Laying the foundation for an employee ownership economy – Written Submission for the Pre-Budget Consultations in Advance of the Upcoming Federal Budget

By Social Capital Partners

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Recommendations

- **Recommendation 1:** That the government introduce legislation in 2021 to create Canadian employee ownership trusts: a new form of business trust to facilitate the transition of Canadian businesses to employee ownership. The new form should model aspects of US Employee Stock Ownership Plan Trusts and UK Employee Ownership Trusts that benefit all of a company's employees.
- **Recommendation 2:** The introduction of employee ownership trusts should be accompanied by a policy framework that aligns incentives for owners, companies and employees to encourage the transition to employee ownership. This should include a review of the *Income Tax Act* to ensure appropriate treatment of earnings, including capital gains and income taxes.

Laying the foundation for an employee ownership economy

The opportunity

The COVID-19 crisis laid bare that we may all be in the same storm, but we are not in the same boat. While many workers across Canada remain unemployed and small businesses are shutting their doors for good, wealthier Canadians have already seen stock portfolios rebound to pre-pandemic levels. There is a real risk that the crisis will accelerate unequal divisions like these across the Canadian economy — between high- and low-income households, between urban and rural communities, and between large and small businesses. As Canada looks to its recovery, employee ownership can be a tool to reverse these divisions and build a more inclusive economy. However, Canada lags countries like the US or UK, where proactive public policy has enabled employee ownership to be achieved at scale. By introducing a policy framework in Budget 2021 to enable "employee ownership trusts", Canada would not only support inclusive growth during the recovery, but also create a more resilient economy long-term.

The challenge

When employees have a chance to participate financially in the growth of their companies, everyone benefits. Employee-owned companies — where a broad base of employees own a significant stake in the company they work for[1] — are associated with better company performance, stronger local economies, and higher wealth and income for workers.[2] Research shows employee-owned companies also have a greater focus on the long-term[3] and are better at weathering recessions.[4]

Despite these advantages, Canada has a low rate of employee ownership. While there are examples like Ellis Don and Beau's Brewery that have programs to help their employees buy a significant share of a company, these add up far fewer employees at far fewer companies than the US or Europe.[5] In addition, there are only 388 worker co-

[1] "Sharing Success: The Nuttall Review of Employee Ownership," 2012.

[2] Jared Bernstein, "Employee Ownership , ESOPs , Wealth , And Wages," no. January (2016).

[3] J et al Lampel, "The Emloyee Ownership Advantage - Benefits and Consequences," *BIS Development for Business Innovation & Skills*, no. July (2012).

[4] Fidan Ana Kurtulus and Douglas L Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions?: Employee Ownership, Employment Stability, and Firm Survival in the United States: 1999-2011* (Kalamazoo, MI: Upjohn Press Upjohn Press Collection, 2017), https://research.upjohn.org/up_press.

[5] Canadian Worker Cooperative Federation, "How Worker Co-Operatives Can Contribute to Improving Canada's Productivity, Competitiveness and Resilience," 2017, www.canadianworker.coop.

operatives employing just over 5,000 Canadians, which makes employee ownership a small fraction of Canada's co-operative ecosystem[6].

Canada's employee ownership gap is a result of public policy choices. Unlike other countries, Canada lacks employee ownership trusts, a purpose-built vehicle to enable existing businesses to transition to employee ownership. The most prevalent employee ownership trust globally is the US Employee Stock Ownership Plan Trusts (US-ESOPs). The growth of these trusts has been aided by clear rules and targeted incentives; there are now 14 million Americans at 6,600 companies holding $1.4 trillion USD in assets through US-ESOPs.[7]

In Canada, the route to employee ownership trusts is blocked. Even if a company spent hundreds of thousands of dollars to design a complex custom trust, tax policy and financing would create issues for both owners and employees. To close the employee ownership gap, we need policy change to make this option available to businesses owners who are considering a transition.

