of a grand new scheme of corporate finance (although the Kelsos did succeed in getting language inserted into the Committee hearings that the "[…] ESOP is a tool of corporate finance"). Rather, it was proposed as a minor modification of the existing rules and regulations that applied to pension and profit-sharing plans. It was not initially blessed with any greater tax incentives or advantages than applied to qualified retirement plans such as pension plans and deferred profit-sharing plans. In effect, all that was proposed (and all that was initially adopted) was that deferred profit-sharing plans would be allowed to invest up to 100% of their funds in shares of company stock, and that deferred profit-sharing plans would be allowed to borrow funds for the purpose of purchasing shares of company stock.

In order to distinguish these new plans from deferred profit-sharing plans (which were not allowed to borrow money), these new plans were called ESOPs; they were also given an exemption from the fiduciary requirement of earning a "fair rate of return" if the plan was designed to be invested "primarily" in shares of company stock. The result was to create an entirely new kind of plan that enabled employees to become capital owners rather than mere recipients of profit-sharing funds. However, from a legislative and tax standpoint, the changes in the rules and regulations were minimal, and hardly anyone in Congress at the time recognised that the ESOP in effect converted employees into capital owners rather than mere beneficiaries of profit sharing largess.

— A.3 —
Key Tax Incentives for ESOPs

In addition to giving a potentially larger stake to employees, the ESOP also created a benefit for the existing owners. The ESOP created a new market for the existing owners to sell part or all of their stock to their employees through the ESOP. Prior to the invention of the ESOP, the only options available to owners desiring to exit the business were to sell their shares to the public in an initial public offering (IPO), sell their shares to a competitor, or sell their shares back to the company itself. For most privately-held companies, selling shares to the public in an IPO is not a viable option unless their company is in a high growth industry and has at least USD 100 million of annual revenues. For many companies, selling to a competitor is also not a viable option, since it usually means that the company will be downsized and merged out of separate existence. Selling shares back to the company itself also has a major disadvantage in that the sale will almost always have to be debt financed. The disadvantage of debt financing is that debt must be paid back with non-deductible dollars, which is prohibitively expensive in many cases.

All of these disadvantages are avoided when the owner sells his or her shares to an ESOP. With an ESOP, the shares are not sold to a competitor. Thus the firm continues its separate existence and its separate identity. With an ESOP, the purchase is usually debt financed, but the debt is paid back with tax-deductible dollars. Further, the ESOP can purchase the shares on a gradual basis so that the debt burden is not extensive at any given moment. For these reasons, as well as the fact that various studies confirmed that ESOPs were also effective in increasing employee motivation and productivity, ESOPs became increasingly prevalent during the ten-year period between 1974, when they were first codified, and 1984. In 1984, Congress determined that additional tax incentives were needed to further spur the growth and development of ESOPs. Consequently, the Tax Reform Act of 1984 added two key tax incentives for ESOPs.

The first new tax incentive was the so-called "tax-free rollover" provision. Under this provision (§1042 of the Internal Revenue Code), if an ESOP acquires 30% or more of the outstanding common stock of a regular corporation (now referred to as a "C" corporation), the capital gains tax that the seller would ordinarily pay is deferred, provided that the seller purchases qualified replacement securities within 12 months of the sale. As long as the seller does not dispose of these replacement securities, the capital gains tax will be deferred indefinitely. If the seller subsequently dies, these qualified replacement securities receive a step-up in "basis." In this event, the capital gains tax is avoided completely. The second new tax incentive added by the Tax Reform Act of 1984 was the so-called "deductible dividend." Normally, any dividends paid by a corporation are not tax-deductible to the corporation. Under this new provision (§404(k) of the Internal Revenue Code), however, dividends paid on shares of company stock held by an ESOP are deductible to the corporation provided that these dividends are "reasonable," and provided further that these dividends are used by the ESOP to repay an ESOP loan that was obtained to purchase shares of company stock. The purpose of this provision was to give companies even greater tax deductions in those cases where the company borrowed money to finance a purchase of company stock by the ESOP.

During the 20 years following the adoption of these two tax incentives, the number of ESOPs in the U.S. soared until the recession of 2002–2003 slowed their growth. In the meantime, U.S. corporate tax rates have changed so as to make the overall tax burden to corporate shareholders more favourable if the corporation is structured as an S corporation rather than as a C corporation. (An "S" corporation is a corporation that is treated as a partnership for tax purposes, thus avoiding any taxation of profits at the corporate level.) Since the two special tax incentives for ESOPs only apply to C corporations, Congress realised that additional ESOP tax incentives would be needed for S corporations. Accordingly, the revisions that were made to §1361 of the Internal Revenue Code in 2001 included an additional tax incentive for S corporation ESOPs. Under this tax incentive, any share of an S corporation's profits that is attributable to the ESOP as an S corporation shareholder will not be subject to the unrelated business income tax that is normally imposed on "unrelated" earnings received by a qualified employee plan. Since the ESOP is otherwise a tax-exempt entity, this change means that the ESOP will be tax-exempt on all of its earnings, whether they are "related" or "unrelated." The practical result of this change in the tax code is that in the case of an S corporation that is 100% owned by its ESOP, 100% of the earnings of the corporation will be exempt from any and all income taxation. In the three years since this change in the tax code, there has been a large increase in the number of S corporations that have become 100% ESOP owned.

— A.4 —
The Interim Balance in 2007

As a result of the Kelsos efforts, the ESOP is now a part of the social and economic fabric of corporate America. Over half of all the *Fortune* 500 companies now sponsor ESOPs. Over 40% of *Inc.* magazine's 100 fastest growing private companies now sponsor ESOPs. Now that ESOPs have existed in the U.S. for over 30 years (some ESOPs were put in place even before the 1974 legislation), there is a wealth of data to support the conclusions that:

— ESOPs have been more successful than any other technique of corporate finance in extending the ownership of capital to people who would otherwise remain non-owners. As a result, there is a great deal more social stability, as well as less animosity, between capital owners and non-capital owners.

— ESOPs have, on the average, provided a much higher level of retirement benefits than other types of pension and profit-sharing plans.

— ESOPs have helped to eliminate the "us versus them" attitude in the great majority of ESOP companies. ESOPs have, in fact, brought about an unparalleled reign of labour-management peace and cooperation.

— ESOPs have been quite successful in increasing employee productivity and company profitability.

— ESOPs have been very successful in providing for business succession and continuity.

As of 2007 there were approximately 11,000 ESOPs in the U.S., covering approximately 10 million employees. The vast majority of ESOPs are sponsored by privately-held companies, of which 3,500 are majority and about 2,000 100% owned by the ESOP. According to a 2004 survey completed by the General Social Survey, out of 108 million people in the U.S. who work in the private sector, 21% of employees own company stock, and the median value of the employees' company stock ownership is over one-fifth of their annual pay. Employee stock ownership is widespread across all sectors of the American economy, ranging from nearly 60% of employees in computer services to a low of 14% in agriculture, mining and construction. Other sectors with a significant degree of employee ownership include utilities (55%), durable manufacturing (30%), non-durable manufacturing (30%), and wholesale (23%).

— A.5 —
Future Prospects for ESOPs in the U.S.

In May, 2007, Senator Blanche L. Lincoln introduced S. 1322, the *ESOP Promotion and Improvements Act of 2007* in the U.S. Senate. The bill's principal feature is a provision that would permit owners of S corporations to sell their shares to an ESOP under the same tax-free rollover provisions of §1042 that currently apply to owners of C corporations. Although it is too early to predict whether this bill is likely to obtain passage by the U.S. Congress, it is clear that a number of representatives in the U.S. Senate and in the U.S. House will continue to press for additional tax incentives to spur the further growth and utilization of ESOPs. Also, as the U.S. economy increasingly becomes more and more a "service" economy, it would seem that the popularity of ESOPs will continue to grow, since service workers are more inclined to demand financial participation in the fruits of their own labour.

Two other recent developments are also likely to result in increased usage of ESOPs. First, globalisation and increased foreign competition have forced U.S. companies to reduce employee wages and benefits in order to remain price competitive with foreign producers. As a result, U.S. companies are increasingly eliminating all forms of guaranteed retirement benefits. For example, defined benefit pension plans and even regular deferred profit-sharing plans are almost extinct among privately-held companies. Among privately held companies, 401(k) plans (which are funded largely by employee deferrals) and ESOPs are about the only types of retirement plans that still remain in vogue. Although a leveraged ESOP, like a defined benefit pension plan, requires a fixed contribution in order to repay the ESOP loan, this fact does not impede the adoption of ESOPs, since the ESOP provides double-duty dollars. That is, an ESOP enables the company to buy out the existing owners, while at the same time providing employee benefits.

Second, among public company shareholders, the perception has developed that the high tech bubble of the late 1990s was caused by overly incentivising top management with stock options. This perception has led the AICPA (the organization that provides accounting standards for the accounting industry) to rule that stock option grants must be expensed on the company's income statement. As a result, many public companies are reducing or eliminating their stock option plans and are considering adopting ESOPs, which provide broad based stock ownership for all employees, not just for the top management group.

— B —

Models of Financial Participation: The U.S. and the French Systems

The American experience in institutionalising techniques for broadening the ownership of capital, valid in all of the 50 American states, provides a model for such a trans-jurisdictional framework. In addition the fundamental principles and structure of the U.S. system of financial participation are in line with the European policy makers' postulates. A comparison with the French model demonstrates (see charts on the opposite page) that both systems are composed of the same basic elements which make up the Building Block Approach.

— C —

Four Case Studies

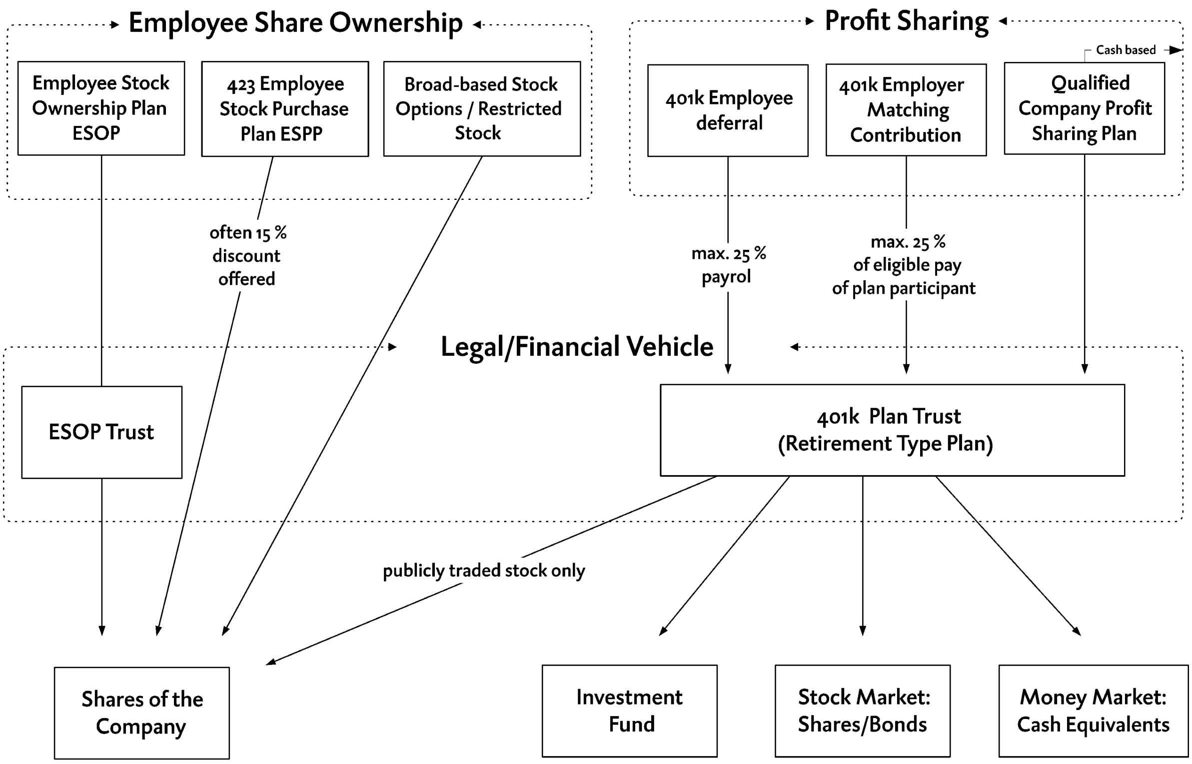
— C.1 —

Market Contractors, Ltd. (Business Succession ESOP)

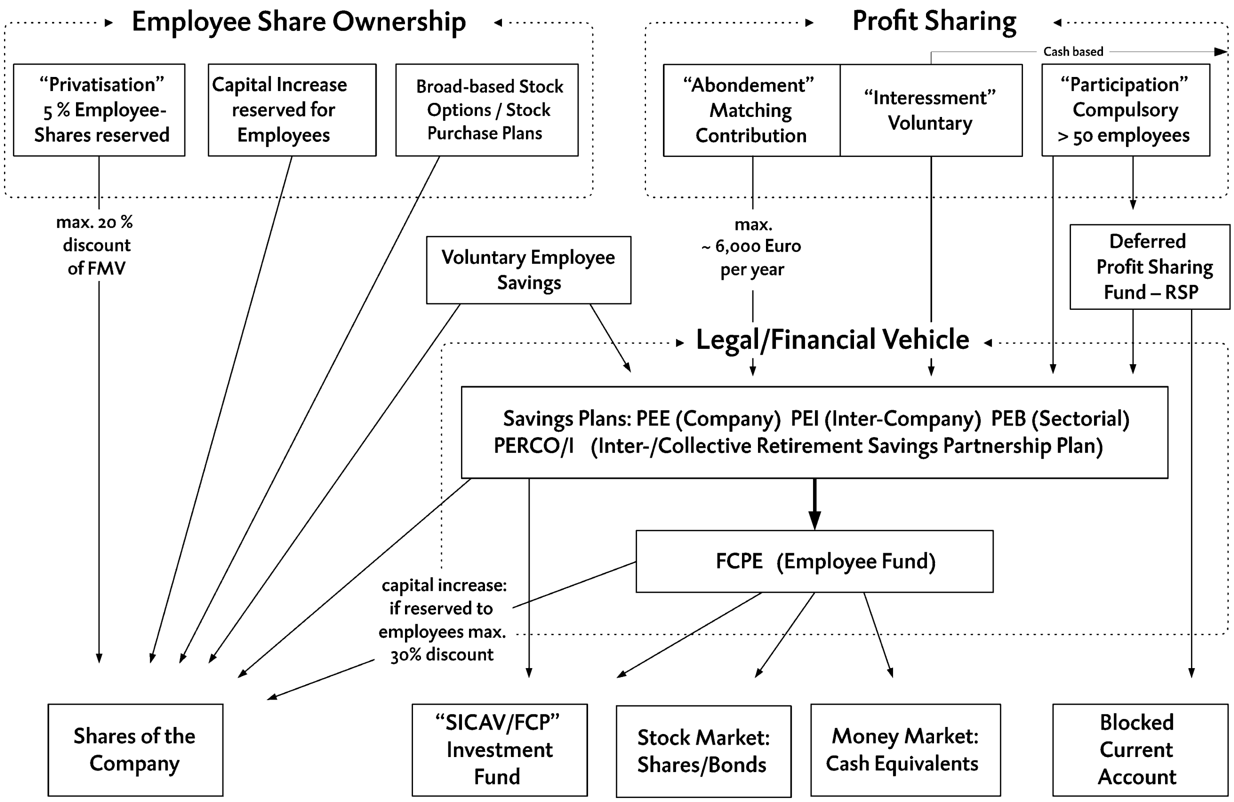
The Company

The company was founded as a C corporation by a sole shareholder in 1978. Services include buildings, tenant improvements, remodels, re-imaging and fixture installations. The original market focus was the grocery industry, providing major remodel, fixturing and maintenance services in Oregon and Southwest Washington. Continuing growth has been achieved through the operation of a regional office and satellite locations. Effectively the company has spread its base of operations so as to provides construction services in 13 Western U.S. states. Its products and services have expanded to include casework and millwork. The client mix includes the following industries: banking/financial; medical/dental; retail; grocery, and restaurants. The company continues to base its growth on a wide diversity of trade disciplines and expertise, and a larger geographical market focus. An exclusive service offers corporate retailers and corp/franchisors a reliable, high-quality alternative to in-house resources for site development, facilities space planning management, and construction management on a national scale. In 2006 the company had a turnover of USD 37,352,888 and pre-tax earnings of USD 1,867,644.

U.S. System of Financial Participation



French System of Financial Participation



The Plan

The Employee Stock Ownership Plan replaced a former Profit-Sharing Pension Plan; it originally became effective November 1, 1989, and was two times amended and restated, effective as of November 1, 1992 and November 1, 1999. In 2005, the ESOP owned 52.2% of the company's shares. That time, the company employed 148 people, 36 of them were participants of the plan.

Originally, distributions of less than USD 3,500 were paid out in a lump sum after a five-year period of break in service. According to the 2000 amendment to the plan, since then, amounts of less than USD 10,000 are distributed in a lump sum as soon as possible after termination. Also since then, the plan provides for distributions in five equal annual instalments after a five-year break in service. QDRO (qualified domestic relations orders) distributions commence as soon as possible after approval. Amounts less than 10,000 USD are to be paid in a lump sum, amounts of more than 10,000 in five equal annual instalments.

In 2006, further 45% shares were sold to the ESOP, which finally owns 97.12% of total shares. The value of the 45% of shares was appraised at USD 9,338,220 (5x pre-tax earnings) or USD 54.34 per share.

Buying out the Owner

Originally there were only 99 shares issued. In order to facilitate the share allocation in the ESOP, the company re-issued the shares, 159,840 for 99. The company was valued at USD 10.00 per share or USD 1,590,840.

In 1990, when the ESOP was installed, the company had just previously entered into a contract with a silent partner to purchase his interest. He held 48 shares or a little over 48% of the company. The company borrowed money from the bank (USD 428,000) which was secured by 42,800 shares. The loan funds were utilised to cash out the silent partner and recapitalise the company. The original 32,800 shares were transferred to the ESOP as part of this transaction. Another 19,680 shares were contributed by the company to the ESOP. Finally, the ESOP owned 62,480 shares, of which 29,680 shares were still encumbered by the remaining balance of the bank loan of USD 296,800. The bank loan was paid down with USD 131,200 of the contribution in that year. So, in 1990, the sole shareholder owned 88,480 shares (55.36%), the ESOP owned 62,480 shares (39.09%), and two previous key employees owned 8,880 shares (5.55%).

