BEYOND SHAREHOLDER VALUE

The reasons and choices for corporate governance reform

TUC

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SOAS University of London

Edited by
Janet Williamson
Ciaran Driver
Peter Kenway

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FOREWORD

Chuka Umunna MP

It is a great honour for me to have been asked to pen the foreword to this fantastic collection of essays. They contain so much valuable food for thought from a wide range of accomplished authors, offering real insight. Corporate governance matters enormously to the nature of our economy and the kind of growth we see. If we are to build an economy that works for all, we must address the endemic short-termism in our corporate culture and the narrow metrics by which success is judged. Here, the rules governing corporate behaviour are critical because they shape the business models firms adopt, the investment decisions that are made, and in whose interests they are made. If we want firms to take a longer-term, broader and more inclusive view of the value they create, we need rules that encourage and support this.

Of course, policy making is not just about good ideas for improvement, based on a rounded understanding of the current situation – although that obviously helps. It is also about understanding why we are where we are – the roads not taken, the opportunities missed, the reasons why, and the lessons of history we must learn. This collection scores highly on both counts, and should prove to be an invaluable resource to anyone with an interest in shaping Britain's future economic success.

This is not surprising. Over many years the TUC has been a thoughtful leader in the debate about corporate governance, as part of their leadership in a much bigger conversation about the direction of Britain's economic future. How – in a world of rapid, profound change and vast opportunity – Britain can build an economy generating sustainable, balanced and inclusive growth. I am clear that an economy succeeding in creating more, better-paid jobs across a range of sectors and in every part of Britain will be an economy succeeding in other ways too – winning in world markets and delivering for people at home.

Achieving this will take more than a return to business as usual, or a few quick fixes. If we are to generate future wealth that can benefit all we need deeper reform of our economy, sustained over a long period of time. Based on their record, it is not clear that the current Government can deliver the change required. It has not acted sufficiently to ensure that executive pay better reflects the value created or given investors and employees a proper voice in determining compensation. It resisted the EU bonus cap. And it failed to understand the long-term consequences for the UK's science base of Pfizer's proposed takeover of AstraZenica.

To build a successful economy – creating more jobs paying wages you can live on, raise a family, and build a future – we need a government that will take a different approach. It will require a rounded strategy that in every aspect supports long-term value creation over short-term value extraction and encourages firms to take a broader view of the value they create. Such a strategy will be based on decentralising decision-making power to cities and regions, putting each in control of its own destiny. And it will encourage entrepreneurship, pluralism in ownership structures, and employee voices within firms because no one has a monopoly on good ideas, and most ideas can be improved when viewed from another perspective.

The rounded strategy will first require clear direction – a compelling story about Britain's future, its sources of strength, where it will generate the jobs of the future, and how it will pay its way in the world. This will bring greater predictability and certainty to the policy environment, offer clear priorities, and make it easier for firms to invest. Second, it means markets that function well in the public interest – fair to consumers and giving insurgent firms with new ideas the chance to compete. We all lose when market power is dominated by a few, so Labour will fix broken markets in energy and banking through measures to increase competition and support new entrants. Third, it means building the institutions that enable firms to collaborate on the supply side on skills, on new technologies and other vital infrastructure. Here, government has an important role to play as an honest broker and to absorb risk over the long-term.

Fourth and finally, the rules of the game that shape the business environment and most directly govern firm behaviour must reinforce the overall approach. They must increase the payoff to firms taking a longer-term and broader view of value creation, so that this becomes a more attractive strategy for businesses of all types and sizes to pursue. Take executive pay. Labour understands the difficulties of charting the successful course of a public company through waters that can rapidly change. To do this well requires experience, judgement, courage and nerve and success should be rewarded. But we are equally clear that executive pay awards should be transparently determined and comprehensible, performance based, and accountable.

This is, of course, a fundamental issue of fairness. But it is every bit as much an issue of efficiency, and ensuring that the incentives facing executives are aligned with the long-term success of the company. It is why we have endorsed the recommendations of the High Pay Commission that pay should be reported in a standardised form, with only one additional performance related element, and with a single figure showing total remuneration. It is why the pay of the ten highest earners outside the boardroom should be published, along with the ratio between the highest paid employees and the median. It is why we will introduce binding votes on remuneration packages that work, by ensuring shareholders must approve a decision in advance, not after the event, and require that investment and pension fund managers disclose how they vote on all issues, including remuneration. And to end the groupthink and the never-ending upward ratcheting of pay that comes with it, it is why we will ensure companies put an employee representative on remuneration committees.

Executive pay, is of course, just one dimension of the broader debate about corporate governance explored in this publication. Indeed, it offers a rich seam of ideas to consider across many dimensions of the debate. I am grateful to the contributors for what they have produced, and to the TUC for bringing it all together. On issues that are finely balanced, and where small changes can have far-reaching consequences – not always intended – it can only benefit us all to have stimulated more informed discussion about the right way forward for Britain. I look forward to engaging in that ongoing debate.

Chuka Umunna is Shadow Secretary of State for Business, Innovation & Skills.

INTRODUCTION

Janet Williamson , Ciaran Driver and Peter Kenway

What is this collection of essays about?

Companies are managed day to day by their senior managers, who are answerable to the board of directors. But to whom do company directors answer? What guides the decisions they make? And in whose interests are companies run?

The answers to these questions lie in our corporate governance system. The effectiveness of the UK corporate governance system and ideas for how it could be reformed are the core subjects of this publication.

For a small owner-managed company, the manager and the owner are by definition the same person. But listed companies – in other words, companies whose shares are listed on the stock exchange – have a body of shareholders who are distinct from their managers (though it is common for company directors to hold some shares). Since at least as long ago as the 1930s, there has been a concern about how this division will affect the fortunes of both shareholders themselves and the wider economy. Until the 1980s, however, company directors were in practice left to develop and implement company strategy with little reference to shareholders. Questions about their accountability went largely unasked.

Since then, a shift in ideas and in the practice of corporate governance arrangements saw this era of "managerial capitalism" give way in many countries to one of "shareholder value". This is the era we continue to live in. In the UK, this shift was in part a response to spectacular corporate failures at the start of the 1990s: Polly Peck, Bank of Credit and Commerce International and Maxwell Communications. These failures put the question of how company directors should be held to account centre stage, given their role in the downfall of these once successful companies. Public concern about excessive executive pay was triggered around the same time by sharp rises in the pay of directors of utility companies following privatisation. This fuelled the argument that stronger systems were needed to ensure that company directors were better controlled and did not run companies primarily in their own interests.

Thus a series of reforms were put in place which aimed to increase the accountability of company directors to their shareholders. At the same time, the idea that the overriding purpose of companies should be the pursuit of shareholder value gained ever-wider acceptance, both among government and regulators, investors and indeed companies themselves.

An important question is whether the ambitions of these reforms have been achieved. What maximising shareholder value means in practice for companies, for their economic performance and for their other stakeholders is a key theme of this publication. There is a significant question-mark over whether shareholder value provides the best framework for running companies, and a lively debate over the best path for future reform.

Both these themes are explored here by the 17 contributing authors. Between them, the authors discuss the problems caused by the pursuit of shareholder value, their causes and their possible remedies. While there is a wide range of opinions on the best options for reform, the problems listed show that the current system is flawed. The problems affect companies themselves, the economy as well as the wider society. The authors have diverse backgrounds, including business and the City, trades unions, academia, think tanks and government advisers, both past and present.

Two things stand out which make what they have to say worthy of attention. First, the problems are many and serious. Second, there are alternatives. While we are not starting from a blank sheet and reform needs to take account of the starting point, this doesn't mean that corporate governance in Britain couldn't be different from how it is now. The problems may be deep and difficult, but they are not inevitable.

Corporate governance reform over the last 20 years

Successive reviews of corporate governance have emphasised the role of shareholders in monitoring and engaging with company boards, rather than regulation, as the means to improve corporate standards and behaviour. Reforms have thus tended to focus on company disclosure and boosting the powers of shareholders. This philosophy is reflected in the recommendations of the Cadbury Committee (1992), the Greenbury Committee (1995) and the Hampel Committee (1998), whose recommendations were brought together in the Combined Code of Corporate Governance in 1998, now renamed simply the Corporate Governance Code.

The Company Law Review, which reported in 2001 and fed directly into the Companies Act 2006, was different in that it did lead to a set of legal reforms. In addition, directors' duties were codified for the first time. A director's primary duty is to promote the success of their company for the benefit of their shareholders, but in so doing they should take account of the impacts on employees, customers, suppliers, local communities and the environment. In practice, these duties have had little impact on corporate practice. Company reporting requirements were also widened, but the principle that company reporting was aimed at shareholders rather than stakeholders was left intact.

Following the financial crisis, the Stewardship Code was launched in 2010, setting out standards governing the responsibilities of investors towards the companies whose shares they own.

Other reports have surveyed and discussed obstacles to effective oversight and to the pursuit of long-term objectives (*Myners* 2001; *Kay* 2012; *Cox* 2013). While these reviews have undoubtedly contributed to a better understanding of the issues, few reforms going beyond the twin tracks of transparency and encouraging greater shareholder engagement have been put in place.

Who is it aimed at?

Politicians are part of the target audience for this publication: many of the reforms recommended by the contributors would require legislation of some kind. However, changes as profound as the ones looked for here can't come about by Acts of Parliament alone. While the authors have differing views about what should be done, all agree that it requires sustained action by other groups and organisations, as well as government and politicians.

The changes sought, and their potential impact, define our target audience. This ranges from key company stakeholders such as workers, trade unions and managers, to local government, industry associations and potentially any part of society that corporations relate to.

In short, the potential audience is wide and by no means necessarily already engaged in these debates! This collection, written by specialists and experts, therefore has the task of conveying some sense of what this subject is about to people who have not previously engaged with it.

What problems is it concerned with?

The problems attributed to the pursuit of shareholder value are widespread. A point made by several authors is that the problems have worsened in over recent years, as the focus on 'shareholder value' has distorted corporate priorities (*Kay*). Furthermore, reforms designed to address failures of corporate governance have, by relying primarily on shareholders to monitor companies, been counter-productive (*Deakin*). At the risk of some blurring between different authors with similar points to make, the main problems highlighted are set out below.

A stifling of innovation and holding back of investment

- A key criticism of shareholder value is that it disrupts and **diminishes the very key to economic prosperity itself, namely innovation**. It does that because it misunderstands innovation by failing to recognise it as an inherently uncertain process of collective and cumulative learning (*Lazonick*). The importance of innovation, and the damage done to it by shareholder value, is highlighted by several authors (*Deakin, Pryce, Kay, Clarke, Corry*).

- A related problem is that the pursuit of shareholder value leads to **lower levels of investment** (*Smithers*), notably in research and development (*Diamond*, *Davis et al*, *Pryce*).

- In turn, **low investment has led to falling labour productivity** (*Smithers*), which has held down real wages growth and living standards.

Destruction of companies and economic value

- **Companies have been badly damaged or even destroyed through the pursuit of shareholder value.** Leading examples include ICI – Britain's leading company for much of the last century, and the US banks Bear Stearns and Citicorp brought down in the financial crash of 2008 (*Kay*) – as too the British banks Northern Rock and Halifax (*Deakin*).

- **The disappearance as independent entities of all the former building societies** which, starting with Abbey National in 1989, converted from mutual to plc (*Michie*). Motivated on the grounds that the shareholder form with all that it implied was the superior business form, their eventual demise shows otherwise.

- Although conducted in the name of shareholder value, **takeovers do not consistently even make money for investors** (*Deakin*) – and frequently end up destroying economic value (*Harrop*).

Negative impacts on stakeholders and the environment

- Takeovers can also be an instance of a third problem, namely the way in which the **wider effects of corporate decisions can be ignored by companies** (*Hancké*). Those affected include communities, the environment, suppliers, workers and more broadly, the national interest. These considerations are often excluded from the way that UK companies make their decisions (e.g. *O'Grady*, *Davis et al*).

- Because the costs of negative impacts on stakeholders and the environment are not borne by companies, **shareholder value can even be increased at the expense of other interests**, as in the case of environmental damage or harmful working conditions (*O'Grady*). Without strong trade unions or labour laws, 'flexible' working practices may be imposed which leave employees exhausted and their family lives damaged – but these are costs that are not borne by the company (*Crouch*).

Inequality and wider economic imbalances

- A fourth problem is the way that the rise of shareholder value has gone hand in hand with very **high pay, greater earnings inequality and a more uneven distribution of wealth** (*Gold, Davis et al*).

- Shareholder value, driven by the bonus culture, is also seen as having turned companies as a whole into chronic, or structural, net savers. Since net savings in one place must be matched by a net deficit elsewhere, the **public sector deficit itself can in part be traced to shareholder value** which makes such a deficit necessary in the first place (*Smithers, Corry*).

Flawed political philosophy on the left

- Last but not least, acceptance of the doctrine of shareholder value reflects a flawed **political "redistributive market liberalism" which has gained ground on the left**. Sanguine about markets which are to be handled with a light touch, the fruits gathered through taxation are used for progressive ends. The flaw in this is that the celebration of self-interested individualism implicit in the former is at odds with the social solidarity required for the latter (*Kay*).

What are the causes of those problems?

The explanations for the problems put forward here can be divided into two groups. The first group objects on grounds of logic or principle to shareholder value. By contrast, the second group is concerned with the practical consequences of shareholder value.

Shareholder value is flawed in principle

Shareholder value has been defended in all sorts of way throughout history but two justifications – one basic and one more sophisticated – are often distinguished. The basic theory says that shareholders own the firm and therefore have control rights over it. This is actually wrong in law – the shareholder does not formally own the firm, only the share. Furthermore ownership does not always imply control – you may own a piece of land but require planning permission to build. A more sophisticated argument is that shareholders *should* have control rights because. they bear the greatest risk and provide essential finance capital. However several of our contributors take issue with this position.

