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ADAPTING EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS) TO TUNISIA

FINAL REPORT

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ABSTRACT

This report is meant to provide assistance to the Government of Tunisia in developing action plans for the implementation of employee stock ownership plans (ESOPs) as part of the government's privatization program and to recommend methods for utilizing USAID/Tunisia's ESOP loan guarantee facility. This ESOP initiative is meant to respond to the charge that the privatization program is concentrating ownership in the hands of a few. ESOPs are viewed as a key component in expanding ownership and enhancing economic performance while also contributing to the goal of promoting social solidarity.

The report presents an historical overview of privatization in Tunisia, including a review of the legal, economic, financial and social environment as it pertains to the implementation and operation of ESOPs. The obstacles to ESOPs are summarized and recommendations are made for removing those obstacles and for creating incentives for ESOPs. A procedure for establishing ESOPs is set forth, along with a series of suggested guidelines for their operation.

Three privatization candidate companies were studied and their managers interviewed. The report includes the results of that analysis along with illustrative ESOP techniques that could be utilized in each of the three companies, including an analysis of the applicability of the USAID loan guarantee program for ESOPs. Lessons drawn from experiences in other countries are incorporated into these recommendations.

Finally, the report reviews the challenges presented by the adaptation of ESOPs to Tunisia and suggests a series of possible means for adapting the ESOP concept to expand ownership more generally.

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1. INTRODUCTION

The objective of this report is to provide assistance to the Government of Tunisia (Government) in developing action plans for the implementation of employee stock ownership plans (ESOPs) as part of its privatization program. Coopers & Lybrand prepared the report at the request of USAID Tunisia under the aegis of the Trade, Investment and Enterprise Support, a project funded and managed by USAID's Bureau for Near East. The team members included Jeffrey Gates, President of The Gates Group, and Denis Langelier, a tax partner from Coopers & Lybrand's Montreal office. The team was charged with assessing the environment for ESOPs and designing illustrative action plans for implementing ESOPs in three enterprises selected for privatization by the Government. To the extent possible, the objective was to utilize the available A.I.D loan guarantee facility. The team's in-country research was completed in March 1993.

The ESOP concept is new and quite different from anything seen before in Tunisia. Properly introduced and implemented, it can assist policy-makers in addressing a broad range of social and economic issues, including fostering social solidarity by contributing to the democratization of capital ownership. While Tunisia must craft its own adaptation of the ESOP concept, the goal common to the various employee ownership mechanisms is the same: to facilitate widespread participation in the private ownership of income-producing capital assets. This suggests that the government -- the only institution with sufficient resources and a broad social mandate -- must be involved in the evolution of ownership-broadening financing techniques.

More than 70 countries now have an active interest in adapting the ESOP concept, ranging across the full spectrum of political and economic environments. This widespread interest reflects the fact that policy-makers worldwide are beginning to recognize that political and economic rights are inextricably intertwined. Political rights protect the individual's right to civil liberty and freedom *from* government impediments or interference (i.e., what the government should *not* do). When the focus shifts from liberty to its economic counterpart, a decent livelihood, the government's obligation shifts from political to economic rights. Securing economic rights requires *positive* action, including legislative enactments designed to foster broad-based economic participation while discouraging undue concentrations of such power.

In attempting to nurture broad-based economic participation, particularly through privatization, policy-makers worldwide increasingly consider it ill-advised to shift from public to private ownership without including as significant owners those whose efforts are essential to the future success of privatized companies, particularly a company's employees. Yet transferring the ownership of state-owned property solely to current employees may well be regarded as unfair to those citizens who are not employees, particularly in the case of the larger, more successful companies. Thus, applying a combination of ownership-broadening techniques may provide the best formula for attaining social solidarity while also contributing to the company's operational needs. For both employees and non-employees, however, policy-makers must address how this goal can be reached among populations widely lacking in significant financial resources. As privatization-related programs have progressed, this dilemma in being addressed via a number of variations on and complements to the ESOP concept.

The goal of the ESOP concept (and its various financing techniques) is to facilitate the broadest possible participation in the ownership of income-producing capital assets. This participation, in turn, is intended to help create a broader constituency for market-based solutions to economic and social problems. In short, the political goal of the ESOP concept is to build a stronger foundation for political democracy by making it possible for more citizens to become less economically dependent on the government. At the same time, the ESOP concept offers a mechanism with the potential for enhancing economic performance, due to the potential impact on the company and the economy of increased motivation, productivity, and profitability, as well as the potential for increased tax revenues.

2. THE ENVIRONMENT FOR ESOPS IN TUNISIA

The Tunisian privatization program, launched in 1986 as part of the Structural Adjustment Program, has involved primarily the sale of assets of state-owned enterprises (SOEs) in financial difficulty. Other techniques have also been used, such as share offerings and leveraged buyouts, though only on a limited scale due partly to the limited liquidity of Tunisian capital markets and the lack of technical sophistication and expertise. Privatization has been a marginal phenomenon thus far; the share of total GDP added by public enterprises remains at about 30 percent.[1] A minimum of ten privatizations per year is the target for the next five years.

The privatization program has become susceptible to the charge that primarily the wealthy and the well-connected benefit from divestiture efforts. The Government has requested assistance in the design of an ESOP component of the privatization program to contribute to the "democratization" of capital ownership, one of the program's primary goals. Among potential small investors are employees of SOEs who wish to participate but who lack the financial resources and the organization required to take advantage of the opportunities offered by privatization. ESOPs are expected to contribute to broadening ownership, increasing productivity and decreasing opposition to privatization by various constituencies.

USAID/Tunisia is continuing its support for the privatization program through assistance under the Private Enterprise Promotion Project. In addition, USAID has established a loan guarantee facility through a Tunisian private bank (*Banque Internationale Arabe de Tunisie, BIAT*). Under this facility, USAID will guarantee 50% of the principal amount of loans made by BIAT to support employee purchases of government-owned shares or assets of privatized enterprises. The guarantee limit is US$3 million (i.e., a covered portfolio of $6 million).

In order to evaluate the context for adapting ESOPs and the loan guarantee facility, the team was asked to examine the legal, economic, financial and social environment, including the incentives and obstacles to the implementation of ESOPs. The team's analysis is presented below.

2.1 Legal Environment

Although the Government has implemented ESOP-like programs in several privatized companies, there are presently no laws, regulations or guidelines governing ESOPs in the sense of requiring broad-based employee participation, imposing limitations on the relative amount of benefits

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[1] Saghir, Jamal. *Privatization in Tunisia*, CFS Discussion Paper Series, The World Bank, Washington, D.C., January 1993.

employee-participants may receive under the plan, or governing the distribution of ESOP benefits.

The privatization law was amended early in 1989 to state three objectives: (i) development of a larger number of small shareholders, (ii) development of the Bourse (*Bourse de Valeurs Mobilieres de Tunis*) and (iii) the intent to sell shares to employees.[2] This legislation also combined in a single body -- the Committee for the Reform and Restructuring of Public Enterprises (French acronym, CAREPP) -- the privatization authority formerly spread over three ministries. This framework consolidated and institutionalized the privatization program and retained responsibility for the program at the higher levels of the government (for example, CAREPP is chaired by the Prime Minister). Responsibility for privatization follow-up was recently transferred from the Prime Ministry to the Ministry of Plan. For political and social reasons, the legislation does not use the term privatization.

Related legislation was enacted in March 1989 with the primary objective of developing the domestic capital market by stimulating the Bourse and by channeling private savings into investments in the productive sectors.[3] This legislation also restructured the Bourse, redefined its functions, provided a new legal framework for the securities sector, described the role of financial intermediaries and allocated authority to the Bourse over the issue, sale and distribution of securities.[4] Current rules of the Bourse permit the provision of incentives, including free shares, discounted shares and delayed purchasing requirements, though CAREPP approval would be required to use such incentives in conjunction with privatization.

This securities legislation has several unique features, including authority to require the registration for sale of securities not listed on the Bourse.[5] All corporations are required to file with the Bourse their approved financial statements, the corporate minutes of the general assembly and their auditor's report.[6] An ongoing revision of the Tunisian investment code reportedly will include several similarly unique features. A Ministry of Finance representative advises that it is late in the process to suggest changes to the currently pending legislation.

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[2] Law No. 89-9.

[3] Law No. 89-49.

[4] Further evidence of the desire to attract private savings into the capital market is reflected in another provision permitting listed companies in certain key sectors to pay corporate taxes at half the normal rate.

[5] The Bourse also requires that a selling shareholder in a non-public company file an acknowledgment of the transaction with the Bourse prior to selling those shares to another shareholder. This form is circulated to other shareholders to provide them an opportunity to offer a competitive bid. This acknowledgment of sale must be received prior to entering a change in the share registry. Noncompliance carries a monetary fine payable by corporate officers and directors and could result in the sale being void. Articles 92-94 of Law No. 89-49.

[6] Article 13 of Law No. 89-49. Although listed companies are required to file audited financial statements, there is very little monitoring. Thus far, generally accepted accounting principles have not been adopted although a process is underway to correct that deficiency.

Tunisian law permits an exclusion from tax for both dividends and capital gains. Both should be helpful in encouraging employees to acquire and hold employer shares, though Tunisians have very little experience in (or, thus far, desire for) investing in shares.

Law 89-9 also specifies certain fiscal and other incentives to facilitate and accelerate the privatization process. Included is wide discretionary authority granted to CAREPP, including the discretion to permit a remission of taxes on the earnings of a privatized company and the authority to grant certain individual tax reliefs to employees. Tunisian interest in investments has the potential to be stimulated by actions taken under this discretion. This discretion includes extraordinary latitude and flexibility (albeit at the cost of transparency) in designing privatizations in such a way that they can achieve stated political goals, including the goal of encouraging employee ownership.

Properly structured, this discretion could permit the ESOP initiative to proceed (at least over the short term) without the need for ESOP-enabling legislation. For example, a CAREPP-granted company tax remission could be structured to enable ESOP companies to repay stock acquisition loans on a tax-favored basis. Similarly CAREPP-granted personal tax relief could enable employees to acquire shares on a more affordable, tax-favored basis.

Recent legislation permits the use of non-voting preferred shares provided such shares are otherwise fully participatory. This legislation was designed, in part, to address the dominant business culture of tightly-closed family corporations in which outside investment is seldom sought or welcome (due largely to concerns about dilution and control). Companies are permitted to convert up to one-third of their existing shares to preferred shares. Absent this single variation, Tunisian law does not presently permit different voting rights among different classes of shares. Trading restrictions are generally prohibited. Up to 10% of a company's shares are permitted to include a redeemable feature provided the company complies with certain requirements upon redemption (described in Section 2.4).

Tunisian law permits a company's shares to be held by an "intermediate repository." For example, government bonds were granted certain tax advantages if held in such a repository for five years. These intermediate repository accounts could be adapted to serve certain ESOP purposes (e.g., to hold shares for employees pending their payment and distribution).[7] Such arrangements may include provisions similar to those that traditionally govern ESOPs, such as conditions relating to transactions and the utilization of accounts, providing for certain reciprocal engagements and providing for periodic statements of accounts. To date, these repositories have typically been maintained and managed by banks.

[7] For example, these devices have reportedly been used as a temporary shareholding device to accomplish a variety of corporate financing objectives.

2.2 Economic Environment

Overall, the Tunisian economy is fairly robust with economic growth averaging 4.3% a year during 1987-91 despite two successive years of drought (1988-89) and a drop in tourist revenue during the Middle East crisis. Per capita income was US$1,260 in 1989, rising to approximately US$1,400 by 1991. Tunisia has managed to stay current on its external debt obligations despite a ratio of debt service to exports of 24%. Foreign exchange restrictions are scheduled for phase out during the Government's VIIIth Development Plan (1992-1996). Reform of the labor code is anticipated and special incentives for investment will be rationalized by the adoption of a pending unified and harmonized investment code.

The VIIIth Development Plan envisions average annual GDP growth of six percent, based on strong expansion in manufacturing (8.7%) and tourism (22.3%). Agriculture and fishing are targeted to grow by 1.8% annually. Investment is set to grow by 10.1% a year, with just over half the total coming from the private sector.[8]

The Government has stated its intention to progressively divest itself of all state-owned enterprises in competitive sectors where the private sector is capable of assuming its role. In the early stages of privatization, the Government focused on the privatization of small- and medium-sized enterprises, which were sold largely free of liabilities and almost exclusively to Tunisian purchasers. The revenues equaled approximately half the total liabilities, with the other half paid off by a social fund, *Les Fonds de Restructuration des Entreprises Publiques* (FREP), and through cancellation or conversion of debt to equity.

Early in the privatization program, the Government did not wish to sell shares to employees, reportedly because most of the firms were in financial difficulty.[9] In addition, because of popular resistance to the privatization program, careful consideration was given to employment issues in the formulation of the privatization policy and the negotiation of individual transactions. Of the 189 public enterprises designated for privatization, more than 75% are under the supervision of six Ministries, with 68 under the supervision of the Ministry of Economy and the Ministry of Finance. One-hundred and forty companies are commercial enterprises, including utilities, railways, and other public transportation systems, oil and phosphate industries, and numerous manufacturing and assembly plants. The balance are offices and agencies that are extensions of public administration activities. The Government is also a minority shareholder in several hundred other enterprises.[10]

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[8] *Tunisia - Country Profile 1992-93*. The Economist Intelligence Unit.

[9] The Government netted approximately US$134 million from the first 37 companies privatized, 80% realized between 1989 and 1992 (source: A.I.D./Tunis).

[10] Changing definitions of SOEs have progressively reduced the number of SOEs under Government control from approximately 500 before 1985 (when 10% was the criteria) to 307 under Act 85-72 (enacted February 1992) under which the definition was based on the state holding a blocking position of 34% or more or a combined ownership of 50% or more through direct or indirect means. Law 89-9 further reduced the numbers of SOEs (to

FREP was established to cover worker redeployment and/or compensation costs, settlement of outstanding company liabilities not covered by sale proceeds (notably to the Social Security Fund), and technical assistance necessary to implement the privatization program. The proceeds from privatization are not paid over to general revenues but, rather, are paid over to FREP and used to support the privatization process, including assisting in the restructuring of other privatizable companies. The Government contemplates using some portion of the proceeds for regional development funds to finance infrastructure and training. The government generally has viewed privatization proceeds as a non-recurring revenue source that should not be used to offset recurring expenditures.

The World Bank has also made available a US$130 million loan to assist in preparing companies for privatization. Thus far, the funds have been used primarily to assist with offsetting the costs of redundancy,[11] paying creditor claims and supporting new investments (largely via FREP). These funds are largely depleted though the Government anticipates a second loan request in the near future. The prognosis for the success of such a request is mixed.

In the current phase of privatization, the Government is privatizing more successful companies; a primary policy objective is to promote broad-based ownership, including employee stock ownership. This phase of the privatization process, which first began in 1992, will generally be applied to the larger enterprises, such as cement plants, food manufacturers, shipbuilding industries and construction materials companies for which it is anticipated that international buyers will be among the target group in many cases.

At present, the Government envisions two types of situations that would lend themselves to ESOPs: (1) large companies in which ESOPs would acquire 10-20% of the shares, and (2) smaller companies in which an ESOP would be used to acquire all or a substantial portion of the shares. Some view this approach as particularly appropriate for service companies due to low required levels of investment and the absence of any need to develop a foreign market or to introduce specialized technology.

In its most recent privatizations, Government policy has been to sell SOE shares to the highest bidder via public offerings, in part to ensure transparency of the privatization transactions. Employees are provided an opportunity to participate in this bidding process (for either shares or assets) provided they can match the best offer.

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189) by generally requiring 50% state ownership before such control could be exercised. Saghir, *ibid.*, p. 7.

[11] Although the circumstances can vary and considerable regional discretion is involved in setting amounts, Article 22 of the Tunisian Labor Code requires, after six months employment, a severance payment equal to one day's salary and benefits for every month of service with a maximum three months total. Collective bargaining contracts frequently increase this figure, particularly for state-owned enterprises where it is reported that redundancy payments are typically one and one-half month's pay for each year of employment plus a 30% bonus.