One key employee shareholders sold his 5,920 shares to the ESOP for USD 16.00 a share in 1996 or as of October 31, 1996 valuation. Also in 1996, many employees were asking about having more stock in the company instead in Other Investments Accounts (OIA) funds because the company was performing better than OIA funds. So the company issued 10,000 new shares as a contribution valued at USD 19.50 per share or USD 195,000 for which the company took a tax deduction as a contribution. This brought the ESOP share in company to 78,400 shares. In subsequent years, the ESOP purchased stock from shareholder B as follows: in 1997, 3.200 shares for USD 59,200 or USD 18,50 per share; in 2000, 3,076 shares for USD 100,031.52 or USD 32.52 per share and again 708 shares for USD 23,024.16 or USD 32.52 per share; in 2001, 958 shares for USD 34,219.76 or USD 35.72 per share. The last purchase was financed by the company through a short-term loan to the ESOP. The sole shareholder sold 3,038 shares to the ESOP in 1999 for a price of USD 98,248.92 or USD 32.34 per share. In 2006, the company had 171,848 shares of its sole class of voting common stock issued and outstanding 77,500 of which were owned by the sole shareholder. He sold all of these 77,500 shares to the ESOP for a total of USD 4,211,350 or USD 54.34 per share.

The ESOP paid USD 1,050,000 in cash, USD 500,000 of which were obtained from the Other Investments Accounts (OIA)[136] of participants in the ESOP and USD 550,000 of which were borrowed by the company from the cash value of a certain life insurance policy owned by the company and loaned by the company to the ESOP in return for its promissory note (ESOP Company Note, interest rate 5.25%). The ESOP shall pay the principal of the ESOP Company Loan in 11 consecutive annual instalments of USD 50,000. The remaining unpaid principal balance of the ESOP Company Note falls due at the end of the 11-year period. In addition, the ESOP provided the seller with its promissory note in the amount of USD 3,161,350 for the balance of the purchase price (ESOP Seller Note, interest rate equal to the greater of the prime rate charged by the National Bank at its main branch in Portland, Oregon, less 1% or the lowest long term applicable Federal rate applicable for purposes of Sec. 1274 IRC 1986, as amended). The ESOP shall pay the principal of the ESOP Seller Loan in 10 consecutive annual instalments of USD 105,378. The remaining unpaid principal balance of the ESOP Seller Note falls due at the end of the 10-year period.

Average plan participant In 2005, the average plan participant (not including employees who were hired during the plan year the majority shareholder of the company) was 44 years of age, had 7 years of service and has been participating in the plan for 7 years. His/her annual gross compensation amounted to USD 60,545. He/she has been vested 88% of allocated shares. The

136 *Cash contributed to the ESOP that has not purchased company stock is allocated to each participant's OIA.*

total value of shares allocated to the account of the average plan participant has been USD 63,115, the value of vested shares USD 60,161.

EMPLOYEE A (EARLY PARTICIPANT) Employee A was born in 1948. In 2005, he was 57 years old. He joined the company in 1989, 17 years ago, and has been participating under the plan for 16 years. His annual gross compensation amounts to USD 57,758. In 2005, to his ESOP account has been allocated shares to the total value of USD 201,423. According to his years of service, he has been vested 100%. Thus, vested shares are valued at USD 201,423.

EMPLOYEE B (LATE PARTICIPANT) Employee B was born in 1966. In 2005, he was 38 years old. He joined the company in 1998, 7 years ago, and has been participating under the plan for 6 years. His annual gross compensation amounts to USD 49,940. As of 2005, to his ESOP account has been allocated shares to the total value of USD 59,592. According to his years of service, he has been vested 100%. Thus, he has been vested shares to the value of USD 60,161.

EMPLOYEE C (CASHED OUT) Employee C was born in 1949. In 2005, he was 56 years old. He joined the company in 1991 and the plan in 1993. In 1998, after 7 years of service and 5 years of participation under the plan, he retired. His last annual gross compensation amounted to USD 37,558. His ESOP account had accumulated shares to the total value of USD 43,105. He cashes out in four equal annual instalments at the amount of USD 10,776 each. In 2005, he received USD 10,776.

— C.2 —

Stone Construction Equipment, Inc. (Business Succession ESOP)

The Company

The company is an S corporation and a national leader in the design, manufacture and marketing of light construction equipment. The more than 350 products designed and manufactured for worldwide distribution include: concrete and mortar mixers; power trowels; concrete and masonry saws; hand held, walk behind and ride on dirt and asphalt compactors. The company was founded in 1967 and is located in Honeoye, New York, in an 150,000 square-foot facility. In 2007, the company ranks 43rd on the Rochester U.S. TOP 100 list of fastest-growing private companies, a program of the Rochester Business Alliance and KPMG.

The company's book value at December 31, 2005 was USD 13,098,910, or USD 36.21 per share, based upon 361,787 shares of common stock outstanding. The company's average pre-tax earnings capacity for the financial years 2001– 2005 was in a range of USD 1,135,000 to USD 1,250,000. The sustainable EBITDA was estimated at USD 2,545,000 (its financial years 2001–2005 weighted average EBITDA). The appraisal applied a guideline of a publicly traded company-based EBITDA multiple of 6.5. The net shipments (sales) in financial year 2005 amounted to USD 55,955,046. The present value of future pretax earnings capacity was estimated to USD 29,990,000.

The Plan

The ESOP was originally installed on January 1, 1979, but was amended and restated effective twice, as of January 1, 1989 and January 1, 2001. Since 1995, a number of stock transactions have taken place each year, consisting of the issuance of restricted common stock to key management pursuant to an incentive stock option plan as well as the purchase of common stock into the company's treasury from terminating ESOP participants. Currently 221 employees are participating under the plan (out of 249).

The plan provides for lump sum distributions in case of death, disability or retirement during the following plan year. In the event a participant's employment is terminated for other reasons, distribution of participant's plan benefit in excess of USD 1,000 shall commence no later than one year after the close of the plan year in which the earliest of the following events occurs: normal/early retirement date, death, disability. Distribution of a participant's plan benefit attributable to employer securities acquired by the plan after December 31, 1986 will be made in a lump sum as soon as administratively feasible during the sixth plan year following the plan year in which the participant separated from service. If the total vested value of a participant's Corporate Savings Account (CSA) and Other Investments Accounts (OIA) is USD 1,000 or less, distribution shall be made in a lump sum as soon as administratively possible after the participant terminates employment. Effective for all plan years beginning on or after January 1, 2005, the USD 1,000 limit was amended to USD 5,000.

As of December 31, 2005, the ESOP Trust owned 83% or 361,787 of the company's outstanding common stock with a value of USD 16,740,000, or USD 46.27 per share. 12% of stock was still held by a second main shareholder, 5% by other employees (due to other retirement plans).

Buying out the Owner(s)

The sole proprietor was born in 1940 and sold all of his stock to the ESOP prior to 1991 in order to start up a new business. In addition to the funds received from the sale of his stock, as participant of the ESOP and with 12 years of participation in the ESOP he received USD 42,179 in 2005. Altogether, between 1985 and 1995, the ESOP obtained 300,635 shares for a total value of about USD 6,000,000: 100,000 shares from outside investors for a total of USD 2,000,000, and 200,000 shares from the sole shareholder and his family for a total of USD 4,000,000.

In the financial years 1983–1984, the ESOP bought about 17% of the outstanding stock (50,000 shares) at an average price of USD 19 per share. These transactions were financed out of operating cash flow. In financial year 1985, the ESOP borrowed USD 1,000,000 from a bank and used the proceeds to buy stock from existing shareholders at USD 19 per share. In financial year 1986, the ESOP borrowed USD 4,000,000 to purchase an additional 67% of the outstanding stock (200,000) at USD 20 per share. In this transaction, the ESOP purchased all of the shares held by the founder and his family. This brought the ESOP to 100% ownership. The loan was repaid over a 10-year term from 1986–1996.

Average plan participant In 2005, the average plan participant was 45 years of age, had 13 years of service and has been participating in the plan for 13 years. His/her annual gross compensation amounted to USD 54,605. The total value of shares allocated to his/her account was USD 52,095. He/she was vested 82.13% of allocated shares having a value of USD 51,361.

Employee A (early participant) Employee A was born in 1968. In 2005, he was 37 years old. He joined the company in 1988, 17 years ago, and has been participating under the plan also for 17 years. His annual gross compensation amounts to USD 44,545. In 2005, to his ESOP account have been allocated shares to the total value of USD 58,368. According to his years of service, he is vested 100%. Thus, he has been vested shares to the value of USD 58,368.

Employee B (late participant) Employee B was born in 1953. In 2005, he was 52 years old. He joined the company in 1999, 7 years ago, and has been participating under the plan for 7 years. His annual gross compensation amounts to USD 73,229. In 2005, to his ESOP account have been allocated shares to the total value of USD 17,203. According to his years of service, he is vested 100%. Thus, he has been vested shares to the value of USD 17,203.

Employee C (cashed-out) Employee C was born in 1953. In 2005, he was 52 years old. He joined the company in 1999 and the plan in 2000. In 2005, after

6 years of service and 5 years of participation under the plan, he terminated. His last annual gross compensation amounted to USD 31,843. He accumulated shares to the total value of USD 5,292. He cashed out with a lump sum of USD 4,234 after taxes.

— C.3 —
Bad Case: Golden Bear Packaging, Inc. (Business Succession ESOP)

The Company

The company was founded by two individuals in 1985 to act as a corrugated box converter that supplies printed cartons to electronics, food, and light and heavy industry clients within a 150-mile radius of the manufacturing facility. Throughout financial year 2001, a recessionary environment prevailed in the corrugated industry and it continued to plague the company in 2003. Management has taken steps to increase sales and cut costs and it appears that those efforts are beginning to pay off. With the debt load down to a manageable level, the company's survivability looks more promising. The FMV dropped from USD 3,949,000 or USD 1,583.65 per share in 1998 to US$ 70,000 or USD 36.52 per share in 2002.

As of December 31, 2004, the fair market value of the company (on a minority interest basis) was appraised at USD 330,000 or USD 179.25 per share based upon 1,841 shares outstanding. The company's book value at December 31, 2004 was USD -172,223. The company had an average pre-tax earnings capacity for the financial years 2000-2004 in a range of USD -604,000 to USD 58,000. The adjusted EBITDA for the same period ranged from USD 327,000 to USD 217,000. The net shipments (sales) range from USD 7,864,000 to USD 4,004,000. The company is presently running at 30% of its capacity and has a significant opportunity for growth.

The Plan

The company adopted a combined ESOP and 401(k) Plan which has become effective as of January 1, 1986, but has been amended and restated effective several times. As of December 31, 2005, the company had a total of 30 full-time employees (excluding executives). 26 of them are participating in the plan.

The plan provides for distributions in a lump sum in case of a participant's death, disability and retirement, not later than one year after the close of the plan year. In the event a participant terminates employment for reasons other than death, disability or retirement, his vested plan benefit, if USD 3,500 or more, will be distributed in five equal annual instalments, commencing not later than one year after the close of the third plan year following the plan year in which he or she terminates employment. Amounts of more than USD 500,000 shall be distributed in five equal annual instalments, plus one year (but not more than five additional years) for each USD 100,000 by which the plan benefit exceeds USD 500,000. If a participant's Corporate Savings Account (CSA) or Other Investments Accounts (OIA) are less than USD 3,500, distribution shall be made in a lump sum as soon as possible after the close of a plan year in which he or she incurs a one-year break in service.

During financial year 2002, the company acquired 484 shares from departing plan participants. During financial year 2004, the company repurchased and retired 76 shares from retiring ESOP participants. As of December 31, 2004, the ESOP owned 40.25% or 741 out of 1,841 shares of the company's outstanding common stock. There was a financial year 2005 transaction in which the company repurchased 6.4 shares from the ESOP to remunerate a departing plan participant.

Buying out the Owner

The ownership (2,500 shares) was originally shared between three shareholders to 56% (1,400 shares), 40% (1,000 shares) and 4% (100 shares). The 56%-shareholder sold his 1,400 shares to the ESOP in 1994 for USD 1,345,000. As of December 31, 2004, 54.32% or 1,000 shares and 5.43% or 100 shares were owned by the other two shareholders.

The transaction was financed by two loans about USD 634,000 (so-called bridge loan) and USD 561,260 (altogether USD 1,195,000) given by the company to the ESOP in exchange for promissory notes and a contribution of the company about USD 150,000. The company borrowed USD 634,000 (terms 90 days) and USD 561,260 (on a prime interest rate and a 7-year term) from a bank. After receiving cash payment for the 1,400 shares from the ESOP, the seller purchased a GE Bond as his qualified replacement property (QRP) and margined against the bond in the amount of USD 634,000. The seller lended USD 634,000 to the company in order to repay the short-term bank loan. The company issued a promissory note to him about this amount.

EMPLOYEE A (EARLY PARTICIPANT) Employee A was born in 1950. In 2004, she was 54 years old. She has been employed at the company since 1991, for 14 years, and has been participating in the plan for 13 years, since 1992. Her annual gross compensation amounts to USD 49,394. In 2004, shares to the total value of USD 7,133 have been allocated to her ESOP account. According to her years of service, she is vested 100%. Thus, she has been vested shares to the value of USD 7,133.

EMPLOYEE B (LATE PARTICIPANT) Employee B was born in 1969. In 2004, she was 35 years old. She has been with the company for 7 years, since 1998, and has been participating in the plan for 6 years, since 1999. Her annual gross compensation amounts to USD 34,680. In 2004, shares to the total value of USD 685 have been allocated to her ESOP account. According to his years of service, she is vested 100%. Thus, she has been vested shares to the value of USD 685.

EMPLOYEE C (CASHED OUT BEFORE RECESSION) Employee C was born in 1972. In 2006, he was 34 years old. He joined the company in 1996 and the plan in 1997. In 2000, after 5 years of service and 4 years participation under the plan, he terminated. His last annual gross compensation amounted to USD 26,796. He accumulated shares to the total value of USD 4,678. He was vested 100% and cashes out in five annual instalments at USD 936 during 2003-2007.

EMPLOYEE D (CASHED OUT DURING RECESSION) Employee D was born in 1971. In 2006, she was 35 years old. She joined the company in 1996 and the plan in 1998. She used to work on a part-time basis since 2000. In 2001, after 3 years of service and 4 years participation under the plan, she terminated. Her last relevant (i.e. full-time) annual gross compensation amounted to USD 17,382 in financial year 1999. She accumulated shares to the total value of USD 1,216. She was vested 100% and cashed out in 2006 with USD 1,216.

— C.4 —

Bad Case: Howland Electric & Electronic Wholesale Company, Inc.

The Company

The company is a C corporation and primarily a wholesale electrical distributor carrying approximately 11,500 stock-keeping units. It produces inventory multiple lines but it also assists customers by providing free electrical design services which is unique among similar types of firms. The company was founded in 1952 as an equal partnership of three owners. In 1955, the company was incorporated.

The company has been suffering consistent loss for the last five years. Currently, the company is in liquidation and all of its assets are being sold. As of December 31, 2005, the fair market value of the company (on a minority interest basis) was appraised at USD 1,250,000 or USD 64.56 based upon 19,361.22 shares outstanding. The company's book value at December 31, 2005 was USD 637,519. The company had an average pre-tax earnings capacity for the financial years 2001-2005 in a range of USD -164 to USD -101. The adjusted EBITDA for the same period ranged from USD -292 to USD -277. The net shipments (sales) range from USD 2,141 to USD 488,000.

The Plan

The company had no plan for business succession. Selling the company to the ESOP was not an option because there was no capital apart from the value of the real estate. That is why, after the death of the owner, the company has come under liquidation. The bad performance of the company has been reflected also in miscommunication between the ESOP advisory firm and the company. In the beginning, the ESOP was administered by other people. After the ESOP advisory firm took over the plan administration, there was a permanent problem of getting necessary data/information in time.

The plan provides for distributions in a lump sum up to USD 3,500 in case of a participant's death, disability or retirement, not later than one year after the close of the plan year. Amounts of more than USD 3,500 will be distributed in five substantially equal annual instalments. Amounts of more than USD 500,000 shall be distributed in five equal annual instalments, plus one year (but not more than five additional years) for each USD 100,000 by which the plan benefit exceeds USD 500,000. In the event a participant terminates employment for reasons other than death, disability or retirement, his vested plan benefit, if USD 3,500 or more, will be distributed in five equal annual instalments, commencing not later than one year after the close of the fifth plan year following the plan year in which he or she terminates employment. Amounts of more than USD 500,000 shall be distributed in five equal annual instalments, plus one year (but not more than five additional years) for each USD 100,000 by which the plan benefit exceeds USD 500,000. If a participant's Corporate Savings Account (CSA) or Other Investments Accounts (OIA) are less than USD 3,500, distribution shall be made in a lump sum as soon as possible after the close of a plan year in which he or she terminates employment.

As of December 31, 2005, the ESOP owned 23.82% or 4,611.22 of the company's outstanding common stock. 76.18% were attributed to the estate of the late sole shareholder. That time, the number of employees dropped from 25 (when the ESOP started) to 2 employees (including one executive).

Financing the ESOP transactions (as opposed to a succession ESOP)

Two of the three shareholders passed away, so that the company had one remaining sole shareholder (14,750 shares) prior to the installation of the ESOP in 1993 (effective since January 1, 1992). This person passed away in 2002.

Newly issued stock was sold to the ESOP in three transactions. In financial year 1992, the ESOP obtained 1,225.32 shares for a total of USD 113,134, or USD 92.33 per share. In financial year 1993, the company conducted a partially leveraged employee buy-out by selling 2.907.93 shares for USD 17,657.93, or USD 89.03 per share. The issuance of 673.01 new shares for USD 59,918 was financed by a bank loan which was repaid in 1994. In financial year 1994 the company issued 5,137.24 new shares to the ESOP for USD 169,160. The purchase of 896.152 shares was financed by a bank loan which was repaid in 1995. During the financial years 1997–2000 shares were redeemed by the company from participants in the ESOP.

Employee A (early participant) Employee A was born in 1951. In 2004, he was 53 years old. He joined the company in 1990 and has been participating in the plan since his installation in 1992. He left the firm in 2004, after 14 years of service. His annual gross compensation amounted to USD 36,052. In 2004, to his ESOP account have been allocated shares to the total value of USD

21,609. According to his years of service, he is vested 100%. Thus, he has been vested shares to the value of USD 21,609.