- **It is not only shareholders who bear risks or supply important inputs: both taxpayers and the workforce do too** (*Lazonick, O'Grady*). Moreover, some stakeholders bear greater risks than shareholders. For some, their livelihoods, pensions, or businesses may be at stake. These points weaken the argument for shareholder primacy.

- This leads to the critique that **the notion of the corporation as something independent of its social context is flawed.** Markets and corporations serve citizens when, and only when, they are embedded in the societies of which they are part (*Kay*). Not every transaction takes place through the market nor can it. This limits the claim of shareholder value which is located in a world of market exchange only (*Crouch*).

- Going further, some argue that the very idea of shareholder supremacy and the lack of opportunity for workers to be involved in company decisions reflect **incompleteness in our democracy** (*Gold*).

- Another way to criticise shareholder primacy is to **expose its adverse consequences as following naturally or inevitably from it** (*Deakin*). This leads neatly into the section below.

Short-termism associated with shareholder value is the problem

Short-termism means that decisions are made with an eye to their consequences in the near future rather than over a much longer period of time. The average time that a share is held for is now measured in days. Company directors can be short-termist too, partly because they may not be in their posts for long and also because they are incentivised by bonus and share-related pay to seek the short-term gains they believe the shareholder wants.

A distinction can be made between those who see boardroom pay as the root of short-termism and those who attribute short-termism to the workings of the complex chain whereby finance is provided via layers of intermediaries. These issues are discussed by several authors here (*Corry, Pryce, Deakin, Diamond, Harrop, Smithers*).

- If the main issue is that short-termism is encouraged by the system of **incentive or performance pay** for company directors (*Smithers*), short-termism could be argued to reflect flaws in the particular arrangements in place for executive remuneration – flaws that could *perhaps* be remedied.

- On the other hand, if the issue arises because of the **short-term horizons of the investors**, a remedy may be harder to find. One argument is that institutional investors are short-termist because the management of clients' money gets delegated to financial managers and that the system of rewarding these financial managers needs reform. Even the long-term institutional investors such as pension funds may end up investing in a short-termist way because of the way their investments are managed by others further down the chain whose incentives can encourage a focus on short-term share price movements. Asset managers lack the capacity or will to engage actively, in part because of the sheer number of their shareholdings; in addition, they pursue business models that include a focus on share trading (*Barker, Deakin, O'Grady*). Institutional shareholders who take a short-term approach seem to have become more prominent in recent years (*Pryce*).

- The various ways in which short-termism arises and operates may be intricately intertwined and perhaps it is not possible to distinguish cleanly one form from another. It can be argued that a fundamental problem is a **culture of short-termist thinking and decision-making** (*Pryce*). This can be described as a shared belief in boardrooms that investors will punish long-term decision-making and a shared view among financial managers that they will lose their jobs and bonuses by taking a long-term view. It is linked to the view that it is the practice, rather than the principle, of shareholder value that is the problem (*Barker*). This sense of a particular culture of capitalism makes most sense by references to contrasting systems such as in Japan or Germany, where companies can more easily plan for the long –term. The Danish foundation company system is another example (*Thompson*). But the UK is an outlier even by reference to the US. Some of the high profile takeovers of UK companies by US companies would be impossible the other way round (*Deakin*).

What can be done to tackle those causes

Not all authors answered all questions. Some of those with the clearest analysis of the problems did not explicitly set out answers in their contributions here. Others offer a possible answer without the preceding analysis. The responses offered here can be grouped under two basic headings, namely **representation** and **institutional reform**.

- **Representation**, directed towards the organisation of companies and the wider economy, focuses in particular on who participates in decision-making. Proposals in this area include both mandatory and voluntary arrangements, with greater or lesser formality.

- **Institutional reform**, that is, of the "environment" in which all companies, at least within any sector, make their decisions. This can range from the tax system or other incentives to corporate governance codes, the law and rules governing takeovers.

Changes in representation

The various changes to representation within company decision-making structures proposed by our authors cover a wide of range of contrasting, at times even opposed, positions.

- An idea proposed by several contributors is that **workers should have a statutory right to representation on the board**. This is the keystone in a series of wider employee rights including to information, consultation and codetermination. This would stimulate innovation by engaging the creative energy of the workforce (*Lazonick, Clarke*). Instead of poorly-informed external directors, decision-making should be more collegiate involving worker representatives alongside senior executives (*Deakin, O'Grady*).

- **Greater diversity of boards' members** could also include a greater proportion of women on boards as well as employee and investor representatives (*Davis et al*).

The goal of greater diversity on company boards could also be achieved via the route of an **independent nominations committee for non-executive directors** on which shareholders and employees could sit (*Pryce*).

- **Voluntary stakeholder boards**. Such boards, although voluntary and advisory only, would still represent a formal mechanism for putting a key principle of the 2006 Companies Act into practice. This principle – "enlightened shareholder value" – says that while a company's legal duty remains that of making decisions in the interests of the shareholders, it should fulfil that duty in a way that takes account of the impact of decisions on all stakeholders. This proposal is consistent with the view that the problem with shareholder sovereignty is not the theory but its application in practice: shareholder sovereignty remains, but should be opened up to other influences (*Barker*). But it is also figures as one element of a much wider programme of reform as a means for involving stakeholders other than workers (*Harrop*).

- A different response with narrower but more focused objectives is for **wider representation on the remuneration committee**. Employees on this committee, which decides on senior executive pay and compensation, would help protect against groupthink (*Corry*) and improve transparency (*Harrop*).

- To build the conditions for successful stakeholding, **small pragmatic steps to help build trust and the basic spirit of co-operation between key stakeholder groups** are proposed. For example, co-operation around local and regional training and/or innovation systems could bring together local unions and industry associations with local government (*Hancké*). Low trade union membership in the private sector means that worker representation on the board is not the same as union representation (*Gold, Clarke*). Yet any proposal would have to have strong union support to be effective and to stiffen the resolve of a government that was bound to face opposition from business leaders (*Corry*).

- Looking beyond individual companies to the wider economy, there is the proposal for **wider representation on the regulatory and other bodies** that populate the environment in which companies make their decisions (*Davis et al*). This includes such specialist bodies as the Takeover Panel, the Financial Reporting Council and the London Stock Exchange. Small businesses and local government as well as employees could be represented on these bodies, thus making them more accountable to the wider interests affected by their decisions.

Institutional reform

Institutional reform covers many things, but is basically concerned with the "environment" in which companies make their decisions.

- There are different ideas for ways to widen **share ownership** and increase motivation. Following a recommendation of the Cox Review, workers could have an entitlement to be paid a proportion of their salary in shares (*Diamond*). Government could take small stakes in companies whose success has depended on public sector intellectual capital, creating a minority shareholder with a very long-term view (*Harrop*). Encouraging the use of **different classes of shares** – a practice much more common in the US – is a way of differentiating among owners, for example to protect the original innovators (*Deakin*)or to restrict corporate governance rights to long-term shareholders (*O'Grady*).

- More radical is the notion of a **foundation company** (*Thompson*) where self-owning, self-managing organisations work for objectives defined by the foundation charter rather than shareholder value.

- **Reform of directors' legal duties** so that directors are required to promote the long-term success of their company as their primary aim could help change the focus and priorities of company decision-making (*O'Grady*).

- **Reform of codes – "soft law" –** concerning corporate governance and stewardship play a part in the fundamental task of changing culture and perceptions (e.g. *Pryce*).

- **A high-level goal of promoting a greater diversity of corporate forms** in the UK could be pursued (*Crouch, Michie*). Hard corporate law and softer government policy could foster viability of alternative forms of governance, such as venture capital and mutuals (*Crouch*). The suggestion of an index of corporate diversity (*Michie*) exemplifies the point that having something measured can be the first step to it eventually becoming the object of policy.

- **Tightening the rules surrounding takeovers** is another focus for reform. This includes increasing the threshold for a "yes" vote, as well as restricting voting to those who have held their shares either for a minimum length of time or since the takeover bid was first made (*Diamond, Davis et al*). Small rule changes since 2010 played a part in the failure of Pfizer's bid for Astra-Zeneca in spring 2014.

- **Ending the requirement for quarterly reporting** is seen as removing one of the pressures that makes for a very short-term perspective (*Diamond, Corry*). Ending this requirement was a recommendation of both the Kay and Cox Reviews. Government has accepted it but so far it has not been implemented.

- **Changes to company and personal taxation** are seen as another powerful tool to alter behaviour in a particular direction. These include changes to capital gains tax to encourage long-term share ownership (*Diamond*). Corporation tax breaks could be used to favour investment and penalise companies sitting on cash surpluses (*Corry*). A fundamental critique of shareholder sovereignty can see the tax system more generally as one means of recognising the role of the public sector in corporate success (*Lazonick*).

Beyond shareholder value

As is increasingly widely recognised, the interests of shareholders, company stakeholders and wider society can diverge. As noted by Andrew Haldane of the Bank of England in a recent speech, if shareholders have all the power and they are short-termist, "...we might expect high distribution of profits to this cohort, at the expense of ploughing back these profits (as increased investment) or distributing them to workers (as increased real wages)" (*Haldane* 2014). An example of the wider societal impacts of shareholder-driven corporate decisions is provided by an Ernst & Young survey (2014) that finds that less than half of UK firms are currently prioritising a growth strategy, preferring instead to continue cost cutting in response to shareholder pressure.

And there is increasing evidence that focussing on the interests of shareholders as the main driver of corporate decisions can be damaging to corporate performance and therefore to the wider UK economy. Many of the essays in this collection illustrate this clearly.

But bad ideas die slowly; practical men, as Keynes once noted, may believe themselves to be quite exempt from any intellectual influence but are usually the slaves of some "defunct economist". Shareholder value still holds many in thrall but its main defence – that shareholders are the main or only risk-takers - is increasingly under challenge, including by many of the contributions here.

The argument for exclusive shareholder decision rights assumes that other stakeholders are simply working to contract without incurring any risk. But few believe that that is the case today, if it ever was. Companies succeed through the commitment of managers, workers and company stakeholders to making companies innovate and grow. It is the relationship between the company and these key stakeholder groups without whom there would be no innovation that needs recognition and attention.

Unlike other stakeholders, shareholders are not generally a source of expertise or technical innovation. While in theory shareholders are providers of finance, in reality in economies like the US and UK shareholders have been net withdrawers of finance from the corporate sector in recent decades. It is surely not a coincidence that countries characterised by shareholder orientation have far lower R&D and investment intensities than their stakeholder counterparts.

There have been many attempts in recent years to design both soft and hard laws to encourage shareholder value to take a more 'enlightened' or responsible path. Most significant was the Companies Act 2006. This maintained the basic principle that the company, through its board, should operate in its shareholders' interest. Its innovation was in requirements that aimed to encourage directors to serve shareholder interests through having regard to the interests of stakeholders and to ensure that shareholders were better informed about stakeholder issues. This approach recognises interests of those other than stakeholders as legitimate concerns of the board, but ignores any fundamental conflict between that position and shareholder value.

A corollary of this approach is that shareholder control should be exercised by shareholders who are actively engaged with firms. This is the basis of what has become known as stewardship, whereby engaged shareholders exercise voice on behalf of their clients, rather than simply buying and selling their shares. Stewardship works only if shareholders intervene by voting and persuasion to implement their long-term goals. On the other hand, if approval and disapproval of board actions are signalled only by buying and selling shares, liquidity becomes paramount and short-termism prevails. Long-termism thus requires the active engagement of financial institutions.

However, it is not clear that global ownership of UK companies is compatible with a vision of shareholder engagement based on taking a long-term view. As the investment group Blackrock put it recently: "as shareholders, our stewardship responsibility is to our clients. Yet we perceive a widespread belief that stewardship implies that shareholders have a responsibility to engage with companies and 'make them better'" (2011). This illustrates a clear recognition that the interests of investors and companies as a whole can diverge. The Kay (2012) report points to a world in which that problem might be ameliorated – simpler finance with less trading, higher levels of trust, and with long-term holdings replacing intermediated speculative investments. A powerful vision, but concrete progress towards such a model is yet to be made.

There is a growing consensus that if we want to move towards an economy in which long-term investment, high productivity and fair wages provide the basis for sustainable growth, corporate governance reform that moves beyond shareholder value is necessary. This is illustrated by many of the essays in this collection and is perhaps its most important overall conclusion. However, as also illustrated by the contributions here, the journey "beyond shareholder value" can take different paths: a shared recognition of the need to move beyond shareholder value does not equal a shared view about what should take its place. Nonetheless, some important themes emerge, the most significant of which is that of representation, which is central to a large number of the recommendations in this collection.

Representation of stakeholders at board level not only makes their risk taking and firm-specific commitments more likely, but overcomes some of the information problems that bedevils all forms of corporate governance. Companies are frequently given market valuations that bear little relationship to their true worth, because even senior management, let alone investors, fail to see through the financial spreadsheets and are unable to collect or interpret the kind of specific information that bubbles up from operational levels. Board representation for those below the most senior executives facilitates such information capture and enables "internal governance" by knowledgeable, committed and long-term workers. Even many of those who remain to be convinced of the need for wider representation on the main board nevertheless accept that good governance requires information beyond that found in traditional financial targets. Mechanisms such as advisory stakeholder councils also aim to change the parameters of company decision-making but seek to do this but through voluntary and consultative means.

However, big bold moves are not the only changes that are needed. There are many smaller, incremental steps that can help to build trust, boost diversity, develop institutions and create the conditions for successful reform. That is why the contributions in this collection are so valuable. Above all, our aim in compiling it has been to demonstrate that there is a wide consensus for corporate governance reform that goes beyond shareholder value and a variety of ideas for how this might be achieved. To quote from one of the contributors, 'let the debate begin!'

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CHAPTER 1
Finding a place for shareholders and stakeholders in the modern corporation

Dr Roger Barker

The invention of the joint stock limited liability company was one of the great innovations of the nineteenth century. Despite suspicion and criticism over the years, the company has proved uniquely successful in harnessing human and financial resources in the undertaking of economic activity. In this article, we argue that shareholders' distinctive role in its corporate governance should not be lightly jettisoned, although a significant new role is needed for other corporate stakeholders.

