

**EMPLOYEE-OWNED ENTERPRISES:
AMERICAN EXPERIENCE AND RUSSIAN PRACTICE**

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The potential and specifics of employee ownership

In the modern market economy, the development and productive use of employees' social-economic potential are closely connected with the expansion in the variety of forms of their participation in contributing to enterprise performance. One of these forms lets employees become company shareholders. Employee Stock Ownership Plans (ESOPs) first appeared in the United States in the 1950s. Expansion of ESOPs was considerably intensified in the middle of 1970s after adoption of the Employee Retirement Income Security Act (ERISA), which gave tax incentives to companies with ESOP.

In the late 1990s, some 11,000 US companies were partly or wholly-owned by their employees through ESOPs. These companies employed 10 million workers or about 8% of the labor force (Logue, 1998, p 15).

Enterprises which are partly or wholly-owned by their employees may be found practically in all sectors of the American economy, including manufacturing, construction, retail and wholesaling, and financial services. Today about 1000 public companies in the US have ESOPs. These corporations account for some 29% of the market value of all stock capital, 27% of sales and 20% of employment in the private sector of the American economy (Blasi).

In evaluating the social-economic potential of ESOP companies, attention should be paid to its particular characteristics. First, the right of ownership is considerably restricted. Employees cannot convert their shares into cash. This measure is necessary to preserve the long-term status of employee ownership. Employees might prefer to have cash sooner rather than later. If such a decision were made by the majority, then the transformation of an employee-owned enterprise into a traditionally-owned company would be inevitable.

Second, the right to own a share is restricted. New employees often go through some probation period before they have an unforfeitable right to their shares. Its duration usually varies from one to seven years and can be extended longer if the shares were purchased with a longer-term loan. Pensioners are usually required to sell their shares back to the company within a certain period of time after receiving them. This restriction is

intended to avoid the appearance of unwanted outside shareholders and also to maintain ownership inside the company.

Third, ownership is collectively shared within an ESOP trust through a trustee; though the monetary value is allocated among the personal accounts of each employee.

Many goals are reached with the adoption of an ESOP. Business owners may be interested in increasing employee interest in stable, long-term and effective work, increasing their sense of responsibility for the results of on-the-job performance, decreasing the number of conflicts between employees and managers, and expanding the possibilities for self-financing of the business related tax savings.

Employee owners have an interest in acquiring company shares free of charge, earning dividends on those shares, and participating in management. Building up retirement income for the future is also of great importance. In some cases, averting a shutdown is the reason to buy the business.

The state also has several objectives for promoting employee ownership. The federal government's main objective is to promote a financial mechanism which will supplement the limited retirement income provided to working citizens through social security. By stimulating employers to contribute company shares to employees and then buy them back after retirement, the government seeks to minimize the possibility that the state will be the only source of income for a considerable number of future pensioners. For regional authorities, the main interest is to preserve jobs and enterprises themselves as taxpayers.

The advantages of employee ownership include its ability to balance the interests of different categories of personnel (workers, managers), to stimulate the development of an entrepreneurial type of economic behavior by employees who become interested in long run company performance, and to promote principles of social and economic justice. There is no discrimination in allocating shares among employees; their share in the capital depends upon their input into production. Predictably employee-owned enterprises develop into highly effective organizations. Where ownership is combined with employee involvement, studies show companies achieving 50% greater profit and double the average annual growth rate in labor productivity (Belotserkovsky, p. 89).

The competitive advantages of employee-owned enterprises have attracted interest in several countries, including Russia, where for the last ten years different approaches to the practical realization of a participative idea of ownership have been tried. The first experiences of enterprises with employee ownership in the USSR date back to the late 1980s, when the Lease Law was put into action and the Soviet Council of Ministers approved an experiment for allowing worker collectives to buy out fixed assets from the state through an association called BUTEK (“Future of the Market Economy”).