How they work:

Employee ownership trusts are a form of employee ownership where a significant portion of a company's shares are held in an employee-owned trust. The most prominent examples are in the US (US-ESOPs) and Employee Ownership Trusts in the UK (UK-EOTs). A core feature of employee ownership trusts is that employees are not required to invest cash in order to participate.

In both US-ESOPs and UK-EOTs, companies set up a trust and typically borrow money to buy shares from current business owners at fair market value. Loans are paid back over time out of the company's earnings. This allows owners to "exit" in a way that is competitive with other buyers and also keeps the company intact while transitioning to employee ownership. This feature makes employee ownership trusts unique as a viable plan for business succession and, as evidence, has allowed USESOPs to grow to a scale where they are today responsible for $1.4 trillion USD in employee wealth.

While similar, US-ESOPs and UK-EOTs differ in how they distribute wealth to employees. In US-ESOPs, employees are allocated shares in individual accounts. When they leave or retire, they receive either the shares or cash in a retirement account. In UK-EOTs, employees receive annual bonus payouts similar to profit-sharing. In all cases, employee ownership trusts have broad and equitable participation throughout the company — everyone from cashiers and cleaners to the C-suite.

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[6] Statistics Canada, "Canadian Co-operatives, counts and employment by categorical variables" https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3310021602

[7] "ESOP (Employee Stock Ownership Plan) Facts," accessed June 23, 2020, https://www.esop.org/.

The benefits

Employee ownership trusts benefit employees, owners, and communities. As a result, promoting broad-based employee ownership should be a priority for policymakers who are looking to strengthen Canada's economic recovery and increase the well-being of Canadians over the long-term.

Weathering recessions

Employee-owned companies are more resilient during economic shocks and downturns. US data from the 2001 and 2008 recessions showed that employee-owned firms have a lower likelihood of layoffs, bankruptcy or merger in recessions.[8] The UK Employee Ownership Index, which tracks the performance of companies with employee ownership initiatives, has seen publicly-traded companies with greater than three per cent employee ownership out-perform the market consistently and substantially.[9]

Protecting local jobs

Compared to nearly any other type of ownership, employee-owners have a stronger interest in maintaining a presence in the community in which they operate. Employee ownership trusts are a tool to maintain anchor employers that are critical to the economy of small and mid-sized Canadian cities.

Business succession

Approximately 70 percent of private business owners are planning to sell or pass on their businesses in the next decade — businesses that account for the majority of jobs in Canada and almost two-thirds of GDP.[10] Canadian business owners often struggle to find local buyers, even for successful businesses. They are left with selling their business either to predominantly American private equity firms or competitors.[11] This can lead to greater industry consolidation, exacerbate growing wealth disparities, and contribute to the hollowing out of local economies.[12]

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[8] Ana Kurtulus and Kruse, *How Did Employee Ownership Firms Weather the Last Two Recessions?: Employee Ownership, Employment Stability, and Firm Survival in the United States: 1999-2011* .

[9] FTSE, "UK Employee Ownership Index ," accessed June 8, 2020, http://www.employeeownershipindex.co.uk/wiki/index.php5?title=Welcome_to_the_UK_Employee_Ownership_Index.

[10] PwC, "Retirement Pushes Canadian Private Company Owners to Keep, Sell or Transfer Their Business," 2019, https://www.pwc.com/ca/en/media/release/retirement-pushes-canadian-private-company-owners-to-keep-sell-transfer-their-business.html; Canadian Federation of Independent Business, "Nearly Three Quarters of Small Business Owners Plan to Exit Their Business within the next 10 Years," 2018, https://www.cfib-fcei.ca/en/media/nearly-three-quarters-small-business-owners-plan-exit-their-business-within-next-10-years.

[11] PwC, "Retirement Pushes Canadian Private Company Owners to Keep, Sell or Transfer Their Business."