The basic concept of a limited liability company is simple but ingenious. Shareholders invest in the enterprise but are not held liable for the company's debts (a wonderful means of encouraging investment). The company's existence is independent of the shareholders and shares can be sold. Nevertheless, shareholders retain significant power over the company and its objectives. They have the right to appoint and dismiss the directors and hold them to account for the success (or otherwise) of the company. Although in large public companies the company may be run by the CEO, ultimate shareholder power ensures that the company's activities remain aligned with shareholders.

Unfortunately, in many UK and US listed corporations this idealised conception of governance – with a clear chain of accountability from shareholders to boards and management – has become distorted (although it lives on to a much greater extent in privately held enterprises). The growing complexity of modern corporations, and the fragmentation of listed company ownership across large numbers of shareholders, has effectively shifted power from shareholders towards executive management. In their ground-breaking study in the 1930s, Adolf Berle and Gardiner Means (1932) already recognised that a dispersed ownership structure worked in the interests of the CEO and key executives in the power structure of the company.

This insight is reflected in the lack of shareholder influence over widely held public, listed companies today. Institutional investors from the UK and overseas own a significant proportion of the UK equity market. But they lack the incentive to devote significant time and resources to governance due both to their small percentage ownership stakes and fear that competing investors would 'free ride' on any governance efforts. Furthermore, their business models demand a focus on short-term investment performance, which they seek to fulfil by share trading rather than long-term corporate stewardship.

Consequently, initiatives like the Stewardship Code, which was introduced in 2010 to act as a roadmap for improved shareholder governance, have so far proved unsuccessful in changing investor behaviour to any significant extent. Moreover, as the Kay Review (2012) has described, complex chains of financial intermediaries now stand between the ultimate owners of shares and the companies: brokers, advisers, custodians, fund managers, pension funds and hedge funds to name but a few. All of these agents distance the company from its ultimate owners and tend to work against a patient ownership approach.

Far from a shareholder-dominated economic system, the reality in the US, the UK and other economies with dispersed ownership is closer to what Harvard Law Professor Mark Roe has described as a system of "weak owners, strong managers". The key policy question is not so much whether we should move beyond shareholder value, but how we can induce shareholders to fulfil their key long-term role in corporate governance.

Periodically, corporate scandals and collapses lead, quite rightly, to calls for a rethink of the way companies are governed. The main response to bouts of public disquiet has typically been new regulation and, in the case of the UK and other European countries, corporate governance codes. Most national codes, including the current UK Code of Corporate Governance, offer a recipe of measures through which to address governance concerns, such as the wider use of independent non-executive directors, the introduction of an audit committee, the division of responsibilities between the chairman and the chief executive, and a requirement to 'comply or explain' with the corporate governance code.

More radical approaches have been suggested. During the early 1970s, the European Commission proposed that the UK's unitary board system be replaced by the two-tier board governance system practised in Germany and the Netherlands. In this system, a separate supervisory board composed of a mixture of shareholder and employee representatives monitors and oversees the work of an executive board.

The UK response to this initiative was a report by Lord Bullock (1977), which argued that the unitary board should be retained for reasons of efficiency, but with worker directors elected by the employees. However, the European Commission's proposals and the Bullock Report were not popular with the mainstream UK business community and neither was ultimately adopted by legislators.

Thirty years later, some commentators continue to argue that company law should move in the direction of abolishing the primacy of shareholders, replacing it with a stakeholder concept in which shareholder interests are only one voice amongst several.

Admittedly, the short-termist behaviour of some institutional investors and market participants has done little to buttress the case for continued shareholder primacy. The Kay Review (2012), the Cox Review (2013) and the earlier Myners Report (2001) have all raised fundamental questions about the capacity of the modern investment management industry to oversee the governance of listed companies.

However, despite the challenges, there are still reasons that caution against a shift to a full-blown stakeholder governance system.

First, shareholders are distinctive in terms of the potentially vulnerable nature of their relationship with the company. Once they have invested, there is no contractual obligation for a company to repay the principal or pay dividends. Although investors can recoup their stakes through transactions on the secondary equity market, this is possible only because the inherent risks underlying equity investment are balanced by a robust body of shareholder rights and influences over key aspects of corporate decision-making.

Shareholders' investment in a company therefore involves the commitment of genuine risk capital. If directors and management were legally permitted to operate the company without close regard to shareholder interests, it would be legitimate for shareholders to ask themselves if such a high-risk investment would be worthwhile and at what cost. Would equity investment make sense if shareholder interests could easily be drowned out by the voices of other interests?

A second justification for continued shareholder primacy relates to the differing incentives of the company's stakeholders. For most of them, the overriding concern is that the enterprise continues as a going concern. Employees wish to keep their jobs. Creditors want to be repaid. Regulators do not want to have to intervene or bail-out the company. All of these stakeholders share a significant concern with the downside risks, but somewhat less of an interest in the upside opportunities.

Shareholders are distinct from other stakeholders in that the upside is just as important as the downside. They are not indifferent to potential profits of £5m compared with profits of £50m. Shareholders are a force for growth and risk taking in a way that other stakeholders are not.

Of course, in some sectors (e.g. banking), such risk taking may lead to unfortunate consequences in view of the ultimate liability of the taxpayer when things go wrong. But for most enterprises, the wealth creation process is likely to be better served if the company's main stakeholder embraces risk taking and exerts pressure on the company to achieve more than just survive. This is also, of course, a strong justification for encouraging employees to play a greater role as shareholders, both as minority shareholders and through employee-owned businesses.

So there are legitimate reasons why shareholders should continue to occupy a key position in corporate governance (at least outside of the financial sector). Nonetheless, it must also be recognised that other key stakeholders of the company, including employees, the company's supply chain and suppliers of debt finance, are crucial and legitimate parts of corporate governance. Even when these interests are not formally recognised in law to the same degree as shareholders, companies ignore them at their peril. If companies are to be successful and sustainable, they must all become, to some degree, stakeholder-conscious enterprises.

How might the important perspective of stakeholders other than shareholders be better incorporated into the governance framework of UK companies? One mechanism would be to encourage companies to establish a stakeholder advisory board within its formal governance structure, which would allow stakeholders, the executive management and the board of directors to better engage with each other on the key issues of the company.

Such an advisory board would not necessarily have decision-making powers. But it could provide an invaluable means by which the various interested parties could improve mutual understanding and build a stakeholder consensus around key decisions (such as restructuring).

More specifically, it would make it easier for the directors of the company to fulfil their legal and common sense duty to direct the company on the basis of an ‘enlightened’ approach to shareholder value creation, taking into account the impact of their decisions on all key stakeholders.

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CHAPTER 2
Beyond shareholder value

Nita Clarke

Thirty-five years after the last serious national debate on the issue – the 1978 Bullock Report into industrial democracy – the role of employees in company decision-making is once again on the national agenda. There are good reasons for this.

First, faith in the traditional hierarchical management style in the private sector has never been lower, fuelled by an increasing sense among the public that too many executives are simply in it for personal enrichment, rather than the overall good of the organisation. According to CIPD, over two-thirds of employees do not trust their managers.

Second, the current system of shareholder primacy has demonstrably failed to hold companies to account over issues such as rampant executive pay, despite the efforts of the 'shareholder spring'. There is an increasing sense of challenge to the UK's model of corporate governance, which prioritises the shareholder above all other stakeholders in a company.

Third, there is a growing number of corporate leaders, among them the CEOs of Unilever, O2 and Sainsbury's, who are willing to say that companies owe a wider responsibility to their employees and the communities within which they operate – that corporate social responsibility can't just be PR add-on.

Fourth, there is an increasing awareness that sustainable shareholder returns are achieved by providing excellent services and products, and that such excellence can be achieved only with an engaged workforce – and that brings us to employee voice.

There is no doubt at all that encouraging, capturing, listening to and responding to employee voice is fundamental to effective employee engagement. And there is equally no doubt that having employee voice at the highest level of the company can be a key part of effective employee engagement. Take the John Lewis Partnership, where in effect employees are the board, and First Group, which has employee representation at the highest level.

Employee voice at senior or board level also seems to work pretty well in most European countries. Of course you cannot simply transpose the continental model to the UK – but surely the penny might be dropping that *Mitbestimmung*, or consensus based on dialogue, has produced some benefits for the resilient German economy and might be worth looking into.

All of which makes it somewhat surprising that some UK business opinion has reacted to the growing interest in employee voice at senior level like a maiden aunt confronted with something nasty in the woodshed.

Take the CBI's reaction to the idea of employee representation on remuneration committees. It would "add little to the process, by comparison with a non-exec who … being an elected shareholder representative, has an understanding of the business thanks to being on the board and experience of the kind of challenge that is required".

Leave aside the patronising 'don't bother the children' assumption that employees don't have an understanding of the business. The CBI itself identifies the problem as being the perception that remuneration is controlled by a "closed shop of senior executives". Yet the solution is: bring in more of the same, even though CBI members identify engaging employees as the number one people challenge facing member companies.

All of this raises some broad questions about how this agenda might be taken forward. I suggest the following:

First, the argument for representative employees on boards needs to be firmly located in the strong evidence for the effectiveness of employee voice in ensuring employee engagement, and thereby high-performing and productive organisations. The argument is simple, compelling and evidenced. Employee voice at all levels supports engagement. This in turns leads to enhanced innovation, productivity and profitability.

Second, while there are increasing calls for employee representatives on remuneration committees, and Labour has already indicated support for such a move, I'm not convinced that this is where we should be concentrating our fire. It plays too much to the old view that all employees care about is pay and reward, rather than the bigger picture. If you believe that employees are an organisation's key asset, then surely the primary approach has to be to make the case for employee representatives on the key strategic decision-making body – the board.

Third, while key stakeholders in making this case, trade unions need to confront some difficult truths of their own. Since union membership is down to less than 15 per cent in the private sector, many if not most employee representatives on boards would have no union role or affiliation. So this is not an argument for extending trade union influence – it is an argument for listening to employee voice. And where high-density union membership would give trade union representatives a role, as the continental experience demonstrates, a *Mitbestimmung* approach demands a deep and sustained partnership approach at the highest level, something some UK unions have found it difficult to embrace. It is hard to make the argument for a respected voice at the top table when the threat of industrial action is the weapon of first resort.

Fourth, the case for employees on boards needs to be taken to the widest possible range of stakeholders so that we can secure the widest possible number of allies, building on the general unease about the current situation. There is a strong strand of modernising opinion among some business leaders, and indeed within the Conservative Party. They need to be engaged in the debate. Major institutional investors, other shareholder groups, the CIPD and the Chartered Institute of Management, the Institute of Chartered Accountants in England and Wales, think tanks from across the political spectrum and company law specialists are just some of the stakeholders who need to be engaged.

I would like to see a national non-partisan Commission established, with respected participants from as wide a range of organisations as possible, including sceptics, to really look in depth at the arguments for and against and the practical challenges, including employee representatives on the board. Those who firmly believe in the case should have no qualms about such a searching examination. And those who don't should similarly have the confidence that their argument will withstand examination.

This is potentially a game changer for UK plc, one way of adapting our model of the company to the twenty-first century and making UK business more fit for purpose in the global age.

Let the national conversation begin.

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CHAPTER 3
Corporate governance: learning the lessons of the New Labour years

Dan Corry

Some people on the centre-left get so unhappy with the market economy they just want to rip it up. But for those on the centre-left who want to work with the grain of a market economy, the task of improving the way it works is subtle and complex. We want to make it one that invests and acts in ways that promote 'good' growth, without too many booms and busts, and which produces a fair and decent society.

There have been many theoretical attempts to articulate the sort of changes that would be needed to achieve this, ranging from particular interventions in areas like labour or product markets to full-on stakeholder capitalism models as suggested by the likes of Will Hutton where "power is shared across parties in industry and finance, labour and capital "(*White and O'Neill* 2014).

There are many ways one can try to change the way a market economy works (see *Corry* 2011). All are about changing the way that firms operate and all are important if we are to make progress. Relying on only one change (or one set of changes) to shift the whole regime to a new trajectory is like searching for the Holy Grail – and just as unlikely to be found. In contrast, a whole plethora of changes – some small, some larger – can add up to a major shift. Measures should not be dismissed just because in themselves they are quite slight and marginal. It is the 'whole' that matters when we are talking about the behaviours of an economy.

One set of changes is to do with factors external to firms, influencing the way that they can behave. This includes areas like competition policy and labour market regulation. Progressive values can be encapsulated in these areas, even if there are some disputes on exactly what to do.

Another set concerns the nature of the world that firms have to operate in. This 'infrastructure' agenda includes areas like skills, transport and utility provision, and finance.

Finally we have the set that concern the way that firms are governed and make decisions. This is the area of corporate governance, "the systems by which companies are directed and controlled" (*Department of Trade and Industry* 1998, paragraph 3.5).

There is some urgency in getting all this right now as the recession has shown up clearly the problems in the UK's market economy. Not only did it produce property and finance bubbles, undermining – fatally as it turned out – the durability of the strong growth up to 2007. But we now see that the system allowed corporate surpluses to become very large and long-lasting (*Kenway et al* 2012). Firms' incentives seemed to push them to hoard finance rather than invest it, which not only contributed to imbalance in the economy but helped build the foundations for our low productivity growth over the last few years.

A lot of this agenda, then, is about trying to create more long-term strategies for firms, based on investment in assets and innovation rather than firms looking for fast bucks, destroying the environment, exploiting labour, damaging communities and trying to create sheltered quasi-monopoly situations.