EMPLOYEE B (LATE PARTICIPANT) Employee B was born in 1962. In 2004, she was 42 years old. She has been with the company and has been participating in the plan for 5 years, since 2000. Her annual gross compensation amounted to USD 22,095. In 2004, to her ESOP account have been allocated shares to the total value of USD 399. According to her years of service, she is vested 60%. Thus, she has been vested shares to the value of USD 239.

EMPLOYEE C (CASHED OUT) Employee C was born in 1944. In 2005, she was 52 years old. She joined the company and the plan in 1994. In 1997, after 3 years of service and participation under the plan, she terminated. Her last annual gross compensation amounted to USD 28,250. She accumulated shares to the total value of USD 6,151. She was vested 20% and got distributed shares to the value of USD 1,230. She can use her "put" option and sell these shares to the company.

— Annex II —

The Legal Framework for Implementing Financial Participation at the Supranational Level

By Jens Lowitzsch and Natalia Spitsa

The diversity of traditional national approaches to both participation in decision making and financial participation are a major impediment to change, as the controversy over European workers' councils has impressively demonstrated for more than 30 years. The same factors make it very difficult to reach a unanimous supranational compromise either in the Council.

— A —

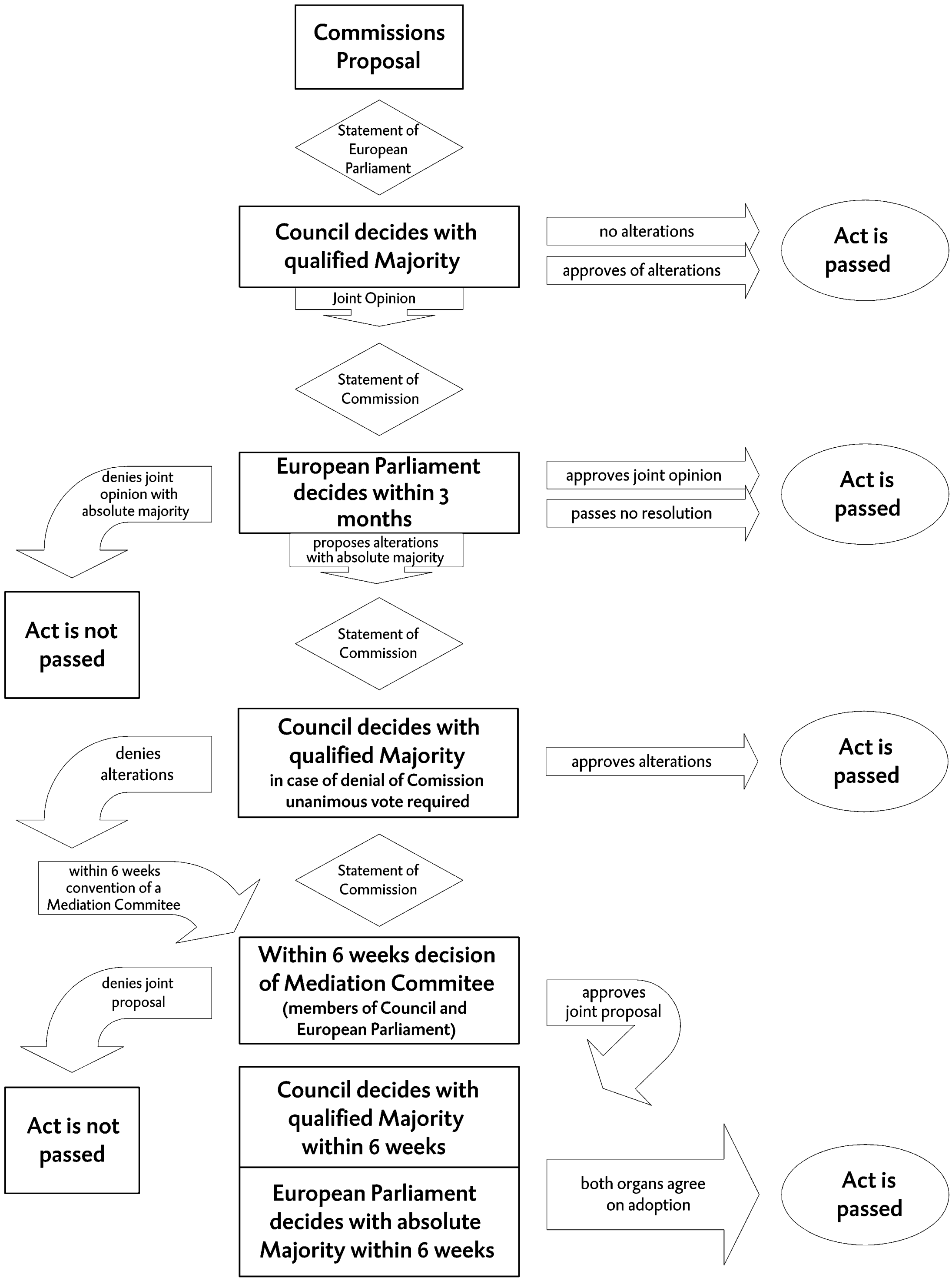
The Legislative Process

The law of European Treaties in general permits majority vote decisions in a limited number of cases, recently expanded by the Treaty of Nice in 2001. No less than 27 provisions have been changed completely or partly from unanimity to qualified majority voting, among them measures to facilitate freedom of movement for the citizens of the Union (Article 18 ECT) and industrial policy (Article 157 ECT). The so called "co-decision procedure" has been extended to apply to seven provisions which are changed from unanimity to qualified majority voting (Articles 13, 62, 63, 65, 157, 159 and 191). Accordingly, most of the legislative measures which, after the Treaty of Nice, required a decision from the Council acting by qualified majority will now be decided via the "co-decision procedure".[137] In the field of social policy (Articles 42 and 137 ECT), despite maintaining the status quo, the Council, acting in unanimity, is empowered to make the co-decision procedure applicable to those areas still subject to the rule of unanimity.[138] But where taxation is concerned, Articles 93, 94 and 175 ECT, maintain the requirement of unanimity across the board. This means that even though tax incentives are the most common way of leveraging financial participation schemes, a common European legal framework imposing such tax incentives would collide head on with the legislative tax sovereignty of nations.

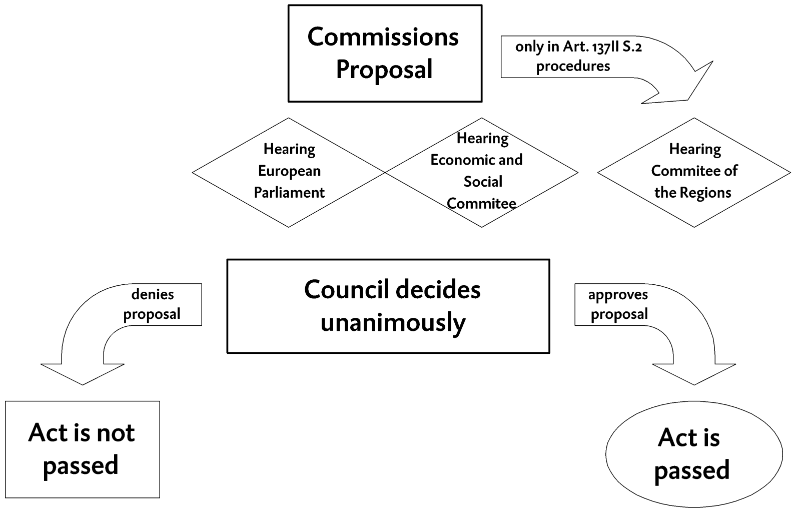
137 *The Intergovernmental Conference has not, however, extended the co-decision procedure (Article 251 ect) to legislative measures which already come under the qualified majority rule (e.g., in agricultural or trade policy).*

138 *This "bridge" cannot, however, be used for social security.*

“Codecision” Procedure according to Art. 251 ECT/Nice



Legislative Procedure according to Art. 94 or 137 II S.2 ECT requiring unanimous Decision



— B —

Legal Sources for Employee Participation at a European Level

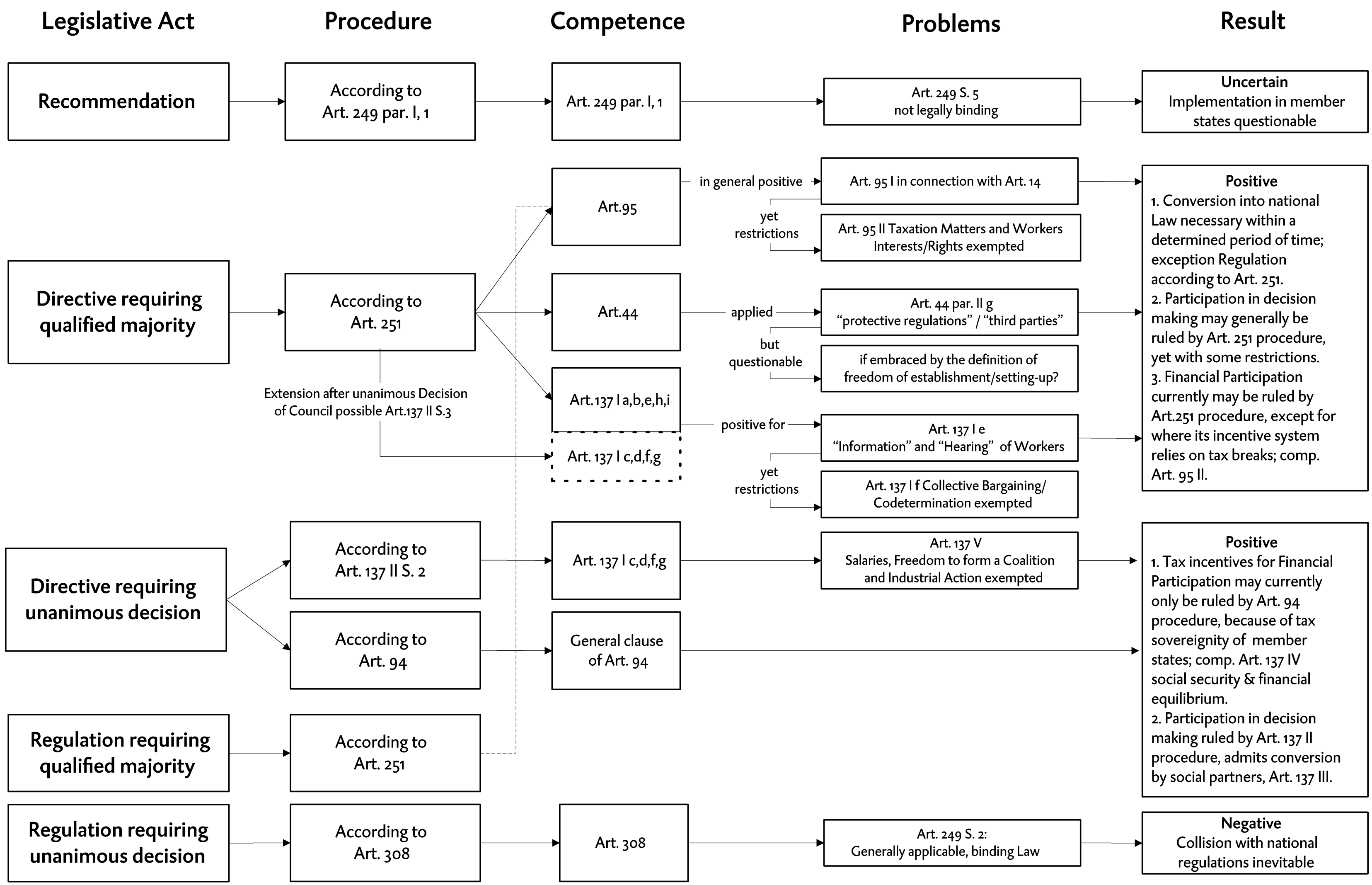
A European approach to the problem must provide a broad incentive system transcending the classical instruments of tax legislation. Establishing such schemes through legislation is of primary importance in order to give companies a clear framework for company decisions and actions.[139] A legal foundation at the Directive level must therefore focus on "majority vote" regulations in order to be successful. This is further necessary because the position of the governments in relation to the social partners, their role in society, and their relation to each other varies significantly in the different member countries.[140] Thus, a European regulation should allow a broad incentive system, one which provides different and flexible solutions corresponding to national situations. An adaptable scheme suitable for use throughout the European Union would collect the best practise of national legislation and customs and combine them in a single programme having alternative options.[141] The available legislative instruments, Recommendation, Directive and Regulation, together with their advantages and disadvantages, are shown in the following chart.

139 *See* A. Pendleton, et al., Employee Share Ownership and Profit-Sharing in the European Union, *European Foundation for the Improvement of Living and Working Conditions, 2001, p. 9.*

140 *E.g., the consensual continental contrasts with the Anglo-American confrontational model; likewise the strong position of the state in France contrasts with the powerful role of the German "Tarifpartner" (collective bargaining parties, much like trade unions and employer associations).*

141 *Compare* White and Case The European Company Statute, *2001, p. 4.*

Legal Sources for Employee Participation in the EU (ECT/Nice)



— C —
Dealing With Tax Incentives

— C.1 —
The Problem

At the national level, taxation can either inhibit or support the spread of employee financial participation. At the EU level, cross-border migration of employees partaking in financial participation plans, as well as the transfer of such plans by multinational companies to subsidiaries in different member states, may involve problems caused by conflicting tax regimes.[142] Generally, attention is centered on tax incentives, often considered the State's main instrument for promoting employee financial participation. Tax incentives, however, are relative; they need to be analysed in the context of the general taxation system in the given country. National tax systems are not easily compared; it is even more difficult to compare taxation laws governing national financial participation schemes.[143] Moreover, compulsory social security contributions must be taken into account since they add substantially to the overall burden of state levies, especially on labour; also, in many countries, they influence the tax base of the main income taxes. A systematic overview of the situation in the EU-27 shows, on the one hand, the impact and, on the other hand, the limits of tax incentives in encouraging employee financial participation. [144]

The objectives here are:

— To outline general systems of direct taxes as they affect employee financial participation in the EU. National tax systems will be classified as unfavourable, neutral or favourable for employee financial participation schemes.

— To review specific tax incentives for employee financial participation in order to determine whether specific tax incentives are a prerequisite for employee financial participation, and whether some tax incentives are more effective than others irrespective of the country where they are offered.

A useful criterion for measuring the efficiency of tax incentives is the increase in the number of a specific form of employee financial participation immediately after a certain tax incentive is introduced. However, historical data on such increases are presently available only for a small number of countries; therefore, the analysis of the efficiency of tax incentives in these countries will be present-

142 *Report of the* High Level Group of Independent Experts, On cross-border obstacles to financial participation of employees for companies having a transnational dimension, *Brussels, December 2003, pp. 43, on obstacles to exportation.*

143 *For the comparison of general tax systems, different types of taxes, different systems of individual taxes, different tax rates, tax bases and taxation moments all must be considered. Tax rates are only comparable if effective tax rates are calculated. However, that is only possible for a specific tax and for a specific personal status and situation. Since most major direct taxes should be examined to determine their effect on employee financial participation plans, effective tax rates cannot be calculated for every possible status or situation.*

144 *Due to the complexity of the issue, a discussion on comparability of individual country tax rates of EU Member States cannot be covered in this publication. For a more detailed discussion see PEPPER IV Report, forthcoming 2008.*

ed only as an example. A detailed and full analysis of tax incentives in all countries where they have been introduced will be included in the PEPPER IV report (2008, forthcoming).

— C.2 —

General Taxation of PEPPER-Schemes in the EU

The following direct taxes are relevant to employee financial participation:

— corporate income tax (CIT),
— personal income tax (PIT),
— taxes on dividends at shareholder level (special rates of personal income tax, "investment tax", "dividend tax", "share income tax", etc.)
— taxes on sale of shares at shareholder level (special rate of personal income tax, capital gains tax, "investment tax", etc.).