The Government currently receives regular requests from employees to consider including them in privatizations. So long as the company is in the group of "privatizables", the Government intends to consider all such requests. All SOEs operating in the commercial competitive sectors are considered to be privatizable. All others are considered "strategic" and are currently omitted from the list of 189 eligible SOEs.

Where an SOE operates as a monopoly, the Government intends for the company to remain in the public sector though the Government also favors introducing elements of competition by encouraging private competition (e.g., by permitting the entry of competitive services in urban transport).

2.3 Financial Environment

Tunisia has a number of potential resources for financing ESOPs. Key resources include: Tunisian banks, the Bourse, and the potential savings and income of Tunisian employees. An additional and relatively new resource for financing ESOPs is available through the USAID Privatization Guarantee Facility established with the *Banque Internationale Arabe de Tunisie* (BIAT). Each of these resources is described briefly below.

The Tunisian Banking System: The bulk of Tunisia's financial capacity resides with the banks and the Bourse, with the banks accounting for approximately 95% of that capacity. The Tunisian banking system is comprised of 13 commercial banks.[12] Banks are permitted to hold company shares up to a maximum 30% of a company's equity.[13] Financial intermediary services remain largely undeveloped. Although each of the 13 banks also operates a stock brokerage subsidiary, their services are offered more as a courtesy to customers than as a commission-driven business presently capable of stimulating stock market activity or development. Four corporations (plus one individual) also offer brokerage services.

Few resources are available to promote investment (e.g., financial analysis, reporting, market research, etc.). Transaction-based fund raising is virtually non-existent due to the absence of investment banking firms or transaction-oriented brokerage firms. This environment offers a limited number of techniques for facilitating project finance and creates for privatization the difficulty in financing divestitures by mobilizing sources of funds external to the enterprise.

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[12] The Government holds a blocking position in five of the thirteen commercial banks (i.e., via a 34% stake, enabling it to block key issues requiring a two-thirds vote on those issues identified as extraordinary in the corporate by-laws such as sale of the company, liquidation, merger, going public and other major decisions).

[13] In addition, no more than 10% of a bank's capital can be invested in one company (though the use of intermediate repositories reportedly provides a means for circumventing this rule). Also, a bank's aggregate equity participations plus fixed assets (i.e., real and depreciable property plus intangible assets) may not exceed 75% of the bank's net funds -- i.e., bank capital plus reserves less non-performing assets and reserve deficiencies (by Central Bank analysis).

Banks look largely to collateral and to guarantees when making loans, as financial statements are viewed as largely unreliable. The Central Bank requires that banks give priority to certain sectors (agriculture, exports, small and medium enterprises, energy savings sectors and crafts) and that they invest at least 10% (recently reduced from 17%) of their capital in such sectors. In return, the banks are provided preferred access to Central Bank refinancing.

Tunisian banks cannot make home loans in excess of TD 30,000 per borrower and construction loan portfolios cannot exceed 2% of total lending. A government bank is designed specifically for real estate promoters and home purchases, with the commercial banks generally participating on a complementary basis (e.g., via second mortgages). Although Social Security Funds are available for home loans, the bulk of those loans are reportedly made largely to government employees with loans generally repaid via payroll withholding.

The institutional investor area is not yet well developed. Ten insurance companies are presently in operation, with STAR, a Government-owned company, accounting for over 40% of premiums. Most insurance company funds are invested in Government and bank bonds. The insurance companies indicate a potential capacity to absorb over US$20 million per year in stock offerings.[14] Tunisia has two pension funds: CNRPS for Government and public sector employees (500,000 members and resources in excess of TD 250 million) and a private pension fund, CNSS, with assets in excess of TD 300 million. Thus far, their investments are similar to those of the insurance companies though this is expected to change with development of the capital markets.

If private sector lenders are to participate in support of ESOPs, Ministry of Finance personnel suggest that a key issue is the source of the guarantee for such financial assistance (e.g., will the bank be satisfied with a pledge of company assets or will it also require a personal guarantee?). For the most part, only senior managers are considered creditable.

The official inflation rate is 5.5%. Interest rates are in the range of 14% to 16%. The money market rate is currently 11%. Banks are permitted to charge any rate provided the average bank margin is no greater than 3% over prime.[15] High interest rates have significant implications for interest in using borrowed funds to acquire shares, including use of the USAID loan guarantee facility.

The Bourse: Tunisia has approximately 6000 corporations of which approximately 160 have offered either shares or bonds for sale. The Bourse includes 17 companies (including 10 banks) listed on the regularly-traded "Permanent Market" with the balance listed on over-the-counter trading ("Occasional Market"). The Permanent Market consists of three boards: the *Premier*

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[14] "Private Enterprise Promotion - Privatization Component" prepared for USAID/Tunisia by Jean-Pierre Schwartz, consultant to Coopers & Lybrand (May 1992).

[15] Although this margin requirement is not based on a weighted average, the pressures of competition among lenders reportedly are effective in keeping this margin within the prescribed range.

Marché, the *Second Marché* and the *Marché Obligatoire*. The *Premier Marché* consists of 11 companies, including 10 banks. Thus, the market is characterized by bank share attributes: high annual dividends, regular issuance of bonus shares and periodic secondary offerings. The *Second Marché* is comprised of six companies, including four industrial companies.

Although the Bourse has been in operation for more than 20 years, it has an extremely thin trading base of TD 28 million in shares in 1991 or 4.5% of total market capitalization (of some TD 600 million). Funds totalling approximately one percent of total private savings have been channeled into the exchange. Trading volumes remain relatively low (TD 68 in 1990), with negative implications for liquidity which, in turn, is likely to negatively impact interest in share offerings and/or depress the attainable price of initial offerings of SOEs.

The Bourse has an education/promotion campaign underway, including television advertisements coinciding with evening news programming. The Finance Ministry predicts that the stock market will be able to absorb some US$100 million in privatization stock offerings over the next year. Bourse personnel agree provided the companies are well-marketed.

Savings: Tunisia reportedly has a savings rate of approximately 20% of GNP. Currently, individuals have approximately TD 2.5 billion in liquid bank savings while another TD 2.8 billion is held by private enterprises comprised of companies, 13 banks, 15 mutual funds (including one specializing in privatizable companies) and one private pension fund. One of the key challenges of the present privatization strategy (as well as one of the primary goals of privatization) is to find mechanisms for transferring these savings into a revitalized stock exchange in order to create the liquidity for financing a progressively larger number of privatization transactions.

Both this goal and the goal of broadening ownership permeate recent financial legislation. For example, current law allows a 50% reduction in the corporate income tax rate (generally 35%) to companies that become listed on the primary or secondary exchange of the permanent market provided (i) such companies operate in one of three designated sectors (agriculture, industry or tourism) and (ii) at least 20% of their capital is owned by shareholders who individually own less than 5% each.[16] In addition, the Government has broad discretionary power to grant tax remissions to selected companies. To date, that relief generally has been reserved for export companies.

Income and Wages: Employees of state-owned enterprises generally lack the personal financial resources (and the organizational capacity) to acquire significant amounts of shares. Compensation is generally set within a fairly constrained range and annual per capita income is quite modest. As a general rule, top managers are interested in purchasing substantial amounts of shares though the Government has been resistant to the idea of management buyouts.

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[16] Article 37 of Law No. 89-49 and Article 51 of the corresponding regulations. This incentive is presently scheduled to expire March 8, 1994.

Employees are generally paid between 13 and 15 months pay for each 12 months of work. This supplemental/bonus element of compensation may be a potential source of funds for share purchases. For example, the Government supported employee purchases of shares with such funds in the privatization of SITEX.[17] Such social funds are commonly accumulated for a variety of uses, including employee illnesses, weddings, funerals, etc. The Government also supported employee acquisitions of fishing trawlers whereby 35 such trawlers were sold to 67 people (typically a ship's captain and a mechanic) with the transactions financed by the Ministry of Agriculture via a fund established for that purpose.

Employer social security contributions are 19% of base payments to employees (plus an additional 6.25% by employees). Currently, these funds have excess liquidity and are available for employees to borrow against to make real estate investments or to purchase a car (at 8.5% vs. the current 14% to 16% commercial rates). There is a difference of opinion within the Ministries regarding whether such funds should be considered a source of financing for employee participation in privatizations. It appears that current law would permit employees to indirectly access such funds for stock purchases (e.g., by borrowing against an otherwise allowable asset such as a home).

The Government prefers to be paid immediately for those shares or assets that it sells though it is reportedly willing to consider a wide variety of possible alternative financing arrangements to support employee participation in privatization, including permitting installment payments, accepting a note for deferred payments and allowing lease-purchase agreements[18] with all or a portion of those lease payments being credited toward the purchase price. However, the Government currently does not have the means either to become a direct lender or to administer such financial arrangements. Also, the Government does not wish to substitute itself in place of commercial lenders. It also fears an onslaught of loan applications should it be viewed as a lender.

USAID ESOP Loan Guarantee Facility: An additional resource for financing ESOPs is available through the USAID Privatization Guarantee Facility. This facility was established with the assistance of the Office of Investment in USAID's Bureau for Private Enterprise, and is housed with the *Banque Internationale Arabe de Tunisie* ("BIAT"), a privately-owned bank organized and operating in Tunisia. BIAT has provided financing and advisory services in Tunisian privatization transactions for the past four years. The $3 million Privatization Guarantee Facility is specifically dedicated to financing employee stock ownership stakes in those enterprises being

[17] It is instructive to note that of 1567 SITEX employees, 560 (36%) elected to participate in this stock purchase scheme whereby their social funds were applied to acquire shares repaid over a 2 to 5 years period from future year-end bonuses (without interest). Among those participating, 18% of the shares were acquired by rank-and-file employees, 9% by supervisors, 21% by mid-level managers and 52% by top managers. It is also instructive to note that the employees were first offered shares at a discount which they bought and immediately sold at a profit. They were then offered a second tranche at market value which they reportedly continue to hold.

[18] Leases have been utilized in the privatization of at least four hotels.

privatized. The facility, established in 1991, has a seven-year duration, with a phase out date of March 15, 1998.

With this facility, USAID will guarantee 50% of the principal amount of loans made by BIAT to support the employee purchase of Government-owned shares or assets of enterprises being privatized. The maximum principal amount for a given loan transaction is the local currency equivalent of US$500,000 subject to the number of borrowers involved in the buyout (see below). The total principal amount of loans outstanding at one time may not exceed US$6 million. Although USAID has discretion to increase the maximum loan amount per borrower, it appears that USAID originally envisioned this fund being available to assist twelve companies (i.e., twelve companies at a maximum US$500,000 per company).[19]

The loan guarantee requires USAID to pay to the guaranteed party an amount equal to 50% of losses incurred on qualified loans. In order for the loan to qualify, the borrower must be either a Tunisian employed by a state-owned enterprise or a private Tunisian organization comprised solely of employees of state-owned enterprises. The facility may support employee ownership in either complete or partial privatizations provided that the Government retains no more than 25% of the equity. With USAID's agreement, the loan may be used to finance more than 15% of the shares of a privatizing enterprise.

The total principal amount of loans outstanding at any one time to any one borrower who is an individual (or an organization comprised of one individual) is limited to the local currency equivalent of US$150,000. The limit increases to US$300,000 in the case of a borrower organization comprised of two individuals and to US$450,000 where the organization is comprised of three individuals.

The loan must be made at a market rate of interest (currently 14% to 16%) and no portion of the loan may be financed with subsidized funds or guaranteed by a governmental authority (i.e., other than USAID). However, while the loans must be made at market rates, the government of Tunisia could offer shares at a substantial discount to employees in order to offset high interest rates. The loan may be extended only after the project has received an USAID environmental clearance or exclusion.

An evaluation of the impact of the facility will take place at the end of the first 3-year period. The objectives of the evaluation are to determine: (i) the progress that has been made under the privatization program in Tunisia and its overall success; (ii) the level of support provided by the financial community in Tunisia for privatization activities involving employee stock ownership; (iii) the degree of influence on BIAT's lending activities as a result of this facility; (iv) the number of employees benefited by this facility; (v) the success of the companies newly privatized under this facility; and (vi) the new employment opportunities generated by those companies created in particular for women as both employees and entrepreneurs.

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[19] This mission originally envisioned the study of twelve companies though the scope was narrowed to three.

2.4 Social Environment

The Tunisian work force numbers approximately 2 million (of an overall population of approximately 8.4 million). More than half the population is under age 20. Tunisians have very limited experience in owning "paper" assets (such as shares representing partial ownership of a fishing fleet). They generally are more interested in owning the underlying tangible asset (such as a fishing boat). Issues of attitudes and incentives may well hamper the privatization process.

The public sector is heavily unionized whereas the private sector is only partially unionized. Compensation levels are generally higher in the public enterprises. To date, the privatization process has not resulted in the loss of a union in any of those enterprises privatized. One major union (UGTT) bargains countrywide every three years, a process that was ongoing during the period of study. Although the unions initially opposed privatization, that resistance has changed to negotiation as the privatization process has gone forward in individual companies.

The primary fear of the unions has been the issue of job losses due to redundancies. However, those fears have reportedly proven to be largely unfounded. For example, of the 37 privatizations to date[20] (affecting nearly 7,500 employees), approximately 1,400 jobs were lost, though all but approximately 100 were due to voluntary departures, early retirements, etc. Of the 100 jobs losses, some of those have since reportedly been rehired. The jobs of redundant workers have often been preserved with incentives provided to purchasers to maintain staffing levels though reductions in salary and benefit levels are not uncommon even if the jobs are preserved.

Union opposition is no longer widely perceived as a significant obstacle to privatization though it was reported that both the Government and the unions could be considerably more forthright in dealing with one another on privatization issues. Information regarding privatization is shared directly between the Ministry of Social Affairs and the unions impacted by the privatization program. The team was unable to gauge employee attitudes regarding privatization during this mission due largely to the fact that union leaders were involved in negotiations.

The Government does not view privatization as simply an exercise to rid the Government of poor-performing companies. The Government often requires from prospective buyers their plans for development, expansion and modernization. When privatizing via a negotiated sale, the government seeks the participation of solid financial partners. Similarly, the introduction of ESOPs is viewed as part of an overall privatization strategy, including expanding participation so as to solidify support for the privatization program by promoting an "equitable" distribution of those assets (by "democratizing" capital ownership). In addition, the ESOP program is consistent with President Ben Ali's priority of focusing on initiatives designed to foster social solidarity.

[20] Privatizations completed as of September 30, 1992 (letter to Director of USAID/Tunis from Prime Ministry responding to letter of October 27, 1992).

A recent World Bank study of privatization in Tunisia[21] summarizes the history of privatization to date and the challenges presented by this latest phase in the program as follows:

> Throughout the first phase of the Tunisian privatization program, public enterprise assets were sold to a small group of buyers with access to financing, government officials, and relevant information. The nature of Tunisian capital markets, the small size of the enterprises in question, and the unsophisticated "all or nothing" character of early divestitures contributed to ownership of elements of former public enterprises by those wealthy enough to purchase whole blocks of assets at one time. Traditional business practice in Tunisia has encouraged such owners to maintain close control of these assets, hampering growth of liquid investment instruments or wider participation of private investment.
>
> With the increasing sophistication and size of the deals to be attempted in the second phase of the Tunisian privatization program, the Government will move away from this simple approach. The Government must, however, provide preferences aimed at multiplying ownership, such as preferential arrangements with public enterprise managers and employees, sales of common shares, or public distribution of shares. Until institutions like the Bourse are strengthened and effective incentives are established, a wider capital market development will not be achieved.
>
> In step with capital market development, an educational effort must be made to support the goal of broader share ownership. It will be necessary to promote investment in securities to the general public, articulate the role and functioning of financial markets, indicate sources of information and guidance on investing, and publicize regulations which protect small investors. Similar educational efforts might be undertaken on the corporate level, explaining the advantages of expanded capital ownership, and easing traditional biases toward closely held companies.