The Russian practice of forming employee-owned enterprises

The broad-scaled attempt at establishing in Russia a sector of employee-owned enterprises was undertaken within the framework of the privatization program of state and municipal ownership. In this program a large number of shares were supposed to be allocated among the employees of enterprises being turned into stock companies. Such a measure had to guarantee the formation of owners who were highly interested in the effective development of the company. The social factor was also considered to be important. It was connected with the realization of the principle: ownership for those who created it and provided its broader reproduction.

Instead of collectively shared ownership, however, employee ownership was being established through individual ownership of company shares. Giving employees the complete freedom to have shares at their disposal led to the process of their mass resale. This process was due to the unstable financial status of most privatized companies and, consequently, the absence or near-absence of dividends, combined with the attempts by ordinary shareholders to improve their family income to some extent. An additional psychological factor also played a role – people tend to value less those things they receive free of charge or at a token price. As there were no real expenditures on the acquisition of their shares, employees’ motivation to hold it was weakened substantially.

As a result, the reduction of the employee holdings in company shares turned out to be one of the tendencies in the post-privatization allocation of ownership. Thus, according to A.Radygin, in 1994-1997, employee ownership of privatized enterprises decreased from 47% to 30,5% on average. The forecast for 1999 was set at 36% (Radygin, p. 60).

A new attempt to create conditions for the formation and development of employee-owned enterprises was undertaken at the end of the 1990s. This was connected with the adoption of the federal law “About the specifics of the legal status of stock companies (people’s enterprises)”, which started functioning on October 1, 1998. This law was passed to prevent the forced transformation of closed stock companies into open ones; a measure necessary to prevent the further dilution of employee ownership.

People’s enterprises are *closed stock companies*, but they have some specific characteristics that entitle them to special treatment. The main attribute is that their primary owners are and always will be *only company employees*. According to the law, ownership by non-employee shareholders cannot exceed 25%. This condition may be only be violated at the moment when a people’s enterprise is established. In this case, a transitional period is allowed – ten years if outside ownership began at more than 45%, five years if between 35 and 45%.

There are other substantial characteristics of people’s enterprises (PEs) (Federal Law):

- A PE may be founded after the transformation of any commercial organization, except those where the employees own less than 49% of the capital;
- One employee shareholder cannot possess more than 5% of the authorized shares;
- A PE can only issue common stock;
- Shares can only be repurchased out of retained earnings;
- A PE can only increase its authorized shares by a sum equal to or less than its retained earnings;
- Upon leaving the company, employees must sell their shares to the PE;
- Voting at shareholder meetings follows the principle, one shareholder – one vote;
- Non-employee shareholders take part in meetings with the right to a consultative voice and become members of an Observer Council.

Thus, employee ownership in modern Russia is represented by two groups. People’s enterprises, whose legal status is strictly defined by the government, refers to one group. The other group is formed by companies established during the process of privatization, where employees retain a certain level of ownership. These companies provide the main reserve for establishing new people’s enterprises. The steady growth of people’s

enterprises, their formation and development as effective functioning organizations, can be encouraged through a series of productive measures based on the ESOP experience but taking into account the circumstances of a transitional economy as well.

The necessity and directions for improving an institutional framework for the formation and operation of employee-owned enterprises in Russia

Let's consider the key decisions upon which the scale and performance of the employee-owned sector depends.

The principal question concerns the form and essence of state support for such enterprises. Currently, the role of the state is limited to the legal regulation of the process of formation and operation of only people's enterprises. At other enterprises, the continuity of employee ownership as a special institutional characteristic is not regulated at all. Nevertheless, employees are co-owners of these businesses as well. The majority of such enterprises, being open stock companies, will not be able to convert to people's enterprises under the current legislation because the share owned by employees is less than 49%.

