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The False Promises of Employee Stock Ownership

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Before entering a major crisis on its proposed reform of job contracts, the French government had announced new legislation to encourage employee stock ownership, i.e. ownership by employees of shares of their employer. However, it is highly doubtful that employee stock ownership schemes are such a good idea.

Every employee's financial interest is to minimize the correlation (all things equal) between risks on his or her job on the one hand, and risks on his or her savings on the other. Enron workers famously lost both job and savings at once: by end-2000, 60% of their retirement plan was invested in Enron shares whose value collapsed to nothing less than one year later. And other blue-chip companies had plans which were even more heavily invested in their own shares, such as Coca-Cola (81%), Pfizer (85%) and Procter & Gamble (95%). In fact, risk diversification concerns should rather lead employees to invest their savings anywhere but in their employer's stock.

The reasons why they do not do so include incentives from tax law and from the employers themselves, as well as "behavioral" biases which are increasingly well understood, if not corrected. Many employees mistakenly see their employer's stock as less risky than other companies' shares and even less risky than a diversified share portfolio (Vanguard, the mutual fund company, has documented this bias with empirical studies). Examples of spectacular success, such as Microsoft in the US or Bouygues in France, tend to obliterate in public perception the many cases where employee stock ownership proved a poor investment strategy. In short, employees tend to see investment in their employer's stock as a better deal than it is in realty. Moreover, being a shareholder is unlikely to affect one's key interests as an employee. Think of situations of downsizing, where the interests of shareholders and employees may not be aligned at all. Finally, the oft-heard point that employee ownership protects employees by deterring hostile takeover bids is relevant only in as far as the success of such bids is contrary to employee's interests, which is far from always being the case.

If employees are not big winner in such schemes, what about employers? Employee ownership can create efficient incentives in start-up, high-growth firms where every employee may have an individual impact on the company's value. In larger enterprises, however, this can only apply to a limited number of manager and executives, notwithstanding the possibility of perverse incentives when greedy managers push up share prices at the time of their options' vesting without caring for longer-term value. Collective profit-sharing

devices such as participation and intéressement in France can have a positive impact of aligning interests, but this does not mean that they should be granted in shares rather than in cash. Actually, tax-free share distribution to employees, as proposed by the draft French bill, is costly both to existing shareholders (through dilution of their stake) and to taxpayers, even though these costs are not as visible as the benefit to the employee. And the corporate governance impact is mixed as best. Employee shareholders run the risk of staying dependent on their management in making decisions, and therefore of not optimizing their interest as stock holders. This risk partly explains the French government's hesitation in clarifying the role of shareholder employee representatives in corporate boards.

Also from the point of view of national savings, the scope for enthusiasm can only be limited. Government-sponsored promotion of employee stock ownership may be confusing at a time when many workers must think ahead for their retirement. Such a policy does not favor the emergence of large pension funds and diversified institutional investors, which are increasingly needed in France as elsewhere in continental Europe. The draft bill also increases the complexity and market-distorting character of French savings law, where a reduction of tax loopholes would seem a wiser way to create a level playing field for asset management services. Another risk of encouraging employee stock ownership is created by the possibility of Enron-style loss of savings by employees of a failed company. If such an event were to result in a political backlash against investment in shares in general, that would be disastrous.

Finally, the French government's claimed vision of the financial system is a cause for serious concern. When, on March 1st, Prime Minister Dominique de Villepin declared that "dispersed share ownership creates a major risk for the independence of our companies", he displayed a dangerous hostility towards institutional investors, despite these being the best known device to efficiently allocate investments in shares. If "economic patriotism" is to mean something reasonable, it is unlikely to be an (ultimately futile) attempt to lock the ownership structure of large companies, but maybe rather a strategy to leverage market forces in fostering the growth of the most promising companies.

In fact, the impact of the draft bill is likely to be limited, and some of its other provisions are welcome. But the overall lesson is clear. Fostering investment in shares is a bright idea; but creating tax and other distortions to direct this investment towards your employer's stock will do more harm than good.

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