The Government seeks assistance in learning how to implement ESOPs and wishes its initial ESOPs to be implemented in highly visible privatizations. It is anticipated by both the Government and USAID that further technical assistance will be required in this area if ESOPs are to be implemented on a broader basis, including assistance in the crafting of legislation and regulations required to promote such schemes.[22]

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[21] Saghir, *ibid.* at pp. 22-23.

[22] "Private Enterprise Promotion - Privatization Component" prepared for USAID/Tunisia by Jean-Pierre Schwartz, consultant to Coopers & Lybrand (May 1992).

2.5 Rationale for ESOPs

The privatization program has been susceptible to charges that it is concentrating ownership in the hands of a few. In order to overcome such perceptions, there is a need to expand ownership in privatized companies to the broadest possible audience. Among potential small investors are the employees of state-owned enterprises who wish to participate but have thus far not participated to any significant extent.

Numerous conditions in the Tunisian economy point to the need for ESOPs and for ESOP-related financial assistance if broad-based Tunisian ownership (including broad-based employee ownership) is to be the result of the privatization process, including:

(a) The demonstrated inability of traditional privatization techniques to promote widespread Tunisian ownership (including significant employee ownership);

(b) Limited access to financing by those targeted for participation (such as employees of state-owned enterprises);

(c) Relatively high interest rates;

(d) Relatively modest income among workers and an accompanying lack of household discretionary funds to invest in privatization;

(e) The lack of employee organizational capacity to participate in privatizations;

(g) The tendency of traditional financing techniques to concentrate ownership (i.e., in the absence of policy intervention).

In order to provide a context for the recommendations in this report, it is essential first to understand the impact on ownership of traditional corporate financing techniques. That requires an understanding of the sources of corporate funds. Practically all corporate funds (whether to finance new capital or to finance transfers in ownership) are generated within a "closed system of finance."

Traditional financing techniques are designed to finance capital -- not to finance the creation of new owners. These are very different goals. If Tunisian policy makers want to see the two goals combined, they must be willing to implement policy initiatives that can promote ownership-expanding financing techniques. Absent such initiatives, this traditional "closed system of finance" will tend to concentrate ownership and income.

Also, it is important for privatization policy makers to understand that this "closed system" begins to operate once a company is privatized. Thus, if the goal is to promote broad-based domestic ownership patterns, that goal can only be achieved with policy initiatives designed both to attain and sustain those patterns. Absent that political will, traditional techniques of finance (including traditional privatization techniques) will tend to create ownership patterns typical of the oligarchies of Central and South America and the Caribbean, with the likelihood of an accompanying erosion of political support for privatization.

It should also be understood that providing investment incentives to this "closed system" does not open the system to new participants. For example, U.S. style "supply-side" economics (comprised largely of deficit-financed reductions in corporate tax rates and accelerated depreciation allowances) only accelerates this closed system's innate tendency to concentrate asset ownership. Also, by failing to promote broad-based economic self sufficiency via broad-based asset ownership, the closed nature of this system tends to exacerbate fiscal strains. These traditional "closed system" financing techniques are "on automatic;" they will not change without policy intervention.

The ESOP financing concept focuses on the employment relationship as the most cost-effective locale for the implementation of ownership-expanding techniques of finance -- due partly to the potential impact on economic performance resulting from increased motivation, improved labor/management relations, productivity, profitability, etc. (along with the potential for an accompanying increase in tax revenues). It is hoped that any fiscal reliefs provided to ESOP companies can also be recovered over time with an increase in economic performance and a decrease in governmental dependency.

Increasingly, privatization policy makers worldwide are viewing it as ill-advised to shift from public to private ownership without including as significant owners those whose efforts are essential to the future success of privatized companies. Yet transferring the ownership of state-owned property solely to current employees may well be regarded as unfair to those citizens who are not employees, particularly in the case of the larger, more successful public enterprises

Thus, applying a combination of ownership-broadening techniques may provide the best formula for attaining economic and social objectives, while also improving the performance of the company and increasing the dignity of working people. Policy makers worldwide are increasingly challenged to devise creative means for achieving this goal among populations widely lacking significant financial resources. The ESOP concept is emerging as one of the key components in meeting this challenge.

3. ESOP POLICIES – ACTION PLANS

The Ministry of Plan has identified three companies for privatization in which an ESOP is to be established as a demonstration project. The three companies are: (i) Autotractor, the sole distributor of Ford spare parts in Tunisia; (ii) La Ceramique Tunisienne, a producer of construction materials such as ceramic tile and brick; and (iii) Tunis Air, Tunisia's national flag carrier.

Before examining these companies, this chapter provides suggestions for building a foundation for the development of ESOPs in four areas: (1) ESOP operating principles, (2) the formation of ESOPs; (3) ESOP policy initiatives, and (4) ESOP operating guidelines. Chapter Four then examines each of the three selected enterprises, assesses the feasibility of adapting ESOPs to their individual circumstances and proposes an action plan for each company. Lastly, Chapter Four examines some the challenges unique to ESOP development, particularly in the Tunisian context.

3.1 ESOP Operating Principles

Absent a legislative and regulatory scheme governing ESOPs on a systematic basis, the Government should implement enforceable guidelines for ensuring that ESOPs are established and operated to achieve an appropriate balance among the interests of the various parties involved in the process, including the interests of employees, managers, lenders, companies and the Government.[23]

The implementation and operation of a successful ESOP initiative should be based on three key principles: (1) participation, (2) limitation and (3) distribution. These principles are described below.

3.1.1 Participation (or the "democratic principle")

Purpose: Where the public sector encourages private capital accumulation, that encouragement should be accompanied by a requirement that a broad base of citizens participate in and benefit from that policy. In the case of an ESOP, this suggests a requirement that a broad group of employees be included as ESOP participants (versus, for example, limiting participation to company executives). Thus, guidelines should ensure that an ESOP sponsor company does not qualify for public support (e.g., in the form of tax reliefs or other preferences) unless a broad base of the company's employees are participants in the plan.

[23] The complexities and uncertainties of specific transactions suggest that the divestiture process cannot be planned in intricate detail. However, to ensure fairness and prevent abuse, the ESOP component of privatization requires a set of policy guidelines, regulations and/or legislation applicable across a broad range of circumstances. An illustrative example of such guidelines appears in Section 3.4.

3.1.2 Limitation (or the "anti-monopoly principle")

Purpose: Any Government-sponsored ownership participation effort should be structured to ensure that the bulk of the benefits are not monopolized by a few of the ESOP participants. In addition, this principle reflects the principle that although government policy will assist employees in gaining an ownership stake in their company, that assistance is limited (for example, with an annual limit on the amount of benefits claimable by individuals and by the ESOP-sponsoring company).

3.1.3 Distribution (or the "private property" principle)

Purpose: This principle encourages the generation of an ownership income for those who gain a private property interest in their employer. Generally, this means an encouragement for the company to distribute that income in the form of dividends and/or profit-sharing. This serves several functions. First, it helps to supplement the participants' labor income. Second, it begins the process of educating workers regarding the rights and responsibilities that accompany the acquisition and nurturing of income-producing private property.

Recommendation: These operating principles should be reflected in interim guidelines governing the establishment and operation of ESOPs implemented as part of this demonstration project -- or until such time as a legislative scheme can be designed and implemented that will serve this function. Properly implemented, these principles can assist in addressing a key issue that stimulated the request for this report: the tendency of traditional privatization financing techniques to transfer ownership from government ownership to a narrow base of private owners.

3.2 ESOPs - Form and Formation

The establishment and operation of an ESOP in the three targeted companies has certain implications, some of which are not obvious. For example, unlike other benefits provided to employees, an ESOP can be designed both to provide employee benefits (in the form of shares) and to operate as a corporate financing technique (to assist in funding the transfer of shares from state to private ownership).

The Government's employee stock ownership initiative need not take the form of the ESOP as a technique of corporate finance (i.e., using some form of credit to "leverage" an acquisition of shares for employees). The ESOP could instead be the passive recipient of employer shares or of employer cash to buy shares (i.e., via an "unleveraged ESOP"). Or the initiative could, for example, take the form of an employee stock purchase arrangement. For example, the USAID loan guarantee program could be targeted not to the ESOP or to the company but, instead, to individual employees. Some combination of forms may be appropriate in certain companies. The company-specific "action plans" (explained below) include an illustrative sampling of techniques designed to promote employee ownership participation. Regardless of the funding technique chosen to promote employee ownership participation, it is recommended that the legal form of this participation be an intermediate repository governed by the key ESOP operating principles.

An ESOP is more than an employee benefit plan. Depending upon the form it takes, it can also become a key component of the financial architecture of the sponsoring company. Thus, before implementing an ESOP (particularly one implemented as a financing technique), a study should be conducted to determine how its implementation will impact the company, both in the short, medium and long-term. This study should include a traditional feasibility study that includes a valuation of the shares (where the shares are not actively traded) and a liquidity study to project the cash requirements -- both for paying for the shares and, in the case of unlisted companies, for repurchasing the shares. This pending "repurchase liability" can be particularly troublesome if not accurately projected and adequately accommodated.

One of the threshold issues is how much input employees should have in formulating the terms of an ESOP. In the case of the three target companies, adherence to the suggested ESOP guidelines should ensure that any ESOP established by unilateral action of the company and/or CAREPP will operate to the benefit of the employees. Nevertheless, it is recommended that employees and their union representatives be consulted early in the process and that they remain involved as the ESOP is designed and implemented. The formation phase of an ESOP can be crucial in determining its acceptance by employees and, ultimately, its impact on company performance. Ideally, employees should not only feel a sense of ownership participation in the company, they should also feel a sense of participation in the privatization process.

Where initial employee contributions will be a part of the ESOP, the company should undertake an intensive promotion and education effort prior to seeking the employees' participation. In addition, an early assessment must be made of the extent to which company-related information should be shared with the employees.[24]

Employee ownership participation also presents a delicate balancing of the interests of other parties to the transaction. For example, where other investors are involved, concerns may arise about sharing ownership with employees, particularly in the Tunisian environment with its tradition of tightly-controlled family businesses. From the perspective of employees with a minority stake, this also creates the challenge of protecting that minority interest against potential abuse by majority shareholders.

Similarly, where an ESOP draws on the company's cash flow to generate employee ownership, that may present an unacceptable burden on financial returns anticipated by other investors. Also, where the company is required to repurchase shares distributed to employees (for example, when there is no active market for the shares), this repurchase liability may be a disincentive

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[24] Legal requirements may mandate a certain level of disclosure (for example, requirements of the Bourse may require prospectus-type disclosure where employees are making an investment decision). Competitiveness considerations may impact the advisability of publishing certain types of sensitive information.

for other investors. Even where there is less concern about financial participation, non-employee investors may have concerns about employee participation in other aspects of ownership, such as information sharing or participation in company governance.

Also, these concerns will differ depending upon the post-privatization ownership structure. For example, the concerns may be very different in Tunis Air where the Government will retain a majority stake than in Autotractor where employees may be the only owners. Those situations, in turn, will be different from Ceramique Tunisienne where the concerns of new private investors must be taken into account.

These concerns suggest that, at this initial stage in the ESOP implementation process, ESOP policy should remain flexible in application while adhering strictly to key ESOP principles. The pragmatic needs of the privatization process should be balanced with policies protective of the interests of all parties involved.

Because of the potential legal issues that accompany the establishment and operation of ESOPs, ESOP-sponsoring companies should seek the advice of counsel. Employee representatives may also need counsel to advise them regarding various ESOP design options, including the costs and benefits of each.

In addition, an administrative procedure should be established to ensure the proper accounting of employees' ESOP interests pending their distribution to participants. That administrative service may be provided either within the company or contracted to outside service providers (e.g., a bank or a brokerage firm). The administrator should be capable of tracking the cost of the shares as well as dividends and any miscellaneous funds that may be allocated to participants' accounts (computer software is readily adaptable to this purpose). Any changes in the law (or guidelines, etc.) impacting ESOPs should be reflected both in the ESOP documents and in the administrative procedures.

An ongoing employee communication (and education) program should be designed and implemented, including not only an initial summary description of the plan but also more extensive, regular and sustained communication. It is recommended that this information include periodic detailed financial information on the company, along with the training essential to help employees understand that information. Tunisian law imposes a "training" tax on companies that is remitted if the company expends those funds on employee training. Such training should include the training essential to assist employees in understanding not only ESOPs but also other aspects of ownership participation relevant to the company (for example, to assist employees in understanding of key financial data).

An annual appraisal should be undertaken where the shares of ESOP companies are not actively traded on the Bourse. Current appraisals are needed to determine current share values and to predict cash requirements in case of events triggering a repurchase obligation. Valuations should be performed by independent qualified professionals.

International practice suggests that ESOPs have the potential to have a substantial positive impact on company performance. However, that impact is not automatic. The research suggests that this potential is best realized in those companies that combine both financial participation (via an ESOP) with workplace participation. That workplace participation can take many forms and goes by many names such as work teams, total quality management, employee empowerment, continuous improvement and other new management systems designed to promote an increased flow of information not only from top to bottom and bottom to top in the company but also laterally among both related and unrelated work groups, and from customers and suppliers.

The ESOP concept represents an attempt to encourage economic systems in which more people feel they are a part. The financial component is one key ingredient; workplace involvement is another. That involvement can range from informal participation to participation that is quite structured. It can involve an expansion of employee participation that ranges from input into the design of the workplace to input into decision-making by the board of directors via employee representation on the board.

The current privatization process includes several structural deficiencies that should be addressed in order to enhance the likelihood of ESOPs being successfully implemented in Tunisia. In the consideration of privatizable companies, the selection process (and often the implementation) is based on information provided to CAREPP by state-owned enterprises that is often incomplete, unreliable and static.[25] In addition, CAREPP lacks full-time professional staff to coordinate and control the process from selection and negotiation to sale. It is recommended that technical assistance be sought and that a long-term capacity-building initiative be designed and implemented to foster the development of technical expertise within the Tunisia professional services sectors (attorneys, accountants, appraisal specialists, business consultants, etc.) to develop and provide, from within Tunisia, the technical skills required.

3.3 ESOP Policy Initiatives

ESOP policy initiatives can take a wide variety of forms. The ESOP financing concept is designed to address the practical need to make investors of those with few if any funds to invest. Thus, a "true" ESOP is designed to include a component of corporate financing, enabling employees' shares to be paid for not with employees' modest past savings or their often-meager future wages but instead (at least in part) with the future earnings of the enterprise. This "self-financing" concept is at the core of the ESOP concept. To encourage the implementation of this self-financing technique, certain policy incentives will be needed, possibly including fiscal incentives that enhance the company's cash flow available for this financing.

The fiscal incentives and other policy initiatives outlined in this section could be used across a broad range of privatizations. Many could also be adapted for the use of companies presently

[25] "Private Enterprise Promotion, Privatization Component" prepared for USAID/Tunisia by Jean-Pierre Schwartz, consultant to Coopers & Lybrand (May 1992) at pp. 9-10.

operating in the private sector, including serving as incentives for employees of recently privatized firms to acquire more shares than may have been feasible at the original date of the privatization.

The Government's ESOP initiatives should include both a short and a long-term strategy. This section sets forth the key components of a suggested short-term financial strategy, focusing primarily on incentives that could be adapted from current law (i.e., relying on CAREPP's broad discretion in lieu of legislation).[26]

These incentives are meant to be illustrative, designed to provide examples of the various methods by which government policy can encourage more broad-based employee participation in privatization. The lists are divided by subject category and, within each category, are organized in approximate order of recommended priority. Tunisian policy makers will need to narrow this list based on their assessment of political and fiscal appropriateness.

3.3.1 Fiscal Incentives for Companies

3.3.1.1 *Tax Deduction for ESOP Privatized Companies*

CAREPP's procedures could permit a tax remission for privatizable companies funding an ESOP. This tax deduction should be conditioned on the commitment of the company to apply a portion of its earnings to repay ESOP-related debt undertaken to finance the acquisition of shares for employees (a "leveraged" ESOP). Thus, ESOP companies would be able to use some portion of their pre-tax earnings to repay ESOP debt, effectively treating ESOP loan principal payments as a business expense similar to other tax-deductible employee compensation costs. Companies could also be allowed a tax deduction for expenses related to "unleveraged ESOPs" -- by allowing a tax deduction for periodic contributions of stock to an ESOP or of cash used to buy stock. Similarly, the tax relief could be allowable only within certain limits -- such as only to the extent that such ESOP expenses do not exceed 10% of the compensation of participating employees.