When working out the state policy with regard to employee-owned enterprises, one should take into account the diversity in terms of percentages owned by employees. It is evident that those enterprises with developed financial sources have favorable opportunities to preserve broad-based employee ownership of the majority of the shares. Enterprises in major industries which are dominated by government or large corporate interests have fewer employees who own shares, since the majority of shares are owned by outsiders. The chance for employee ownership in unprofitable enterprises where long term external investments are needed is minimal, because the investors will want to have enough shares to control the actions of management or at least block strategic decisions which are not in their interests.

In other words, the amount of employee ownership appearing as a result of privatization and preserved in the process of further redistribution will cover a wide range of ownership positions from a fraction of a percent to 100%.

We should mention that such a situation exists in the US, where only about 2500 of approximately 11,000 ESOP companies (less than 23%) are majority-owned by the employees. These majority-owned ESOPs employ more than 1.5 million workers (Logue,

p. 18). This diversity reflects the natural differences in goals pursued by the initiators of ESOPs, including company strategies, financial positions and sources of development. The American legislation is more flexible than the Russian in as much as there is no minimum percentage required to be owned by the ESOP, unlike requirements for people's enterprises.

We suppose, in this respect, that there is an urgent need for developing a legal basis that will assist in the retention and expansion of employee ownership regardless of size. Being shared ownership, there should be a restricted list of criteria which is enough to establish an employee ownership status recognized by the government. Considering the American experience, such criteria might include: the participation of all permanent employees in ownership; allocation of shares according to certain rules; and the right of the company to repurchase the shares from departing employees.

Turning our attention to the improvement of legislation, we propose that the Law "About the specifics of the legal status of stock companies (people's enterprises)" should be amended since it restricts the potential sphere of formation of people's enterprises; for example, this legislation does not include state and municipal enterprises. The process of privatization is not over yet and, consequently, a large number of these will be transformed into private commercial organizations. We believe the effectiveness of such a process depends upon the flexibility of forms for its realization. One of them may be the transformation into employee-owned companies.

It is obvious that in the process of its development one could avoid unjustified transitions of ownership rights and, connected with them, market transactions, if while working out the privatization plan of the concrete object one could give reasons for the preferable role and share of this ownership. To reach these goals it is expedient to include in the privatization plan of the enterprise a clause called, "The interest of the employees and forms of their realization" which would clarify the minimum percentage of shares which must remain employee-owned; the dates and sources of stock redemption for employees; and the means and guarantees for protection of the employees' interest in the case of new issues.

The state cannot restrict the support for employee-owned companies only to this new legislative base. Looking at the American experience, it is clear that ESOPs appeared

in the 1950s; however, before 1974 this plan was used only at a couple hundred firms employing less than 100 000 people. The rapid growth of employee-owned enterprises started when the federal government granted tax breaks to companies with ESOPs. When a company can save 40 cents on the dollar as a tax deduction, it is a powerful stimulus for the business's owner to initiate actions to create and expand employee ownership.

In Russia, tax benefits for employee-owned enterprises would mean a lot if one takes into account that the sources of self-financing and limited bank credits needed to renovate the fixed capital are not accessible to such enterprises.

We believe it would be justified to include banks as recipients of tax benefits. In the US, one option for establishing employee ownership is to get a bank loan, which is used to purchase shares from existing owners. There was legislation for several years, which allowed banks to exclude from their taxable income half of the interest earned on loans to ESOPs owning over 50% of a company's shares and passing through the voting rights on these shares to the employees. In Russia such a variant could spark the interest of banks to invest in the real sector of economy.

Along with direct financial support for employee-owned enterprises, the state may use indirect support. For example, it would make sense to allow employee-owned companies the right to issue preferred shares. This would create beneficial opportunities for attracting external financial resources, which are necessary for enterprise reconstruction and the qualitative replenishment of technological resources. In this case, the potential investor would receive a guaranteed fixed income, but not the right to manage the enterprise.