Quite a lot of elements of this agenda were tried in the years of the last Labour government, even if its own rhetoric tended to play this down. In came the minimum wage and other labour market regulation; tougher competition policy was introduced to attack monopoly and utility regulation was re-vamped; schools were rebuilt and universities expanded while skills for the workforce were upgraded; and finance and tax were amended to try to help investment, start-ups and growth firms. Debates can rage as to whether they were the right policies, whether they were pursued with sufficient vigour or indeed whether they even worked enough but what felt like an attempt at major change was certainly embarked upon.

However, in the key area of corporate governance, although the Labour government did try some things, it turned out not to be that radical. It is interesting and important to see why that was and what lessons we can learn for the future.

The case for doing things in corporate governance is that it is a key element in pushing companies towards a more long-term view. If companies feel that maximising short-run profits is both what they are legally supposed to be doing and something for which they will be punished by shareholders if they don't pursue, then it is hardly surprising that we get short-termism.

In the Labour government's early phase a major Company Law review was set up by Margaret Beckett, Secretary of State at the Department of Trade and Industry, partly to follow up issues raised in the report from the Commission on Public Policy and British Business that ippr had run a year or two earlier. It had good and fairly radical thinkers on corporate governance on its steering group, including economist John Kay, academic John Parkinson, the *FT* journalist John Plender and PWC's Rosemary Radcliffe.

Some steps in this area were taken arising from this and other work. A shareholder vote was introduced on company remuneration reports (*Department of Trade and Industry* 2002), although it was only advisory; the accompanying regulations required greater transparency and more detail in a common format for company reporting. Further reforms were also signalled with the establishment of the combined Code on Corporate Governance, including the 'comply or explain' model, soon to be adopted in many other jurisdictions, including the EU. Although the Code was primarily a bringing together of existing codes and had been suggested by Hampel before Labour was elected, its implementation in this period was important.

Best practice recommendations of the Combined Code, taken on by the Financial Reporting Council in 2003 and extended over time and renamed the UK Corporate Governance Code, paved the way for what organisations like PIRC believe to have been a useful period of voluntaristic change adopted by many companies and asset managers even if its overall impact can be debated. There was also a reserve power in the Companies Act 2006 allowing mandatory voting disclosure in the future that helped put pressure on increasing voting disclosure from institutional investors on a voluntary basis.

However it is still the case that the UK Stewardship Code of 2010 (aimed at institutional investors and including the phrase that "Institutional investors should disclose publicly voting records" (*Financial Reporting Council* 2012)), which came out of a report by the Institutional Shareholders Committee in 2002, and the Corporate Governance Code are about good practice – comply or explain – with no compulsion involved (*Financial Reporting Council* 2010).

But, beyond these sorts of measures, there were two important ideas that come from this work that are well worth revisiting. One was about the duties of directors. Here the Company Law Review played around with the idea of widening them so they were not just about a duty to the shareholders but also to the employees, the wider community, and things like the environment (*Department of Trade and Industry* 1998, para 3.7). This could have been more or less directive.

Pushing these stakeholders higher up the list in what the review group coined "enlightened shareholder value" might have led to a need to have explicit regard to these issues or have gone further to make them have a duty to consider them. It would have forced firms to look more at the long-term and the more general impact of their activities. A step further still would have been to make such consideration something firms had to do in its own right and "not subordinate to or as a means of achieving shareholder value" (*House of Commons Library*, p 11), which the group called a 'pluralist' approach.

On this agenda the group pitched towards the enlightened shareholder value model, although in the end did not pursue this very far, simply clarifying the duties and making clear that firms should take these factors into account as a means of serving shareholder interests. Such clarity, when introduced for the first time in Company Act 2006 legislation, had and has potential, but the wording leaves implementation in the hands of the corporation to decide what different interests contribute to the overall aim of shareholder interests and so what should be reported on.

Another idea was to force more transparency and debate about how firms were behaving in regard to all the wider factors by making larger firms produce better company reporting with an Operating and Financial Review (OFR).This survived as government policy until the Bill was introduced in 2005 when the Chancellor decided to ditch it at a speech at the CBI (*House of Commons Library*, 2006, p 32).

Why did these radical parts of the review never come to fruition?

At a practical level, the review itself lost its way and was taken over by lawyers and officials and became a legal tidying-up process. Maybe it never had much chance as there was little buy-in from key players at Downing Street and the Treasury – who were suspicious, not least as they did not 'own' it.

It also came up against some very hostile opposition from organised business, something New Labour was not always strong enough in resisting. It did not help in this area that there was comparatively little support pushing it on from the public, the Labour movement or the trade unions at the very top level. With a few honourable exceptions, few saw it as an issue they wanted to make their number one focus as they lobbied us in government. So with business hostile; many tricky international issues to overcome; the evidence of benefits, at least in the short-term, not being that obvious; and the economy going well, radicalism never had much of a chance. Moreover a lot of focus in this period was around avoiding more scandals like Enron and WorldCom more than the role of corporate governance in growth strategies (*Becht et al* 2005).

There are three issues at least about reviving this agenda.

First, would just changing it achieve much if we did get it through? Some say that reforming the traditional corporate governance in the direction of 'stewardship' just makes the current system work a bit better, achieving little but window-dressing.

Second, how far *can* we go in any of this agenda? Playing with corporate governance of firms is not easy when firms can relocate and register in other areas; where shareholders are often foreign; and where the world is very fast moving and any structures that slow down decision-making can have negative results.

Third, how far *should* we go? Sometimes on the left there is a hope of copying the German model by having its form of corporate governance but this puts far too much weight on this aspect of the German system, which is only one of a whole set of differences. In addition, if the German stakeholder model is often paraphrased as 'workers on the board', do we really think that it would work in the very different UK context and is it worth the struggle to achieve it?

At present it seems most important to carry out a set of changes within the corporate governance world; improving investors behaviour and transparency (*PIRC* 2011); getting rid of quarterly reporting and other incentives to short-termism; and tightening up takeover and merger policy as the 2010 Labour manifesto suggested. Looking again at directors' duties, and at a new Operating and Financial Review going beyond the change in 'narrative reporting' recently introduced, would also help; and having workers on the remuneration committee makes lots of sense, not least to avoid 'group think' that pushes salaries and bonuses up.

As part of such a new approach we may need a new agency: replacing the FRC with a Companies Commission that could include non-investors, to provide market intelligence, promote best practice innovation from corporate experience and provide investor leadership independent of market pressures. Crucially different from the previous experience characterised above, we need a strong force in the market (but not of it) to actively lead and push for change. Then we might actually see some implementation of long-termist behaviours rather than what is too often just advocacy and rhetoric.

There may also be cases for giving rewards for different types of firms when they act in a 'good' way or want to change their governance. And if we want to get firms investing not hoarding, let's think about raising corporation tax and give big investment tax breaks for a period.

Finally in the agenda of getting corporates to think harder about their social impact, a lot can be copied from some of the attempts to produce systems and metrics going on in the impact investing world (*Corry* 2014).

In short, there is much in this area that is capable of producing a stronger, more long-term and fairer economy. Parts of the 2006 Act can be pushed further and there is a strong case for re-looking at the more radical elements that never made it into legislation. Even small changes in this area can have important effects over time. So progressives should embrace and get their teeth into this agenda, while keeping a keen eye on the lessons of the past.

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CHAPTER 4
What's wrong with maximising shareholder value, and can we do better?

Colin Crouch

The central claim of the shareholder value maximisation approach to corporate governance is that, in a pure market, share values can be maximised only by meeting consumers' preferences and by using resources as efficiently as possible; and that therefore shareholders' interests represent the general interest. The claim can be contested on two grounds: very few markets are pure or can become pure; and not all human needs can be served by trading in markets. That leads us to the search for alternatives. There must be a variety of these, as one lesson of the failure of neoliberal market theory to realise its ambitions is that there is no one best way. Neoliberal dogmatism must be replaced by a genuinely liberal pursuit of diversity. However, part of this pursuit must include appreciation of the neoliberal contention that a plethora of government intervention and other means of asserting wider interests can produce an inefficient protection of special ones.

The original motivation for the changes to corporate governance that placed all emphasis on the maximisation of shareholder value was to combat the power of senior corporate executives, who were widely believed to use their firms to aggrandise themselves, building up enormous firms through mergers and acquisitions that were often inefficient, often at the expense of the share price. The claim that shareholders represent a more general interest rests on argument about pure markets. It is not that shareholders as people are seen as possessing particular wisdom in assessing companies' prospects; rather, by buying and selling shares depending on firms' profitability, they will be following customers' own expression of preferences. The fact that much share trading today is carried out totally automatically by computers in high-velocity trading, making profits by timing sales and purchases in milliseconds, does not undermine the shareholder value argument. In fact it strengthens it in the eyes of orthodox economists, because such trading represents the peak of perfection of markets. It must always be remembered that one of the claims on behalf of rule by the market is that it replaces the vagaries of human judgement by an impersonal calculating machine.

The general reasons why pure markets are seen as maximising efficiency belong in general economic theory, and there is no space to analyse them here. To examine their relevance to corporate governance we can concentrate on just two aspects: the practical difficulty of achieving pure markets; and problems that arise from equating them with the sum total of social or individual human interests.

Markets can achieve the economists' ideal of containing and processing all the information needed to produce perfect outcomes only if they are themselves pure; that is, they comprise large numbers of producers and consumers, none of which is powerful enough by itself to affect prices. As soon as the number of producers becomes very small, as is the case with several key sectors of the economy, this condition ceases to hold. Firms can act strategically to affect prices; mergers and acquisitions can have the goal of restricting competition and therefore limiting consumer choice rather than improving efficiency. In such circumstances the maximisation of shareholder interests no longer coincides with a general one. Competition law tries to address these issues by reducing the holdings that any one firm can have in a market, but it can rarely do more than increase the number of firms in a market by a small number; almost never can it produce the large numbers of producers necessary for a pure market to operate.

Bigger problems arise when, even if markets are more or less perfect, their operation can be shown not to be the equivalent of a general interest. There are two main ways in which this is relevant to corporate governance. First, where the short-term nature of financial markets prevents firms from fulfilling long-term investments; second, where there are major market externalities.

In important sectors of the economy, particularly highly innovative, science-based ones, product development can be very slow, requiring years of research and development. Stock markets are notoriously impatient, almost unimaginably so in the case of the computerised high-velocity trading that has become their cutting-edge form. Firms with long-term projects and therefore low levels of current profit in relation to their total resources may well find that their share price falls, making them vulnerable to hostile takeover by firms less committed to long-term research and development.

Firms can seek answers to these problems within the overall framework of a capitalist economy, finding shelters from the immediate impact of the short-termism of the model. One example is venture capitalism, where investors take a particular interest in a firm or sector, being content to wait for a long-term investment in which they have confidence to mature and deliver an eventual profit. Two important points, on both sides of the argument, are embedded in this. First, venture capitalists do not depend solely on market signals for their knowledge but on substantive knowledge of the firm and sector concerned. Second, however, venture capitalists may often be willing to stay with a firm because they can also realise short-term gains in the stock market. Venture capitalism thrives best where there are well-developed markets in shares.

Another form of shelter from short-termist share markets is private equity. Here, investors temporarily remove a firm's share capital from the stock market while major reorganisations are carried out, for the outcomes of which the markets would not be patient. But private equity is of more dubious value than venture capital, as it can present opportunities for asset-stripping rather than rescue.

Market externalities present a bigger problem and constitute the main challenge to the idea that in a pure market shareholder interests are equivalent to general ones. This contention holds only if all relevant factors are represented in the market transactions involved. Factors that are not included are known as externalities. The most obvious, and today the most important, are those concerned with pollution and environmental damage: shareholder value is not affected by the extent to which the firm's activities create general problems of this kind, and may even be enhanced if costs can be cut by not being concerned about damage. Other examples come from work relations. Flexible, efficient working methods can leave employees stressed and exhausted, their family life, which is outside the range of the labour market exchange, suffering as a result. In theory this damage is not a pure externality, as workers in the occupations involved might make it internal to the market by demanding better pay and conditions as part of the labour contract. However, in reality and apart from a small elite of highly rewarded employees, workers are not in a position to make such demands because of the imbalance of power in most labour markets, where individual employees confront corporate organisations. This market-distorting power imbalance can be redressed only where there are strong trade unions or counterbalancing labour law.

The main response of orthodox economists to externalities is to deny their importance. They argue that, if the only reliable knowledge is that which is embodied in the market, any attempt to include factors outside its scope will be totally unreliable and will lead to both inefficiency and, through the assertion of some people's values over others, dictatorship. This amounts to arguing that, if an interest is not represented in the market then by definition it does not exist. It is unlikely that many people outside the narrow ranks of neoliberal theorists share this extreme view, and as soon as we take up a critical position we are forced to reject the premise that shareholder interests stand for a general one. At the same time, neoliberals' warnings about the difficulties of identifying and agreeing on these non-market interests cannot be ignored.

Several approaches are available to recognise greater plurality, provided we accept that all we can do is to make possible the search for alternatives, not impose a narrow set to rival neoliberals' own narrow set. We must also recognise that, for many purposes and where markets are sufficiently pure, the claims for shareholder value are valid. Corporate law and government policy must facilitate and ensure the viability of alternative forms of governance, such as venture capital and mutuals. During the 1990s and 2000s successive UK governments did the opposite, facilitating building societies changing away from mutual to the shareholder form, with the consequence that many ran into deep crisis in the 2007–8 crash. That serves as a warning against 'one best way' theories of corporate governance. It is likely, however, that shareholder value maximisation will remain the dominant form; we then continue to look to government action through taxation and regulation to change firms' incentives, making it difficult for shareholders to realise their interests without taking account of wider ones. Both to avoid national protectionism and to cope with global corporations, such action needs to be first Europe-wide and then more extensive still.

These alternatives will always be vulnerable to abuse and inefficiency; but they should be compared, not with a pure, unrealisable model of the shareholder ideal, but with its own very grubby reality.