3.3.1.2 *Interest Expense of ESOP Debt*

The interest expense paid on ESOP debt should be allowed as an ordinary business expense.

3.3.1.3 *Repurchase Expense*

An ESOP company could be allowed a tax deduction for the expense of company shares repurchased from employees. This repurchase-related tax relief may be particularly important in the early years of ESOPs implemented in those companies where the shares are not actively

[26] Annex 2 of this report includes an overview of potential components of a long-term ownership-broadening initiative that could operate in support of the Government's broader economic and social policies.

traded (i.e., assuming employers are required to create a market for those shares). This tax relief could be limited to a specified period of time.

3.3.1.4 *ESOP Dividends*

ESOP-sponsor companies could be permitted a tax deduction for dividends paid on ESOP shares as long as those shares are held in an ESOP. This tax deduction should be allowed where dividends are either: (a) paid out to employees on a current basis or (b) used to repay ESOP debt. By limiting the tax relief to shares held in an ESOP, this tax relief would encourage long-term shareholding.

This incentive would also enable ESOP sponsors to accelerate the repayment of ESOP-related privatization debt while providing the company and its employees an incentive to make the company sufficiently profitable that it can pay dividends. In addition, the receipt of such dividends should help workers understand the rights and responsibilities associated with generating a capital-based ownership income.

3.3.1.5 *Profit-sharing ESOPs*

Companies could be allowed a tax deduction for profits shared with employees when that profit sharing takes the form of employer stock (for example, with employer contributions of shares or of cash to acquire shares). Company tax deductions could also be allowed for cash profit sharing, whether immediate or deferred (i.e., where retained in an intermediate repository for distribution at some future date). This would provide employees an opportunity to share in the success of the company without committing the company to a fixed expense.

3.3.1.6 *Reduced Corporate Tax Rates for ESOP Companies*

Corporations with significant ESOPs could be allowed a reduction in their corporate income tax rates. A precedent can be found in Tunisian tax law permitting a 50% reduction in income tax for companies that become listed on the primary or secondary exchange of the permanent market provided: (i) such companies operate in one of three designated sectors (agriculture, industry or tourism) and (ii) at least 20% of their capital is owned by shareholders who individually own less than 5% each.[27] An analogous tax preference could be offered companies with broad-based inside/employee ownership (vs. outside/investor ownership). One goal of the ESOP is to promote proprietor versus spectator ownership.

[27] See Section 2.3.

3.3.1.7 *Bonus Depreciation for ESOP Companies*

The Government could grant ESOP companies more rapid depreciation allowances and/or permit such companies to "expense" a prescribed amount of qualified investments. Such enhanced cash flow would make ESOP companies more financeable.

3.3.2 Fiscal Incentives for Employees

3.3.2.1 *Employee Tax Deferral for Employer-paid Shares*

Permit employees to accumulate employer-paid shares in their personal ESOP accounts without tax. Without this tax deferral, Tunisian tax law may require employees to pay tax on shares acquired for them by the company (similar to other types of compensation), thereby potentially requiring employees to sell shares to pay the tax. To encourage long-term shareholding, relief could be provided from the tax imposed on ESOP-distributed shares based on the amount of time shares remain in the ESOP.

3.3.2.2 *Employee Tax Credit for ESOP Combined with USAID's Guarantee*

CAREPP should encourage ESOP privatization financing structures that require employees to make a modest personal payment toward the purchase of shares, with employees allowed to claim a personal tax credit for that expense of up to, for example, 5% of compensation each year for a prescribed period following privatization (such as 5 years). While recognizing the financial reality that employees generally have insufficient funds to buy a significant amount of shares, this approach also recognizes the psychological reality that people generally place more value on that which they receive with some degree of personal sacrifice. Thus, it is recommended that employees generally be required to contribute some modest amount of non tax-relieved personal funds toward the purchase of shares (for example, by limiting the tax credit to some percentage of the cost of the shares -- such as 50%)..

To facilitate this purchase, the USAID loan guarantee facility should be used to support commercial bank loans to enable employees to borrow, for example, five years of such payments. Because personal income taxes are withheld at the source of payment, employees could be allowed an immediate tax credit for funds withheld from their paychecks to repay this debt.

Thus, for example, employees could borrow five years of employee contributions toward the purchase of ESOP-held shares. In turn, their tax credits could be pledged to service the principal portion of that loan, with employer tax withholding practices coordinated with terms of the loan repayment, including the interest expense. This also provides a mechanism for indirectly addressing the unattractive high interest rates required in the USAID loan guarantee facility. In addition, the tax credits could be targeted to favor lower-paid employees. A more direct route would be to offer the shares at a discount.

3.3.3 Fiscal Incentives for Lenders

Commercial lenders could be permitted to exclude from their taxable income a portion of the interest earned on ESOP loans (e.g., 50%). The competition for such tax-relieved loans would be reflected in lower interest rates for ESOP companies. Banks also could be granted more favorable corporate tax rates (or capital requirements) based on a formula linked to the percentage of their assets held in the form of ESOP loans.

A Tunisian precedentfor such incentives is the fact that the current Central Bank requirement gives priority to lenders in certain economic sectors[28] -- but without any requirement that those loans result in broad-based ownership of those favored businesses.

3.3.4 Other Policy Initiatives

3.3.4.1 *Discount Shares*

Permit employees to buy shares at a discount. This discount could be a direct percentage of the price or may, for example, take the form of bonus shares (for example, buy three shares, get one free).

Although discount sales offer the advantage of being totally transparent, they suffer from the disadvantage of not addressing the key problem: employees' lack of financial resources. Unless discounts are substantial, they are ineffective in fostering substantial employee stock ownership. Yet if they are too substantial, they can lose significant amounts of revenue and could generate resentment from those who do not benefit from the discount. However, the revenue implications may be offset by employee support gained for privatization.

3.3.4.2 *Employee Credit Purchases*

Several forms of employee credit purchases should be considered, including the following:

- Employee loans from commercial lenders. Where bank funds are available at reasonable rates, banks may be willing to accept a security interest (e.g., a house or a car) and arrange with the employer to withhold loan payments from employees' paychecks or from periodic bonuses. Purchased shares are unlikely to be adequate security unless they are readily tradable.[29] Present interest rates (including those available under the USAID loan guarantee facility) may make this option infeasible unless some compensating factor is included, such as selling the shares at a discount.

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[28] The favored sectors are agriculture, exports, small and medium enterprises, energy savings and crafts. See Section 2.3.

[29] Or unless, upon default, the company agrees to allow the bank to exercise an immediate put option and there is sufficient guarantee of liquidity.

- Loans (or credit) from the company. This may provide a viable strategy provided (a) such loans (or credit) are not simply reflected in higher pay or benefits and (b) such arrangements do not unduly erode returns to non-employee investors. Such schemes could take the form of installment payments for shares, with company payroll withholding and/or a pledge of bonus payments.

- Credit from the government for the purchase of shares. Employees could be allowed to subscribe for shares and pay for them over a period of time. For example, employees could be permitted to pledge five years of periodic contributions toward the purchase of shares. As with commercial or company credit, a portion of employees' periodic pay checks (or bonuses) could be pledged to service the loan with a bank contracted to provide the administrative services.[30]

- Social Security Funds. CAREPP could permit employees to borrow from the Social Security Fund to acquire shares in their employer.

3.3.4.3 *Lease/Purchase Arrangements extended to ESOPs*

Lease-purchase privatizations should be made available either directly to ESOPs or to companies sponsoring major ESOPs. The initial payment could be some fraction of the first year's lease payment (e.g., 25-50%) and the USAID loan guarantee facility could be made available for employees to borrow this amount. Some portion of such lease payments (e.g., 50%) could be credited toward the purchase price of the company. A bank could be contracted to provide the administrative services.

3.3.4.4 *Reserve Shares*

Where the employee purchase (or the company financing) of a significant tranche of shares is not feasible at the outset of privatization, the Government could reserve a tranche of shares for employee purchase within some specified period of time, with those shares sold to employees (or financed via an ESOP) at a price no higher than the value of the shares at the date of privatization.

Thus, this approach provides employees an opportunity to acquire shares in the future (a type of "option") provided the company can be made sufficiently productive and profitable that earnings are available to afford the purchase -- yet without over committing either the company or the employees at the outset of privatization.

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[30] As a variation on this theme, employees could be offered an opportunity to buy shares on an installment basis, with title to the shares transferring as each payment is made -- vs. a loan where title transfers at the outset (with the lender retaining a security interest in the shares).

3.3.4.5 *ESOP Shares as Redundancy Compensation*

The government could make a grant of shares as a non-cash form of compensation for addressing redundancies, with terminated employees being paid, in part, with an extraordinary allocation of company shares along with a preference in the liquidation of those shares. Assistance could be sought to facilitate the creation of a liquidation contract for this purpose.[31] Properly timed, such share distributions could also help stimulate trading on the Bourse (i.e., for those companies where privatization will be combined with a listing of the company on the Bourse).

3.3.4.6 *ESOPs as a First Step Privatization Initiative*

ESOPs could be utilized as a component of the first step in a privatization process.[32] This may be a particularly appropriate mechanism for Government to respond to employees' requests to consider including them in privatizations. Thus, for example, employees could be provided an opportunity to acquire shares in a state-owned enterprise

3.3.4.7 *ESOPs in State-Owned Enterprises*

Implement ESOPs in those companies in which the Government intends to maintain a majority stake, including those companies characterized as strategic.

3.2.4.8 *Purchases in Liquidation*

ESOP financing could be available to buy the assets of a business in liquidation. The USAID loan guarantee facility could be made available for this purpose.

3.2.4.9 *Privatization Proceeds In Support of ESOP Financing*

A portion of privatization proceeds could be used to support ESOP financing by, for example, funding an "ESOP Development Bank" (managed by a commercial bank) funded on a revolving basis with privatization proceeds. The USAID loan guarantee facility could be used in support of this effort. A precedent exists under current FREP guidelines where privatization proceeds are used to support the privatization process, including assistance in the restructuring of other

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[31] The Government should consider whether its next application for World Bank structural adjustment assistance should include a request for funds to support an intermediary providing a liquidity contract for this purpose. This may prove more cost effective than the current policy of relying solely on direct cash payments to fund severance costs (i.e., instead relying partly on market liquidity). A substantial portion of a US$130 million World Bank loan was used to fund such redundancy payments.

[32] For example, pending full privatization of its capital structure, a U.S.-owned railroad, Conrail, was 85% government-owned and 15% ESOP-owned -- though managed on market-based principles. This model suggests the potential for using the ESOP as an opening wedge for privatization, particularly where combined with a management contract designed to direct the enterprise based on market-based operating principles.

privatizable companies. Similarly, the Ministry of Agriculture established a fund to support employee acquisitions of fishing trawlers. Because the Government insists that privatization proceeds not be used to cover recurring expenses, policy makers should consider directing these proceeds into the support of financing techniques capable of "leveraging" these proceeds to finance employee participation in privatizations.

3.2.4.10 *Privatization Proceeds to Fund Liquidity Contract*

Some portion of privatization proceeds could be used to underwrite a liquidity contract for shares acquired by employees via ESOPs in unlisted (or thinly-traded) companies.

3.2.3.11 *Institutional Investors in Support of ESOPs and Privatization*

Provide incentives for institutional investors (i.e., particularly insurance companies and pension funds) to participate in privatizations and to assist in creating a market in the shares of ESOP companies. For example, the Government could require that some minimum percentage of pension plan assets (and/or new contributions to such plans) be invested in equities of listed companies, including investing in ESOP companies. This equity could provide a "leverageable" equity base to support ESOP debt financing. Attracting only 10% of the TD 550 million public and private sector pension plan assets into privatization-supporting investments would make available TD 55 million.

Similarly, the Government could offer (or require) that some portion of government bonds now held by pension plans be converted into equity in privatizables. The Government-owned insurance company, STAR, could be required to invest a minimum portion of its assets in a prescribed private sector manner, such as participating in privatization public offerings.[33] Initially, the Government could offer a partial guarantee for such investments (e.g., an option to convert that equity into government bonds for a limited period). Privatization participation by institutional investors could provide a powerful way to stimulate the capital markets. Enhanced market liquidity, in turn, could help attract personal savings into Bourse-listed investments and into participating in privatization public offerings.

3.2.3.12 *Ownership Training -- via Tax Remission and/or Privatization Proceeds*

To promote education, training and communication regarding ownership issues, a tax could be imposed on companies (possibly limited to ESOP companies) requiring payment of a tax that is remitted provided the funds are used to implement ownership-oriented employee training programs. A Tunisian precedent presently exists in the form of a company-based training tax that is remitted provided the company utilizes the funds for employee training. As an alternative, the Government could require that some portion of this present training tax be

[33] Where divestment of existing holdings is problematic, such investment criteria could be phased in and/or limited to new funds.

targeted for ownership training in ESOP companies. In addition, a portion of the privatization proceeds could be directed to this ownership training. A precedent exists in the form of the Government's announced intention to utilize FREP-administered privatization proceeds to finance training. Such training could be coordinated with the ongoing Bourse-directed education and promotion campaign.

3.2.3.13 *Ownership Impact Report*

To promote and sustain a political environment in which this broad-based ownership (and social solidarity) issue remains in the forefront of privatization policy-making, it is recommended that, in conjunction with each proposed privatization, the Prime Ministry publish an "Ownership Impact Report" disclosing both the short and the long-term projected impact on private ownership of the proposed privatization, including an indication of both the quantity of shares employees are expected to own and the government incentives provided to foster that ownership stake. In addition, it is recommended that CAREPP publish an annual privatization plan indicating its employee ownership goals for the forthcoming year and its success in achieving its goals for the previous year.[34] Sustaining public attention on this political goal is an important ingredient in sustaining the focus of this initiative.

3.4 ESOP Operations -- Suggested Guidelines

3.4.1 An Overview

The ESOP operating guidelines should reflect the three primary ESOP principles: participation, limitation and distribution. The procedures for establishing an ESOP must necessarily reflect a mixture of both policy and practical concerns. The practicality issues concern not only how the ESOP will be established but also how it will secure the financing (including any employee funds) within the relevant time frame of privatization. Unless the policy aspects are well coordinated with the practical aspects of implementing ESOPs as a technique of finance, the ESOP initiative will fail to achieve the desired policy results.

In the three initial privatizations targeted to include ESOPs, it is recommended that the ESOP be established by the company at the direction of (and based on guidelines provided by) CAREPP in conjunction with consultation with employees. It is recommended that the ESOP shares be held by an intermediate repository (maintained by a bank or a brokerage firm) based on CAREPP- established guidelines governing the operation of this repository. Thus, the repository would become the ESOP mechanism by which the shares would be acquired, held and distributed, with the terms of the repository required to reflect the operating guidelines

[34] This report could form one component of the comprehensive annual privatization plan recommended in the recent World Bank study of privatization in Tunisia. Saghir, *ibid.*, page 26.

(including suggested ESOP qualification requirements).[35] Illustrative examples of such guidance are summarized below, with additional detail in Annex 1.

3.4.1.1 *Participation Recommendations*

Employees eligible to participate in ESOPs. In determining those employees eligible to participate in an ESOP, the guidelines should require inclusion, at a minimum, of those over age 18 who have been employed by a company for at least one year (including service prior to establishment of the ESOP) and who work at least half time. Those who own 5% or more of the company's shares should be ineligible to participate.

Participants. At a minimum, at least 50% of those eligible should be participants. This requirement is meant to recognize that some employees will not want to (or cannot afford to) participate. This requirement is also intended to ensure that ESOPs are designed in a way that makes them sufficiently attractive so that a majority of employees participate.

