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Welcome to *NCOE Update* -- a biweekly report on economics and the entrepreneurial economy. Through *NCOE Update*, we bring you short summaries and analyses of trends and transformations driving the innovation economy. We welcome your input and suggestions for how we can improve this service. In addition, please feel free to share this with friends and colleagues. To subscribe or unsubscribe, send an email to ncoe@sso.org.

The Upside of Stock Options

At NCOE, we're still fans of stock options. At a time when some CEOs are facing jail time for options abuses, that's a little bit like touting the health benefits of smoking. But, we persist because, while some corporate chieftains have clearly misused options, equity sharing has also benefited many rank and file employees. A new book, *In the Company of Owners: The Truth About Options (And Why Every Employee Should Have Them)*, by Aaron Bernstein, Joseph Blasi, and Douglas Kruse, provides compelling evidence that, when used correctly, stock options can have a powerful effect on the bottom line of both employers and employees.

Bernstein, Blasi and Kruse take a comprehensive look at the effects of stock options in leading corporations. They're not just interested in effects on incomes and compensation; they also seek to understand how options affect corporate culture.

The heart of the book focuses on the "High Tech 100," an index of 100 publicly-traded information technology firms who heavily use options as a compensation tool. The group includes many household names like Cisco, Sun, America Online, and Intel. Overall, the "High Tech 100" companies share several characteristics:

-They provide options to all employees.
-They derive 50% of sales from Internet-related business.
-They all rode the ups and downs of the dot-com craze. Eight of the firms declared bankruptcy at one point, but nearly all are still in business.

The authors' review of the High Tech 100 as well as employee ownership among
the top 1,500 U.S. companies yields some interesting findings. First, it is clear that some executives have misused options. For example, the authors examined compensation for the top five executives at those 1,500 leading firms. They found that this small cadre of senior managers gained $18 billion in options profits in 2001---a fivefold increase from the early 1990s. This small executive group still controls nearly 11% of all outstanding public shares.

Moreover, these more traditional firms reserved most options for those at the top. Roughly 30% of all options are held by senior management; rank and file employees controlled only 2% of total equity. Overall, only 6% of large corporations provide options to all employees.

Second, the High Tech 100 were much more democratic in their use of options as a compensation tool. Managers in these firms are not making major pay sacrifices, as the top five executives group in the High Tech 100 still controlled 14% of total equity. Yet, rank and file employees in these firms do better. They controlled 19% of total equity, compared to only 2% in the larger 1,500 firm sample.

Third, employees can gain from options even in bad times. Employees in the High Tech 100 paid dearly after the 2000 tech downturn as their options lost $171 billion in paper value (an 83% decline) between March 2000 and July 2002. Yet, even in these doldrums, the average value of remaining options was $25,000 per worker. While that total will not create new millionaires, it's still a sizable compensation component.

Finally, widespread use of options seems to have a positive effect on company performance. The authors conclude that broadly distributed ownership boosts a company's productivity by about 4% and raises total shareholder return by about 2%. At the same time, they find that concentrated ownership has no beneficial effect on corporate performance.

So, what does this all mean? One clear conclusion is that fat options packages are often an ineffective way to motivate and reward senior managers. However, at the same time, it seems clear that widespread distribution of options to all employees---from the janitor to the CEO--can have a positive impact on both employee morale and company performance. Shareholder value is built through wide equity sharing, not just by rewarding those at the top. The authors argue that the U.S. should embrace this form of "partnership capitalism" as an effective means to turn employees into economic partners in the enterprise. Members of Congress, regulators and other policy makers should keep this more complicated picture in mind as they continue to consider reforms of existing compensation practices.

In the Company of Owners: The Truth About Options (And Why Every Employee Should Have Them), by Aaron Bernstein, Joseph Blasi, and Douglas Kruse (Basic Books, 2003) is available at major bookstores.

UPCOMING EVENTS

The next few months are packed with events of interest to followers of the entrepreneurial economy. For a listing of upcoming events, click here: www.ncoe.org.

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