According to Art. 3 (1) h) ECT, an EU priority is to prevent the diversity of national tax systems from negatively affecting the development of the Common Market by harmonising national legal codes. As a special case of Art. 3 (1) h) ECT, Art. 93 ECT stipulates that indirect taxes (VAT and excises) must be made consistent. Prompted by this provision, numerous directives have been issued and indirect taxation has already been harmonised to a great extent. However, there is no special provision on harmonisation of direct taxes.[145] Moreover, potential harmonisation in this area is restricted by Art. 5 (2) ECT. On the one hand, the European Commission supports competition of direct taxes[146], regarding tax autonomy as the core component of state sovereignty, closely related to country-specific economic, social and cultural structures. On the other hand, it recognises the importance of preventing unfair tax competition, especially in the area of corporate taxation.[147] Since there is neither a legal basis nor political support for harmonisation of corporate tax rates, the European Commission currently favours the development of the Common Consolidated Corporate Tax Base (CCCTB).[148] However, even if the CCCTB should be introduced in all member states, it will not apply to enterprises having no cross-border activities.[149]

Nevertheless, international tax competition is exerting considerable pressure, especially on corporate income tax rates, since the U.S. tax reform of 1986. This is responsible for two persistent tendencies observable worldwide. Firstly, the tax burden has been shifted, from direct to indirect taxes[150] (with some exceptions, e.g., France), and, from capital to labour.[151] Thus taxation of share-

145 *Only more general provisions of Art. 94, 96 and 97 ECT on prevention of market distortions and, in cases of substantial discrimination, Art. 87 ECT on prevention of state subsidies, Art. 39, 43, 49, 56 ECT (basic freedoms) and Art. 12 ECT (general anti-discrimination provision) apply. However, these aim at non-discriminatory taxation of physical persons and legal entities from other EU member states as compared with domestic physical persons and legal entities and at prevention of double taxation. They do not lead to a higher degree of harmonisation.*

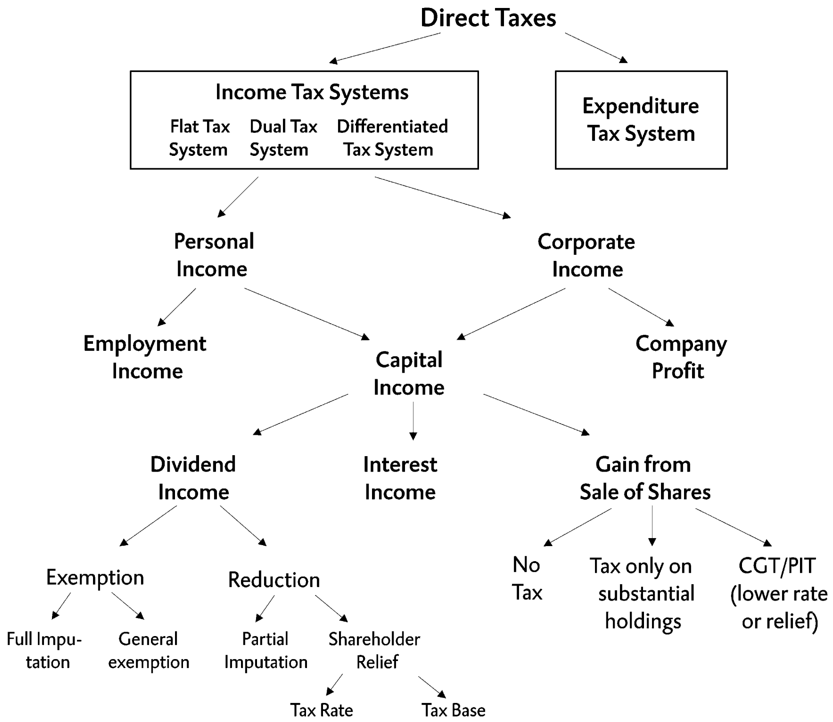
146 *See COM (1980), 139;* H. Weber-Grellet, *Europäisches Steuerrecht, Munich, 2005, pp. 28, 152.*

147 *Whereas the issue of unfair tax competition was originally connected with such traditional tax havens as the Channel Islands and Monaco, it has gained even more importance with the accession of new member states having generally much lower corporate and partially also personal income taxes than Western European EU member states, except Ireland. See* H. Weber-Grellet, *Europäisches Steuerrecht, Munich, 2005, p. 163.*

148 *See COM (2001) 582 of 23.10.2001; COM (2003) 726 of 24.11.2003; CCCTB/WP/046 of 12.12.2006; COM/2007/223 of 2. May 2007; the proposal, due in 2008, has not yet been completed, but it seems probable that the CCCTB could be introduced in several years. Seven member states with relatively low tax rates are opposed to the idea, but no unanimous decision is required in this case. The EU Tax Commissioner declared that the initiative can, if necessary, be implemented by eight member states through enhanced cooperation.*

149 *Moreover, the usefulness of this instrument for harmonisation of corporate taxation is considered to be questionable if no limits for corporate tax rates are set at the same time. See* Bundesministerium der Finanzen, *Einheitliche Bemessungsgrundlage der Körperschaftssteuer in der Europäischen Union, in: "Monatsbericht des BMF", April 2007, p. 73.*

based plans may become more favourable over time than that of cash-based plans, since the tax burden on dividends and capital gains is lower than on employment income. Secondly, tax rates are lowered while the tax base is broadened.[152] Although this might lead to the abolishment of specific tax incentives, it does not necessarily mean less favourable taxation: if the rates become sufficiently lower, this may compensate for the loss of tax incentives. The general characteristics of national systems of direct taxes are illustrated by the following chart:



A common feature of all direct tax systems of EU member and candidate states is that only income and not expenditure is taxable.[153] Accordingly, as affecting the relationship between the respective tax burden on capital and labour, income tax systems can be divided into flat tax, dual tax and differentiated tax systems; all these systems have advantages and drawbacks from an economic standpoint and are currently present in different EU member states. In a genuine flat tax system, represented by Romania and Slovakia, the tax burden falls equally on all sources of income, flat and relatively low, since the basic tax rate to which other tax rates are adapted is the tax on capital income. This system is generally equally favourable to all forms of employee financial participation. The same is true of tax systems which impose different tax rates on labour and capital income, but levy a flat personal income tax (Estonia, Latvia, Lithuania).[154] Dual tax systems represented, e.g., by Sweden and Finland, are characterised by

150 *See OECD (2005): Tax Policy Conclusions, OECD Centre for Tax Policy and Administration, p. 6.*

151 *See H. Weber-Grellet,* Europäisches Steuerrecht*, Munich, 2005, p. 30. There is no theoretical basis and/or empirical evidence for the assumption that the tax burden on capital should be lower than on labour, although the practice is based on it. See* S. Ganghoff, *Wer regiert in der Steuerpolitik?*, Frankfurt/M, New York, 2004, *p. 35.*

152 *See OECD,* Tax Policy Conclusions*, OECD Centre for Tax Policy and Administration, 2005, p. 6.*

153 *However, Croatia has had an expenditure tax system from 1994 till 2000. I. a. Bulgaria, Estonia and Hungary have an expenditure tax on fringe benefits payable by the employing company. The quite unusual Estonian corporation tax system (replacement of corporate income tax by the tax on distributed profits) could also be connected with the idea of expenditure tax.*

154 *These systems give more leeway to share ownership since tax rates on capital income are usually lower than those on labour. However, in practice the advantage of flat tax systems may not be so substantial since often relatively high compulsory social security contributions will be levied additionally.*

General Taxation and Compulsory Social Security Contributions

Country	Type of dividend treatment	CIT [A]	Taxation of dividends at Shareholder level [B]	Taxation of share sale at shareholder level [C]	PIT [D]	Compulsory SSC [E]
Belgium	Shareholder Relief: reduced tax rate.	34%	15%	generally 0%	progressive 25–50% central + 0–9% subcentral; SSC deductible.	Emp.: overall rate 13,07%. EmpC: Overall rate 35%.
Bulgaria	Shareholder Relief: reduced tax rate.	10%	7%	shares of public companies listed at Bulgarian Stock Exchange 0%.	progressive 20–24%, voluntary SSC deductible.	Emp.: (cumulative) 12.43–13.86%. EmpC: (cumulative) 23.34–25.74%.
Croatia	Dividend tax exemption for shareholders.	20%	0%	0%	progressive 15–45% +city surtaxes 0–18%; SSC deductible.	Emp.: 20% to pension fund. EmpC: 17.2% to the health, unemployment, injury funds.
Cyprus	Dividend tax exemption for shareholders.	10%	generally 0%	generally 0%	progressive 20–30%; SSC deductible.	Emp.: overall rate 6.3%. EmpC: overall rate 6.3%+2% to Social Cohesion Fund.
Czech Republic	Shareholder Relief: reduced tax rate.	24%	15% withholding tax at source	general PIT for sale of shares within 6 months.	progressive 12–32%; SSC deductible.	Emp.: (cumulative) 12.5%. EmpC: (cumulative) 35%.
Denmark	Shareholder Relief: reduced tax rate.	28%	28% Share Income Tax up to DKK44300 43% above; not for professional traders.	28–43%	progressive 5–26.5% central + 29–35% subcentral; ceiling 59%.	Emp.: 8% labour market tax. EmpC: 0%.
Germany	Shareholder Relief: reduced tax base.	38.7%	general PIT + solidarity surcharge 5.5%; tax base reduced to 50% of the dividend income (half-income system); no SSC.	0% for small long-term holdings; for substantial share-holdings general PIT on difference between 50% of proceeds and 50% of acquisition costs.	progressive 15– 45.4% + solidarity surcharge 5.5%; limited by an absolute amount; pension and health care contributions partly deductible.	Emp.: (average) 13–21.4%. EmpC: (average) 20.5%. Both limited by an absolute amount.
Estonia	Tax exemption for shareholders ; exemption of retained profits from corporate tax.	22%	0%	general PIT	flat 22%; mandatory SSC deductible.	Emp: contribution to the unemployment fund 0.6%. EmpC: “social tax” 33% + contribution to the unemployment fund 0.3%.
Greece	Dividend tax exemption for shareholders.	25%	0%	generally 0%; 20% on sale of shares of LLC or partnerships.	progressive 15–40%; SSC deductible.	Emp.: 11.55% (16%). EmpC: 23.1% (28.06%). Both limited by an absolute amount.
Spain	Partial Imputation	32.5%	15%; imputation credit	15% if held more than 1 year, otherwise general PIT.	15–45% saving income deductible.	Emp.: 16.35%. EmpC: 30.6%.
France	Partial Imputation	34.4%	general PIT with tax credit of 40% + social levies (CRDS, CSG) -11%.	CGT 16%; on stock options 30–40%.	progressive 5,5–40%	Emp.: (cumulative) 10.6–17.8%; limited by an absolute amount. EmpC: (aggregated) 29.72–34.22%.

Country	Type of dividend treatment	CIT [A]	Taxation of dividends at Shareholder level [B]	Taxation of share sale at shareholder level [C]	PIT [D]	Compulsory SSC [E]
Hungary	Shareholder Relief: reduced tax rate.	17.5%	25% for dividends on up to 30% of equity; 35% above + 14% health care contribution.	25%; on up to 30% of equity; 35% above.	progressive 18–36%; voluntary SSC deductible.	Emp.: 17%; limited by an absolute amount. EmpC: 32% + health care contrinution.
Ireland	Classical system	12.5%	20%	20%	progressive 20–42%; voluntary SSC deductible.	Emp.: 2–6%. EmpC: 8.5–10.75%.
Italy	Shareholder Relief: reduced tax base.	37.3%	general PIT; tax base reduced to 5% of the dividend income; below 5% share holding 12.5%.	12.5% for small shareholdings; 27% on substantial; tax base reduced to 40% of gain.	progressive 23–43% + surcharge 0.9–1.4%; SSC deductible.	Emp.: (cumulative) 9.2–10.2%. EmpC: (cumulative) 32.08%.
Latvia	Classical system	15%	general PIT	general PIT	Flat 25%	Emp.: overall rate 9%. EmpC: overall rate 24.09%. Both from after-tax income.
Lithuania	Shareholder Relief: reduced tax rate.	15%	15%	generally 15%; 0% if held more than 1 year and no substantial shareholding for last 3 years.	Flat 27%	Emp.: 3%. EmpC: 30.7%.
Luxembourg	Shareholder Relief: tax base reduced.	29.6%	15%; tax base reduced to 50% of the dividend income.	general PIT for short-term holdings; high allowance and 1/2 PIT rate for longterm holdings.	progressive 8–38%	Emp.: 11.8–14.05%. EmpC: 13.15–20.75%.
Malta	Full imputation	35%	general PIT and tax credit for CIT.	stamp duty; shares quoted on Malta stock exchange tax exempt.	progressive 15–35%	Emp.: overall rate MTL 2.84–13.38 weekly. EmpC: overall rate MTL 2.84–13.38 weekly.
Netherlands	Shareholder Relief: reduced tax rate.	25.5%	15% for small, 25% for substantial holdings.	0% for small, 25% for substantial shareholdings.	progressive 33.65–52%	Emp.: 5.2–31.7%. EmpC: 6.5–11.31%.
Austria	Shareholder Relief: reduced tax rate	25%	25%; optional: general PIT at a half rate; generally no SSC.	0% for small shareholdings; for substantial shareholdings 25%.	progressive 23–50%; statutory and voluntary pension contributions partly deductible.	Emp.: (cumulative) 16.85–17.2%. EmpC: (cumulative) 20.5–20.7% deductible. Both limited by an absolute amount.
Poland	Shareholder Relief: reduced tax rate	19%	19%	19%	progressive 19–40%	Emp.: average 22.2%. EmpC: average 20.6%.
Portugal	Partial Imputation	27.5%	20%; imputation credit of 50%.	generally 10%; tax exemption if shares are held more than 12 months.	progressive 10.5–42%	Emp.: overall rate 11%. EmpC: overall rate 23.75% 78.

Country	Type of dividend treatment	CIT [A]	Taxation of dividends at Shareholder level [B]	Taxation of share sale at shareholder level [C]	PIT [D]	Compulsory SSC [E]
Romania	Classical system	16%	"Investment Tax" 16%	"Investment Tax" 16%; 1% for longterm investment.	Flat 16%; voluntary contributions to private pension funds deductible.	Emp.: (cumulative) 17%. EmpC: (cumulative) 30.35–31.35%.
Slovakia	Dividend tax exemption for shareholders.	19%	0%	general PIT	Flat 19%	Emp.: 13.4%. EmpC: 28.4%.
Slovenia	Shareholder Relief: reduced tax rate.	23%	20%	0–20% according to the holding term.	progressive 16–41% contributions to private pension funds deductible.	Emp.: 22,1%. EmpC: 16.1%.
Finland	Full Imputation	26%	"Investment Tax" 28%; generally no SSC.	28%	progressive 9–32% central+ 18,46% (average) sub-central; SSC deductible.	Emp.: (cumulative) 6.61–7.18%. EmpC: (cumulative) 20.69–32.69%. Both limited by an absolute amount.
Sweden	Shareholder Relief: reduced tax rate.	28%	"Individual Capital Income Tax" 30%.	30%	progressive 20–25% central+31.6% subcentral.	Emp.: 7%. EmpC: 32.28%.
Turkey	Partial imputation	20%	15%; imputation credit of 50%.	0% if held more than 4 years, otherwise general PIT.	progressive 15–35%	Emp.: 15%. EmpC: 21.5%. Both limited by an absolute amount.
United Kingdom	Partial imputation	30%	10% up to the basic rate limit; 32.5% above; imputation credit.	CGT 40%; taper relief.	progressive 10–40%	Emp.: overall rate 11%. EmpC: overall rate 12.8%.

[A] *Data on corporate tax for 2007 are presented in the report of the German Federal Ministry of Finance of April 2007, p. 68, Table 1. The generic term "corporate tax" includes in this context all central and sub-central statutory taxes and surcharges on corporation profits.*

[B] *Data on dividend taxation own research and from the database at www.deloittetaxguides.com (log-in: 20 July 2007)*

[C] *Data on capital gains taxation from the database at www.deloittetaxguides.com (log-in: 20 July 2007)*

[D] *Data on personal income tax rates for 2006 are generally downloaded from the database of the European Union, ec.europa.eu/taxation_customs/taxinv (log-in: 20 June 2007)*

[E] *Data on social security contributions for 2006 can be downloaded from the homepage of MISSOC ec.europa.eu/employment_social/missoc/2006 (log-in: 20 June 2007)*

Abbreviations: *CIT = Corporation Tax, PIT = Personal Income Tax, CGT = Capital Gains Tax, SSC = SocialSecurity Contributions, EmpC = Employing Company, Empl. = Employee, IC = Intermediary Company* a highly progressive personal income tax as opposed to a flat tax on capital income. This combination is, theoretically, negative for cash-based profit-sharing and positive for share-based schemes. Most EU member states have a differentiated tax system which generally favours employee share ownership if taxes on capital are flat and relatively low. As far as tax systems are concerned, no common tendencies can be observed. Taxation traditions and goals of EU member states are different and none of the prevailling systems can be considered the best objectively.[155]

As far as the system of corporate income tax (taxation of dividends at the corporate and shareholder level) is concerned, no EU member state provides relief for corporations, but many mitigate double taxation by providing relief for shareholders. Within the EU, classical, imputation, shareholder-relief and exemption systems are all represented. From the point of view of employee financial participation, classical systems (double taxation of dividend income, e. g., Ireland, Latvia, Romania) are generally unfavourable.[156] Partial imputation generally leads to a higher tax burden at shareholder level than full imputation and shareholder-relief[157] and is, therefore, relatively unfavourable. Most countries presently offer shareholder-relief, but it is difficult to assess the effect on employee financial participation without comparing effective tax rates.[158] The best system for share-based plans is undoubtedly one that exempts dividend income from taxation by law (e.g., Croatia, Cyprus, Estonia, Greece, Slovakia) or through full imputation (e.g., Finland).

Taxation of capital gains from sale of shares is of great importance for employee share ownership. In this context, three concepts can be distinguished within the EU: exemption from taxation (e.g., Belgium, Portugal, Cyprus, partially Bulgaria, Malta); taxation only on substantial holdings (defined differently in different countries, e.g., Austria, Germany, Italy, Luxembourg, Netherlands) and taxation by capital gains tax or by personal income tax at a lower (and usually flat) rate. Obviously, tax exemption is the most advantageous for employee financial participation. Taxation of substantial holdings also favourable, since employee shareholdings are usually small. There is no common tendency for the taxation of capital gains.

Compulsory social security contributions[159] can either reduce the tax base of corporate and personal income tax or be calculated on after tax income (e.g., Latvia). Otherwise, they impose an additional burden on gross income and are thus very unfavourable for cash-based profit-sharing, even when general taxes are low as in Slovakia. Further, social security contributions can be levied on capital income as in France (this would have had negative consequences for share-based schemes had France not introduced specific tax incentives). Gener-

155 *Most Western European countries cannot introduce a flat tax system because of the potential loss of revenue. See for Italy OECD,* TAX POLICY REFORMS IN ITALY, *OECD Centre for Tax Policy and Administration, 2005, p. 4.*

156 *However, it depends on the personal income tax rate. I. a. the income tax rates in Ireland, Latvia and Romania are relatively low.*

157 *See* C. Spengel, INTERNATIONALE UNTERNEHMENSBESTEUERUNG IN DER EUROPÄISCHEN UNION, *Dusseldorf, 2003, p. 23.*

158 *Due to globalisation of business and to the requirements of the EU law, there is a tendency to exchange imputation for shareholder relief systems. See* C. Spengel, INTERNATIONALE UNTERNEHMENSBESTEUERUNG IN DER EUROPÄISCHEN UNION, *Dusseldorf, 2003, p. 25.*

159 *Whether social security is levied as a tax, e.g., as in Denmark and Estonia, or takes the form of social insurance contributions merely means that in the case of taxes there is no corresponding claim against a social insurance institution.*

ally, no common tendency in the development of social security is discernable, since in most countries contributions are connected to long-term insurance and thus are not as easily altered by the state as are taxes.

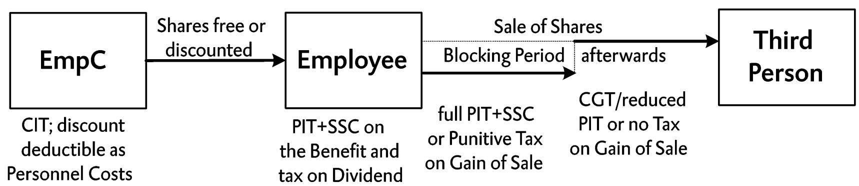
Tax and social security rates and deductions are interdependent within a national tax system, therefore each national system has to be analysed separately as a whole; details are presented in the table on pages 78 to 80. In the context of taxation, it is only relevant whether a financial participation scheme is cash-based or share-based and whether an "intermediary entity"[160] is used as a vehicle. The same taxation rules apply to employee share ownership schemes and share-based profit-sharing schemes, both direct and deferred.