3.4.1.2 *Limitation Recommendations*

Individual Limitation: No employee may have credited to his ESOP account shares equal in value to more than 3 months compensation on an annual basis.[36] Shares may be credited to participants' accounts on the basis of salary, length of service, job responsibilities or any job-related criteria provided that for any year the maximum ESOP benefits credited to the highest-paid participant does not exceed seven times that credited to the lowest-paid participant.[37] In addition, on an ongoing basis: (a) no participant's ESOP account may exceed in value more than 10% of the total value of all ESOP accounts, (b) the allocation of ESOP shares among participants may not result in any participant being allocated in that year less than 10% of the number of ESOP shares allocated in that year to any other participant, and (c) no more than 80% of the ESOP's assets may be held in the accounts of the highest-paid 20% of participants. Working together, these limitations are meant to recognize that pay and/or service-related ESOP benefits tend to favor long-service, high-paid employees -- which is a rational policy but one that should operate only within certain prescribed limits.

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[35] As this initiative moves forward, it will require that more attention be paid to certain of the legal aspects. For example, it may prove useful to amend Article 51 of the general regulations to Law No. 89-49 to ensure that, in computing whether 20% of a company's shares are owned by shareholders who individually hold no more than 5%, the individual beneficiaries of the repository (i.e., the employees) are considered to be the shareholders. Conversely, for purposes of determining the number of shareholders within the company for purposes of the Bourse, it may prove useful to consider the repository as the sole shareholder (see Articles 28-29).

[36] For purposes of determining whether a participant's account is approaching the limitation criteria, the price of the shares on the date acquired by the ESOP should be utilized (vs. some later date when the shares may be credited to the participant's ESOP account).

[37] In making this annual computation, it is further recommended that this amount exclude any amounts attributable to dividends paid on ESOP-held securities.

Company Limitation: For the first five years following privatization, CAREPP should allow a privatizing company to claim an annual tax deduction no greater than 10% of participants' payroll to the extent that such funds are applied to repay ESOP debt or to acquire company shares for employees. In addition, the interest expense of any ESOP-related debt should be allowed as an ordinary business expense.

3.4.1.3 *Distribution Recommendations*

Shares subject to loan encumbrance should be released and credited to employees' ESOP accounts as ESOP loan principal is repaid.[38] The trading of such shares should be permitted on a company's internal market on a tax-free basis.[39] Employees should have early access to their privatization-related shares but with sensitivity to the financial needs of the company. Thus, employees should be able to call for in-service distribution of a portion of their ESOP account but with an incentive structure designed to encourage long-term shareholding.

For example, where distributed shares are sold prior to the passage of three years following their allocation, the shares could be subject to individual income tax on 100% of that portion of their value attributable to employer funds,[40] with that tax declining by 25% in each of the subsequent four years such that proceeds realized from the sale of shares sold after the end of the sixth year following allocation would be free of tax.

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[38] The guidelines should include a requirement ensuring the reasonable amortization of ESOP loans (i.e., that principal payments are spread evenly over the loan term).

[39] This aspect should be coordinated with rules of the Bourse (e.g., requiring a filing with the exchange prior to sale).

[40] That portion attributable to payments from employees' after-tax income would be recovered tax-free. It is suggested that such employee payments be considered as recovered first.

4. ADAPTING ESOPs TO TUNISIA: ACTION PLANS FOR THREE COMPANIES

This section summarizes recommended techniques for including ESOPs in the privatization of three target companies. It is recommended that each of the privatization candidates be subjected to a thorough "due diligence" process so that the Government and potential investors are fully apprised of the true condition of the companies, including a inventory of all assets (properties, intangibles, and financial assets).

In the time allotted to this effort (and the limited amount of information available for analysis), the team did not feel confident in offering only one recommendation concerning how best to adapt an ESOP to each of the three specific cases. Instead, we offer, by way of illustration, several recommended employee ownership privatization modalities for each of the companies. The appropriateness of any particular modality will need further assessment and, to a great extent, is dependent on the Government's willingness to support the recommended ESOP incentives and initiatives.

We were unable to appraise the interest of particular employee groups in the companies studied (or their capacity to pay for shares). The bulk of our appraisal was accomplished through interviews with government officials and company managers. We also were unable to directly appraise the interest of union leaders. Also, it should be noted that, by international practice, an opportunity is often provided to certain employees to enable them to acquire a separate tranche of shares (i.e., outside the ESOP) -- generally as a mechanism for attracting and retaining proven performers.[41] Although this stock participation can take a variety of forms, the most common approach is to grant options to select managers to enable them to acquire shares in the future at a price set today. That same strategy could, of course, also be used for rank-and-file employees or for select high performers regardless of position.

An employee ownership stake (and an ESOP) is feasible in each of the three targeted companies; however, that feasibility is partly a question of the support that the Government intends to grant this effort. There appears to be genuine openness to a wide variety of employee ownership mechanisms, including a willingness to provide incentives in support of ESOPs. The privatization process embodies a remarkable range of governmental discretion, with each privatization custom-designed to the circumstances of the company and the economic and political environment. It is in that spirit that we offer an array of mechanisms that can be "mixed and matched" in order to accomplish the intended objectives.

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[41] In most developing countries, state-owned enterprise employees at lower skill levels are more highly paid than their private sector counterparts whereas managers are typically less well paid than private sector managers. Kikeri, Sunita, John Nellis and Mary Shirley. 1992. *Privatization - The Lessons of Experience*, A World Bank Publication, Washington, D.C.

The implementation steps required will vary depending upon numerous factors, including: (a) whether employee contributions are required, (b) the circumstances in which the ESOP is implemented and (c) the short and long-term goals for implementation of the ESOP. An overview of the basic steps involved in establishing an ESOP is provided below. These steps will need to be modified based on the privatization strategy chosen for each of the three target companies and the incentives provided by CAREPP to foster employee participation.

When an ESOP is established as a financing technique (versus simply implementing an employee stock purchase arrangement), the required action plan implies a certain level of preliminary financial analysis and compliance with certain procedures and guidelines concerning design and execution of the plan. In the "generic" action plan lists set forth below, it is assumed that the company is working with a professional advisor in the implementation of the plan and that CAREPP has approved company-based ESOP tax reliefs based on the payroll of plan participants.

4.1 ESOP Action Plans -- An Overview

4.1.1 Initial Financial Analysis

1. Collection of company data

2. Analysis of a company's financial structure and tax status

3. Analysis of projected pre-tax profits, income taxes and anticipated payroll of ESOP participants

4. Preliminary valuation of the company's stock (assuming the stock is not publicly traded)

5. A dilution study to determine the impact, if any, on the holdings of existing or other shareholders

6. A liquidity study to determine the cash requirements for repurchasing shares (if required).

7. A study to determine whether an ESOP should work in tandem with or replace any existing employee benefits.

4.1.2 Design and Implementation of the Plan

1. Plan design and execution

    a. Design of a mechanism for holding the shares, such as an intermediate repository arrangement with a bank

    b. Select plan committee members (overall governance of the ESOP)

    c. Plan design issues for governing the operation of the intermediate repository: qualification period (age/service requirements); allocation methodologies (pay, service, combination); terms of distribution (timing, method, retirement provisions, repurchase obligations), etc.

    d. Terms of employer contributions

    e. Terms of employee contributions (information required, incentives, default provisions)

    f. Terms of management-employee participation (purchase, personal loans with personal guarantees, stock options).

    g. Voting provisions -- major issues, all issues, direct vs. indirect voting

    h. Information sharing -- scope of financial disclosure, reporting

    i. Governance issues -- board representation, supervisory board

2. Draft intermediate repository agreement

3. Draft Board of Directors' resolutions approving the plan and the terms of the repository agreement

4. Prepare information materials for employees

5. Review of above-listed materials by the company, by company counsel and by managers/trustees of intermediate repository

6. Solicit approval of drafts from managers/trustees

7. Board of Directors approves establishment of ESOP, designates managers for intermediate repository, ESOP Committee members and takes other

relevant action

8. Execute the ESOP and the intermediate repository agreement.

9. Implement employee communication program

4.1.3 Plan Implementation

1. Determine valuation of shares to be acquired by the ESOP

   For non publicly-traded companies, this valuation process should include the services of a qualified, independent appraiser whose inquiry should encompass several tasks, including:

   - Gathering company data (financial statements and projections, business plans, etc.);
   - Conducting field visits and due diligence interviews (interview managers, review operations, assess the company's operating environment, etc.);
   - Collecting and analyzing data on comparable companies;
   - Reviewing the industry;
   - Evaluating requirements to adjust for certain matters (such as inventory methods, non-operating assets, minority interests, etc.);
   - Analyzing financial statements;
   - Comparing financial analyses (size and diversity of operations, operational efficiency, profitability, leverage, etc.);
   - Assessing overall strengths and weaknesses compared to publicly-traded companies (such as key client risk, key manager risk, etc.).

2. Make any needed applications to the Bourse (such as disclosure needed for solicitations to employees, registration requirements, acknowledgments needed for the transfer of securities, etc.).

3. Negotiate any needed financial assistance for the ESOP (such as commercial loans, USAID loan guarantees, government acceptance of company note, etc.).

4. Execute any needed loan agreements -- such as (a) having the managers/trustees of the intermediate repository sign the loan agreement and the promissory note to the lender, (b) having the company sign a loan repayment guaranty agreement and (c) having the repository managers/trustees purchase the shares (i.e., with the loan proceeds) and pledge the shares as loan collateral. Alternatively, have the trustees acquire the shares from the seller (the Government) in exchange for a promissory note payable to the seller. Or have the company borrow the funds and on-lend them to the ESOP, with an agreement between the lender, the company and the repository manager/trustee that the company will make sufficient contributions to the plan to repay the loan. These agreements would be appropriately altered where the Government serves both as seller of the shares and as lender (e.g., accepting a promissory note).

5. As the loan is repaid, have the repository managers/trustees obtain a release from pledge of an equivalent amount of shares based on the original purchase price of the shares and allocate such shares to the accounts of plan participants.

6. An appropriate governmental entity (such as the Finance Ministry) could be granted oversight jurisdiction of this process to ensure basic fairness, particularly as it impacts employee-participants in the ESOP.

4.1.4 Plan Administration & Communication

Design and implement an initial and an ongoing employee education and communication program. This could be as rudimentary as distributing a written summary of the ESOP. Or the company could design a program to keep employees abreast of developments within the company and to solicit their input into the operational affairs of the company. More extensive efforts can include a vast array of methodologies, including periodic meetings, booklets, paycheck reminders, posters, slogans, company mission statements, company logos, periodic benefit statements, suggestion mechanisms, work teams, cross-functional work teams, employee empowerment programs, employee recognition programs, etc. The best programs seem to be those that are "organic" to the company (vs. imposed by a consultant) and that arise from a genuine commitment by both managers and workers.

This basic overview of ESOP action plans will need to be adapted to each of the targeted companies, an adaptation that is impossible to outline with specificity without first knowing the nature and the magnitude of Government-provided incentives for employee participation and ESOPs.

4.2 Autotractor

4.2.1 Background

In 1962, the Government nationalized this company which, until 1984, was the only authorized Ford dealership and the sole distributor of Ford auto parts in Tunisia. Due to Government-imposed import restrictions announced in 1984, Ford-Europe has subsequently declined to participate in a call for tenders to allow the import of Ford vehicles into Tunisia. Despite losing its ability to sell Ford vehicles, Autotractor continues to be the sole distributor of genuine Ford spare parts in Tunisia (though the original exclusive contract has since expired). Autotractor also maintains a market niche in the local automobile maintenance market by servicing primarily Ford vehicles. Autotractor markets itself as Autotractor, not as the sole Ford parts wholesale distributor. A new call for tenders from foreign automakers is scheduled for 1993 though Ford is not expected to participate. The next tender is scheduled for 1998.

An examination of the company's financial statements for 1992 reveal that the company remains modestly profitable, largely due to interest earned on its investments, including TD 1.3 million invested in one-year bank deposits and TD 400,000 in bank deposits with a six-month maturity. Thus, interest income of TD 130,000 accounts for 56.8% of Autotractor's net operating profit of TD 229,000 (before tax). Management indicates that this trend was approximately the same in 1990 and 1991. The company is also holding TD 159,000 in non-marketable, non income-earning securities consisting of shares of other unlisted state-owned enterprises.

Autotractor's top manager has been with the company more than 20 years. Seven other staff members with management responsibility have 15 to 25 years of service with the company. Most of the remaining 45 employees are also long service employees, with only 15-20% of the employees having less than five years of service. Employees may generally be divided into three salary categories: (a) top management (TD 9,000 per year), (b) middle management (TD 4,000 per year), and (c) workers (TD 2,000 per year).

The Director General indicated that his top management team is very interested in purchasing Autotractor shares and would be prepared to arrange a management buyout. He also indicated enthusiasm among middle managers and the workers but stressed their lack of resources to buy shares. He suggests that salaries would probably be raised by approximately 20% following privatization with any additional increases dependent on improved company performance. He also indicated support for the idea that shares be allocated among the employees based on a formula that takes into account both salary and years of service with the company. In anticipation of a possible privatization, Autotractor employees have set aside a special fund by withholding a special levy on three months' salary for the past four years. At the end of 1992, this fund totaled TD 35,000. The social fund holds an additional TD 123,000.

Autotractor -- Selected Financial Data (1992)
(in thousand Dinars)

Total Revenues:	2,612
Sales of parts	2,100
Maintenance/Service	366
Interest Revenues	130
Other Revenues	16
Net Profit	153
Shareholders' Equity	2,209
Total Debt (short-term)	491
Total Assets	2,739
Total Cash Equivalents	1,805
Profitability ratio (after-tax return on equity)	6.9%

4.2.2 Recommended Actions for ESOP Development

It is recommended that the passive assets held in Autotractor be separated from those active assets relevant to the company's operations as a spare parts supplier and automobile maintenance facility. The company currently holds short-term deposits totalling TD 1.7 million plus approximately TD 159,000 of non income-earning, unlisted securities in other state-owned enterprises.[42] These assets increase the intrinsic value of the company by approximately TD 1.859 million. The remaining assets total approximately TD 390,000.

The modestly-paid employees of Autotractor (TD 2,000 per year) do not have the financial resources to purchase the investment management portion of Autotractor. Also, it is financially irrational to require employees to borrow acquisition funds at 14% to 16% to buy financial assets earning only 7.6%.[43] In addition, it is understood that the ESOP privatization policy is to enable the employees of Autotractor to acquire 100% of an operating company (i.e., not an

[42] The TD 1.7 million in short-term deposits is reportedly being held as a reserve to assist the company in financing inventory for a Ford auto dealership should such a dealership again be granted. The management agrees that it is highly unlikely that the dealership will be forthcoming this year (i.e., government tenders for such dealerships are offered only once every five years). Thus, the earliest such a dealership could be granted is during the next tender period in 1998.

[43] Two issues worthy of further study as part of a due diligence effort: (1) why is the company reflecting term deposits of TD 1.7 million on which it is reportedly earning 10% per annum yet reflecting only TD 130,000 in pre-tax interest income (i.e., a blended return of only 7.6%), and (2) why is the company holding approximately TD 159,000 in non income-earning shares in unlisted state-owned enterprises.

investment management company). Stripped of its financial assets, Autotractor shows an annual adjusted return on equity of 33.5% (see below)

As a matter of policy, CAREPP should determine whether those financial assets should remain with the company and be privatized as company assets or whether those assets should be treated as an as yet unpaid dividend. If the latter, then the company should first be restructured in preparation for its privatization in order to first pay that dividend. Because Autotractor has retained earnings of approximately TD 1.718 million (per its 31 December 1992 balance sheet) and because we are informed that dividends cannot be paid "in kind" (i.e., they must be paid in cash), the payment of this dividend would first require that the assets be liquidated.

Thus, if this is considered the correct course of action, we recommend that Autotractor take the following steps prior to privatization: (1) sell its investments in the state-owned enterprises to other SOEs that are not currently scheduled for privatization, (2) liquidate its investments in short-term deposits, (3) calculate the company's retained earnings and, if less than TD 1.859 million, amend the corporate by-laws to permit a reduction in capital, (4) declare and pay a dividend not to exceed TD 1.859 million, and (5) distribute any shortfall as a reduction in capital.