[12] Jason Furman et al., "A Firm-Level Perspective on the Role of Rents in the Rise in Inequality for Us," 2015; Technology and Innovation OECD Directorate for Science, "The Great Divergence(s): The Link between Growing Productivity Dispersion and Wage Inequality," 2017, www.oecd.org/sti; Ray Bawania and Yelena

Employee ownership trusts can provide another pathway to business succession — one that lets owners sell for a fair market price but makes it more likely that businesses stay in their communities. Owners often stay involved in management roles after the sale is complete, along with independent boards.

Increased wealth for employees

Employee ownership trusts put wealth into the hands of employees that might not otherwise have access to ownership and profit-sharing opportunities. A 2017 study, drawing on data from the US Bureau of Labour Statistics, found that median household net wealth is 92 percent higher for employee-owners than for non-employee-owners.[13] Employees in all types of jobs that are part of employee ownership trusts have more income and wealth than those in similar jobs with traditional ownership.

Laying the foundation for employee ownership

US policymakers have supported employee ownership trusts since 1974. Since that time, a bipartisan consensus has supported an array of public policy incentives that have allowed US-ESOPs to grow to reach 14 million workers. More recently, the UK has strengthened its own framework for employee ownership, creating a streamlined dedicated form called Employee Ownership Trusts and providing tax incentives for businesses majority-owned by trusts on behalf of their employees.

A Canadian policy framework does not need to look the same as the US or the UK, but can build on many of the core features to be effective. For employee ownership trusts to be a viable part of the ownership landscape in Canada, we need a public policy framework that provides:

- **A clear structure:** While it is legally possible under Canadian trust law to replicate an employee ownership trust, doing so results in significant tax, legal and administrative issues. In both the US and the UK, governments created a clear set of dedicated rules for employee ownership trusts. The US and UK experiences show that this clear operating environment makes a significant difference.[14] We recommend the creation of a new form of company ownership — Canadian employee ownership trusts — that allow a much clearer process for companies and allow incentives to be targeted to companies with broad-based employee ownership that benefits local economies.

Larkin, "Are Industries Becoming More Concentrated? The Canadian Perspective," *SSRN Electronic Journal*, May 13, 2019, https://doi.org/10.2139/ssrn.3357041.

[13] Nancy Wiefek, "Employee Ownership & Economic Well-Being," 2017, 1–24, https://www.ownershipeconomy.org/wp-content/uploads/2017/05/employee_ownership_and_economic_wellbeing_2017.pdf.

[14] John Menke and Dixton C. Buxton, "The Origin and History of the ESOP and Its Future Role as a Business Succession Tool," *Journal of Financial Services Professionals*, 2010, https://cleo.rutgers.edu/articles/the-origin-and-history-of-the-esop-and-its-future-role-as-a-business-succession-tool/.

- **Targeted incentives:** The wide range of incentives and support for businesses in Canada (including federal and provincial tax incentives, grants, low-interest loans) do nothing to encourage broad-based employee ownership. In other jurisdictions, incentives are generally used to ensure employee ownership is competitive with other buyers as an exit plan for owners, to encourage lenders to finance transactions and to encourage companies to stay employee-owned over the long-term. These typically include modest incentives focused on capital gain tax, corporate income tax, and personal income tax for employee-owners. Policymakers elsewhere have either tied incentives to a minimum level of employee ownership or made incentives proportional to the level of employee ownership.

Conclusion

COVID-19 has created a significant risk that businesses across Canada, especially in local communities, will be forced to sell or close down. Given that this is the second major crisis in recent memory, even owners of successful businesses may accelerate plans to retire and sell. Unlike in the US and UK, Canada lacks the tools for employee ownership to be a viable alternative for these transitions. By making a commitment in Budget 2021 to enable and promote employee ownership trusts, Canada can protect local jobs and create an unparalleled wealth building opportunity for employees during the recovery. Such a commitment would also lay the foundation for long-term inclusive growth that can build a stronger and more resilient Canadian economy.