— C.2.a —

Employee Share Ownership

Employee Shares

The benefit in value from transfer of discounted shares is generally deemed employment income and correspondingly subject to full personal income tax and compulsory social security contributions at the employee level. The employer company can generally deduct the discount as a personnel cost. However, valuation rules, especially for non-quoted shares, differ considerably between countries.[161] Taxation of dividends depends on the country-specific type of dividend treatment. Since there is no tax relief for the employing company in any EU member state, full corporate tax generally is to be paid by the employer company on the entire profit, including the part to be distributed.[162]



Different systems of dividend taxation at shareholder level are explained above. Taxation of gains from sale of shares depends on whether the shares are sold during or after the end of the blocking period. If the shares are sold during the blocking period, there are no major differences between EU countries: either full personal income tax and social security contributions or a special (high)

160 *The generic term used for intermediary companies, funds with a separate legal personality and trusts (in common law countries UK, Ireland and Malta), which accumulate distributed profits, hold, allocate and transfer shares, options or certificates of the employer company for employees, sometimes pay out dividends or returns, administrate dividends, and make investments.*

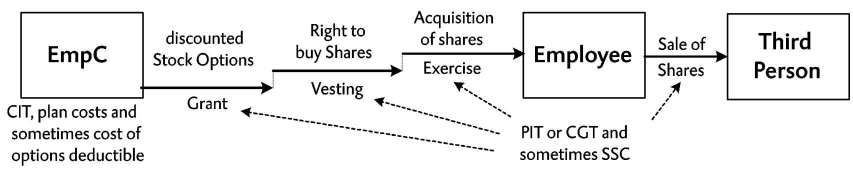
161 *The valuation of the same shares for the purpose of taxation of employees or employers may follow different rules and lead to different taxable amounts than in Austria. The moment of valuation of shares may also be different in different countries and lead to differences in value and in the tax base derived from it.*

162 *However, in one EU member state, Estonia, corporate tax is replaced by the tax on distributed profits. This original system may have a positive economic effect on accumulation of funds, but it constitutes a strong disincentive for the employer company in relation to share-based employee participation plans as well as to cash-based profit-sharing.*

punitive tax will be imposed. If the shares are sold after the end of the blocking period, taxation depends on the system of taxation of capital gains presented above. If there is no general exemption, or exemption for small shareholdings, other forms of tax relief usually apply.

Stock Options

Taxation of employee stock options is complex due to differences in the taxation moment and valuation methods which depend on it. In most EU member states, taxes are imposed at exercise; taxation at grant or optionally at grant or exercise, as well as taxation at sale of shares, are also practiced.

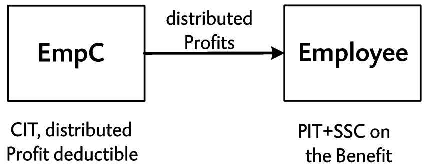


Upfront taxation at grant is connected with considerable risks, so that special tax relief such as reduced tax rate or tax base and exemption from social security contributions are necessary as compensation. Although it could be argued that stock option benefits should be considered as capital gains, it is deemed to be employment income in most EU member states; as such it is usually charged as personal income tax and partly also subject to social security contributions. The employer company can generally deduct setting up and operating costs of the plan as well as cost of options if the shares are repurchased (with the exception of, e.g., Belgium). In some countries (e.g., Belgium, Denmark, Ireland, Luxembourg, Portugal), both the employer company and the employee are exempted from social security contributions.[163]

163 *For details see* EC, *Stock Options*, *2003*; PricewaterhouseCoopers, *Employee Stock Options in the EU and the USA*, *London*, *2002*.

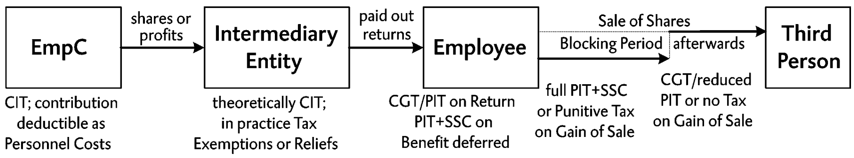
—— C.2.b ——
Profit-Sharing

As far as cash-based profit-sharing is concerned, no major discrepancies exist between different EU member states. Distributed profit is generally deductible for the employer company as a personnel cost (with the exception of Estonia, where it is instead subject to the tax on distributed profits), and it is subject to full personal income tax and social security contributions for the employees. The same taxation rules as for employee share ownership apply to share-based profit-sharing (see C.2.a above).



— C.2.c —
Intermediary Entities

Share ownership plans and profit-sharing plans using a vehicle for the holding of shares and the investment of accumulated funds exist in many varieties in different EU member states, especially because of substantial differences in company law. However, there is a similar basic logic: the employer company can usually deduct contributions to the intermediary entity, as well as set up and operating costs, from the tax base of the corporate income tax; the intermediary entity is usually established in a tax-friendly form. Taxation of employees would be the same as for simple share-based plans (see C.2.a above) if it were not for specific tax incentives (e.g., deferred taxation of the benefit), which in most cases are granted.

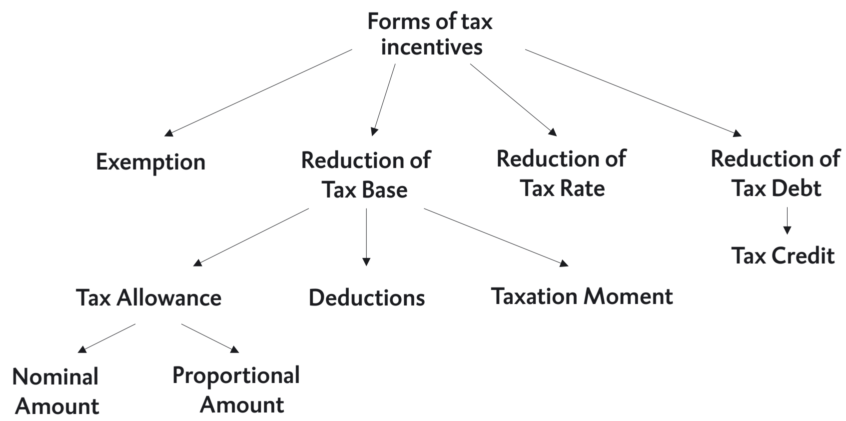


— C.3 —
Specific Tax Incentives for pepper-Schemes in the EU

Aside from specific tax incentives, most national taxation systems are more or less favourable to financial participation. The only tax system which actually hinders the development of financial participation is that of Estonia, due to taxation of distributed profits at company level instead of general corporate income tax.[164] National taxation systems which exempt dividends and capital gains from taxation and social security contributions are especially advanta-

164 *For this reason, it is contrary to the financial interests of the employing company to distribute profit to employees in cash-based profit-sharing schemes or as dividends to employees who have become shareholders. However, the Estonian tax system is to be changed in 2009 to comply with the EU Parent-subsidiary Directive.*
See KPMG, *Corporate and Indirect Tax Rate Survey 2007, 2007, p. 15.*

geous to share-based schemes. Although details differ, generally in most countries the same taxes apply to similar plans, so that the important difference is the general level of the tax burden of standard income taxes and compulsory social security contributions determined by tax rates and tax bases. As mentioned above, comparable effective rates cannot be calculated for all possible situations. Nevertheless, a substantial difference in tax rates implies a difference in tax burden. Thus it can be argued that low-tax countries generally have more favourable tax regimes for financial participation so that specific tax incentives are not necessary. The example of Ireland, however, shows that the government of a low-tax country can have a strong political interest in promoting employee financial participation; it can offer additional tax incentives even though the low level of general taxation limits their impact.[165] Therefore the different instruments used to create specific tax incentives are important. Incentives may take the different forms diagrammed below.



Tax rate reductions and exemptions, although most effective because they are based on law rather than arbitrary judgments of tax authorities, and confer the same advantages to all categories of income, are seldom utilised.[166] One reason for this neglect is that such tax incentives result in heavier losses of revenue; also tax authorities have virtually no discretionary power over their use.[167] Deductions favour higher incomes under a progressive system of taxation, like the personal income tax in most EU member states; tax credits (direct reduction of tax liability), on the other hand, are non-discriminatory and usually more valuable than an equivalent tax deduction or tax allowance.[168] Tax allowances benefit lower incomes whereas nominal tax allowances benefit the taxpayer less and therefore involve smaller revenue loss than would a proportional determination of the tax allowance. Deferred taxation favours share ownership schemes avoiding otherwise necessary additional liquidity at the moment of acquisition.

165 *See Irish Department of Finance, TSG 98/12.*

166 *See* C. Spengel, Internationale Unternehmensbesteuerung in der Europäischen Union, *Dusseldorf, 2003, p. 28.*

167 *To compensate for revenue losses caused by lowering the tax rate, either rates of other taxes are increased or the tax base is broadened. Thus a lower tax rate does not necessarily lower the total tax burden. It is not surprising that countries with low statutory tax rates like Ireland have fewer tax concessions than countries with high statutory tax rates like France, Italy and Spain.*
See C. Spengel, Internationale Unternehmensbesteuerung in der Europäischen Union, *Dusseldorf, 2003, p. 29.*

168 *However, more value for taxpayers means higher revenue losses for the state. In addition, tax credits generally cause higher tax administration costs. Recently, tax credit systems have been replaced by tax allowances in France and Italy.*
See K. Tipke, J. Lang (eds.), Steuerrecht, *18th Ed., Cologne, 2005, pp. 799, 802.*

Specific tax incentives for employee financial participation are currently in effect in 16 (mainly Western) countries out of the 29 member and candidate states; these differ substantially in type and size. But two general principles and several conclusions may be drawn from the combined data on tax incentives and the incidence of financial participation from the various countries.

Tax incentives are not a prerequisite to financial participation

Financial participation schemes without tax incentives (e.g., profit-sharing plans in Austria and Germany) sometimes have a higher incidence than those with tax incentives (e.g., share ownership plans in Austria and Germany).[169] Therefore tax incentives are not to be considered a prerequisite to the development of financial participation. Furthermore, in low-tax countries (e.g., Ireland), tax incentives are less important and, in any case, cannot be as large as in high-tax countries.[170]

Tax incentives effectively promote the spread of financial participation

Countries with a long tradition of employee financial participation (e.g., UK, France)[171] universally confirm this experience, but so do countries where tax incentives are quite recent, e.g., Austria,[172] where a substantial increase has been observed, even though total numbers are still relatively low.

—— C.4 ——

Conclusions

Firstly, tax incentives should (and in most countries actually do) target those taxes which constitute the heaviest burden in the national taxation system. Usually (with the exception of countries with flat tax systems which at present do not offer specific tax incentives) these are the progressive personal income tax and social security. Many countries therefore provide:

— exemptions from social security contributions for certain plans (e.g., France, Belgium, UK, Ireland, Finland),
— levying a capital gains tax (e.g., UK, for dividends Belgium),
— levying a special low tax (e.g., France) instead of personal income tax, and
— tax allowances for personal income tax (e.g., Austria, Finland, Ireland).

169 *In Austria, only 8% of enterprises and 6% of the workforce participated in employee share ownership plans in 2005, tax incentives for which were introduced in 2001, whereas 25% of enterprises operated profit-sharing plans without tax incentives (see* R. Kronberger, H. Leitsmüller, A. Rauner, (eds.), MITARBEITERBETEILIGUNG IN ÖSTERREICH, *Wien, 2007, pp. 11, 17, 162). In Germany, 2.4% of enterprises had an employee share ownership plan in 2001, supported by (marginal) tax incentives, whereas at the same time 8.7% of enterprises operated profit-sharing plans without tax incentives (see* S. Würz (ed.), EUROPEAN STOCK-TAKING ON MODELS OF EMPLOYEE FINANCIAL PARTICIPATION, RESULTS OF TEN EUROPEAN CASE STUDIES, *Wiesbaden, 2003, p. 59).*

170 *In countries which are considered low-tax, not all statutory taxes are necessarily low; the statement refers only to low statutory taxes. For example, in Ireland, corporate income tax is exceptionally low (12.5%), whereas personal income tax is close to the EU average (20–42%). Therefore, most tax incentives for employee financial participation in Ireland concern employees and not employer companies. The Irish Government declared that no tax relief which reduced the revenue from corporate income tax can be introduced because the low tax rate leaves very little leeway (Irish Department of Finance, TSG 98/12).*

171 *In France, legislation on voluntary employee financial participation without tax incentives of 1959 and even legislation on compulsory employee financial participation without tax incentives of 1967 did not lead to a significant number of plans in operation. Only in 1986 when the first tax incentives were introduced did the number of plans increase rapidly; this upward tendency has been supported by the introduction of new tax incentives (see* Würz *(2003), p. 39). In the UK, although profit-sharing has existed since the 19th century and share ownership since the early 1950s, the number of plans remained small until the first tax incentives were introduced in 1978. Since then, the system of tax incentives and economic efficiency of incentives and plans are regularly reviewed by the government, and the number of plans is steadily increasing, especially Revenue Approved plans (see Würz (2003), p. 130; www.ifsproshare.org, log-in: 20 July 2007).*

Secondly, tax incentives should be provided for both employees and the employer company, inasmuch as participation is voluntary for both parties in all EU member states except France. However, this requirement is relative: in most countries the employer company has already been granted tax incentives in the form of deductions under general taxation law and only tax incentives for taxes involving the cost of shares and stock options are needed. In most countries, the only important incentive for the employer company is the exemption from social security contributions; this has actually been introduced in many countries (e.g., France, Ireland, Finland, Belgium). The employee is usually more in need of direct incentives as the heaviest burden of progressive taxes falls on him or her.

Thirdly, even substantial tax incentives may prove inefficient when the pre-conditions of eligibility are too restrictive, complex or inflexible. This is the case (e.g., in Greece) for cash-based profit-sharing and in Germany and Belgium for schemes of all types.[173] The flexibility problem can be solved, as in Ireland and the UK, by allowing the employer company to choose between less flexible approved schemes combined with substantial tax incentives and more flexible unapproved schemes combined with minor tax incentives. Another interesting approach was presented in the EC Report on Stock Options.[174] Since direct taxes cannot be harmonised under the effective EU Treaty, shown above, it might be reasonable to harmonise the pre-conditions for the application of tax incentives where they exist in a particular country. National legislators would be authorised to introduce additional national plans and to decide the size and the form of tax incentives for these as well as for those plans encompassing all of Europe. Harmonisation canl only be accomplished if the existing pre-conditions in different EU member states are at least comparable for all types of employee financial participation schemes, as is apparently the case for stock options. This comparison will be made in the forthcoming PEPPER IV report.

Fourth, some forms of tax incentives are more favourable for certain types of plans and also lead to higher efficiency:

— For share ownership and stock options as far as benefit taxation is concerned: generous valuation rules combined with a favourable taxation moment (often linked to holding period) and, if possible, exemption from SSC for both the employer company and the employee.
— For dividends and sale of shares: a special tax rate or capital gains tax in lieu of personal income tax and, if necessary, exemption from SSC.

172 *In Austria, only 8% of employee financial participation plans were implemented before first tax incentives were introduced in 1993, while 45% of plans were introduced in four years after more substantial tax incentives became effective in 2001. See* R. Kronberger, H. Leitsmüller, A. Rauner, (eds.), MITARBEITERBETEILIGUNG IN ÖSTERREICH, *Wien, 2007, p. 32.*

173 *See* EC, CROSS-BORDER OBSTACLES, *2003, pp. 17, 24.*

174 *See* EC, STOCK OPTIONS, *2003, pp. 42, 43.*

— For ESOPs and Intermediary Entities: exemptions from income tax on share acquisition[175] or on share sale if the profit is realised after a holding period or within a retirement program; the company may qualify for tax relief on both interest and principal payments on the loan; sale of stock to an ESOP on a tax-deferred basis if the proceeds of the sale are reinvested in securities of other domestic corporations (tax-free rollover).
— For profit-sharing: a special tax rate in lieu of the progressive personal income tax as well as exemption from SSC for both the employer company and the employee.

However, the most effective forms of tax incentives do cause revenue losses. Therefore, efficiency should be weighed against the revenue requirements of each country independently. Should a government wish to introduce specific tax incentives, it might well begin with "soft" tax incentives which do not cause substantial revenue losses, e.g., tax allowances defined by nominal amount (as in Austria). Later, depending on revenue needs and the political climate, it may proceed to more effective measures: tax allowance as a proportional amount, deductions, tax credits, introduction of special low tax rates, and, finally, full exemption from taxation.

175 *In Ireland this is the case only where the ESOP comprises an ESOT working in tandem with an Approved Profit Sharing Scheme.*

Fifth, in spite of the difficulty of their implementation at the European level (because of the exclusive jurisdiction of national legislation over tax law), tax incentives remain powerful tools for enhancing and broadening financial participation. This is especially true when they remain optional for the member countries and not subject to a unanimous vote of approval. Countries could voluntarily offer tax incentives singly or in groups. Such a step would create an increasingly favourable environment in which countries having an advanced tradition, such as France or the United Kingdom, would encourage emulation. Optional preferential treatment as part of the Building Block Approach requires distinguishing between profit-sharing schemes, share ownership schemes and employee stock ownership plans.

— Annex III —

Systematic Overview of Financial Participation

By Jens Lowitzsch and Axel Bormann

— A —

Participation in Property Rights: Control and Returns

There are two kinds of property rights inherent in employee participation, namely, *control* – participation in decision-making – and *returns* – financial participation.[176] Whether or not a given scheme embraces participation in decision-making depends on the prerogatives and rights that it confers upon employees. In the case of employee share ownership, these rights are determined by whether ownership is direct or indirect; whether stock is held through an employee trust or cooperative, and whether voting rights and other forms of immaterial participation accompany ownership. In the case of profit sharing, there is no necessary link to any form of employee input into company decisions at any level. In practise, however, these schemes are often part of a package of participatory measures, including information and participation in control.

— A.1 —

Participation in Decision-Making

Employee participation in decision-making generally takes two forms: entrepreneurial co-determination and co-determination within a going concern.[177] While the first is executed indirectly by representatives chosen by the employees, the latter can be either direct or indirect.