In assisting the development of employee ownership, the state should consider that not only its size and share are very important, but also the mechanism of operation as well. Let us pay attention to its key elements. One element is a trust fund established within the company, but isolated from its finances and completely removed from the sphere of management control. The trust should be governed by a trustworthy trustee who acts only on behalf of the employee shareholders. The trust would use funding from the company or a bank (the loan would go through the company which would be responsible for the repayment of principal and interest) to buy shares and allocate them to employees' accounts.

The Russian legislation regulating activities of people's enterprises includes the norm which stipulates creation of a special fund (as a part of retained earnings) to finance the purchase of newly issued company shares. It is important to draw attention to the fact that the fund is an integral part of the company's finances and is controlled by its management.

The comparative analysis of the named funds' potential shows that the American variant is the most preferable. This conclusion is supported by the following arguments.

1) Due to its organizing status, a trust fund is initially oriented to realize a collective interest of enterprise personnel. Naturally it is quite difficult to avoid the situation where a trustee seeks to use the fund on behalf of the interests of a particular group of people, or to his or her own advantage. In American practice, such a behavior is restricted by legal liability of fiduciaries for actions that are not in the best interest of the ESOP participants (Logue, 1997, p. 352).

2) A trust fund has several funding sources. The first one is the company's revenue exempt from taxation. The second one is loans. The third one is proceeds from securities of other emitters (the state, non-financial corporations, financial institutions).

3) A trust fund ensures transparency of its financial operations so that the state can control the intended use of revenue exempt from taxation.

4) A trust fund is able to reduce the risk of its financial operations with securities by means of investment diversification and its professional management.

5) A trust fund can promote the accelerated growth of employee ownership by using its proceeds to purchase shares from the company, which fulfills the ESOP plan.

An important feature of the ESOP, the US's primary mechanism for organizing employee ownership, is the restriction on concentrating shares in the hands of individual insiders. For example, when allocation of shares is proportional pay, federal legislation sets a limit on the amount of pay which can be taken into account for highly-paid employees. This limit generally does not exceed a 6:1 ratio (Logue, 1997, p. 331). Companies can set their rules to lower the ratio.

In Russia only the ratio between levels of the Managing Director's pay and the average pay of an employee at a people's enterprise is legally regulated. It should not exceed 10:1. In addition, as has already been mentioned, the maximum share of corporate

stock which an employee can own is set. For other types of enterprises with employee ownership, these restrictions do not exist.

It is obvious that the top management of people's enterprises known to be highly profitable (highly profitable enterprises seek to get this status to avoid possible outsider takeovers) can acquire the maximum number of shares in a relatively short time. Ordinary employees can achieve the same result at a different speed. That is why the "weight" of their block of shares will be ten times less than that of the enterprise management for a long time. This situation is predetermined by the legally set order of share distribution in proportion with pay. At other employee-owned enterprises, the practice of capital concentration in the hands of management has already become common. According to A.Radygin, during the period of 1994-1996, the share owned by management increased from 9% to 15%. In our opinion, concentration of property in the hands of a small group of employees will turn out to be a powerful factor that will demotivate the working activities of a considerable part of personnel. It is impossible to solve the problem without the development of relevant legal norms. We think that Russian enterprises seeking state support should develop a strict limitation on the level of pay eligible to be considered for allocation purposes.

It is also advisable to use length of service at the enterprise as a criterion for defining the number of shares an employee should get.

In our view, the financial rights of people's enterprise employees are also violated by the legislated practice of buying out shares from redundant people. First, the deadline for the purchase of an employee's shares is not set. Second, the legislation's term, "just price", for the purchase does not have identifiable criteria. So we can foresee a situation where employees do not know about specific time limits for conversion of their shares into income and are not aware of the possibility of getting fair compensation which considers their actual value.

It seems advisable to take into account the American experience for an effective solution to this problem. The ERISA law requires that retired employees receive their settlement during the year immediately following their retirement year, and for employees who leave the company before retirement to receive their settlement during the fifth year immediately following the year they leave. If the company spreads the payment of this

settlement over a five-year period, it must pay a reasonable rate of interest on the unpaid balance.