After extracting Autotractor's net operating revenues for the years 1990 through 1992, what remains would be a relatively strong performing company, as demonstrated in the table on the next page.

Selected Financial Data
(in thousand Dinars)

	1990	1991	1992
Total Net Operating Profit before Taxes	293	304	228
Total Interest Income before Taxes	151	128	130
Interest Income as a percentage of Total Net Operating Profit	52%	42%	57%
Total Net Income after Taxes	197	193	153
Net Operating Revenue before Interest and after Taxes	95	112	66
Shareholders' Equity (1992)[44]			2,056
Less distribution of surplus			
- Term deposits - 1,700			
- Nonmarketable securities - 159			1,859
Adjusted Shareholders' Equity			197
Net Operating Revenues before Interest and Taxes			66
Adjusted Return on Equity (1992)			33.5%[45]

Once the company is stripped of its passive assets, it has net assets remaining of approximately TD 390,000. It is recommended that the following alternatives (or some combination) be considered as methods for generating payment for the employees' shares (assuming a total value of TD 390,000). In each of the alternatives, it is assumed that both the social fund and the funds set aside for employees would be transferred to the ESOP and used to buy shares.

[44] Excludes a reserve for exempted investments of TD 38,600 but includes an investment fund of TD 216,000.

[45] Assuming for illustration purposes that adjusted shareholders' equity was identical in 1990 and 1991 (i.e., stripping out the financial assets from the operating assets), the adjusted return on equity for those two years was approximately 48.2% and 56.9%, respectively.

Autotractor: ESOP Alternative One

1. Company payment of TD 35,000 previously set aside by employees for the purchase.

2. Company payment of TD 123,000 from the social fund.

3. Employee payment of TD 50,000 from funds borrowed from the Social Security Fund or from FREP (@ 8.5% interest); tax credit allowed for loan repayment.

4. Manager payment of TD 82,000 from personal funds (personal savings or borrowed via personal guarantees).

5. Company note to the Government for TD 100,000 bearing 5% interest, 10-year term, 3-year interest-only grace period; tax deduction permitted for principal payments equal to 10% of payroll plus deduction for dividends applied to loan repayment. Loan administered by a commercial bank in return for a fee.

Comments: This approach enables employees to borrow at a preferred rate of interest (versus commercial rates or use of the USAID loan guarantee -- linked to commercial rates). The individual tax credit is a type of government subsidy (and could be replaced with a more transparent grant or discount). The company note is a traditional ESOP financing technique, enabling the shares to be bought, in part, from future earnings of the enterprise (i.e., with company tax deductions not to exceed 10% of participants' combined pay). The lengthy payment terms (plus a grace period) also offer a type of subsidy. It is assumed that a commercial lender would negotiate and administer the note for a fee.

Autotractor: ESOP Alternative Two

1. Company payment of TD 35,000 previously set aside for the purchase.

2. Company payment of TD 123,000 from the social fund.

3. ESOP borrows TD 150,000 from BIAT with A.I.D. loan guarantee and company guarantee (w/ pledge of ESOP shares), repaying loan with a combination of (a) company contributions (deductible up to 10% of payroll), (b) dividends on ESOP shares (tax deductible) and (c) employee withholding (with tax credit of up to TD 100 per year).

4. Manager payment of TD 82,000 from personal funds (outside the ESOP).

Comments: This model combines the loan guarantee with the ESOP financing technique. It also includes an individual tax credit targeted to lower-paid employees. The management portion of the buyout may prove particularly attractive to this company.

Autotractor: ESOP Alternative Three

1. Company payment of TD 35,000 previously set aside for the purchase.

2. Company payment of TD 123,000 from the social fund.

3. ESOP borrows TD 232,000 from BIAT with A.I.D. loan guarantee and company guarantee (with pledge of ESOP shares), repaying loan with a combination of (a) company contributions (deductible up to 10% of payroll), (b) dividends on ESOP shares (tax deductible) and (c) employee withholding (with employee tax credit of up to TD 100 per year for withheld amounts).

Comments: This alternative utilizes the USAID loan guarantee, with loan repayment comprised not only of company earnings and profits but also employee funds, with the individual tax credit targeted to lower-paid employees (i.e., with an annual limit of TD 100).

Autotractor: ESOP Alternative Four

1. Company payment of TD 35,000 previously set aside for the purchase.

2. Company payment of TD 123,000 from the social fund.

3. ESOP borrows TD 132,000 from BIAT with A.I.D. loan guarantee and company guarantee (with pledge of ESOP shares), repaying loan with a combination of (a) company contributions (deductible up to 10% of payroll), (b) dividends on ESOP shares (tax deductible) and (c) employee withholding (with tax credit of up to TD 100 per year).

4. Company note to the Government to acquire for the ESOP company shares for TD 100,000 at 5% interest over 10 years, with similar tax deductions available for repayment.

Comments: This variation uses a combination of USAID loan guarantee-supported ESOP financing and ESOP financing utilizing Government-provided terms, with Government incentives used to support the debt repayment. In each of these alternatives, the company could be granted a tax deduction for the expense incurred in repurchasing shares from employees. This tax relief could be limited to a prescribed period (e.g., 10 years).

4.3 La Ceramique Tunisienne

4.3.1 Background

This Tunis-headquartered producer of construction materials (i.e., ceramic tile and brick) employs 1,200 in six major cities. Although its fortunes are closely aligned with the building industry generally, it has recently enjoyed at least three consecutive profitable years. The work force has been scaled back by 600 employees over the past six years; further lay-offs are not anticipated as part of the privatization.

The company's senior management consists of approximately 40 key employees, comprised of 10 headquarters staff and five each at the six plants. The operation is relatively low technology-based. Approximately 80% of the employees have worked for the company for ten years or more, with more than 25% having more than 20 years of service.

The company is scheduled for privatization and is currently soliciting tenders to perform an appraisal. Due to its size, the Government has informed senior management that the company will be privatized by public offering. It is anticipated that a 10-15% tranche will be reserved for sale to the workers.

The Director General indicates considerable interest in purchasing company shares among the managers. He also suggests (via his informal polling) interest among workers, with concern regarding methods of payment (most suggesting that they be allowed to purchase shares for a nominal sum). He suggests that many employees have never dealt with a bank, with more than 25% being paid in cash. Average pay is approximately TD 4,000. He proposes that the company acquire a tranche of shares for the workers as part of the public offering, allowing the employees to purchase those shares from the company on favorable terms. For example, he suggests that FREP funds be lent to the company (at a low interest rate) to buy 5% of the shares, with the company also buying 5% of the shares and then offering the entire 10% tranche to the workers to buy at 5% interest.[46] It was suggested that the shares be offered to employees based on the relative amounts that would be due them under the terms of their termination agreement (computed by multiplying monthly salary by years of service with the company).

The company provided financial statements for 1989 through 1991 (1992 statements are not yet complete though management indicates the 1992 results are comparable to 1991).[47]

[46] Given the Stock Exchange restriction requiring that company stock repurchases be sold within six months, this structure would need either to seek a waiver or to ensure that the sale to employees is completed within six months -- or to design another structure to ensure that within six months the shares are no longer held by the company.

[47] The statements were not accompanied by an auditor's report.

Selected Financial Data
(in thousand Dinars)

	1989	1990	1991
Total Revenues	14,836	19,460	19,513
Sales Revenues	13,998	18,252	17,942
Other Revenues	759	1,056	1,120
Interest Revenues	79	158	331
Net Profit	2,981	3,364	2,070
Shareholders' Equity (Deficit)	(4,795)	(1,432)	961
Total Debt	22,454	24,038	26,407
Short-term Debt	14,865	17,732	20,247
Medium & Long-term debt	7,589	6,306	6,160
Total Assets	18,574	23,522	28,263
Profitability Ratio (Net Margin)	20.09%	17.29%	10.61%

Other information taken directly from the company's financial statements include:

(1) The company is holding TD 3.5 million in securities, including equity interests in other state-owned enterprises plus cash on hand of TD 0.7 million.
(2) The company's employee fund is holding TD 548,000.
(3) The company owed the Government TD 13 million as of December 31, 1991. This debt was classified as short-term; no interest charges are reflected. It appears that the Government may have made short-term advances to fund the company's operating losses.
(4) The company paid 1991 taxes of only TD 206,000 on pre-tax earnings of TD 2,276,000, possibly due to loss carryovers.

4.3.2 Recommended Actions for ESOP Development

It is recommended that the USAID Loan Guarantee facility be used in support of the company's interest in assisting in the acquisition of 10% of its shares by an ESOP. For this purpose (and assuming that the company is valued at TD 20 million), the following alternatives are illustrative.

La Ceramique Tuniesienne: ESOP Alternative One

1. As part of the public offering, the company uses TD 2 million (of its TD 4.17 million in cash reserves and securities) to acquire company shares.

2. ESOP Tranche 1: ESOP borrows TD 1 million from BIAT (with the support of a US$500,000 A.I.D. loan guarantee), using those funds to buy TD 1 million of the shares acquired by the company.

3. ESOP Tranche 2: the company contributes the balance of those shares (i.e., TD 1 million) to an interim account in the ESOP (i.e., an intermediate repository), claiming for that tax year a tax deduction for employee benefit expenses to the extent that employees are allocated shares not exceeding 10% of their compensation.

4. Regarding Tranche 1:

   a. The company offers an employee share purchase procedure permitting employees to buy shares from payroll deductions, with such amounts paid over to BIAT as due. Shares are released from the interim ESOP account and allocated to participants' individual repository accounts as loan principal is repaid.

   b. The company-charged interest rate should not exceed 5% per annum, with the company paying the balance of interest payments as due (as a deductible expense).

   c. Employees are permitted a tax credit for 50% of each year's ESOP loan payments up to a maximum TD 250 per year.

5. Regarding Tranche 2:

   a. The shares are allocated to employees' ESOP accounts at a rate not exceeding 10% of pay each year until the tranche is fully allocated to employee's accounts.

   b. To the extent that the tax deduction permitted for the initial ESOP contribution is not equal to the value of the shares contributed, the company is permitted to carry over the unused portion of such amount for deduction in subsequent years until used.

Comments: This alternative offers a blend of approaches that may prove useful in stimulating privatization-related public offerings (for example, by insuring that the company is prepared to help create a market in the shares at the outset of the privatization). In addition, this approach adopts the company's suggestion that company funds be used to support the ESOP but with a structure that does not run afoul of the Bourse's restrictions regarding a company's ability to repurchase its shares.[48] Also, by treating the company's contribution as a deductible expense, this approach adopts the common fiscal treatment of employer ESOP expenses (i.e., as a type of tax-deductible employee compensation) yet this approach also commits the employer to a major ESOP contribution at the outset rather than limiting the first year's contribution to the amount of tax deduction claimable in that year. This approach also generates proceeds for the Government, with the ESOP-related tax expenditures deferred to a later date. Of course, by using the company's liquid reserves to acquire shares for employees, the Government is reducing the price that other investors may be willing to pay for their stake in the company. Policy makers will need to be sensitive to the ESOP-related commitment of the company's future cash flows, a primary determinant of company value to a financial investor.

This approach includes the USAID loan guarantee facility in a way that may be replicable in other privatizations, particularly where the privatizable company has a large amount of liquid reserves on hand. In this case, half of the cash is recovered immediately (via the loan facility) while a portion of the other half is recovered over time (albeit at the cost to the Government of tax deductions linked to the payments). The USAID loan facility's unattractive market interest rate requirement is addressed by committing the company to pay a portion of that cost. Offering a discount on the price of the shares is another possible approach. Also, by proposing for employees a modest (TD 250/year) 50% tax credit for their stock purchases, this alternative focuses the Government's financial assistance on those employees most in need.

[48] Bourse rules limit to six months the period that a company may hold its shares. This strategy transfer those shares to another entity (i.e., the ESOP/intermediate repository).

La Ceramique Tuniesienne: ESOP Alternative Two

Same as Alternative One except that, for Tranche 1:

(a) Use the company's Social Funds to buy TD 0.5 million of shares, with employees allowed to subscribe to buy a tranche of shares from the Social Fund over a period of years, with those shares transferred to the ESOP as payments are made with modest interest charges (e.g., 5%) retained by the ESOP, and

(b) Use A.I.D. loan facility for the balance of tranche 1 (per procedure outlined above).

Comments: This approach offers access to lower-interest Social Security Fund lending.

La Ceramique Tunisienne: ESOP Alternative Three

The Company lends TD 2 million to the ESOP at 5% interest to buy shares for the ESOP in the market, thereafter making cash contributions to repay the loan (with a tax deduction of up to 10% of participants' pay for the cash contributions). Dividends applied to loan repayment would also be tax deductible. Employee contributions also sought for loan repayment with 50% annual tax credit claimable for up to TD 250/year.

Comments: This approach generates proceeds for the Government while also using the ESOP as a vehicle for making a market in the shares. Missing from each of these three alternatives: a management equity opportunity.

4.4 Tunis Air

4.4.1 Background

Tunis Air is Tunisia's national flag carrier and, as such, has high visibility within the country and is well regarded by most citizens. While ranking 85th in air transport revenues worldwide (TD 294 million), it is one of the world's most profitable airlines (15.8% net income margin for 1991). The Government's objective is to privatize only a part of the airline, reflecting both practical and policy considerations. Tunis Air's current ownership structure is as follows: 84.86% by the Government, 5.58% by Air France, 3.9% by *Caisse Nationale de Securite Sociale*, 3.9% by *Caisse Nationale de Retraite & de Prevoyance Sociale*, and 1.76% by *Caisse d'Assurance Vieillesse Invalidite & Surire.*

Tunis Air's strong points are its high profit margin, low debt and excellent name recognition. Its weak points include the fact that 35.6% of its net income arises from interest income (on TD 131 million in cash and equivalents). In addition, it is currently anticipated that it will face an increase in its corporate taxes, an increase in depreciation (associated with its purchase of A320 airplanes) and an increase in competition. It currently derives 80% of its revenue from tourist trade.

In privatizing Tunis Air, the Government plans to reserve the sale of shares for Tunisian nationals, primarily small shareholders and investors. Maintaining a high level of Government ownership is a policy objective, partly due to the ongoing deregulation in Europe and elsewhere.

Tunis Air owns only 17 aircraft yet it employs 4,365 full-time employees plus 790 part-time contractual employees (e.g., for peak season and charters). This includes 188 pilots with an average annual salary of TD 54,800, 367 other personnel with an average salary of TD 12,374 and 4,600 ground personnel with an average annual salary of TD 10,900 (for an average salary of TD 12,150). Managers suggest that approximately 20% of the work force is redundant. However, they anticipate no lay-offs as a result of privatization, suggesting that the company may even be forced to hire more employees. Employees are expected to be quite interested in investing, particularly if incentives are provided. The pilots are expected to be extremely interested due to their general familiarity with investments and their high salary level.

Tunis Air's recent financial results are indicated below.[49]

[49] See "Tunis Air: Action Plan" (31 December 1992) prepared for A.I.D./Tunis by Price Waterhouse.

Selected Financial Data
(in million Dinars)

	1989	1990	1991
Total Revenues	270,960	299,896	293,906
Transport Revenues	217,707	233,949	235,580
Other Revenues	53,253	65,947	58,326
Net Profit	70,618	57,663	46,461
Shareholders' Equity	235,122	290,849	337,310
Total Debt	96,988	178,939	197,952
Short-Term Debt	89,438	124,467	119,907
Medium & Long-Term Debt	7,550	54,472	78,045
Total Assets	355,379	518,808	594,296
Total Cash & Equivalents	224,960	269,430	131,032
Profitability Ratios			
Return on Equity (before taxes)	30.00%	19.83%	13.77%
Net Margin	26.06%	19.22%	15.81%

(Source: 1991 Annual Report)

Those senior managers interviewed doubt that employee interest in stock ownership extends beyond the relatively high-paid pilots and some 500 mid-level employees, though they like the idea of salary deductions as a method for spreading out the cost of purchasing the shares. Having the company loan funds to the employees to acquire shares is not a well-regarded strategy among the managers interviewed. However, the action plan for the privatization of Tunis Air suggests that if the company acts as a lending source for its 4,364 "lifetime" employees at a 0% interest rate they should expect to sell shares valued at TD 3.7 million to 4.4 million.