176 *See* A. Ben-Ner *and* D. C. Jones, Employee Participation, Ownership and Productivity: A Theoretical Framework, *in: "Industrial Relations", Vol. 34, No. 4, 1995, pp. 532–554.*

177 *See* K. R. Wagner, Renaissance der Mitarbeiterbeteiligung, *in: "Betriebsberater 1995", Supplement to Issue No. 7; as well as* Management buy-out: Führungskräftebeteiligung, Arbeitnehmerbeteiligung; Grundlagen – Modellhinweise – Neue Bundesländer – Rechtspolitik, *Neuwied, Kriftel, Berlin, 1993.*

— Entrepreneurial co-determination usually concerns strategic, macro-level decision-making in the firm. The best known examples are the German "Mitbestimmung",[178] with labour representatives occupying half of the seats on the company's supervisory board, cooperatives, and socialist labour self-management.[179]
— Co-determination within a going concern, on the other hand, consists of indirect participation through chosen representatives as well as direct participation by employees themselves. It usually involves shop-floor, micro-level decision-making on social questions as well as on organisational matters. Familiar examples include workers' councils elected by employees (common in European countries like Germany[180] and more recently also found on a supranational level)[181] on the one hand, and Japanese quality circles[182] or Swedish autonomous work teams,[183] on the other.

— A.2 —
Financial Participation

With respect to financial participation of employees, a distinction has to be made between profit sharing (including gain-sharing) and employee share ownership (excluding executive stock options). The distinction is important since there are fundamental differences between the two (e.g., in taxation). A third type of financial participation is through asset accumulation or employee savings plans which offer a vehicle to allocate and invest sums received in other schemes. Financial participation of employees is thus a form of remuneration, in addition to regular pay systems, that enables employees to participate in profits and enterprise results.[184] Although it can take a variety of forms, the most common are employee share ownership and profit sharing, often in combination. Since this study is mainly concerned with financial participation, participation in decision-making will only be referred to when relevant.

178 *See* H. G. Nutzinger, U. Schasse *and* V. Teichert, *Mitbestimmung in zeitlicher Perspektive: Ergebnisse einer Fallstudie in einem Grossbetrieb der Automobilindustrie, in:* Felix R. FitzRoy, Kornelius Kraft (eds.), *"Mitarbeiterbeteiligung und Mitbestimmung im Unternehmen", Berlin, 1987.*

179 *See* N. Vučić, *Die sozio-ökonomische Lehre des Jugoslawischen Selbstverwaltungssozialismus, in: "Osteuropa", Vol. 6/1972, p. 430 et seq.*

180 *See* J. R. Cable *and* F. R. FitzRoy, *Work Organisation, Incentives and Firm Performance: An Empirical Analysis of West German Metal Industries, University of Warwick Mimeo Paper presented at the Ninth Meeting of the European Association for Research in Industrial Economics, 24–26 August 1983, Bergen, Norway.*

181 *Council Regulation (EC) No. 2157/2001 on the Statute for a European Company (or Societas Europaea, SE) and Council Directive 2001/86/EC supplementing the Statute for a European Company with regard to the involvement of employees adopted on 8 October 2001.*

182 *See* S. Watanabe, *The Japanese Quality Control Circle: Why It Works, in: "International Labour Review", Vol. 130, No. 1., 1991, pp. 64, 72–73; also* H. Leibenstein, *Inside the Firm, Cambridge, MA, 1987.*

183 *Regarding the U.S.A., see Autonomous work teams spread in the USA, Associated Press article by* S. Cohen, *9 December 1990.*

184 *See* M. Uvalić, *The PEPPER Report, published in Supplement 3/91 of the brochure "Social Europe", Office for Official Publications of the European Communities, Luxembourg, 1991;* V. Pérotin *and* A. Robinson, *Profit Sharing in OECD Countries, OECD, 1995, pp. 139–169.*

— B —

Employee Participation in Profits and Enterprise Results (pepper Schemes)

The term "financial participation" refers to all schemes which give workers, in addition to a fixed wage, a variable portion of income directly linked to profits or some other measure of enterprise performance.[185] The main feature of this bonus is that it is specifically linked to enterprise results and is not just a predetermined proportion of pay. There are two basic ways in which employers can distribute the financial results of improved enterprise performance to their employees: profit sharing and employee share ownership.

— B.1 —

Profit Sharing

In profit sharing, part of an employee's remuneration is directly linked to the profits of the enterprise. Unlike individual incentives, this concept involves a collective scheme which generally applies to all employees. The formula, depending on the national scheme, may include profits, productivity and return. [186] Since profit-sharing schemes are related to measures of company performance in general, they are perhaps the most widespread form of financial participation.[187] The bonuses are normally paid in addition to the basic fixed wage, and provide a variable source of income.

Although profit-sharing bonuses can take several different forms, two main concepts[188] should be distinguished:

— Distribution on a deferred basis, commonly covered by the term "deferred profit sharing", with the bonus being:
  a. invested in enterprise funds or frozen in special accounts for a specific period;
  b. granted as a number of shares in the company, frozen in a fund for a certain period before employees are allowed to sell them (deferred share-based profit sharing).

— Direct payment of profit-sharing bonuses to the workers in cash, usually referred to as "cash-based profit sharing".

A related form of participation is gain-sharing, which is designed to provide variable pay, and usually to encourage employee involvement, by rewarding employees for improvements in individual and organizational performance.

185 *See* H. J. Schneider *and* E. Zander, ERFOLGS- UND KAPITALBETEILIGUNG DER MITARBEITER IN KLEIN- UND MITTELBETRIEBEN, *p. 20; compare with* D. Vaughan-Whitehead, WORKERS' FINANCIAL PARTICIPATION, *Geneva, 1991, pp. 2, who includes gain-sharing in the definition of financial participation.*

186 *See* H. J. Schneider *and* E. Zander, ERFOLGS- UND KAPITALBETEILIGUNG DER MITARBEITER IN KLEIN- UND MITTELBETRIEBEN, *pp. 20, 68.*

187 *A positive relationship was found by* D. G. Blanchflower *and* A. J. Oswald, PROFIT RELATED PAY: PROSE DISCOVERED?, *in: "Economic Journal", Vol. 98, 1998, and* F. R. FitzRoy *and* K. Kraft (eds.), FORMEN DER ARBEITNEHMER-ARBEITGEBERKOOPERATION UND IHRE AUSWIRKUNGEN AUF DIE UNTERNEHMENSLEISTUNG UND ENTLOHNUNG, *in: "Mitarbeiterbeteiligung und Mitbestimmung im Unternehmen", Berlin, 1987.*

188 *See* D. Vaughan-Whitehead, WORKERS' FINANCIAL PARTICIPATION, *Geneva, 1995, p. 2. and* M. Uvalić, THE PEPPER REPORT, *published in Supplement 3/91 of the brochure "Social Europe", Office for Official Publications of the European Communities, Luxembourg, 1991.*

Gains, measured by a predetermined formula, are shared with employees, usually through cash bonuses. Gains constitute an addition to the basic salary paid to all employees, usually in order to reward individual or small unit performance. The formulas for measuring employee performance vary considerably; piece rates and productivity bonuses are most common, but other performance indicators may be employed, such as profit, productivity, costs, sales, etc.[189]

— B.2 —
Employee Share Ownership

Employee share ownership is the second major form of financial participation. Funds can be raised either from the company or from employees. In the latter case, employees might voluntarily purchase company stock (thus acquiring equity) or employees might lend money to the company or purchase company bonds (thereby increasing corporate debt).[190] In the case of company equity, the shares are transferred directly or indirectly to employees, who may receive dividends and/or capital gains that accrue to company equity. Participation through the construction of a silent partnership or a usufructuary is rare, especially in the context of employee participation, and may result in both equity as well as corporate debt.[191]

Employee share ownership in practice – whether shares are held individually or under some form of trust – does not automatically entitle employee shareholders to have a say in the operation of the company.[192] Employees may be issued either non-voting stock or voting shares, but they have little or no control over the management of shares held in trust. Trustees may be appointed by management rather than elected by employees.

— B.2.a —
Direct Purchase of Shares/Share Savings Plans

The broadest spectrum of models is offered by share plans, in which shares are distributed free or sold at market price (non-discounted) or under preferential conditions.[193] These preferential conditions can be sale at a discount rate (discounted stock purchase plan), sale at a lower price through forms of delayed payment (usually within a capital increase), or by a grant of priority in public offerings to all or a group of employees.[194] Finally, the purchase may be effected through periodic deductions from pay, with or without employer's match or

189 *See* D. Vaughan-Whitehead, *Workers' Financial Participation, Geneva, 1995, pp. 2.*

190 *In the case of corporate debt, no share ownership is generated, and the revenue of the employees takes the form of interest and principal payments or only interest payments if a debt to equity swap is foreseen later. If employees are holding bonds from the company they receive dividends.*

191 *See* K.-R. Wagner, *Management Buy-out: Führungskräftebeteiligung, Arbeitnehmerbeteiligung; Grundlagen – Modellhinweise – Neue Bundesländer – Rechtspolitik, Neuwied, Kriftel, Berlin, 1993.*

192 *In the majority of cases in the U.S. and France (outside workers' co-operatives) employee share ownership is associated with little or no employee influence on entrepreneurial decisions. Even if they hold the largest block of shares, employee shareholders are not automatically represented on the board of directors.*
See V. Pérotin, *Employee participation in profit and Ownership: A review of the issues and evidence, SOCI 109, European Parliament, Directorate-General for Research, Luxembourg, 2002, p. 8.*

193 *E.g., in Great Britain, see Consultation on Employee Share Ownership, "Treasury Public Inquiry Unit", December 1998; also* G. Nuttall, *Employee Ownership: UK Legal and Tax Aspects, Field Fisher Waterhouse, January 1999. As to the "method of choice" in Eastern Europe, see* M. Weitzman, *How Not to Privatize, Rivista di Politica Economica, Vol. 81, No. 12, 1991.*

194 *See* D. Vaughan-Whitehead, *Workers' Financial Participation, Geneva, 1995, p. 2.*

bonus. When the employer does contribute an (equal) amount in cash or shares, the plan is called a "share savings plan".

Other forms of direct purchase include producer cooperatives,[195] in which all the firm's shares are owned by its workforce, and employee buy-outs, under which company shares are purchased exclusively by its individual workers.[196] For example, Poland implemented an employee buy-out program in the context of privatisation. It took the form of "Leveraged Lease Buy-Outs" (LLBO).[197]

— B.2.b —
Broad-Based Stock Options

Employee stock options,[198] unlike those granted to individual employees or small groups (especially managerial) to reward individual performance ("executive stock options"), are broad-based. The company grants employees options over shares, which entitle them to acquire shares in the company at a later date, but at a price fixed when the option was granted. The option has an expiration term and a vesting period commencing with the grant date; it can take various forms, mainly depending on grant and exercise price.[199] The possibility of gains arising from upward movements in stock prices is the primary reward emanating from options. Unlike 'conventional' options, employee stock options as a rule cannot be traded, and the holder usually cannot hedge against the risk of declines in option value. Furthermore, employee stock options normally are subject to forfeiture prior to vesting should the employee voluntarily leave the firm.

— B.2.c —
Employee Stock Ownership Plans

In the United States[200] the most popular form of workers' share ownership is the Employee Stock Ownership Plan (ESOP),[201] which has also been implemented in Europe[202] and Japan.[203] An ESOP usually involves a loan to an employee benefit trust, which acquires company stock and allocates it through periodic contributions to each employee's ESOP account. The loan may be serviced by payments from the company out of company profits, out of dividends paid on the stock held by the ESOP or (in rare instances) from employee salary reductions. There seems to be some confusion about amortizing ESOP loans from the company's profits. Theoretically, it is the earnings of the ESOP shares which

195 *For France, see* J. Defourney, S. Estrin *and* D. C. Jones, The Effects of Workers' Participation on Enterprise Performance: Empirical Evidence from French Cooperatives, *in: "International Journal of Industrial Organization", Vol. 3, No. 2, June 1985. For Italy, see* D. C. Jones *and* J. Svejnar, Participation, Profit Sharing, Worker Ownership and Efficiency in Italian Producer Cooperatives, *in: "Economica", Vol. 52, November 1985.*

196 *Usually dominated by managers, especially in the U.S. form of management led buy-outs.*

197 *See the studies by* M. Jarosz (ed.), Management Employee Buy-Outs In Poland, *Warsaw, 1995, and* Polish Employee-Owned Companies in 1995, *Warsaw, 1996; also* M. Jarosz (ed.), Ten Years of Direct Privatisation, *ISP PAN, Warsaw, 2000. For East Germany, where management buy-outs were prevalent, see* F. Barjak, G. Heimbold, et al. (eds.), Management Buy-Out in Ostdeutschland, *Halle, 1996.*

198 A. Pendleton, J. Blasi, et al., Theoretical Study on Stock Options in Small and Medium Enterprises, *study for the European Commission, Manchester, 2002;* Employee Stock Options in the EU and the U.S.A., *Pricewaterhouse Coopers, London, 2002.*

199 *Johnson and Tian (2000) distinguish six types: premium options, performance-vested options, re-priceable options, purchased options, reload options, and indexed options.*

200 *The scale of the phenomenon is summed up by* J. R. Blasi, Employee Ownership: Revolution or Ripoff?, *Ballinger Publishing Company, Cambridge, MA, 1988, p. 2; compare also* J. R. Blasi *and* D. L. Kruse, The New Owners: The Mass Emergence of Employee Ownership in Public Companies and What It Means to American Business, *HarperCollins Publishers Inc., New York, 1991.*

201 *For American ESOPs, see* L. Kelso *and* P. H. Kelso, Democracy and Economic Power: Extending the ESOP Revolution through Binary Economics, *University Press of America, Lanham, Maryland, 1991.*

comprise the collateral for the loan; paid out, these are dividends, but since only ESOP participants receive this full pay-out of earnings they represent, in effect, a preferred dividend. When using the mirror loan approach (bank loan to company – company loan to trust), of course, the bank regards the entire asset base of the company as collateral for its loan, not merely the ESOP shares.[204]

— B.2.d —
Privatisation Related Voucher/Coupon Schemes

In post-socialist countries, employee share ownership occurs in the form of shares which are distributed or sold to the workers of the company, or vouchers or coupons that are distributed to all citizens. Although the second option does not correspond strictly to the definition of financial participation, under which only the workers of the company should be involved, it can lead in practice to substantial employee share ownership.

Thus, for example, voucher privatisation in Slovenia, Poland and Croatia provided a way of creating employee ownership in conjunction with the privatisation process. Although the privatisation framework did not subsidise employee ownership by giving employees the right to acquire shares of their companies under favourable conditions, neither did it prevent employees from converting their vouchers into shares of the employer enterprise. Some companies did explicitly encourage employees to invest in their shares.[205]

202 *E.g., for the U.K., see* K. Walley *and* N. Wilson (ed.), *ESOPs: Their Role in Corporate Finance and Performance, Macmillan, Hants, 1992, pp. 126–151; for Hungary, see* B. Galgoczi *and* J. Hovorka, Employee Ownership in Hungary: The Role of Employers' and Workers' Organizations, *International Labour Office, Geneva, 1998.*

203 *See* D. Jones *and* T. Kato, The Productivity Effects of Japanese Employee Stock Ownership Plans: Evidence from Japanese Panel Data, *in: "American Economic Review", Vol. 85(3), 1995, pp. 391–414.*

204 *For American ESOPs, see* D. Ackermann, How to Cash Out Tax-Free, Yet Keep Your Business … ESOPs – a Practical Guide for Business Owners and their Advisors, *Conference Paper, National Center for Employee Ownership, San Francisco, CA, 2002.*

205 *For examples, see* M. Uvalić *and* D. Vaughan-Whitehead (eds.), Privatisation Surprises in Transition Economies, *Cheltham, 1997.*

Summary of differences between profit sharing and employee share ownership

Dimension	Profit Sharing	Employee Share Ownership
Liquidity of benefit	Cash. Highly liquid (except when deferred).	Shares. Liquidity depends on presence of equity markets.
Immediacy of benefit (i.e. when employee can use it)	Immediate where profit share paid in cash, except where paid into company savings scheme or shares.	Deferred in most schemes (especially schemes where shares acquired at a future date), variable in privatisation schemes. Except dividends.
Link to profits	Direct link. Profit share usually directly linked to level or growth in profits.	Indirect link. Value of reward mainly linked to potential growth in share value, which is contingently related to profitability.
Link to performance period	Based on company performance in the most recent or current financial year.	Company performance after receipt of shares or grant of options usually most important for value of reward.
Accounting treatment	Treated as a wages item (though tax/social insurance exemptions may be available). Entered onto profit and loss account.	Separate from wages and salaries. A balance sheet item. "Losses" to company from gains in value of options or discounts On share acquisition not usually recorded on profit and loss account.
Tax treatment	As wages item, subject to income tax and social insurance charges, although exemptions or reductions (for employee and employer) may be granted by Statute. Company tax offset usually available to company.	As balance sheet item, share schemes per se do not attract tax concessions for the company (although direct financial support to employees to acquire shares may attract concessions). Employees usually liable to capital gains tax, not income tax, where schemes have statutory basis.
Employee risk	Risk that future payments may fluctuate in value.	Risk that current share holdings/ options may fluctuate in value.

Source: A. Pendleton, et. al., *Employee Share Ownership and Profit Sharing in the European Union, European Foundation for the Improvement of Living and Working Conditions, 2001, p. 10.*

— C —

Asset Accumulation and Employee Savings Plans

Asset accumulation and savings plans offer a vehicle to allocate and invest sums received as salary or as remuneration in collective schemes of financial participation. They allow employees to set aside a portion of their income in an account that is, in most cases, invested in stocks, bonds or other investment choices for a period of time before being made available to the employee. Additional individual contributions by employees are possible, and sometimes an employer-contribution is received. To promote savings, governments in some countries (e.g., in Germany) match employee contributions. Although usually intended as a long-term savings programme, plans may allow for withdrawals or loans.

Commonly known as savings plans, incentive plans, or investment plans, these vehicles appear under a variety of names. They are most common in the U.S., France, Germany and the Netherlands. In these countries, savings plans are usually defined contribution plans, following specific tax provisions. As a rule, the regulating legislation defines the maximum amount of both employee and employer contributions, eligibility criteria to prevent discrimination, and the retention periods as preconditions for the tax exemption. The main objective of savings plans is asset formation – encouraging employees to save, while involving little risk for them.