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CHAPTER 5
Rethinking corporate governance: a question of representation

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The chapter argues that reform of UK corporate governance is best achieved by focusing on the issue of representation. To date, corporate governance has largely been discussed within a narrow definitional framework involving a limited number of stakeholders. Debate is primarily focused on large public limited companies (Plcs) listed on the London Stock Exchange (LSE) and what constitutes best practice when it comes to aligning investor and manager interests. Consultations and regulatory institutions are dominated by big financial interests and large Plcs. Compared to the corporate governance regimes in many other OECD economies, it also shows minimal regard to the long-term interests of companies themselves, as well as other stakeholders and wider socio-economic issues. Significant reform, therefore, is best achieved through changes in representation on several levels: in public consultations, multi-stakeholder-oriented corporate governance remits, on Plc company boards, and on the boards that advise and regulate good corporate governance practice.

Although law and economic and fiscal policy are implicated in corporate governance, the subject in the UK has largely been discussed within a narrow definitional framework that focuses on directors and shareholders. This is because many key reports and regulations in the UK, US and other liberal market economies have emerged as direct responses to large-scale company frauds and scandals, and a loss of investor confidence.

In the UK, the cases of Polly Peck, BCCI and the Maxwell Group strongly influenced the Cadbury Report (1992). This emerged from a committee established by the Financial Reporting Council (FRC), LSE and accounting profession. Its aim was to produce a voluntary code of corporate governance with a specific focus on 'financial reporting and accountability', thus ensuring greater shareholder protections. The less publicly stated aims were to fend off greater legislation or regulatory intervention by government, and to maintain investor faith in the LSE. The final outcome was thus self-regulatory, fairly flexible in practice, only applied to listed companies, and made good corporate governance practice synonymous with shareholder value.

Subsequently, the committees involved in consultation, and producing new codes and practices, have been dominated by representatives of high finance and large quoted companies. After Cadbury came the Greenbury Report (1995) and the Hampel Report (1998), each with similarly restricted sets of representatives and outlooks. Enforcement has been on the same basis. The FRC, which now produces updated versions of 'The UK Corporate Governance Code', and the LSE, which enforces compliance on FTSE 350 companies, all follow these same narrow remits and are similarly represented at board level. It is the same with the Takeover Panel and other bodies with a hand in a largely self-regulatory ('comply or explain') process. More importantly, enforcement is mainly left to shareholders, and based on a blind and misplaced 'market forces' argument about the owners of capital holding its managers to account.

Consequently, UK corporate governance now shows little regard for the wider set of stakeholders and economic issues that are equally affected by company behaviour. Thus, there is almost no reference to the best interests of the company itself or the wider set of stakeholders, including employees, customers, suppliers, communities, creditors and the wider economy and state. Outside of the UK and the Anglo-American tradition, this is not so (see *OECD* 2004, *EC* 2011; for other regime accounts, see also *Coates* 2000, *Dore* 2000). It is also primarily designed for FTSE 350 companies with UK patterns of dispersed shareholdings. In 2009 (*Davies* 2010) there were 2.7 million British registered companies, two million of which were classed as small businesses; 16,500 were limited partnerships, 38,500 were LLPs.

Quite apart from the exclusion of large parts of British business from UK corporate governance considerations, the very basis of enforcement – large investors and City-based regulators – is increasingly outdated. New technologies, high-capacity instant trading and globalisation has changed the nature of share ownership and trading patterns. Shareholders have become increasingly detached from the companies they invest in. Investors and managers alike have become more short-termist (see *EC* 2011, *Kay* 2012, *Haldane* 2013). By 2012, pension and insurance funds, traditionally long-term investors, held only 10.9 per cent of shares, and foreign investors 53.2 per cent (*ONS* 2012). Hedge funds and other 'high frequency traders' were responsible for 72 per cent of market turnover. In the 1960s, the average share was held for almost eight years: by 2008, it was three months (*High Pay Centre* 2012). In effect, the owners of capital (shareholders) have far weaker and more temporary links with the managers and companies they invest in and are unlikely to be enforcers of good corporate governance in the long-term.

As links become weaker, so short-term 'shareholder value' has become the accepted norm driving trading decisions in the City and elsewhere (*Davis* 2002, *Froud et al* 2006). This is reflected in the particularly high level of takeovers. From 1998 to 2005, takeover activity in the UK, as a percentage of GDP, was 21.8, or double that of the 10.7 of the US. The UK also had the highest success rate for hostile takeovers at 67 per cent (*Jackson and Miyajima* 2007). Conversely, company managers have reacted by putting a greater weighting on maintaining a high share price in the short-term, often instead of making long-term investments. One study (*Ownership Commission* 2012) found that 75 per cent of managers would avoid projects with long-term value creation if they were damaging to short-term earnings.

Managers then keep their jobs and are financially rewarded accordingly. Indeed, for some decades executive pay rises in FTSE companies have far outstripped those of national average pay rises and company growth rates. In 1998 average FTSE 100 CEO pay was 47 times that of the average employee. By 2010 it was 120 times. Although CEO pay grew fourfold, the FTSE index was no higher (*BIS* 2011). Shareholder activism and stewardship has had little impact here.

The consequences of a narrow and self-interested corporate governance system go rather wider in terms of the larger economy and society. Financial markets have become more unstable and prone to bubble tendencies as investors treat them increasingly like casinos. The list of corporate scandals, tax evasion schemes and fraudulent behaviour, particularly in the financial sector, continues to grow each year. Critics (*Hutton* 1996, *CRESC* 2009, *Chang* 2010, *Cox* 2013) cite a link between the UK financial system's power and takeover culture, and the rapid decline of the UK's manufacturing base since the 1970s when compared to rivals. A clear part of the decline can be put down to low levels of investment where short-term shareholder value is prioritised. As CRESC (2009) calculated, 'productive investment', in business itself, declined from 1996–2008, from 30 per cent to 12 per cent. Both the Kay (2012) and Cox (2013) reviews also revealed that R&D, as a percentage of GDP, has continued to lag behind all the UK's main industrial rivals since then. In addition, the UK has disproportionately more Plc's and a disproportionately small SME sector.

Wider inequalities and economic imbalances have developed. Lawton and Lanning (2013) state that the "UK has one of the highest levels of wage inequality among the advanced economies". Hargreaves and Williamson (*High Pay Centre* 2013) find that the UK has one of the poorest records of staff consultation in large companies. Only 16.5 per cent of FTSE 100 board members and 3 FTSE 100 CEOs are women (*High Pay Centre* 2013). London/the South East has thrived economically while the regions elsewhere have declined.

All this suggests that shareholder and director interests may be aligned but both may not necessarily be aligned with the long-term interests of the corporation itself, and even less so with the wider set of stakeholders, including customers, employees and communities. The logical conclusion is that a wider overhaul of first principles of corporate governance and more substantial legal reform is now required.

True reform of the UK corporate governance system requires radical action and, above all, making all parts of the process – consultation, remits, guidance, company boards, enforcement practices and regulatory authorities – more representative. It also means government taking a more active role in overhauling existing systems without necessarily being involved in day-to-day enforcement thereafter. The obvious tools for achieving reform, include changes to company law, fiscal policy, government procurement guidelines, encouraging alternative ownership and financing structures, and the overhaul of existing regulatory bodies. None of these need result in governments intervening in particular markets, 'picking winners' or interfering with daily company management. But the most significant changes are likely to involve wider representation.

Thus, company boards need to have more women and a wider set of non-executive directors (NEDs) drawn from their employee and investor stakeholder bases. Shareholders need to be more engaged and present, with long-term investors having a greater say and/or dividend pay-out than short-term investors. Only those holding shares at the time of a bid should have a vote on proposed takeovers. The Takeover Panel, FRC and LSE should have far wider representation from other parts of society (e.g. employees, SMEs, local government, etc.) on the boards that develop and enforce good corporate governance practices. Remits should be extended to include non Plcs over a certain size. These regulatory bodies, in turn, need to be more directly accountable to one or more of the following: BIS, an expanded Companies House, the HMRC. National and local government procurement (and possibly fiscal) policy needs to be more directly tied to good corporate governance practices. Poor performers should be excluded from government procurement and have a less beneficial corporation tax rate. Each of these measures will help develop a more multi-stakeholder and long-termist form of corporate governance in the UK. Such changes will not only make companies more public-facing once again, it will also make them more sustainable and profitable in the longer term.

About Labour Finance and Industry Group (LFIG)

LFIG was established over 40 years ago. It is a democratic national organisation of Labour Party members, affiliated to the Labour Party. Its membership is drawn mainly from people in business, enterprise and financial services, or who are specially interested in policy in those areas.

The group has business engagement events, links with and submits policy suggestions through its groups to the Labour Party and shadow ministers, and works with other centre-left research and campaigning organisations.

The views of the authors here are made in a personal capacity and do not in any way reflect the views of the organisations in which they are employed.

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CHAPTER 6
Against shareholder empowerment

Simon Deakin

For the past three decades, corporate governance reforms around the world, including in Britain, have had the overriding aim of increasing shareholder power. This policy has been widely seen as a progressive one that would make managers more accountable and improve the performance of companies. In fact, the empowerment of shareholders has done little to enhance managerial accountability, and has had a weak and sometimes inverse relationship to the creation of corporate value. Meanwhile it has contributed to many of the downsides of a financialised economy. These include less innovation and growing earnings inequality. How did this come about?

The case for shareholder empowerment is a mix of fairness and efficiency arguments. The argument from fairness claims that as shareholders are the owners of companies, it is only right that their views should prevail when it comes to determining corporate priorities. The argument from efficiency is that a market economy works best when capital is free to seek the highest returns wherever it can find them. Shareholders, in their capacity as the holders of capital in the firm, should insist that managers act to maximise its financial value, and should be prepared to initiate a change of control and resulting redistribution of assets if they fail to do so. Shareholder power makes managers work harder while ensuring that society's scarce resources are allocated to the most efficient uses.

Much follows from this. Boards should be independent and focus on monitoring rather than managing the company themselves. Shareholders should engage with companies on issues ranging from strategy to corporate responsibility. Executive remuneration should be linked to the financial performance of the firm and expressed in the metrics of shareholder value. Takeovers should be welcomed for their disciplinary effects.

Since the early 1990s these policies have become increasingly embedded in corporate governance codes, listing rules, company legislation, European Directives and transnational regulatory standards. The international financial institutions and credit rating agencies use these standards to benchmark national business environments, so that they directly influence transnational capital flows.

Corporate governance standards also affect firm-level performance. However, the results are generally not as intended. We know this from a growing body of empirical research (summarised in *Deakin* 2013). Board independence is not correlated with increased corporate value; indeed, the opposite is generally the case (*Bhagat and Black* 2002). Compliance with corporate governance standards has a positive short-run effect on share prices but this often doesn't last (*Bebchuk et al* 2011). Companies that conform to the standards set out in the UK Corporate Governance Code are out-performed by those that opt not to conform in return for explaining their non-compliance (*Arcot and Bruno* 2007). Takeover bids do not consistently make money for investors (except those in the target company) (*Martynova et al* 2006). Shareholder activism, of the kind practised by hedge funds and other specialised investors, has an equivocal effect on corporate performance and often impacts negatively on bondholders and workers (*Buchanan et al* 2012).

There are wider economic and social effects of shareholder empowerment. In cross-national studies, legal protections for shareholder rights are correlated with dispersion of ownership and higher equity values in relation to national GDP (*La Porta et al* 1998), but also with reduced innovation (*Belloc* 2013), higher earnings inequality (*Sjoberg* 2009) and a more uneven distribution of wealth (*Ireland* 2005). In the crisis of 2008, independent boards, share options and takeover activity were correlated with a higher failure rate among banks and other financial companies in the US and Britain (*Ferreira et al* 2013).

An idea can truly be said to be entrenched when it is resistant not just to empirical social science research (which is hard to interpret and even harder to translate into policy) but also to practical experience. This is the case with shareholder empowerment. At the start of the 2000s, the Enron and Worldcom scandals demonstrated that when a company was 'laser focused' on shareholder value, there was a high risk of it slipping into self-dealing, false accounting and earnings manipulation. The warning did not just go unheeded: it was interpreted to mean its opposite. Thus US policy-makers decided that companies like Enron had been paying *too little* attention, not too much, to shareholder concerns. The result, in the Sarbanes-Oxley Act, was a huge and complex body of new legislation, premised on the need to enhance the accountability of managers to shareholders. Rules on independent boards and real-time financial reporting were tightened up and a battery of financial regulations introduced to ensure that there would not be another Enron.

So when the Enron crisis was repeated on a much bigger scale in the financial crisis of 2008 – even down to the very similar use of creative accounting to give a false impression of earnings – it was clear that something was not right with US corporate governance. In the British case, corporate governance was also implicated in the crisis, although in a slightly different way. The major corporate failures of 2007–8 occurred in banks that were aggressively focused on leverage and takeovers. Northern Rock and HBOS were former building societies that had exchanged mutual status for the freedom to lend and borrow on a greatly expanded scale. RBS had grown through mergers and acquisitions funded by enormous levels of debt. The credit crunch left them all exposed and dependent on state aid for survival.

The 2008 crisis occurred because of corporate governance reforms in the US and Britain, not in spite of them. Independent boards lacked the expertise and company-specific knowledge to rein in executive risk-taking. Senior managers, whose remuneration was linked to rising equity prices, had strong incentives to pursue strategies aimed at maximising financial returns over the short to medium term. Institutional shareholders had few opportunities to engage directly with management but also limited incentives to do so. In some cases they actively pressed for deals that would 'release shareholder value' through takeovers and restructurings, and throughout this period they benefited from share buy-backs and dividend increases that saw capital flow out of the productive sector of the economy.

It was clear in the US context that the 2008 crisis could not be addressed by enacting another Sarbanes Oxley law. The response took the form of a highly complex measure of financial market regulation, the Dodd-Frank Act, which seeks to contain some of the more risk-prone trading activities. The US is often described as a 'liberal market' system but its capital markets are the most intensively regulated in the world. This in itself may be a problem as it creates opportunities to game the system.