Managers are concerned that employee-owners will want to impose their management views on the company. Labor relations are apparently uneasy. Providing employees with non-voting shares would likely create a problem (according to the managers). Managers anticipate that employees will ask for a seat on the board of directors. The managers have not yet been approached to determine their level of interest in investing in the company.

Notwithstanding the fact that Tunis Air derives 80% of its revenue from tourist trade, management reports that they have been unsuccessful in persuading the Government that the company should qualify for the 50% tax remission allowed companies in the tourism sector.[50] Managers indicate that they may now seek tax relief on the basis of the company's impact on exports.

4.4.2 Recommended Actions for ESOP Development

It is recommended that the USAID loan guarantee fund not be used to assist Tunis Air employees purchase shares. Given their relatively high pay and the large number of employees involved, it is recommended that these limited resources be reserved for use in other companies.

In constructing an ESOP recommendation for Tunis Air, we assume participation levels consistent with those appearing in the Price Waterhouse report for Tunis Air. For example, we assume that higher-paid employees (i.e., pilots and other air personnel) if offered an opportunity to invest one month's pay will participate at an 85% level while ground personnel will participate at a 75% level and contractual employees at 30%. If these assumptions prove true, employees can be expected to invest approximately TD 3.9 million which could mean a purchase of 2% to 2.4% of the total equity (or 15.6% to 23% of the anticipated offering). Where the government provides incentives to encourage employee purchases (as we recommend), these percentages could increase significantly. Because the government intends to retain a majority interest in Tunis Air, the concerns of other investors are less of a factor than in the other two companies targeted for privatization.

The following alternatives are illustrative of the types of employee ownership modalities that could be included in this proposed semi-privatization.

[50] Article 37 of Law No. 89-49 permits a 50% reduction in income taxes for those companies operating in certain sectors (tourism, agriculture and industry) that are listed on the permanent market of the Tunisian Stock Exchange. Article 51 further requires that 20% of the company's shares are owned by shareholders who individually do not hold more than 5% of the capital.

Tunis Air: ESOP Alternative One

Company funds (in combination with funds from the Social Fund) are used to purchase shares amounting to 2% of the company's equity as part of the public offering. Employees are permitted to buy the shares from the company (and/or the Social Fund) with payroll withholding. In addition, Tunis Air provides the Government with a note to acquire another 3% tranche of the company's shares (i.e., in addition to those shares comprising the public offer), committing itself to repay that note over a 10-year period at 5% interest, with the company permitted annual tax deductions for loan payments (up to 10% of participants' pay).

Comments: This approach ensures an element of employee commitment via personal purchases while also generating immediate market demand for Tunis Air shares. The payroll withholding component enables Tunis Air (in conjunction with the employees' representatives) to design an employee subscription (and payroll withholding) arrangement that is attractive to all employees. By Tunis Air providing a note to the Government for an "ESOP-financed" tranche of shares, this component ensures that employees gain access to a "leveraged" ownership stake paid for out of future tax-relieved company earnings. Labor/management negotiations could determine whether employees partly "pay" for these shares in some indirect manner (for example, via an agreement to restrain future increases in wages or benefits).

Tunis Air: ESOP Alternative Two

Tunis Air provides a note to the Government for the purchase of a 5% tranche of shares (which the company, in turn, contributes to the ESOP), with that note paying 5% interest over a 5-year term and with the company permitted an annual tax deduction for principal payments on that note to the extent that such payments are not in excess of 10% of participants' pay. Payments to be made from company contributions and dividends on ESOP-held shares.

Comments: This approach provides a fully "leveraged" ESOP purchase, with the full purchase price paid from future company earnings on a tax-relieved basis.

Tunis Air: ESOP Alternative Three

The Government offers employees a 2-4% tranche of shares for purchase on an installment basis with no interest cost.

Comments: With this approach, the Government could offer employees the opportunity to acquire shares, with the payments made in the form of payroll withholding. A subsidy would be provided by agreeing to forego any interest payments on the unpaid balance. Given limited Governmental means for administering such an arrangement, the Government could contract with a commercial company to provide this service (e.g., such as a bank). A key policy decision: procedures to follow in case of defaults in payments.

Tunis Air: ESOP Alternative Four

The Government provides employees with an option to buy a reserved tranche of shares in the future (at a price set by the initial offering price) provided the company meets pre-determined performance criteria. No tax reliefs would be offered.

Comments: This approach would provide employees with a type of "stock option," with the price guaranteed to be no higher than a prescribed price and with employees having the opportunity to share in some portion of any increase in value. The lack of incentives to assist in the purchase may make such an arrangement impractical for lower-paid employees.

Alternatives/Supplements to ESOP Modalities:

- Provide Tunis Air managers a "stock option" keyed to predetermined performance criteria.

  Comment: This could provide a mechanism for motivating, attracting and retaining highly qualified managers.

- Provide a profit-sharing formula for all employees.

  Comment: Profit sharing could provide a means for Tunis Air employees to share in the future success of the company without committing the company to another fixed cost.

This profit-sharing could be in the form of shares (e.g., with the Government agreeing to make available a prescribed tranche of shares for this purpose provided the company can attain certain performance criteria). Or it could take the form of cash profit sharing, with the cash either distributed currently or retained in the intermediate repository for distribution at some future date. Or the company could implement some combination: stock profit sharing and cash profit sharing; current profit sharing and deferred profit sharing. Similarly the annual "bonus" component of pay could be utilized to buy shares and/or pledged to repay debt for the acquisition of shares.

- Employees could be permitted to borrow limited amounts of funds from the Social Security Fund to buy Tunis Air shares.

  Comment: 3.9% of Tunis Air's equity is currently held by the Social Security Fund and another 5.66% by two other funds: *Caisse Nationale de Retratie & de Prevoyance Sociale* (3.9%) and *Caisse d'Assurance Vieillese Invalidite & Surire* (1.76%). This loan could be set at a preferred rate (e.g., 5%) on the basis that this employee ownership tranche could help increase long-term investment returns on Tunis Air shares by enhancing company performance. Employees could pledge their shares as security and assign a portion of their year-end "bonus" for repayment of the loan. Defaults could become additional assets of the funds or the shares could be offered to other employees.

- The Government could use Tunis Air shares to fund redundancy payments, ensuring liquidity via a liquidity contract arranged with funds provided via FREP (and/or via World Bank funds).

  Comment: To the extent that Tunis Air rationalizes its operations by reducing staffing, terminated employees could be compensated, in part, with Tunis Air shares. This approach could provide a non-cash means for funding redundancy payments. If market liquidity for these shares is determined to be insufficient, a liquidity contract could be offered that is limited to shares held by former employees, thereby enhancing the value of those shares. A portion of Tunis Air privatization proceeds could be set aside for this purpose and/or structural adjustment funds could be adapted to support this alternative. This approach could provide a more cost-effective means for addressing redundancy costs (i.e., by shifting some component of the cost onto market liquidity and the public's demand for Tunis Air shares) -- rather than relying solely on cash payments funded via structural adjustment funds, fiscal receipts or company revenues.

- Tunis Air could be directed to utilize some portion of their training budget to provide training on ownership issues.

  Comment: Relationships between labor and management could be improved if some resources were directed to that goal. The current training tax remission program provides funds for employee training. Placing an emphasis on this particular aspect of training could have a positive impact on company performance.

- The Government could publicize the Tunis Air privatization model with an emphasis on the employee ownership component.

  Comment: Due to the high visibility that this privatization will have in the Tunisian (and the international) community, the Government should use this opportunity to showcase its employee ownership initiative, thereby generating support for privatization among employees of other privatizable companies.

Note: The three company-specific action plans described above provide an illustrative overview of alternative employee ownership modalities that could be utilized in the three companies targeted as demonstration projects for the Government's employee ownership privatization initiative. In addition to these various modalities, policy makers could also incorporate additional incentives or initiatives described in Section 3.3.

4.5 ESOP Challenges

Many of the challenges to ESOPs stem from unrealistic expectations by the parties involved. Managers, for example, may expect that employees will automatically become more motivated and productive, yet those managers may neglect to install management systems designed to solicit and implement ideas generated by the workers. Employees, on the other hand, may think that suddenly they will become rich or that they will now have the chance to manage the company, neglecting to realize that capital accumulation requires time and includes risk -- and that management, like many other jobs, requires specialized skills, training and experience.

One of the most challenging areas is that of creating new relationships between company managers and union leaders -- and between union leaders and their members. Those discussions should begin early in the process, including candid discussions of not only the costs and the benefits of ESOPs but also the nature and extent of the new rights and responsibilities. For example, should employees have representatives on the board of directors? Should managers be able to terminate clearly redundant positions? In the old pattern of relationships, what could begin to be changed in order to improve the company's performance? And who among the leaders will have the courage and the foresight to initiate (even fight for) those changes?

In dealing with their members, union leaders have often won their position on the basis of their ability to prove to their members that they are fluent in the rhetoric of the class struggle and that they can successfully confront management. Yet once their members gain an ownership stake, that may well change. For example, employees may still want assurance that their leaders can confront management because workers will continue to want fair wages and safe working conditions. Except the workers may also want leaders able to contribute to the formulation of a strategy for improving the company in order to increase share value and dividends. That requires considerably more training and sophistication than has historically been required of union leaders who will also now be required to respond to their members in their dual capacity as both workers and owners. This can be an unsettling experience for those accustomed to fostering an "us versus them" workplace environment. In making this transition, union leaders would be well advised to retain the services of financial and business-oriented professionals such as accountants, attorneys and investment bankers.

Managers also need to realize both the limitations and the potential of ESOP-type ownership. Employees granted access to financial participation (via an ESOP) may have ideas about how to improve the performance of the company. They may well view themselves as knowledgeable "inside" shareholders whose views should be considered. If there is no system in place for turning those ideas into action, disillusionment, cynicism, even hostility becomes a predictable by-product, potentially eroding the ESOP's intended impact on company performance. Yet if an ESOP is implemented in conjunction with the introduction of modern management systems, the establishment of an ESOP can have a lasting impact on company performance.

Quite often, managers have been educated and trained in an environment where command and control were the key benchmarks of successful management, despite often clear indications that such techniques are sorely dated. One of the key challenges lies in instituting a more participative, interactive management style, a style where information flows are encouraged not only from top to bottom but also from bottom to top and laterally within the company. The challenge can be frustrating and very time-consuming yet international experience suggests that the most successful, dynamic and adaptable companies are those that succeed in making the difficult shift from management by command and control to management by commitment and coaching. That observation may be met with skepticism by those familiar with the Tunisian management culture, yet that is the challenge that Tunisian managers must meet if they are to hope to compete in an increasingly competitive global economy.

Another key challenge is the fact that share values can increase or decrease, often without any rational explanation and despite the best efforts of the workers. In addition, the ESOP investment represents a non-diversified, perhaps even highly illiquid investment. Risk-averse workers may be concerned about the nature of what may be their first opportunity to own investment assets. In the future, Tunisian policy makers may wish to require that long-term employees be offered a diversification option for those amounts left in an ESOP over the long term. On the other hand, all parties must recognize that, unless the company has a ready market for its shares, creating share liquidity may burden the company with additional liabilities, thereby depressing the value of everyone's shares. Workers will need to realize that this investment is one where their efforts can have a substantial influence on share value and that their sustained, dedicated effort is the best insurance this investment can have.

Numerous cultural and uniquely Tunisian challenges will arise in adapting this international concept to Tunisia. For example, certain workers may feel that everyone should receive the same amount of shares in the ESOP. Yet one key strategy for attracting and retaining highly effective employees (including key management employees and those with other specialized skills) is through motivating them with a chance to own a stake in the future success of the company. Salary levels are typically viewed as a "proxy" for the value that an employee contributes to the company. Thus, the ESOP guidelines permit the ESOP's shares to be divided among employees based on their relative salary levels or on the basis of salary and length of service. Such an approach has an inherent logic to it, yet that logic may require a period of education. Additional stock participation arrangements may be appropriate to attract, retain and reward skilled managers or other top performers.

The greatest challenge may be education and communication. Tunisians (like people everywhere) are not educated to be owners. At best, they are educated to be workers. Ownership opportunities have traditionally been limited to personal effects and perhaps a car or a home. Stock ownership is not widely known, with many Tunisians having only the faintest notion what stocks really are. That challenge can best be met by providing an opportunity to own and by combining that opportunity with a long-term national education initiative and a short-term initiative established as part of the Government's privatization process and as a sustained effort within ESOP companies.

Maturing ESOPs present several unique challenges that should be anticipated. For example, once the initial tranche of shares has been acquired, paid for and allocated to employees' ESOP accounts, what will happen to the ESOP thereafter? Will the ESOP be acquiring more shares? How are new employees to be brought into the plan? Will allocated shares be available for diversification (for example, in lieu of distribution)? What, if anything, will be done to change the culture of the workplace? Is it intended for corporate management structures to change? International experience suggests that these and other challenges are best resolved in a collaborative process involving all affected parties.

ANNEX 1

ESOP OPERATIONS: EXPLANATION OF SUGGESTED GUIDELINES

This section provides an illustrative overview of suggested guidelines that could be adapted to ensure that ESOPs are implemented with appropriate fairness standards. Thus, this section is divided into three primary subject categories: (1) participation requirements, (2) limitation requirements and (3) distribution requirements. The ESOP guidelines should also include certain qualification criteria whereby those ESOPs not in compliance with the requirements will lose their employer and employee-based tax reliefs. Recommended qualification requirements appear at the end of this section.

Unless otherwise noted, it is recommended that requirements similar to these be made a part of the ESOP Guidelines, serving both as a guide for establishing ESOPs in the targeted three companies establishing ESOPs and as a guide for indicating to the Government whether an ESOP is implemented and operated to reflect the intended privatization policies.

Participation Requirements

Eligibility to participate. Every employee who works at least half time and has been employed by the company for at least one year should be eligible to participate in the plan.

Participation in the plan. An ESOP should not be considered eligible to qualify for the policy initiatives provided by CAREPP unless such plan benefits at least 50% of those employees eligible to participate in the plan.

Voluntary participation. Participation in a plan should not be made a condition of employment for those employed by a company when the plan is established. Deductions from employees' compensation should not begin until the company has provided the employee with a summary description of the plan.

Similar terms. An ESOP should require that all eligible employees are entitled to participate in the plan on similar terms. The plan may provide for a distinction between participants in the allocation of ESOP shares based on the level of their compensation or length of service or both. Discrimination in favor of lower-paid employees should be disregarded.

Limitation Requirements

Allocation Limitations. Contributions and other additions to a participant's ESOP account for the year (i.e., including contributions but excluding dividends) should not exceed 10% of the participant's annual compensation. The plan should contain provisions ensuring that no allocation of plan assets is made to any participant owning more than 5% of the share capital of the company.[1]

Allocation Formula. The plan allocation formula should not discriminate among participants on any grounds other than length of service or relative compensation or some combination. The allocation formula should be such that in its application it does not result in the plan becoming a top-heavy plan.

Top-heavy Rules. A plan should be considered "top heavy" if (a) a participant's ESOP account exceeds in value more than 10% of the total value of all ESOP accounts, (b) more than 80% in value of the assets of a plan are allocated to participants comprising the most highly compensated 20% of all participants or (c) the allocation of ESOP shares among participants results in any participant being allocated in that year less than 10% of the number of ESOP shares allocated in that year to any other participant.

Distribution Requirements

Distributions and Distribution Options. Distributions to a participant should commence not later than 90 days after a participant's termination of employment unless he is re-employed before the end of such period by the company. In-service distributions shall be in accordance with the terms of the plan. A participant should have the right to demand that the assets comprising his account be distributed to him in the form of company shares.

Put Option. Shares must be subject to a put option if not publicly traded when distributed.[2] A put option must be exercisable during a minimum 15-month period which begins on the date the security is distributed by the ESOP. Payment under a put option may be in the form of periodic payments over a period not in excess of three years provided reasonable interest is paid on the unpaid balance.