— D —

Discussion: Pros and Cons

— D.1 —

Motivation, Productivity and Economic Performance

Economic arguments for financial participation are based primarily on the improvement of motivation[206] and productivity.[207] The change from a rigid system of guaranteed wages in which rewards are independent of effort, to a system which provides workers with an income that is more directly linked to enterprise performance[208] is considered likely to lead to greater commitment, lower absenteeism and labour turnover, greater investment in firm-specific human capital and reduced intra-firm conflict.[209] If well designed, financial par-

206 *See* A. A. Buchko, Employee Ownership, Attitudes and Turnover: An Empirical Asessment, *in: "Human Relations", Vol. 101, 1992, pp. 711–733.*

207 M. Conte *and* J. Svejnar, Productivity Effects of Worker Participation in Management, Profit-Sharing, Worker Ownership of Assets and Unionization in U.S. Firms, *in: "International Journal of Industrial Organization", Vol. 6, 1988; compare also* Jean Baptiste Say, Treaties on Political Economy; or the Production, Distribution and Consumption of Wealth, *Vol. I , Chapter XIV, On Production (Paris 1803), 2nd American Ed., Wells and Lilly, Boston, 1824, p. 79.*

208 *An exception may be certain financial participation plans such as employee savings plans which are less directly linked to company performance.*

209 H.-G. Guski *and* H. J. Schneider, Betriebliche Vermögensbeteiligung in der Bundesrepublik Deutschland, Teil II: Ergebnisse, Erfahrungen und Auswirkungen in der Praxis, *Cologne, 1983; for Malta, see* G. Kester, Transition to Workers' Self-Management: Its Dynamics in the Decolonizing Economy of Malta, *Den Haag, 1980, pp. 171, 233–234. These results were confirmed in a recent analysis of Germany, France, Sweden and the U.K. by* Festing, et al. *(1999), based on data of the Cranfield Network on European Human Resource (Cranet-E), however,* Festing, et al., *added that compared to profit-sharing the argument for employee ownership was not that straightforward.*

210 *See* A. Pendleton, N. Wilson *and* M. Wright, The Perception and Effects of Share Ownership: Empirical Evidence from Employee Buy-Outs, *in: "British Journal of Industrial Relations", Vol. 36(1), March 1998, pp. 99–123;* J. Stack, The Great Game of Business: The only sensible way to run a company, *Doubleday, New York, 1992.*

ticipation schemes influence the decision of future employees to join the company, while encouraging present employees to remain. In contrast to individual incentives, financial participation also promotes teamwork and a co-operative spirit, thereby facilitating improvements in work organisation and the adaptation of the labour force to new technologies. A truly effective productivity enhancement program relies, of course, not only on the rewards available through a financial participation plan, but also on a well designed informational campaign which instructs each employee on how he personally can most directly increase company profits and thus the stock price of his shares in the plan.

More sceptical theoretical appraisals of employee participation suggest that the individual incentives provided by financial participation are diluted by free-rider effects, particularly in larger organisations, since the gains from a productivity increase generated by one employee are shared among all employees who participate in a profit-sharing or stock ownership plan. Therefore, the argument goes, the positive productivity effects of financial participation will be wiped out in all but the smallest organisations. However, according to the findings of other theoretical and empirical studies,[210] these negative aspects are more than offset by the enhancement of co-operative behaviour and teamwork resulting from financial participation. Collective payment systems should provide an incentive to overcome rivalry at the workplace, and tend to encourage collaboration between individuals with a view to increasing effort and productivity.[211] A related argument holds that without a third party to monitor his or her effort, each member of a team of workers will try to shirk.[212] This, however, ignores the fact that workers are often much better equipped to monitor each other than is any third party.[213] For example, partnership arrangements with profit sharing and mutual monitoring or self-monitoring can be viable in small-team situations. When the nature of work performed by individual workers makes monitoring costs prohibitively high, self-monitoring and participation are adopted frequently, e.g., in the case of many law firms.

Since the 1970s a rapid growth in employee ownership has been noted in Western countries, especially the United States,[214] West Germany,[215] Great Britain[216] and France.[217] Despite the initially rather sceptical attitude towards financial participation, the empirical research on this phenomenon has failed to prove a negative correlation between a firm's economic performance (profitability, productivity, etc.) and employee ownership. On the contrary[218], most recent results indicate a positive effect of employee share ownership.[219]

211 *Profit-sharing may work particularly well as a group incentive scheme in mass assembly plants where alienation is widespread and individual efforts cannot be effectively monitored. It may also be effective in highly skilled, diverse work teams in areas such as high technology production.*

212 A. A. Alchian *and* H. Demsetz, *Production, Information Costs, and Economic Organization, in: "American Economic Review", Vol. 62, No. 5, December 1972.*

213 *See* H. Leibenstein, *Inside the Firm, Cambridge, MA, 1987, relating to the "low effort conventions".*

214 *See* J. R. Blasi, *Employee Ownership: Revolution or Ripoff?, Ballinger , Cambridge, MA, 1988, p. 2; compare also* J. R. Blasi *and* D. L. Kruse, *The New Owners: The Mass Emergence of Employee Ownership in Public Companies and What it Means to American Business, HarperCollins, New York, 1991.*

215 *See* H. Tofaute, *Arbeitnehmerbeteligung am Produktivkapital – Fortschreibung einer unendlichen Geschichte, in: "WSI Mitteilungen", June 1998;* H.-G. Guski *and* H. J. Schneider, *Betriebliche Vermögensbeteiligung: Eine Bestandsaufnahme, Cologne, 1986.*

216 *See Consultation on Employee Share Ownership, Treasury Public Enquiry Unit, December 1998; also* G. Nuttall, *Employee Ownership: U.K. Legal and Tax Aspects, Field Fisher Waterhouse, January 1999.*

217 *See "European Federation of Employed Shareholders (EFES) News", No. 1, September 1998; also* J. A. Massie, *Simplification du Plan Epargne Groupe – ELF, 7th International Employee Ownership Conference, January 1999.*

— D.2 —

Economic Growth and Distributive Effects: Binary Economics

Louis Kelso's paradigm of binary economics[220] strongly supports financial participation in the form of employee share ownership. Impacting such widespread issues as economic growth, income distribution and the democratisation of economic power, binary theory provides an alternative conception of market economics and private property. Louis Kelso and Patricia Hetter Kelso[221] believe that the problem of poverty might be better understood as the inevitable consequence of our closed private property system, and that the appropriate remedy is to open the closed private property system so that growing numbers and eventually all individuals and families gain the effective right to acquire private capital on market principles. This solution recognises that physical capital – tools, machines, structures, processes – is an input factor on the production side of the free market, just as labour is. It recognizes that things produce wealth and earn income just as people do. Instead of eliminating private property and thereby destroying the market economy (the formal Marxist way), non-owners should be encouraged to acquire income-producing property. Non-owners can thus be given the opporunity to participate in the economic success of the company for which they work not only as wage-earners, but also as shareholders.

— D.3 —

Position of Trade Unions

Trade unions often fear the loss of power and influence in companies with substantial employee share ownership. Theoretical[222] and empirical[223] studies in Western countries have found no evidence for a negative correlation of financial participation and the position of trade unions. Rather than eliminating the need for unions, employee ownership expands the unions' role on the shop-floor, as well as at the entrepreneurial level. At the same time, employee ownership often expands the scope of collective bargaining agreements.[224] Although in transitional economies there seems to be a decline of trade union representation in companies after employee buy-outs,[225] this decline appears more often to be linked to the change of the role of trade unions in these countries in general. In this context it should be stressed that it is the trade unions in transitional countries that are lobbying in favour of financial participation schemes.

218 *See* D. Vaughan-Whitehead *and* M. Uvalić (eds.), Privatization Surprises in Transition Economies, *Cheltenham, 1997, pp. 19, 20;* K. Bradley, S. Estrin *and* S. Taylor, Employee Ownership and Company Performance, *in: "Industrial Relations", Vol. 29(3), 1990, pp. 385–402;* M. Conte *and* J. Svejnar, The Performance Effects of Employee Share Ownership Plans, *in:* A. Blinder (ed.), *"Paying for Productivity: A Look at the Evidence", Brookings Institution, Washington D.C., 1990.*

219 *For a recent, comprehensive overview of the positive economic evidence (esp. for ESOPs) see* J. R. Blasi, D. Kruse, A. Bernstein, In the Company of Owners, *Basic Books, New York, 2003. They find an average increase of productivity level by about 4%, of total shareholder returns by about 2% and of profit levels by about 14% compared to firms without PEPPER schemes.*

220 *First expressed in* L.O. Kelso *and* M. J. Adler, The Capitalist Manifesto, *Random House, New York, 1958; further developed and explicated in* L.O. Kelso *and* P. Hetter, Two-Factor Theory: The Economics of Reality, *Vintage Books, Random House, New York, 1967.*

221 *See* L.O. Kelso *and* P. H. Kelso, Democracy and Economic Power: Extending the ESOP Revolution through Binary Economics, *University Press of America, Lanham, MD, 1991.*

222 *See* R. Harbaugh, Equity-Sharing – Effects on Collective Bargaining Position of Trade Unions, *Working Paper, Prague CERGE EI, Charles University, 1993.*

223 A. Pendleton, A. Robinson *and* N. Wilson, Does Employee Ownership Weaken Trade Unions? Recent Evidence from the U.K. Bus Industry, *in: "Economic and Industrial Democracy", Vol. 16, pp. 577–605.*

224 *See* J. Logue, et al., Participatory Employee Ownership, *Worker Ownership Institute, Kent, OH, 1998, pp. 109.*

— D.4 —
Financial Participation and Participation in Decision-Making

There appears to be a positive relationship between performance and direct employee participation in decision-making.[226] Some recent findings[227] indicate that incentive effects of financial participation schemes are much greater when accompanied by greater worker participation in decision-making. The implication is that co-owners can only be expected to make the changes necessary to attain greater productivity if they are given power to make the decisions that bring about those changes. While financial participation may provide employees with the incentive for maximal involvement, direct participation gives them the tools to realise it. Often, to be sure, a long apprenticeship is needed before some employees begin to understand how their individual work influences profitability, while for those who aspire to participate in decision-making at the management level, this period is correspondingly longer. The introduction of profit sharing without a parallel development of workers' participation in decision-making is neither practicable nor desirable.

In the vast majority of employee share ownership arrangements there has been no significant transfer of decision-making authority from management to employees. Depending on the structure of the plan, however, it is possible that management could lose some control as employees (and their representatives) gradually become more substantial shareholders. However, with the exception of distress buy-out situations, where unions have at times taken an active role in establishing share ownership, it is almost always management that initiates and implements employee share ownership, hence preventing any loss of control by influencing the design of the scheme and its subsequent control and voting rights.

— D.5 —
Failure Rate of Conventional and Employee-Owned Companies

Although companies with financial participation schemes have generally outperformed their conventional competitors, there have been a number of highly publicised failures of enterprises in which the employees are majority shareholders.[228] A United States study in 1995/96 surveyed all majority employee-owned firms which had failed over the past 25 years.[229] The research found no

225 *See* H. Szóstkiewicz, *in:* Jarosz (ed.), *Management Employee Buy-Outs In Poland, Warsaw, 1995, and Polish Employee-Owned Companies in 1995, Warsaw, 1996; also* Jarosz (ed.), *Ten Years of Direct Privatisation, ISP PAN, Warsaw, 2000.*

226 *Employee Stock Ownership Plans: Interim Report on a Survey and Related Economic Trends, GAO/PEMD-86-4BR, U.S. General Accounting Office, Washington D.C., 1986; Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership, GAO-PEMD-87-8, Washington D.C., 1986; Employee Stock Ownership Plans: Little Evidence of Effects on Corporate Performance, GAO/PEMD-88-1, Washington D.C., 1987.*

227 *See* D. Vaughan-Whitehead *and* M. Uvalić (eds.), *Privatization Surprises in Transition Economies, Cheltenham, 1997, p. 20; also* A. Pendleton, J. McDonald, A. Robinson *and* N. Wilson, *The Impact of Employee Share Ownership Plans on Employee Participation and Industrial Democracy, in: "Human Resource Management Journal", Vol. 5(4), 1995, pp. 44–60.*

228 *See* J. Logue, et al., *Participatory Employee Ownership, Worker Ownership Institute, Kent, OH, 1998, pp. 123.*

229 *Conducted by* W. Patton *and* J. Logue *at the Ohio Employee Ownership Centre; see* J. Logue, et al., *Participatory Employee Ownership, Worker Ownership Institute, Kent, OH, 1998, pp. 125.*

simple explanation for the failure of democratically controlled and operated ESOP or co-op enterprises. During the same period, poor management, compounded by the inability to master the market, were also responsible for the failure of thousands of conventionally run enterprises. This study found that financial participation and co-determination were positive rather than negative factors. No evidence could be found to support the hypotheses of confrontational labour relations or of newly assertive shareholder-employees. Almost all of the firms in the study had become totally uncompetitive and abandoned by the market by the time they were sold to the employees, in most cases to avert plant closure. All cited lack of capital; three quarters cited market problems, and over half cited production problems as causes of failure. The only deviation from conventionally run enterprises was found where workers accepted compensation concessions, but hesitated to lay people off. These cases were few. The dual corporate goals of making money while simultaneously preserving jobs were all too often the source of irregular business practices. The more important question is: why have so many enterprises acquired under similar circumstances *not* failed.

— Annex IV —

The Challenge: Functional Changes in Property Rights in Europe

By Herwig Roggemann and Jens Lowitzsch

There is nothing which so generally strikes the imagination,
and engages the affections of mankind,
as the right of property.
William Blackstone, Commentaries on the Law of England, 1793

— A —

Ownership in the Welfare State and in Post-Socialist Transformation

At the dawn of the eastward enlargement of the European Union, once again it becomes obvious that "[…] ownership is a historical, not a logical category".[230] The Western model of the welfare state is in a state of severe crisis[231] and can no longer be maintained in its present form. At the same time, the Central and East European countries are trying various ways to integrate private ownership into the legal framework of a new post-socialist welfare state concept,[232] or are at least trying to lighten the social burden of transition to a market economy.[233] In this context, the role of property goes beyond the mere *functional control of men over legal objects and nature*; it assumes another dimension of property rights, that of *social integration* as an element of social stability, democracy, and economic justice.[234]

Furthermore, ownership, a fundamental legal institution in every developed economic society and legal community, has now taken a central place in the ongoing privatisation processes in Europe. The (re-)introduction into law and economics of private ownership in Central and Eastern Europe, including ownership of land and the means of production, marks a point of no return in the privatisation process.[235] With the process of (re-)establishing private ownership in East and Central European countries still underway, the discussion of the issue and its implications for legal, economic and tax policy in the Member States of the EU remain highly controversial.

230 *See* O. Gierke, Privatrecht, *Frankfurt/M, 1889, p. 348.*

231 *In Germany this is exacerbated by the high and apparently long-term budget deficit, which arose due to the extensive transfer of funds after the re-unification of Germany. The Bundesrechnungshof (Federal Court of Financial Control) stated that this West-East transfer of capital reached the amount of 325 billion Euros in the first five years. Other authorities, such as the Ministry of the Treasury of Northrhine-Westphalia, estimate that the cost of unification totals 500 billion Euros.*

232 *Although embodied in the constitutions of a number of post-socialist states (e.g., Poland, Croatia and Russia) the principle of the welfare state has been developed only partially or not at all; for the role and renaissance of private property in the post-socialist societies of Eastern and South-Eastern Europe see* H. Roggemann, *Die Verfassungen Mittel- und Osteuropas, Berlin 1999, pp. 98.*

233 *See* W. Gärtner, *Die Neugestaltung der Wirtschaftsverfassungen in Ostmitteleuropa, Berlin, 1996.*

234 *Compare a recent study on the history of dogmatics and ideas on ownership and its historical relativity by* D. Hecker, *Eigentum als Sachherrschaft – Zur Genese und Kritik eines besonderen Herrschaftsanspruchs, Paderborn, Munich, et.al., 1990, pp. 18, 204, 252.*

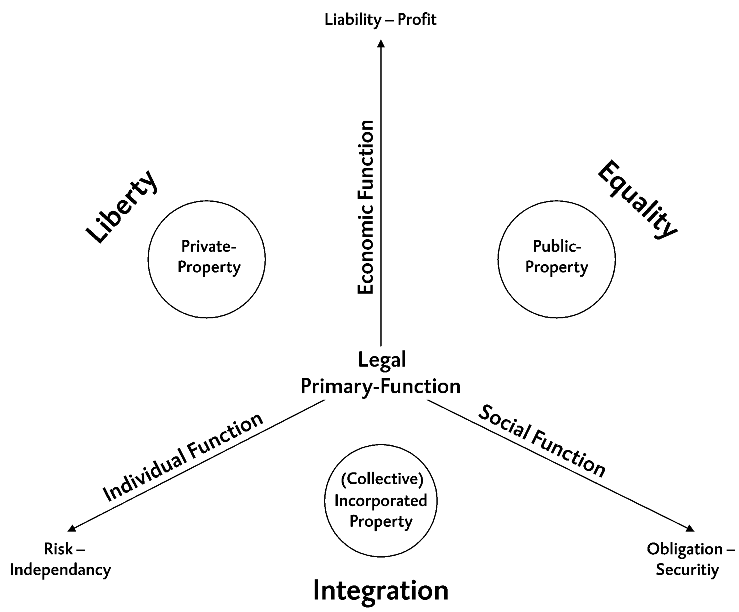
235 *For further remarks see* H. Roggemann (ed.), *Eigentum in Osteuropa, Berlin, 1996.*

— B —
Legal Foundations of Property

— B.1 —
Functions of Ownership

Property has both a legal and an economic dimension. The general assignment of liability and risks is one aspect of this duality. On the one hand, the economic essence of property is the owner's right to receive the income it earns.[236] On the other hand, private property has the economic function of both assessing and assigning economic risk and liability; it is the foundation of a credit system based on collateral. Property law not only provides the legal basis of a market economy and competition, it defines other economic categories: "Property does not exist outside the economy, but it rather gives significance to all the terms/concepts which are meaningless in non-ownership economies. This applies especially to interest, money and credit, but also to value, price, profit and market".[237] Four legal functions of property may be distinguished:[238]

— the (primary) triple legal force of the model proprietor – to own, to use and to dispose exclusively;
— the right to receive the entire yield and to assume the liability and risks – the "economic function";
— the integrational or "social function"; and
— the guarantee of personal rights[239] and freedom,[240] the "individual function".