The British approach has been, by contrast, to rely on soft law and codes of practice. The Walker Review made some sensible if belated suggestions about the need for independent directors of banks to have training in and experience of banking. The Stewardship Code is the latest in a series of measures that assume, in the tradition of the Takeover Code and Corporate Governance Code, that the City of London can regulate itself, with a bit of 'nudging' from government. Many have questioned whether the Stewardship Code will make any difference to investor-manager relations. Perhaps a better question is whether we want institutional shareholders to have even more influence over corporate strategy.

Other countries with strong economies show that there are plenty of alternatives. It is often assumed that nothing much can done to change corporate governance because in a global economy every country is affected by the same pressures to attract investors and provide a 'business-friendly environment'. In fact, the UK is an outlier when it comes to shareholder-focused corporate governance (*Deakin and Singh* 2009). The US, for example, has a more balanced approach.

Consider takeover bids. US listed companies can protect themselves against bids by inserting 'poison pill' provisions into their company bylaws (the equivalent of articles of association). Only very rarely will a court order a target company to abandon its poison pill. This will not happen where, for example, there is only one serious bidder. In the UK, the Takeover Code outlaws 'frustrating tactics' of this kind. Some of the most controversial takeover bids of the last decade, such as the Glazers' bid for Manchester United or Kraft's bid for Cadbury, would not have gone ahead if UK companies had had the same flexibility over takeover defences as American ones. It also follows that there is no level playing field: UK companies are fully exposed to bids by American competitors, which are, for most practical purposes, bid-proof. We have seen this dynamic play-out in numerous takeover contests since the 1980s.

Then take the issue of innovation. Innovation requires long-term planning and strategic investment in complementary assets, including skills. Shareholder empowerment, by contrast, shortens the time horizon for corporate decision-making. Companies such as Google and Facebook have two-tier voting arrangements that have allowed the founders to retain control of the company after a listing. This was done in order to avoid the negative effects of shareholder pressure on research and development and long-term planning. Voting arrangements like this are virtually unknown among UK-listed companies, as they are seen as diluting shareholder influence.

Japan has some of the most consistently successful companies in the world in industries requiring close cooperation between the firm and its core workforce and suppliers, such as automobile production and consumer electronics. There is a recognition that for sustained business success, the interests of the different stakeholders must be kept in balance. The government also sees itself playing a strategic role in preserving the independence and autonomy of large Japanese companies, on the basis that they are national strategic assets. Hedge fund activism of the kind that has led to downsizing and asset destruction in the US and Europe has had virtually no impact on Japan, thanks to a combination of managerial resistance, government action and flexible judicial interpretation of company law (*Buchanan et al* 2012).

What then should be the way forward for the UK? We need to rebalance our corporate governance system away from its current focus on shareholder value. A vibrant corporate sector should be seen as a vital national asset, and planned for accordingly. This will require a radical rethink of the Takeover Code and a realistic reassessment of what can be achieved by other soft law mechanisms such as the UK Corporate Governance Code and the Stewardship Code. At board level, there should be less reliance on under-informed outsiders as monitors of management, and a greater role for collegiate decision-making involving senior executives and worker representatives.

Above all, what is needed is a shift in perceptions, which changes to laws and codes can influence. Corporate governance should proceed from the view that the company is an exercise in group cooperation and not simply the property of the shareholders. If managers and investors themselves began to see things that way, real progress would have been made.

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CHAPTER 7
'Corporate Stewardship': from shareholding to stakeholding?

Patrick Diamond

A major priority of institutional innovation in *rebalancing* the British economy relates to the constitution of the firm in the United Kingdom, and the system of corporate governance. Britain has corporate governance arrangements that are still markedly 'shareholder-centric', more so than in the United States where managers have greater day-to-day autonomy and discretion (*Bruner* 2011). Shareholders in the UK have more power to remove executive directors, and to accept hostile takeover bids than in the United States. Nevertheless, the 2008 crisis revealed the weakness of the existing corporate governance system in preventing risk-taking activities and excessive remuneration, particularly among banks and financial institutions. Similarly, Mayer (2012) has emphasised the fundamental importance of shareholders fulfilling their legal responsibilities in embedding a culture of 'corporate stewardship' in the UK economy.

The culture of corporate governance has long been the target of reformers, going back to the 'stakeholder economy' literature of the early 1990s (*Kay* 2003, *Plender* 1996, *Hutton* 1996). This had been fuelled in part by the behaviour of the boards of the privatised utilities during the Thatcher governments, and a series of scandals in global corporations including Enron and Parmalat. The hostile takeovers boom in the 1980s led to a number of long-standing British companies being taken over, leading to heightened public concern about the culture of mergers and acquisitions. Owen (1999) refers to the lack of involvement of institutional investors in the management of companies, and the apparent ineffectiveness of company boards in challenging poor management practices.

The alternative 'stakeholder' (rather than 'shareholder') model of the firm has several distinct advantages: one is improving the profitability and productivity of the firm through creating a culture of long-term investment; another, more ambitiously, is embedding companies within the communities and environment they serve (*Kay* 2003, *Hutton* 1996). There are, of course, important distinctions between these objectives. The former emphasises the traditional virtues of the liberal market economy, stressing the importance of long-term value creation and economic efficiency. The latter stresses more 'communitarian' goals that seek to alter the underlying structure and values of the market capitalist system.

It is important for policy-makers to be explicit about which strategic goals they are pursuing. Adair Turner (2003), for example, has argued that stakeholder models that seek to transform the values of firms within the market economy are flawed. It is important to retain the distinction between the *private realm* of market interests and the *public realm* of social interests. Companies exist to maximise value and profitability, while it is the role of the state to intervene to correct externalities and market failures. Communitarian thinkers such as Amitai Etzioni (1994) and Robert Putnum (2002) argue that no clear distinction can be drawn: the priority must be to restore trust in the institutions of modern capitalism. In any society, levels of social capital will have a significant bearing on the nature and viability of competitive capitalist enterprise.

In practice, the distinction between 'private purposes' and 'public virtues' may have been somewhat overstated. Nevertheless, it remains important in considering institutional strategies for reform: arguably the goal of public policy is to incentivise firms to prioritise long-term value creation rather than the short-term profit maximisation associated with particular 'Anglo-Liberal' models of shareholder capitalism. Moreover, it appears unlikely that any government in Britain would seek to interfere so as to explicitly amend or redraw the corporate strategies of firms. However, it is legitimate to incentivise certain behaviours that are conducive to high-value, high-productivity and high-wage growth over the long-term.

The United Kingdom has been subject to a series of high-level corporate governance reforms since the early 1990s (*Filatotchev et al* 2007). This includes the company law review after the Labour government's election in 1997, which proposed new regulations and additional legislation to oversee the governance of firms. According to Owen (1999), governance reforms are intended to strike a more rational balance between external market pressures and internal management controls, although too little has been done to address the problems of 'passive absentee ownership' created by inactive institutional investors. Nonetheless, the post-2008 financial crisis, together with ongoing concerns about 'short-termism' in British industry and the 'predatory practices' of institutional investors, led to renewed calls for fundamental corporate governance reform.

The entrepreneur George Cox has conducted one of the most recent independent reviews of short-termism in British business for the opposition Labour party (*Cox* 2013). The review concludes unsurprisingly that too many firms in the United Kingdom are focused on the maximisation of returns to shareholders, rather than long-term value creation built on investment in the skills, capabilities and human capital of the workforce. Cox argues that the declining rate of investment is a major issue for the British economy, as the Asian economies have made ambitious investments in training, productivity, technology and public infrastructure over the last 20 years. The rate of investment in R&D in Britain is lower than in the United States, Japan, Germany and France. More worryingly, 'research-intensive' sectors such as pharmaceuticals and aerospace have experienced declining research funding since the 1990s.

The Cox review accedes to the case for stronger government action. Cox draws from the analogy of the Olympics, where government investment in sport increased the United Kingdom's tally of gold medals from one at the Atlanta Olympics in 1996 to 29 at London 2012. It is legitimate for the state to create a long-term investment culture in the private sector. This includes proposals to encourage long-term investment in businesses: Cox proposes that capital gains tax should be tapered on shares from 50 per cent in year one of ownership to 10 per cent after 10 years to incentivise long-term shareholding. Companies should be encouraged to issue different classifications of shares, with committed shareholders attracting 'preferential' dividends or 'bonus' shares; shares held for significant periods may be subject to a beneficial tax regime.

More ambitiously, Cox argues that pension fund unit trusts should be taxed on the incomes they generate, just as individuals are taxed currently. He proposes that 30 per cent of executive remuneration could be deferred for up to five years, so pay better reflects long-term performance. As in the Kay review, Cox insists that quarterly reporting should be phased out since it further encourages short-termism, a reform the current government has accepted in its response to the Kay report. In relation to takeovers, shareholders appearing on the share register during the offer period should be excluded from voting until a bid has been concluded.

Both the Cox and Kay reviews agree that there needs to be greater scope to take account of the national interest in takeover decisions, which the previous government was unable to do, most notably in relation to the Kraft Foods takeover of Cadbury. This was a disquieting event for ministers, not least because Cadbury was an apparently well-run company that had outperformed Kraft, and which had strong local roots and a sense of local identity. Roger Carr, then Chairman of Cadbury, observed that 'individuals controlling shares which they had owned for only a few days or weeks determined the destiny of a company that had been built over almost 200 years' (*Peston* 2010). Raising the threshold for a takeover from 50 to 60 per cent while ensuring that those who vote owned the shares for at least a year would have enabled the Cadbury board to see off a hostile bid (*Bailey* 2012). Indeed, it is more important than ever to protect the principle of 'stewardship', enhancing the long-term value of British businesses.

Another strategy to change the culture of firms is to widen the base of employee share ownership. The Thatcher government introduced employee share ownership plans (ESOP) in the mid-1980s to accompany the sale of national utilities, but the shares were soon bought up in corporate takeovers, and the level of employee share ownership declined significantly. It ought to be made easier for businesses to give their workers an equity stake in firms, augmented by 'profit-sharing' schemes. Moreover, share ownership should be more actively encouraged among employees: the Cox review proposes that workers should have the right to be paid up to 5 per cent of their basic salary in shares, to a maximum of £5,000 per annum.

The Company Law Review in the late 1990s made important proposals for reform that offer a bridgehead towards further reforms in the 2010s. The leadership of the Labour party is aiming to enforce a distinction between 'predators' and 'producers' in the British economy, emphasising the importance of sustainable value creation. However, the question remains as to whether legislative changes are too blunt an instrument in comparison with tax incentives and other forms of regulatory intervention. Reforms of corporate governance that lead to long-term improvements in economic performance are likely to require further changes in the culture of British capitalism.

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CHAPTER 8
Unfinished business: the case for citizenship at work

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Tax evasion, excessive pay rises for senior executives, an unconstrained bonus culture and bank mis-selling scandals… Though such malpractices have characterised Anglo-American corporate governance for many years, it has taken the economic and financial crisis that broke in 2008 to highlight the scandalously widening gulf between the lives of workers on the one side and many senior executives on the other. While countless workers and their families face an 'age of austerity' with pay cuts, longer hours and deteriorating conditions, the senior executives of many UK and US multinational companies continue to make millions, lining their pockets through various forms of barely concealed kleptocracy.

Yet resistance is weak and fragmented. Several chief executives were forced to quit and others faced protest votes from shareholders at their companies' AGMs in the 'great pay revolt of 2012' (*Guardian* 2012). The managing director of John Lewis warned that corporate tax evasion was damaging the UK economy, and business lobbies like Engage for Success and Pro Business Against Greed have emerged to put the case for corporate responsibility. However, though these moves are welcome, they do not address the fundamental question: how can we move corporate governance beyond a reliance on shareholders, and ensure that boards operate responsibly towards all their stakeholders, including consumers, suppliers and workers? This question has moved to the top of today's political agenda: 70 per cent of UK consumers believe that corporate greed is responsible for the current financial crisis (*YouGov* 2012). Hence a bold programme designed to tackle corporate irresponsibility would be both timely and popular.

Clearly there is no magic formula to dispel corporate greed, so we need a wide debate on the range of mechanisms – economic, financial and political – to regulate corporate affairs more fairly and accountably. This article focuses on just one piece of the jigsaw: the role workers could play as stakeholders in their companies and the extent to which they can, or can't, influence the strategic decisions that shape their lives. True, shareholders invest their capital in companies for profit, but workers invest their lives in companies for income, and without their working lives there would be no profit – yet their voice is absent from the board of UK companies and frequently ignored below board level too.

Our democracy remains 'unfinished business' while workers continue to lack coherent rights to information, consultation and co-determination, particularly at board level. The way forward is to extend our understanding of the term 'citizenship' so that it embraces our working lives alongside its three more familiar dimensions: civil citizenship ('the rights necessary for individual freedom', such as freedom of speech); political citizenship ('the right to participate in the exercise of political power'); and social citizenship ('the right to a modicum of welfare and security') (*Marshall* 1963).

'Citizenship at work' covering rights to information, consultation and co-determination must encompass all employed adult workers unconditionally as a consequence of their having an employment contract, whatever their hours, background or status, and whether or not they are members of a trade union. Such rights exist across much of continental Europe. Citizenship in its civil, political and social dimensions already extends to all adults in the UK and is now as natural as the air we breathe. Citizenship at work would complete, in the twenty-first century, these existing dimensions that have resulted from the hard struggle of previous generations.

Progress towards citizenship at work has already been made, but it has been opportunistic and sporadic, and not always well understood or implemented. So far, it has spread largely as a result of three pieces of EU employment legislation:

- The European Works Councils Directive
- The Information and Consultation of Employees Directive
- The European Company Statute.

