# Protecting Employee Entitlements

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Proposed legislation, the Corporations Amendment (Maximum Priority for Employee Entitlements) Bill, would place employee entitlements ahead of other creditors in the event of employer insolvency. While protection of employee entitlements is highly desirable, this is a sub-optimal solution to the problem.

Legislative re-ordering of creditor priority involves many problems. An alternative approach is available involving fewer distortions and lower costs.

Australian workers, through deferred benefits such as annual and long service leave entitlements, are significant providers of funds to Australian companies. In aggregate these entitlements probably exceed $50 billion.

Unlike other providers of finance, finance provided by workers entitlements amount to "conscription by legislation", rather than a voluntary response to promised returns which reflect the default risk involved.

The risks to employees can be substantial – and compounded by the fact that default coincides with loss of job and current income stream. Given a choice, it could be expected that workers would demand a quite high rate of return to voluntarily invest funds in accrued entitlements held by their employer.

Accrued entitlements are often wrongly considered a "free" source of working capital for employers. This is not so.

The implicit cost of entitlements as a source of capital is approximately the annual rate of remuneration growth (since the dollar cost of a week of leave accrued now and taken in (say) a year will increase in line with the employee's salary). This implicit cost can be significantly higher than the cost of capital market funding.

Employers cannot avoid this cost of funding via employee entitlements, but alternative arrangements can be put in place to better protect workers' funds. To the

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extent that these require employers to replace this form of funding with other funds, our analysis indicates that additional costs will be small (or warranted).

Suppose a firm placed assets of equivalent value to employee-entitlement provisions into an income-earning trust established to pay entitlements, and raised equivalent funds (to replace the working capital so lost) from the financial markets.

In a perfect capital market this would have no effect on company value. Suppose however there is, in reality, a cost to the firm.

This suggests one of two things. A first possibility is that there are excessive spreads between investing and borrowing rates in the financial market, which are unrelated to risks involved. If so, further financial market reform is called for to ensure adequate competition.

The second possibility is that the spread faced by a company is high because of the company's risk. What that tells us is that the firm is receiving funding from employees at a cost below that appropriate for the risks associated with the investment of funds.

An appropriate policy response should both provide protection and rectify this legislative impost on employees.

It should also recognise that the current arrangements are not conducive to good corporate governance. A significant group of creditors (employees) have no effective control rights associated with their financing stake.

Our proposal for protection of deferred benefits, the DB Scheme, is briefly outlined below.

Employers would be required to maintain balances at least equal to reasonable aggregate provisions for entitlements (as reported in monthly management accounts) in designated interest earning DB Funds at financial institutions. DB Funds would be structured similarly to Cash Management Trusts (CMTs) and invest only in short-term high-rated financial assets.

Amounts held in DB accounts would, by enabling legislation, be available only to meet the entitlements in the event of company failure (or demonstrated reduction in provisions). Boards, management (and perhaps auditors) would be held accountable for ensuring adequate funds were maintained in DB accounts.

The requirement to replace this working capital with other forms of external funding would enhance external monitoring and thus governance within firms. If it is at a higher cost than conscripted funding from workers, that is a correction of an existing inequity which should be applauded.

Our proposal is not the entire solution. The GEERS scheme would still be necessary to cover cases of corporate non-compliance with the DB provisions (or increases in entitlements due to redundancy payments brought on by insolvency).

The *Corporations Law Amendment (Employee Entitlements) Act 2000* provides the teeth to prosecute non-compliers.

The DB plan may not appeal, at first glance, to employers. But it will be less costly in the long run than legislative reordering of creditor priority.