236 L. O. Kelso *and* M. J. Adler, The Capitalist Manifesto, *Random House, 1958, p. 15; referring to* Pollock v. Farmers' Loan & Trust Co., United States Supreme Court Reports, Vol. 157, 1895, *pp. 429: "For what is the land but the profits thereof? […] A devise of the rents and profits or of the income of lands passes the land itself both at law and in equity."*

237 *See* D. Heinsohn *and* O. Steiger, The Paradigm of Property, Interest and Money and its Application to European Economic Problems: Mass Unemployment, Monetary Union and Transformation, *in: "IKSF Discussion Paper", No. 10, July 1997, p. 346; see also* J. Hölscher, Privatisierung und Privateigentum, *in: "Bedingungen ökonomischer Entwicklung in Zentralosteuropa", Vol. 4, Marburg, 1996, p. 109: "Money and private property constitute the framework of categories for the market process, in which the accumulation is determined by the relation of interest rate and expected profit rate."*

238 *See* H. Roggemann, Eigentumsordnung in Osteuropa, *in: "Recht in Ost und West", 1993, p. 321; the same,* Eigentum in Osteuropa, *Berlin, 1996, pp. 29, 39.*

239 *"[P]roperty performs the function of maintaining independence, dignity and pluralism in society by creating zones within which the majority has to yield to the owner. Whim, caprice, irrational and 'antisocial' activities are given the protection of law […]",* Charles A. Reich, Yale Law Journal, *April 1964.*

240 *"[…] in the main, it will be found that a power over a man's support is a power over his will.",* Alexander Hamilton, The Federalist Papers, *No. 73, 1788*

These legal functions of property give rise to forces which are in a permanent state of tension, confirming that property is a historically evolving category. The resulting force field can be expressed in the relation between freedom, equality and integration. The legal institution of property thus works in three ways:

— As *private property*, it guarantees the owner his personal and economic freedom.
— As *public property*, it ensures a minimum level of equality of all citizens that are formally holding part of it.
— As *(collective) incorporated property* – in the form of public insurance institutions or joint stock companies – it secures the individual as a part of the community and leverages, independent of the individual capacity, his integration in the civil society.

B.2

The Changing Content of Property

The social functionality of property as developed in the jurisdiction of welfare states leads to a differentiation of the absolute concept of property. One can discern two lines of differentiation, each of which represents diminishing individual function and increasing social function:

Increasing Social Relationship

Owner as defined in civil law (personal property).

↓

Owner as defined in civil law (land, houses, means of production).

↓

Owner as defined in civil law (joint owner, partner, shareholder).

↓

Non-owner as defined in civil law (occupant, user, tenant).

↓

Non-owner (contract partner, employee).

↓

Non-owner (interested party, neighbour, passer-by, co-user of nature).

↓

Non-owner (rightful claimant, pensioner, unemployed person).

Decreasing Relationship to Material Assets

Home ownership (apartment ownership).
↓
Land ownership.
↓
Direct ownership of the means of production.
↓
Ownership of the means of production mediated by company law.[241]
↓
Valuable private legal positions.
↓
Pension or other social entitlement under public law.

Within this system of functions, the law has a broad range of pro and contra arguments at its disposal for the solution of conflicts. The resulting compromises led a commentator on the United States Constitution to advance the extreme thesis that property rights themselves are fading away.[242]

—— B.3 ——

Ownership and the Control of Productive Property

Property rights were also observed as failing in the relationship of ownership and the control of productive property, as the following quotations illustrate:

"In the most important sectors of our political economy, most individuals are in the process of being effectively separated from any discernible ownership relation to industrial property. That relation is tenuous enough when individuals are actual stockholders. It ceases to exist when the individual becomes a contract-claimant for the pension or other benefits he expects to receive through a trust fund or other similar institution which holds legal title to the stock and other corporate securities making up its portfolio".[243]

And referring to the previous: "This notion from the late 50's that ownership has been divorced from control of productive property today has become commonplace. The evidence is now before us that, with the advent of Pension Trusts, Mutual Funds and the large accumulation of corporate stock in the hands of Bank trustees, ownership itself as an operating reality is diminishing. We have reached a stage in the evolution of property – speaking only of productive property – where the individual is an owner because he possesses a

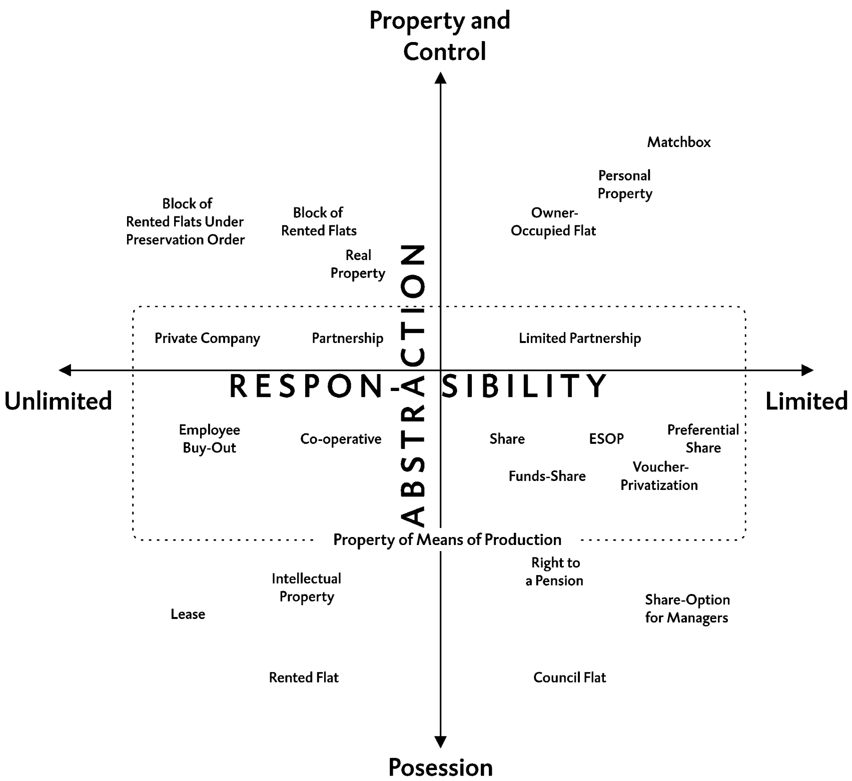
241 *In this context see* P. Badura, EIGENTUM, *in: "Handbuch des Verfassungsrechts", § 10, p. 386: "In large companies, the personal relation to individually exercised ownership rights is more or less weakened. [In this case] it is evident how much this economic property is related to society."*

242 *See* A. Schwartz, *A* COMMENTARY ON THE CONSTITUTION OF THE UNITED STATES, *Part II, 1965, p. 229. Against this thesis also see* Rittstieg, *op. cit.*, No. 24.

243 A. A. Berle, Jr., TOWARD THE PARAPROPRIETAL SOCIETY, *The Twentieth Century Fund, 1959, p. 22.*

piece of paper which says he is. The sole advantage left to the possessor of the paper, however, is the right, under certain circumstances, to receive income".[244]

Differentiation of Ownership according to Level of Abstraction and Extent of Responsibility



Because of further economic differentiation, particularly the rise of the business corporation, the earlier simple forms of property acquisition and use by an owner or a holder have become inadequate. This has led to the evolution of forms of property (for example, share ownership) which are more abstract. Equitable ownership, for example, leads to the solution that the *possessor* holds the right to (not abusively) use, possess and dispose. The formal owner, on the other hand, does not have the right of possession, but an abstract control right which is in no respect identical with the typical rights of a model owner.[245]

244 L. O. Kelso, LAWYERS, ECONOMISTS AND PROPERTY, *San Francisco, 1960, p. 3.*

245 *Consequently the legislature attempted to deal with the equitable ownership differently than with "real" ownership (e.g., in Germany) when passing the new insolvency code, leading to accusations of expropriation.*

— C —

Ownership in European Law

The legal rules of the European Union do not contain a binding concrete ownership constitution. This is still true of the ownership-related constitutional and political question of privatisation-socialisation (Article 222 of EEC treaty). But the European Court of Human Rights (at Strassbourg) developed its own legal dogma of fundamental ownership protection, drawing on the European Convention on Human Rights of 1950, the rules of the treaty, and a comparison of national constitutions. The court's decisions have significant similarities with the (sometimes controversial) concept of the German Federal Constitutional Court, whereas some Western European constitutions do not acknowledge the legal categories defining content, limitations and social responsibility to the same extent. Most recently the European Charter of Fundamental Rights has complemented and brought forward this substantial process.

— C.1 —

European Community Law in a Narrower Sense

Property law as European law was not included in the EEC Treaty. Article 222 of the contract states: "This treaty does not interfere with the system of property ownership in the member states". Otherwise the project of European integration would not have had a majority to begin with because of differences and variant traditions regarding the system of property ownership.[246] But the whole logic of the treaties (limitation of national subsidies, freedom of services, freedom of goods traffic)[247] implicitly requires – despite state interventional tendencies (especially in agriculture) – an economic system which is based on a market economy and (at least also) on private property.[248] This is reflected in Article 4 (former 3a) of the EEC Treaty, included under the "Maastricht Treaty" in 1992, establishing the "basic principle of an open market society with free competition", which seems to acknowledge private ownership. Likewise Article 44, where the "freedom of acquisition and possession of real estate" enunciated in the context of the freedom of entrepreneurship clearly refers to private ownership.

Nevertheless, in accordance with Article 222 of the EEC Treaty, which expressly excludes legal and political jurisdiction over property from the competence of the EEC, the areas of authority developed in the secondary legislation of the European Community (Regulations and Directives) do not contain a

246 J. M. Thiel, *Grundrechtlicher Eigentumsschutz im EG-Recht*, *in: "Juristische Schulung", 1991, p. 274, deals with the problem of whether Article 222 leaves only the organization of ownership to the Member States or whether all ownership guarantees are excluded from EC control.*

247 *About interaction of ownership law and freedom of establishment, see* R. Riegel, *Zur Bedeutung der Niederlassungsfreiheit im Europäischen Gemeinschaftsrecht*, *in: "Neue Juristische Wochenschrift", 1986, p. 2999.*

248 *See* Beutler and Bengt, *Die Europäische Union, Rechtsordnung und Politik*, *4th Ed., 1993, p. 63.*

specific ownership law. Since European ownership law is poorly developed, the national systems of ownership law differ to a great extent.

— C.2 —

Ownership and European Fundamental Rights

A broader development took place in the area of fundamental rights. The foundation treaty, the "Constitution of the European Community", does not contain a catalogue of fundamental rights.[249] But the European Court of Justice developed European Community fundamental rights in the manner of the English common law through its decisions concerning specific cases. The court drew on the main principles of freedom in the EEC Treaty, the regulations of the Convention, and the constitutional traditions of the Member States. The work of the court is already approved by secondary legislation. After the Common Declarations of the Community's organs regarding fundamental rights from 1977[250] (soft law), Article F II (now Article 6 II) of the treaty now confirms that "the community respects the fundamental rights as they are guaranteed in the European Convention on Human Rights and as they result from the constitutions of the members as general principles of Community law". This way national courts and the European Court of Justice have enough means to control whether fundamental rights are respected or not. The standard of the European Community's fundamental rights is in permanent development.[251]

Furthermore the concept of the Convention and interpretation by the European Court of Human Rights plays an important role regarding the development of the property function in the European legal system.[252] Article 1 of the additional protocol of ECHR from 1952 guarantees that property is respected. Expropriations are only licit in the public interest and may be done only by law. State regulations limiting the use of property for the general welfare remain unaffected. As in the German Federal Constitutional Court's ownership decisions, European courts must distinguish between expropriation limits on the one hand and rules for determination of limits on the other, according to their effect – use limitations do not establish a duty of compensation.[253] The integrational or "social function" of ownership has also been recognised on a European level. The European Court of Human Rights interprets the Convention in such a way that the guarantee of property not only includes real rights, but also all legally acquired rights, including rights to incorporeal goods.[254]

Since the adoption of Article 17 of the European Charter of Fundamental Rights as part of the Treaty of Nice in 2001, the definition of the contents of

249 *Efforts to enact them later failed; having the European Human Rights Convention ratified by the European Community/Union as an organisation was discussed, but not realised.*

250 *OJ, C 103/77, p. 1.*

251 *See summary by* M. Schweitzer *and* W. Hummer, EUROPARECHT, *4th Ed., 1993, p. 200. Sceptical about the possibility to define protection of fundamental rights on the basis of the European Human Rights Convention and constitutions is* W. Skouris, WERBUNG UND GRUNDRECHTE IN EUROPA, *in: "Europäische Zeitschrift für Wirtschaftsrecht", 1995, pp. 438, 439.*

252 *See* W. Peukert, ZUR NOTWENDIGKEIT DER BEACHTUNG DES GRUNDSATZES DES VERTRAUENSSCHUTZES IN DER RECHTSPRECHUNG DES EUROPÄISCHEN GERICHTSHOFS FÜR MENSCHENRECHTE ZU EIGENTUMSFRAGEN, *in: "Europäische Grundrechte-Zeitschrift", 1992.*

253 *See* M. Villinger, HANDBUCH DER EUROPÄISCHEN MENSCHENRECHTSKONVENTION, *1993, p. 385.*

254 *See* W. Skouris, *loc. cit., p. 441;* M. Villinger, *loc. cit., p. 384.*

ownership became more precise.[255] At that time, the Charter, as a mere catalogue of policies, was not genuine *jus cogens* and thus had no *res judicata* effect. With the genesis of a European Constitution and the inclusion of the European Charta of Basic Rights as part of it, the Charter will become binding European Law.

— D —

The Problem: Unequal Distribution and Concentration of Capital

In the context of the current crisis of the welfare state, the challenge for the social function of ownership is the extremely unequal distribution of capital.[256] It is to be assumed that, as a result of this disproportion in the distribution of ownership, the market society will soon reach its limits. The thesis described in the equation "ownership = freedom" is matched by the contrary equation "non-ownership = non-freedom". Despite this extremely important function of ownership for individual citizens, it seems equally unquestionable that at least a minimal role for the social functions of ownership must also be protected. The conflict over changes and cutbacks in the welfare state brings up the question of how to define the core minimum of social rights (pension, unemployment benefit, social aid) included in the ownership guarantee which cannot be withdrawn by the legislature without violation of the Constitution.

Each individual's income and asset ownership are treated more or less differently in all developed market economies. All current industrial societies are still far from reaching the revolutionary ideal of a free and equal social system. This leads to two further questions:

— What are the barriers to establishing and setting up employee ownership in the EU Member States?

— Should there be limits to ownership concentration, and, if so, what should the legal means for implementing such limits be?

255 *Article 17, Right to Property, Paragraph 1. Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest. Paragraph 2. Intellectual property shall be protected.*

256 *According to a 1997 survey, the wealthiest one million households in Germany possess much more property than the poorest 25 million households taken together. See* Die Woche, *17 January 1997, p. 10.*

— E —

The German Example

The Federal Republic of Germany, may serve to illustrate the problem of ownership distribution: The country was (as FRG before unification in 1990) and remains one of the rich countries, even with its decline in wealth.[257] Despite rising national income in Germany over the last four decades since World War II ("explosion of wealth" because of a fourfold increase of per capita income),[258] income and asset differences increased along with social inequality. The asset differences are much larger than income differences. Concentration of assets, which can be defined as ownership concentration, is twice as large as income concentration. This development can be described as follows: "The rich and wealthy in the FRG got richer and wealthier".[259] Widely disputed statistics showed that one-tenth of the population owned half of overall assets in 1983. In this group, 1% of the households owned 23% of overall assets.[260] Another figure showed that about 74% of domestic productive assets (excluding ownership by the state and foreign owners) was concentrated in the hands of 1.7% of West German private households in 1966.[261] It is presumed that this high concentration remains stable or has even increased.[262]

This process of private ownership concentration in Germany has been accelerated by privatisation and (re-)privatisation in the new parts of Germany (former GDR).[263] Post-socialist (re-)privatisation in East Germany led to a transfer of ownership of productive capital. Nearly all middle-sized and big enterprises were transferred to West German or foreign owners. (Only about 10% of such enterprises were transferred to foreign owners).[264] Of the largest 50 enterprises privatised prior to 1994, 45 were transferred to West German owners, two to French owners and one to an Austrian owner. The Federal States Saxonia and Thuringia each received one enterprise. Former socialist state property was transferred to the local federal state.[265] The East German population became owners of newly privatised productive property only when small or middle sized enterprises were transferred by management buy-out. However, this happened only in a small minority of enterprises.

257 *See* R. Geißler, *Die Sozialstruktur Deutschlands, 2nd. Ed., Opladen 1996, p. 65;* H. Schlomann, *in:* E. U. Huster (ed.), *Reichtum in Deutschland, Frankfurt/M., 1993, p. 54.*

258 *From DM 8,600 in 1950 to DM 36,000 in 1989, see* R. Geißler, *loc. cit., p. 45.*

259 *See* R. Geißler, *loc.cit., p. 61.*

260 *See* H. Schlomann, *loc. cit., pp. 71, 73.*

261 *See* W. Krelle, J. Schlunck *and* J. Siebke, *Überbetriebliche Ertragsbeteiligung der Arbeitnehmer, Tübingen, 1968, pp. 72, 250.*

262 *See Die Zeit*, No. 40, *23 September 2004, Economy Wo stehen die Reichen? (Where do the rich stand?), and ibid.* No. 34, *August 2004, Economy Nur die Reichen werden reicher (Only the rich get richer); see also* W. Krelle, *Wirtschaftswachstum und Vermögensverteilung, in:* Deutsche Bischofskonferenz (ed.), *"Beteiligung am Produktiveigentum", Hannover/Bonn, 1993, p. 37.*

263 *See* G. Guttmann, *Geldvermögen und Schulden privater Haushalte Ende 1993, in: "Wirtschaft und Statistik 1995", p. 391; G. E. Zimmermann, Neue Armut und neuer Reichtum. Zunehmende Polarisierung der materiellen Lebensbedingungen im vereinten Deutschland, in: "Gegenwartskunde 44", 1996, pp. 5, 14.*

264 *See* J. Priewe, *Die Folgen der schnellen Privatisierung der Treuhandanstalt, in: "Aus Politik und Zeitgeschichte", Beilage der Wochenzeitschrift "Das Parlament", 1994, B 43–44, pp. 21, 23.*

265 *See* V. Offermann, *Die Entwicklung der Einkommen und Vermögen in den neuen Bundesländern seit 1990, in:* J. Zerche (ed.), *"Vom sozialistischen Versorgungsstaat zum Sozialstaat Bundesrepublik", Regensburg, 1994, p. 96; summary see* R. Geißler, *loc. cit., p. 67.*

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