The first two measures cover sub-board levels of employee participation at European and domestic levels respectively. In particular, the Information and Consultation of Employees Regulations – which enacted the Directive in 2004 – bring the UK into line with many European countries, where citizenship at work is already guaranteed. However, because these Regulations in the UK are complex, difficult to trigger and have been viewed by the unions with limited enthusiasm, they remain patchy and little known. Meanwhile, the European Company Statute, which in certain circumstances allows for employee board-level representation (EBLR), is deficient because it applies only to those cross-border companies that opt to register. For that reason the UK lacks any regulation of EBLR, the very level at which employee representatives by participating in corporate strategy may best be able to come to grips with issues like executive pay, bonus cultures and exploitative marketing strategies.

The glimmerings of citizenship at work therefore already exist in the UK, but its implementation needs to be simplified and publicised, for which union support is critical. The unions have traditionally and understandably defended their interests through their 'single channel' of employee representation, but there are encouraging signs that some are reconsidering this position because – as their membership has fallen – employee-based forms of representation, alongside union recognition procedures, can help them organise within companies. Indeed, in countries like France and Germany, union slates in works council elections give them significant bases of influence within companies.

In particular, action is required to fill the vacuum in worker influence at board level. The argument for EBLR as a statutory right must be made as the necessary complement to complete citizenship at work. This is because board-level decisions, by their nature, involve planning and strategy affecting the future direction of the company. The board determines workers' prospects and conditions, along with their possible redeployment or redundancy. Sub-board forms of participation may involve them in the implementation and monitoring of these decisions, but it never involves them at the earliest, planning stages. For this, EBLR is essential.

This argument needs to be presented principally as a right, not as a business case. Though the business case for EBLR in Germany and other countries is convincing (*Kluge and Vitols* 2009), it remains controversial and may prove a diversion from the key point: that EBLR should be seen as a right that helps guard against corporate irresponsibility.

What is required is to regard EBLR as part of a vision of the kind of fair and accountable company that we want to see evolving in the UK in the future, just as the right to vote in the nineteenth century and the introduction of the welfare state in the twentieth were seen as means to achieving a fairer and more accountable society. Indeed, there is evidence from Germany that EBLR is "significantly related" to lower levels of executive remuneration (*Thannish* 2011), while in Germany and elsewhere employee board-level representatives successfully argue the case for workers' interests in areas like investment strategy and merger policy, among many others. Their sense of union identity and support networks allow them to maintain their independence on the board. Shareholder representatives generally regard their employee counterparts as specialists in the company's working conditions and employment relations, recognising that their different views about the company contribute to more rounded discussions on the board (*Gold* 2011). Overall, EBLR is "positively associated with better social and environmental performance by companies", such as policies on job security, compliance with ILO Conventions and targets for CO2 emission reductions, and the presence of a European works council improves such performance even more (*ETUI* 2014).

Of course, the introduction of employee representatives on to the boards of UK companies requires much further debate, particularly with regard to the size of eligible companies, the optimal number of employee representatives and their relationship with the unions, voting mechanisms and the kind of legislation required. The role of EBLR undoubtedly also needs to be complemented by other amendments to company law to redress shareholder primacy, such as requiring directors to promote the long-term performance of the company rather than short-term shareholder interests, and requiring ownership of shares for two years before they entitle shareholders to corporate governance rights (*TUC* 2013).

These arguments need to be made clearly – and made now. We have a once-in-a-generation chance to seize the opportunity to finish the unfinished business.

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CHAPTER 9
Why stakeholding is difficult in the UK – and what we can do about it

Bob Hancké

The UK is caught in a bind. On the one hand, the main comparative advantage of its economy is associated with the financial sector in the City of London; on the other, that sector has shown little interest in the domestic economy, and where it did, it often imposed draconian short-term solutions on companies. In a capitalist economy, like it or not, capital is the central actor, and that means thinking through how links between capital and the wider economy and society are structured, and how they could be changed, is of crucial importance. On the whole, the UK has a reasonable track record in this regard: the Cadbury report two decades ago offered sensible ideas about how to turn an opaque system into a more transparent one that served shareholders quite well. The question, however, of how wider societal effects could more constructively be taken into account has rarely been the subject of a sustained debate.

A glance across the Channel might be helpful here. German companies have representatives on their boards of many social groups that are affected by the actions of a large company. Suppliers, workers and labour unions, local politicians, suppliers and other companies often have a say in strategic management decisions alongside the banks and others who own the company. Sometimes other interests that are affected, ranging from environmentalists to local football clubs, have the right to be heard. This setup responds to a crucial message in the German constitution: *Eigentum verpflichtet* ('property imposes obligations'). While such an extended representation may slow down decision-making at the start, the advantage is that once a decision is made its implementation is relatively painless and fast. Possible conflicts of interest are argued out in a measured manner in these forums and do not become the subject of heated confrontations afterwards that delay implementation. And possible contributions of these diverse interests easily find their way into the debate: after all, for a capitalist company it is far less important how profits are made than that they are made; if alternatives are discussed, the chances are high that the outcome allows the company to gain the benefits without imposing social and environmental costs on others.

This stakeholder model, as it is often called, is very different in logic from the prevailing shareholder model in the UK: owners of the company are one voice among many in a stakeholder model, and their interests are balanced against those of society at large. That was the main reason why this idea gained traction in the early days of New Labour. But then it quickly disappeared from the public debate. Leave aside for a moment the relatively feeble political will in the Labour Party to think through how to make such an idea work – Labour had to demonstrate its seriousness as an economic manager and was therefore more interested in getting macro-economics right and skimming off the taxes from a fast-growing financial sector to finance its ambitious social policy plans. Ignore also the crucial question of who the social bearer of such a project would have been: popular as it was among left-wing intellectuals, it never really galvanised any of the broad social movements that would have benefited from the idea.

Something deeper was going on. Put bluntly, even if the Labour Party had mustered a lot more energy, things would not have looked very good for the project: the entire institutional and cultural make-up of the UK economy militated against introducing a stakeholder model, in which rights and responsibilities of different socio-economic actors affected by corporate decision-making could be carefully balanced. There are several sides to this problem, and since they affect the possibility of the country to re-engage with that debate today as well, it makes sense to consider them carefully.

The first is that the notion of a stakeholder economy is based on the necessity to avoid, pro-actively, what are called in the language of political economy 'negative externalities'. Negative externalities occur when the actions of one party have effects that make others worse off than they would have been without the action, but where that party does not have to bear (all) the costs of the negative consequences of the action. We live with those things all the time – when someone jumps on a bus without taking off their backpack, their gains (not taking off the backpack) are our costs (nasty bumps and a lack of space) – but we do not always seek redress as it would stop society from functioning. However, when a company makes a decision from which it benefits, the effects can be disastrous for its environment. Mass redundancies can plunge a local economy into a calamitous future, for example, or investment in a new product line may well destroy an entire ecosystem. Avoiding those outcomes is not always easy, if only because sometimes the consequences are hard to predict and, in a primarily market-based economy such as the UK, the solution is primarily found in regulation to provide a minimum level of protection, courts and fines (to punish) and taxes (to increase the costs of the externality to the company). In a few instances, such as HS2 or a new airport runway and similar infrastructure works that affect a large number of people, some consultation procedures exist, but on the whole in this country the governance of externalities is organised post-hoc, and not pro-actively.

Second, there is a deeply ingrained level of distrust among the potential parties in the deal. A stakeholder model requires all parties to build a certain level of trust – the assurance that A will not renege on a joint project after B has committed its resources. Sometimes the lack of trust leads to deeply perverse outcomes. When BMW set up shop in the Midlands in the 1990s, it was surprised that the unions were initially sceptical of its attempts to bring German-style labour relations to the shop floor: after many decades of adversarial industrial relations in the industry, unions simply lacked trust in management initiatives, however benign they may have been.

Third, the key players in the economy need to have developed a working relationship. If companies, labour unions, employers and industry associations are unable to work together on issues that directly influence their constituencies, it is hard to imagine that wider interests will easily find a place in the decision-making arrangements in the economy. One problem here is the low level of trust alluded to above. Another is the lack of representativeness, and with that of a wider societal responsibility of many of these collective actors: the main industry associations are lobby groups, not negotiating channels, whose myopia makes it sometimes hard to understand them as anything other than special interests who are looking after number one. There are, in effect, no proper private employer associations in the UK that aggregate interests of their members and explore how to pursue them in constructive negotiations with unions. With the exception of the public sector, union density is low, and the organisational capacity of unions in the private sector varies tremendously.

Fourth, and in part as a result of the above, attempts to build necessary collective goods, such as sophisticated skills and technology transfer systems on the basis of which an innovative manufacturing industry can be built, have always been hard to get off the ground. Companies in the UK have to vie for themselves, and often find it hard to organise their environment in such a way that they can make a jump into a more technologically advanced world. In such atomised economic structures it makes no sense for individual companies to adopt structures and strategies that makes their lives harder if their competitors are not doing the same.

Combined, these problems suggest why a stakeholder model might be so hard to introduce in the UK. But it is, perhaps, not absolutely impossible. If the analysis above is correct, the key issues are to find ways to make important collective actors more liable to work together on issues that are of immediate relevance to them, such as local and regional training and innovation systems. The trust that such small experiments may produce could then be the basis for a broader discussion: trust is, in contrast to other goods, something that grows in value with its use. That broader discussion will, at the start, be restricted to issues where the key parties see immediate benefits. But as the system grows other problem areas could become part of the story, and companies will take on board wider concerns. Local and central government could help here, by making those associations 'representative' of wider interests, and by enticing, financially and otherwise, companies and workers to join in those associational governance systems. It won't be easy to turn the UK into a stakeholder economy, and it certainly won't happen from above. But small, pragmatic steps, supported by government, can produce the necessary conditions for such a model. Given where we are, that is worth considering.

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CHAPTER 10
Business short-termism and the new inequality

Andrew Harrop

The British disease of business short-termism is entrenched and takes many forms: the UK suffers from low levels of investment in capital and R&D, with companies hoarding cash and buying back shares; there are too many value-destroying acquisitions and restructures, arising from optimism-bias and boardroom hyperactivity; and equities are held for shorter and shorter periods, by disparate global investors more interested in daily trading and quarterly results than long-term stewardship. So in a recent Fabian report Robert Tinker and I argued that 'long-termism' should be one of two key objectives for economic policy under the next government (2014).

You don't need to be on the left to agree that short-termism is a problem; or to recognise that other European market economies have both different corporate governance arrangements and more long-termist business cultures. Proposals for reform of governance relationships therefore deserve a hearing from across the political spectrum: increasing the breadth of reporting requirements; giving workers representation on boards or remuneration committees; or introducing continental-style supervisory board arrangements.

But there is another argument for change: the second economic objective proposed in the Fabian report is for an incoming government to tackle inequality. And corporate governance reform is an essential component in any response to the new inequality: the rise of the 'one per cent'. For under New Labour, income and wealth at the top soared away, even while the party was successful in preventing the gap widening between the poor and the affluent middle classes. Thomas Piketty shows that it was the same across the advanced economies in his widely praised study *Capital in the 21st Century* (2014). He demonstrates that the widening gap between the top one per cent and the rest is an embedded feature of today's capitalism, unless policy makers intervene.

The first part of the argument is remarkably simple: Piketty shows that, while returns on capital are higher than GDP growth, in coming decades the owners of capital will gain a greater share of each nation's economic output. This is particularly true in an era of low economic growth. The second component of the 'one per cent' story concerns the earnings of people at the top of companies: since the 1970s there has been a shift in power within firms, caused by the decline of collective bargaining and increased incentives for executives to take more, as a consequence of lower top rates of tax.

Corporate governance must take a share of the responsibility. While once you might have thought of executive board members as salaried officials, their remuneration has increasingly been tied to returns for investors; and hence has risen by far more than economic growth or typical earnings. There was also the ratchet effect of remuneration committees, each vying to pay executives above average, accelerated by the unintended consequences of increased reporting transparency. All this was driven by an apparently rational response to the 'principle-agent' problem: if the owners could not directly supervise the executives, then the incentives of the two groups should be aligned. But it was a sticking-plaster solution, masking wider governance problems and it super-charged the cult of short-termist 'shareholder value'.

The rise of the 'one per cent' has far-reaching implications for public policy. It demands a major institutional response, one not motivated out of envy but because this is the only way that we can hope even to stabilise inequality at today's high levels. There are three practical avenues for reform, which look radical only when you ignore the practice of other advanced economies. The UK must take action on ownership, taxation and corporate governance.

First, ownership. If the tendency is for capital to grow faster than wages, then who owns capital really matters. The left therefore needs a new politics of asset ownership. Much more should be done to promote a wide range of corporate ownership models, including help for firms to become employee-owned businesses, either in whole or in part. For example, there could be tax incentives for businesses that placed a 10 per cent stake of their firm in a trust for the workforce. Future governments must also broaden the personal ownership of investment assets, with policies like pension auto-enrolment (or perhaps compulsion) and the pound-for-pound matching of modest savings.

More radically, the government should also become a strategic long-term investor on behalf of us all. The nation should take small minority stakes in companies whose success has depended on public sector intellectual property. And the Treasury could also establish a UK sovereign wealth fund, capitalised with some of the proceeds of the sale of the nationalised banks. (From the perspective of net public debt, it doesn't matter whether you use the money to repay debt or invest in liquid assets.) The main purpose would be to ensure that we all benefit collectively from the asset markets. But think about the implications for business stewardship too: here would be one minority shareholder taking an ultra long-term perspective. Companies committed to investment could expect to prosper, augmenting the view already taken by enlightened public sector pension funds, including the new National Employment Savings Trust.

Second, tax. If we are to widen the ownership of assets, distribute the returns on capital broadly across society and ameliorate dangerous asset bubbles, then our tax system needs radical reform. Tax reliefs should be designed to broaden not deepen asset ownership, so pension tax relief should be redirected to low and middle earners. We should stop taxing gifts and unearned income less than earnings, by gradually merging national insurance into income tax and by treating receipt of gifts and bequests as taxable income. A proper system of property taxation would share wealth and suppress house price inflation. And a higher marginal rate on payroll taxes for the highest-paid workers would stop top executives being quite so focused on extracting rewards from their firms, at the expense of workers and owners (*Piketty et al*, 2011).