As 95% of employee-owned enterprises in the US are privately held, legislation requires that company hire an independent valuator to calculate the fair market value of shares bought from an employee. In addition, the state sets guidelines to be followed by valutors in making these calculations.

US practice shows that participatory management and ownership training are integral components for the effective operation of employee-owned companies. Participatory management is carried out at two levels: workshop and enterprise. In the first case, employees-owners take part in deciding matters concerning the conditions and results of their labor. The range of questions is rather broad, including equipment design, organizing of supplies, technical and technological preparation of production and relationships with customers.

In the second case, employee representatives are included in the process of discussing and making strategic enterprise decisions. This takes a variety of forms including employee representatives on boards of directors, joint steering committees and ESOP administration committees. While American legislation does not ensure worker-owners the right to vote their shares, the most dynamically developing companies use this practice. The law does require that employees vote their shares on key questions (mergers, acquisitions, sale of a significant share of assets). Many employee-owned companies use open book management to further spread responsibility for the final results of economic activity to more employees.

The increasing complexity and dynamic changes in production and the intensification of interconnection of processes of social-economic life in an enterprise are leading systematically to heightened requirements in regards to the level of an employee's knowledge and skills. It is becoming necessary to provide systematic training on a wide range of issues: technical, economic, and organizational.

For Russian entrepreneurs, participatory management is not a particularly new phenomena. In the 1960s in the USSR, numerous forms of public management were implemented: the office of scientific organization of labor, the office of personnel, the office of technical information and others. Their participants were workers.

In 1980s, worker committees were formed, which functioned at both the workshop and whole enterprise level. Current reforms are reversing past worker involvement in managerial activity. Even at state enterprises, let alone private ones, the personnel is deprived of an opportunity to show and act upon their interests by taking part in management. It is our considered opinion that the initial condition for the revival of participatory management in Russia is a change in the state's attitude towards it. One possibility for increasing participatory management would be to legislate it into the organizational structure of enterprises, as it is done in Germany, Sweden, Austria and other European countries. Naturally, such a step would require the adequate actions on the part of management to create similar elements of participatory management at the level of workshops and work teams.

The idea of training is difficult to realize for many Russian enterprises. It is predetermined by the shortage of financial resources and the lack of specialists who are professionally trained to work in market conditions. In our opinion, the way out of this situation may be found in studying and using the American experience of establishing networks of employee-owned enterprises.

The purpose of these networks is to sum up and spread (by means of education) the vanguard experience in organizing the activity of employee-owned enterprises. The data characterizing the work of Ohio's Employee-Owned Network which began in 1989 is very interesting. The Network's financial resources are obtained mostly through member dues. One fourth is financed out of the regional state budget (OAW, p. 1).

The results of the Network performance are also revealing. Compared to only 51% of non-members, 79% of Network members reported there had been a positive impact after they started using the information they had received at Network seminars and conferences. Employee participation increased and manager-worker communication improved. Almost half of the Network members elect non-managerial employees to the board of directors, compared to just 6% of non-members (OAW, p. 3).

Regional Centers, which provide information, technical assistance and personnel training for enterprises that implement employee ownership, play a special role in the process. Such centers have been established in Massachusetts, Michigan, New York, Ohio and Washington. According to the National Center for Employee Ownership, in 1987-1990

the increase in the number of companies with ESOPs in the above mentioned states exceeded the average rate in the country by 26% thanks to the programs realized by these Centers.

We believe it is justified to form such Networks in Russia. The initiators of this process might be state bodies, for-profit consulting firms or non-profit research and educational centres.

In short, definite steps have been taken in Russia to establish employee ownership as a stable part of the new market economy. An overview of the American experience over the past quarter of a century reveals several ideas for further strengthening this important ownership form. The combination of employee ownership and worker participation in enterprise decision making will contribute to an economy which is both meaningful and effective for the broadest sectors of Russian society.

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