ESOP Right of First Refusal. A company may subject such shares to a right of first refusal in favor of the company or the ESOP. The price and terms of this right of first refusal should be no less favorable than the price and terms offered by a bona fide purchaser making an offer in writing in good faith to purchase the shares.

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[1] This 5% threshold may be too high for companies with many employees and too low for those with few employees. In the case of companies with less than 100 employees, it is suggested that 10% be substituted for 5%.

[2] It is recommended that the put option be required of any ESOP company except those listed on the Premier Marche. See Section 2.1 ("Legal Environment") for a review of certain Bourse requirements that will require adaptation in order for these distribution guidelines to become fully operable (e.g., the Bourse requires an acknowledgement of sale procedure for unlisted companies and prohibits restrictions on sale).

Call Option. A company whose articles of incorporation include an intention for it to become and to remain substantially employee-owned should have the right to require that employees sell distributed shares to the company.

Internal Market. An ESOP may provide for the creation of a market in allocated ESOP shares.

Taxation on Acquisition and Distribution of Shares. No income tax should be payable by the participants upon the acquisition of shares on their behalf by the plan or upon the payment to the plan of dividends or of dividends used to repay ESOP debt. Upon the distribution of shares to a participant or a designee of the participant, the taxable income of the participant for purposes of income tax should be 100% of the value in the first 3 years after the date of allocation of such shares, 75% of the value in the fourth year after allocation, 50% of the value in the fifth year after allocation and 25% of the value in the sixth year after allocation.[3] Any distribution of shares more than 6 years after the date of allocation should be tax free. Shares distributed due to retirement, death or involuntary termination due to redundancy should be exempt from tax.

ESOP Qualification Requirements

ESOP Qualification Requirements. To qualify as an ESOP, the plan must meet such requirements as may be prescribed. An ESOP meeting such requirements should be granted tax-exempt status.[4]

ESOP Shares. ESOP-held shares should be limited to company securities that rank at least equally with the best class of ordinary voting shares of the company and are not subject to any restriction other than restrictions which attach to all shares of the same class.

Participants should be entitled to direct the voting of allocated shares. Unallocated and undirected shares should be voted in the same proportion as votes on the allocated shares.

Written Plan. The terms of the plan should be set out in writing, identify the sponsor company and contain provisions identifying participants and providing an individual account for each participant. The plan should be designated as an ESOP in the plan document and should be designed to invest primarily in securities of the employer.

Certain Arrangements Banned. An ESOP may not obligate itself to acquire securities from a particular shareholder at an indefinite time determined upon the happening of an event.

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[3] That portion attributable to payments from employees' after-tax income would be recovered tax-free. It is suggested that such employee payments be considered as recovered first.

[4] An ESOP may be operated as an intermediate repository in association with a bank or a brokerage firm.

Plan Established before Due Date; Date of Contributions. In order for a plan to qualify for any available employer-related tax reliefs, the ESOP should be established prior to the filing date for the employer's tax return.

No Assignment or Alienation of Benefits. The ESOP Law should include a requirement that benefits provided under an ESOP may not be assigned or alienated except to the extent that (a) shares acquired with a ESOP loan may be pledged as security for such loan and (b) allocated shares may be pledged for the purchase of a principal residence.

Merger, Consolidation or Transfer. An ESOP should provide that in case of any merger or consolidation with or transfer of assets or liabilities to any other plan each participant will receive a benefit equal to the benefit existing prior to such transaction.

Use of Loan Proceeds. The proceeds of a loan undertaken to acquire employer shares must be used within a reasonable time after receipt only for the purpose of acquiring such shares. The interest rate of a loan must not be in excess of a reasonable rate of interest. Shares acquired with an ESOP loan must be released for allocation to participants' individual accounts as loan principal is repaid provided that the amortization of loan principal should be no less rapid than level amortization over the term of the loan.

Valuation. Except where ESOP-held shares are listed on the Premier Marche, the shares should be valued no less often than annually by an independent, qualified appraiser and such valuation may be used for all purposes necessary to the operation of the plan.

Employee Communication. The employer sponsor should provide to employee-participants a summary description of the plan, including sufficient details such that the ordinary person should be able to comprehend the operation of the plan, including the individual tax consequences to the employee. Such a description should be provided to employees prior to their being solicited for funds to participate in the plan.

ANNEX 2

THE FUTURE OF ESOPS IN TUNISIA

The Government's interest in ESOPs is a symptom of a broader problem: the tendency of traditional corporate financing techniques to concentrate ownership and income in the hands of a few (or in the Government).[5] Neither alternative is capable of advancing the goal of social solidarity. Thus, it is recommended that the Government consider: (1) means for expanding the ESOP's applicability beyond the limited realm of privatization and (2) means for adapting the ESOP concept to expand ownership more generally within the Tunisian population (i.e., beyond those employed by privatizable companies). Consideration should also be given to how ESOP financing can be adapted to strengthen related sectors (for example, financial institutions).

The balance of this section offers an overview of potential ownership-expanding initiatives and recommendations for enhancing the applicability of the ESOP as a privatization financing technique and as a technique to address more general concerns of the Government regarding economic participation. Additional analysis would be required to recommend specific components of a comprehensive ownership-broadening initiative appropriate to Tunisia.

The following examples are illustrative of such components:

ESOPs for Financing New Capital. The initiative could permit ESOPs to be used for the financing of new capital (i.e., by allowing ESOPs to be used to acquire newly-issued or treasury shares of the company). This could provide a tax-incentivized method for simultaneously expanding both private productive capacity and private capital ownership.

Stock Options for Workers. Encourage companies to offer stock options to a broad base of their employees.[6] Such options can be structured (and encouraged) in a wide variety of ways.

ESOP Incentives Available for Private Companies. The ESOP-related tax reliefs could be made more broadly available. For example, by providing encouragement to ESOPs in already-private companies, the Government would be providing those companies a means by which present and future shareholders in unlisted companies could use the ESOP as a market for all or some portion of their shares (the most common use for ESOPs in the U.S. and the U.K.). The availability of such an in-house "exit mechanism" could also help attract the capital of both foreign and domestic investors who may otherwise be concerned about the liquidity of their Tunisian investments. Thus used, the ESOP also provides an excellent business succession tool, for example, with retiring family members selling their stake to an ESOP. In addition, this ESOP application could provide a way to balance the need for foreign investment capital with

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[5] See Section 2.5.

[6] Pepsico recently offered stock options to over 145,000 of its employees worldwide.

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the political distaste for long-term foreign ownership and control -- by providing foreign investors a means (and an incentive) to transform this foreign capital into domestic ownership; by providing a tax-favored means to phase-down or exit that interest. In addition, encouraging this ESOP market for foreign-owned shares provides a way to conserve foreign exchange earnings (i.e., by transferring to domestic ownership those shares on which foreign owners would otherwise have a claim in perpetuity).

ESOPs As Purchasers of Separate Units of a Company. The separation of a unit of a company may be an attractive method for privatizing viable components of a state-owned enterprise that also includes nonviable components. Although this approach presents certain problems (e.g., a separate valuation is needed, the allocation of debts must be addressed, etc.), these problems could be resolved in the interest of accelerating the privatization process and strengthening the operation of viable components of the enterprise.

Financial Support. The Government could seek financial support for ESOP privatizations from the International Finance Corporation, an investment affiliate of the World Bank, including utilizing their equity capacity to support ESOP debt financing and using ESOPs as a mechanism both for exiting that equity investment and in support of capital structures designed to transfer to Tunisian ownership some or all of the interests of foreign investors.[7]

Matching Grant Program. The Government could apply to one or more donor organizations (e.g., The World Bank or USAID) for funds to facilitate a grant program to provide assistance for ESOP-related feasibility studies. Those funds could convert to a company-paid 10-year, interest-free loan in those instances where an ESOP/privatization transaction is completed. This matching grant program could be structured on an employer-matching basis and expanded to allow the funds to be utilized both for feasibility studies and for implementation costs.

Warrants.[8] Warrants can provide a mechanism for sharing the benefits of the potential success of privatized companies with those not directly employed by the company -- such as those who may be stakeholders rather than stockholders -- including those providing such critical community services as education, security, fire protection, water and sewage treatment, etc. For example, the privatizing entity (or a designated agent) could take warrants in privatized companies and dedicate any proceeds to fund housing or pensions for such stakeholders, or to finance projects designed to support economic reform efforts (such as infrastructure projects), or to provide capital for banks agreeing to support ESOP loans for other privatizations, etc.

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[7] The primary role played by the IFC lies in catalyzing additional flows of risk capital from foreign and local investors prepared to provide needed technical and management services. Recently, a primary focus of the IFC focus has been on completing model privatization transactions.

[8] A warrant is a type of security that entitles the holder to buy a proportionate amount of stock of a company at a specified price for a period of years or for an indefinite period.

Company- sponsored ESOPs could provide a potential market for the shares when those warrants are exercised. This approach provides a method for more widespread social (i.e., stakeholder) sharing in privatizations.[9]

Capitalizing Banks. The Government could group ESOP-related notes, installment sale contracts and lease-purchase agreements into portfolios to average the risk. These portfolios could become a capital contribution to a bank (or a component of a bank). In return, the bank could agree to dedicate some portion of the resulting loan capacity to support ESOP financing and agree to perform the administrative tasks that accompany such contracts and agreements.

Grant of Shares to ESOP. The Government could consider granting a modest tranche of shares to employees via an ESOP. This grant would be a method for aligning employees' economic interests with the long-term performance objectives of the company. Although this tranche of shares conceivably could be sold to the employees via ESOP financing repaid from future company earnings, the Government may wish to consider foregoing a modest amount of such revenue (also relieving the company of that strain) and instead make a grant of shares in order to accelerate the speed of privatization and widen the scope of participation. The revenue foregone in the form of sale proceeds could possibly be recovered by hastening the privatization, thereby relieving the Government of any continued subsidies while gaining increased tax revenues from companies privatized via means that can enhance company performance by ensuring that employees gain a significant ownership stake.

Promotional Campaign. Implement a promotional campaign to educate Tunisians about capital ownership and to assist ESOP companies in communicating with their employees on a sustained basis.

Beyond ESOPs. The ESOP privatization technique could be combined with broader ESOP-type financing to assist in creating ownership not only by those directly employed by an enterprise but also by those employed by companies with whom the enterprise has significant economic relationships (such as suppliers and customers) via related enterprise stock ownership plans "RESOPs". Similarly, the ESOP financing concept could be adapted to create ownership by the customers of those companies providing certain public services (such as gas and electricity services) via consumer/community stock ownership plans ("CSOPs").

RESOPs. The related enterprise share ownership plan ("RESOP") provides a technique for employees of related companies to own shares in a non-employer company. This can help facilitate a type of vertically-integrated, cross-ownership system with the potential: (1) to positively impact the quality of productive throughputs (i.e., by creating motivated employee-owners at each stage of the production process), and (2) to include as owners those individuals who may otherwise be excluded, such as enabling micro-enterprise proprietors (such as small

[9] For example, in return for granting Chrysler Corporation a $1.2 billion government loan guarantee, Chrysler Corporation provided the U.S. Government with warrants that, initially valued at $6 per share, were later sold at $72 per share.

farmers and employees of smaller, more volatile yet often more dynamic businesses) to participate in the ownership of larger, more established and (importantly) more value-added enterprises.[10]

This same concept could be applied to larger related enterprises such as including the employees of shipping companies in the ownership of a railway or including the employees of transporting companies in the ownership of a natural resource-extracting company, etc. This approach could also enable corporate employees to diversify their ownership stake by owning shares both in their employer and in a separate yet related enterprise. Facilitating the internal trading of shares among employees in such related enterprises could also advance this goal. Such ownership structures could also contribute to enterprise viability and competitiveness by encouraging capital structures that reflect the logistical, financial and psychological environment in which companies operate.[11]

CSOPs. As Tunisia continues its transition, it may wish to consider transferring to private ownership all or a portion of certain state-owned public service providers (such as gas and electricity). When considering how to structure that privatization (or partial privatization), Government officials should recognize that the company's consumers are required to pay a price for those services that includes the cost of debt service, capital expenditures for expansion, environmental cleanup, and the generation (i.e., cost) of a fair return to any other private investors (i.e., a return adequate to encourage them to continue their investment in this company rather than another). As the sole source of such a company's revenue for such public service providers, the consumer's patronage both maintains the value of the company's shares and finances new capital expansion for all investors -- generally via rates set by a governmental body.

In financial markets, the value of a company is a function of the cash flow it is expected to generate over time. The discounted present value of those projected cash flows approximates the value of the enterprise and the price investors are willing pay for its shares. In the case of

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[10] For example, a large Casablanca-based dairy sold 40% of its shares to the employees and to its small, non-employee milk suppliers. The shares were acquired from the company with the proceeds of a company-negotiated bank loan secured by the shares, with the micro-enterprise milk suppliers paying for their shares by the company withholding a prescribed amount of milk from that delivered for sale to the company. The shares were released as they were paid for with this "milk deduction" system. This ESOP/RESOP combination enabled small farmers to gain an ownership stake in the larger, more stable milk processing/marketing/retailing company -- wherein resides more of the value-added component of dairy production. A similar arrangement was found while assisting with the design of an ownership-broadening initiative in Jamaica where a chicken-processing company includes share ownership not only by it direct employees but also by its contract growers and its contract truckers. Currently pending Jamaican legislation is designed to encourage such "related enterprise share ownership plans" ("RESOPs").

[11] See *Capital Choices - Changing the Way America Invests in Industry* (1992)-- a research report presented to The Council on Competitiveness and cosponsored by the Harvard Business School in which the report's author, Harvard Professor Michael Porter, advocates that "Ownership should be expanded to include directors, managers, employees, and even customers and suppliers."

a public service provider, the sole cash flow source is bills paid by its customers. Thus, the "CSOP" concept suggests that those customers should have an opportunity to see some portion of their cash payments applied to finance capital ownership for themselves rather than solely for (often absentee) investors. Where a provider of such services has monopolistic or near-monopolistic consumer relationships (the usual case), the rationale for including such a CSOP component is strengthened.

General Stock Ownership Plans ("GSOPs"). Similar ESOP-type "self financing" techniques could also be used to expand ownership more generally. One such mechanism is the general stock ownership plan similar in many ways to "voucher" privatization plans.[12] In one version of the GSOP concept, a corporation is permitted to operate tax free provided it complies with the operational principles of ESOPs (i.e., broad-based participation, individual limitation and an incentive for earnings distributions that create widespread capital-based incomes).

For example, the U.S. enacted GSOP legislation in 1978 authorizing "general stock ownership corporations" granting tax-free status to any corporation that:

1. includes as a shareholder each citizen of the chartering state,
2. limits individual ownership to 10 shares, and
3. pays out 90% of its pre-tax earnings to shareholders on a currently taxable basis.

A similar approach could be adapted, for example, to foster broad-based ownership of all or a portion of a company extracting natural resources[13] or a public service company or any other revenue-generating activity. The scope of inclusion need not be national; it could be regional, local or even community-based (e.g., broad-based, community-oriented, private ownership of a local industrial or business park). Or a GSOP could be combined with an ESOP or with any of the other ESOP-like financing techniques (e.g., RESOPs or CSOPs).

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[12] Whereas voucher privatization schemes often provide means for citizens to invest in a variety of companies (either directly or via mutual-type funds), the GSOP concept enables a large number of citizens to acquire shares in a single company, although a GSOP could be adopted in a number of companies, thereby achieving the same effect. Voucher privatizations typically enable citizens to acquire shares for a nominal sum whereas GSOPs envision the shares being paid for over time largely with the earnings of the company.

[13] The U.S. GSOP legislation was originally designed to enable Alaskan citizens to acquire the interest of British Petroleum Pipeline, Inc. in the TransAlaska Pipeline Service Corporation, paying for it with the future dividend stream. Although never implemented (for state political reasons), the scheme was regarded as financially feasible. A similar approach could be adapted to foster widespread citizen ownership participation in mining deposits or drilling rights located on public lands (for example, with the GSOP retaining a royalty interest and a more conventional company gaining the extraction rights -- perhaps with an ESOP or a RESOP).

ANNEX 3

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