Third, corporate governance. This is the critical piece in the jigsaw for regulating the distribution of rewards between the executive class and the workforce; and for reducing the extent to which owners put immediate profit over their long-term interests.

We need a new governance model that ensures owners take their responsibilities for stewardship seriously and executives concentrate on the long-term interests of the firm. The current policy agenda – requiring long-term executive incentive plans and better stewardship along the investment value chain – is just not enough. It is a 'transactional' response to a problem of relationships, networks and culture. So it is time to experiment with an alternative, along the lines of continental supervisory boards. The creation of mediating structures between individual shareholders and the executive team would be the institutional manifestation of current efforts to promote 'voice' rather than 'exit' in relations between firms and their owners. The detail of a new supervisory structure could be tailored to the UK context: there are many models on offer so we don't need to blindly copy Germany.

Alongside structural change, more transparency is essential. Reporting should include information on the relationship between the pay of executives and typical employees (as recently proposed by the European Commission) and on conditions in domestic and global supply chains. How this is presented is all-important. Boardroom pay transparency was initially counter-productive, because executives used the information to bid-up their own rewards. But other reporting requirements could have the opposite effect.

Publishing pay ratios might work, but how about going a step further, and requiring boards to report the annual pay rise and bonus for each tier of employees in their organisation? Boards should be required to explain whenever growth in rewards for the top outstripped those for the middle and bottom, extending the principles in recently introduced requirements. This might nudge executive mind-sets, so pay expectations at the top became (a little more) tethered to the experiences of those below, not just to corporate peers. Transparency is not a panacea, but I'm optimistic enough about human nature to think that a requirement for executives to say publicly why they deserve a bigger rise than their shop-floor workers might have an effect: after all, executives don't like public embarrassment and recognise the link between staff morale and long-term corporate success.

The pressure of this openness on pay would undoubtedly be amplified by a true stakeholder approach to corporate governance, including substantial employee representation (ideally alongside some element of collective employee share-ownership). David Coats' recent study for the Smith Institute explored options for employee participation in great detail (2013). He showed that employees on boards could be important for establishing a broader, fairer decision-making process, but only in the context of other workplace reforms. (It is also worth considering how other stakeholders could be represented, not least customers and suppliers. Here an exploratory, voluntary approach might work best, with firms invited to test different approaches.)

Employee representation and pay transparency is, however, intended to be a lot more than a short-term, zero-sum initiative to rebalance corporate power. Alongside a supervisory structure, the point is to create more collaborative, long-term behaviours among all stakeholders, with mutual respect and benefit, to achieve more equality and shared interests over time. This insight has always been at the heart of egalitarian arguments for corporate governance reform. In the 1952 *New Fabian Essays* Tony Crosland proposed workers on boards not just as a tool to redistribute resources but to transform social relations. It was an example of what he termed a 'socio-psychological' measure, designed to eradicate class enmity and create 'a sense of common interest and equal status'.

In the 1950s, the 1970s and the 1990s the left considered corporate governance reform and drew back. The arguments for long-termism, mutual respect and common interest never quite won the day. This time it can be different, because all these good arguments sit alongside the rise of the 'one per cent' and what that means for the whole economy. Without institutional reforms to channel the direction and distribution of corporate success, Britain's future prosperity is at stake.

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CHAPTER 11
What became of the stakeholder society?

John Kay

For a brief period before the 1997 election, 'the stakeholder society' was New Labour's big economic idea. Nothing came of it. The failure to develop this idea was representative of a broader and continuing failure – the inability of the European left to find a coherent economic philosophy in the face of the collapse of central planning and the rise of market fundamentalism.

Stakeholding meant different things to different people – and that was part of the problem. But my interpretation of stakeholding gave it, and continues to give it, the meaning it has always carried in management theory (see *Freeman* 1984, *Donaldson and Preston* 1995, *Kay and Silberston* 1995). Stakeholding is the idea that the corporation is a social institution that evolves organically, rather than a temporary coalition of people who find it profitable to do business with each other. The objective of the manager of the stakeholder company is to promote the development of the business in the interests of investors, employees, customers, suppliers and the broader community, rather than to maximise shareholder value.

In 1996, in the transitory heyday of British attention to stakeholding, I described these issues at the annual conference of the CBI, the association of Britain's leading businesses. I illustrated the issue by reference to the changes between the 1980s and 1990s in the mission statement of ICI, for most of the last century Britain's leading industrial company.

> "ICI aims to be the world's leading chemical company, serving customers internationally through the innovative and responsible application of chemistry and related science.
>
> Through achievement of our aim, we will enhance the wealth and well-being of our shareholders, our employees, our customers and the communities which we serve and in which we operate."
>
> **ICI 1987**

> "Our objective is to maximise value for our shareholders by focusing on businesses where we have market leadership, a technological edge and a world competitive cost base." **ICI 1994**

There are three obvious sources of difference between these accounts. The older statement puts operations first – "the application of chemistry and related sciences" – and finance second – "through achievement of our aim, we will enhance the wealth of our shareholders". The newer statement put financial objectives first – "our objective is to maximise value for our shareholders". Operations are secondary, the means by which that goal is to be achieved. The older statement looks forward to new businesses – it emphasises innovation. The newer focuses on "businesses in which we (already) have cost leadership". The older statement expresses concern for shareholders, employees, customers and communities. In the newer statement, only shareholders feature.

The change at ICI can be directly traced to a period when the company believed – probably mistakenly – that it was vulnerable to a threat of takeover by the predatory Hanson Trust. But similar shifts in focus were observed in many large companies over the same period, as the financial sector grew larger and more global, and came increasingly to dictate priorities in both business and economic policy.

We now benefit from hindsight and can describe what happened before – and after. The older ICI was a world leader in its industry from its formation in the 1920s (*Pettigrew*, 1985). The origins of the company were in explosives and dyestuffs, but in the inter war period the emphasis of the business shifted to petrochemicals and agricultural fertilisers. After the Second World War, the ICI Board recognised, presciently, that the most important 'responsible application of chemistry' in future would be the nascent pharmaceutical business. But ICI's pharmaceutical division lost money for almost two decades until in the 1960's the company discovered, under the direction of James Black, who would be the father of Britain's continuing strong pharmaceutical industry, one of the early blockbuster drugs: beta-blockers, the first effective anti-hypertensives. In the quarter century that followed, pharmaceuticals would be the principal driver of ICI's growth and source of its profit.

The experience of the newer ICI was not such a happy one. The stock market reacted favourably to the announcement of its changed objectives, but less favourably to the subsequent reality. ICI's share price peaked at almost £10 a few months after that CBI speech, its zenith coinciding with the election of the New Labour government The decline thereafter was relentless, and in 2003 the share price dipped below £1. In 2007 what remained of the once-great business was acquired by a Dutch company. The company whose objective was solely "to maximise value for shareholders" was not successful even in achieving that.

In this dispiriting experience for shareholders, ICI was also representative of wider trends. In the 15 years from 1984 to 1999, UK share prices rose more than fivefold; the FTSE all share index, below 600 in 1985, peaked in September 2000 at over 3000. The hope of shareholder value proved more rewarding than the reality. Today, the index has barely regained that 2000 level.

The financial sector provides the most extreme examples. In a duet resonant of the transformation of ICI, the veteran banker John Reed briefly shared at the turn of the century the position of CEO of Citigroup with the newer upstart, Sandy Weil. The two men provided contrasting views of the future of the company for an American journalist. "'The model I have is of a global company that really helps the middle class with something they haven't been served well by historically. That's my vision. That's my dream,' said Reed. 'My goal is increasing shareholder value,' Sandy (Weil) interjected, glancing frequently at a nearby computer monitor displaying Citigroup's changing stock price" (*Langley*, 2003). Weil soon ousted Reed to become sole CEO. Within eight years, Citigroup's share price would have lost almost all its value and the business would be rescued by the US government.

There was an economic philosophy of sorts during New Labour's term of office from 1997 – 2010, but it was not stakeholding. The 2006 Companies Act does lean towards a stakeholder interpretation, requiring directors to promote the success of the company for the benefit of its members – a formulation clearly closer to old ICI than new. But few directors see it that way. The mood of the times was very different, and so was the economics of New Labour in government (*Balls et al*, 2004). Their philosophy is best described with the two phrases 'the market failure doctrine', and 'redistributive market liberalism'. The market failure doctrine adopts the premise that market outcomes are broadly efficient, save for a limited class of 'market failures'. The concept of market failure derives from the startling premise that a failure of a particular economic model of markets to conform to reality reflects a failure of the market rather than a failure of the model (*Kay*, 2007). Yet the grip the notion of market failure holds on the thinking that underpins modern economic policymaking is hard to exaggerate. It has been, and remains, difficult to make a case for collective intervention in economic affairs except by reference to 'market failure'.

'Redistributive market liberalism' develops the market failure approach by broadly accepting market outcomes while ameliorating the consequences through tax and benefits. Redistributive market liberalism is capitalism with a human face. Thus redistributive market liberals are untroubled, even enthused, by the devotion of companies to shareholder value and by the financialisation of the business sector. Redistributive market liberals, although to the left of the political spectrum in their views on social policy, favour 'light touch' regulation, believing that government should generally stay out of productive activity unless such activity is characterised by 'market failure' (*Kay*, 2003).

Redistributive market liberalism requires us to make a sharp distinction between our economic lives and our civic values. In commerce, we may – even must – pursue our self-interest. We then vote for high taxes so that the proceeds of our self-interest can be fairly redistributed to be a beast in business and a concerned citizen at the ballot box. Except we don't. The individualism that is central to redistributive market liberalism's economic philosophy undermines the solidarity on which its approach to social policy depends.

Redistributive market liberalism can never provide an economic basis for the politics of the left because it concedes, mistakenly, the validity of the simplistic model of the market economy espoused by the new right. The implied distinction between economic process and social outcomes is untenable. How could we ever hope to frame rules and institutions except in the light of knowledge of the practical consequences of these rules and institutional arrangements? Markets (and here I mean real markets for goods and services rather than markets for securities) are social institutions, not mechanical contrivances. Corporations are organisations embedded in communities and possess character and values of their own; they are not just a transitory association of contracting parties. The weaknesses of the underlying economic theory go far beyond the conventional list of "market failures'.

Market fundamentalists espoused a model of the market economy that was simultaneously repulsive and false. The central lesson of the financial crisis is that an organisation of financial markets which applauds greed and emphasises anonymous trading over trust relationships does not work even in its own terms. The corporation (Bear Stearns) that famously proclaimed that it made nothing but money proved, in the end, incapable even of that. The ICI managers who pushed shareholder value ended up destroying it.

Markets work, in the long run, because they are the economic expression of the disciplined pluralism that is the basis of a democratic society. They facilitate experiment and innovation. Markets and corporations serve citizens when, and only when, they are embedded in the societies of which they are part. With proper recognition that successful market economies are necessarily embedded in a social context, it is time to return to the stakeholder debate.

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CHAPTER 12
Innovative enterprise: a prosperous economy needs it, but 'maximising shareholder value' undermines it

William Lazonick

A successful economy is one that can achieve equitable and stable economic growth – or what I call 'sustainable prosperity'. A major intellectual barrier to understanding how business and government can work together to achieve sustainable prosperity is the brand of economics known as agency theory with its policy prescription of 'maximising shareholder value' (MSV). Legitimised by agency theory's arguments for MSV, corporate boards have authorised massive cash payouts to public shareholders in the forms of dividends and buybacks that come at the expense of taxpayers who have invested their money and workers who have invested their effort in the innovation process with the expectation of future returns. The results of MSV-dominance, as my research has shown for the case of the United States, are income inequity and employment instability, both of which threaten the growth of the economy as a whole.

MSV is a theory of value extraction that lacks a theory of value creation.
The purpose of the business enterprise is to produce competitive goods and services: that is, products that buyers want or need at prices that they are willing or able to pay. Given market prices of labor and capital, a competitive good or service is higher quality and/or lower cost than one that does not succeed on the product market. A business that generates higher-quality, lower-cost products over a sustained period of time is an 'innovative enterprise' that creates more value through its output than the value of the inputs that it consumes. It is possible, however, for certain economic actors – let's call them 'financial interests' – to assert control over resources and revenues of the innovative enterprise to extract value from it that is far in excess of their contributions to the process that creates value. Members of these financial interests, including corporate CEOs, investment bankers and hedge-fund activists, can be found among the top 0.1 per cent of the income distribution.

Here is how a value-creating enterprise works.
A firm generates a profit (what agency theory calls a 'residual', reflecting its lack of a theory of innovative enterprise) when revenues from the sale of competitive products exceed the costs of producing and distributing those

products. The key to understanding the innovative enterprise is that, by investing in innovative capabilities, it deliberately incurs costs, and hence potential *losses*, that *un-innovative* firms avoid. The innovative enterprise *develops* productive resources through collective and cumulative learning processes that, in and of themselves, burden the company with *high fixed costs* and expose it to the possibility of losses. If, however, through organisational learning, these *high fixed costs* enable the business to generate products that are *higher quality* than its competitors, it can potentially gain a large market share that, through economies of scale, transforms these high fixed costs into *low unit costs*. Through the generation of a good or service that is not only higher quality but also lower cost than those of competitors, potential losses can thus become actual profits or, to put it differently, competitive disadvantage can be transformed into competitive advantage.

The essence of this innovation process is collective and cumulative learning, the success of which is inherently uncertain.
If we knew how to innovate when commencing this collective and cumulative learning process, we would not be engaged in innovation. Given uncertainty, investments in organisational learning must be made without any guarantee of returns. The innovative enterprise faces three types of uncertainty: technological, market and competitive. Technological uncertainty exists because the firm may be incapable of developing the higher-quality processes and products envisaged in its innovative investment strategy. Market uncertainty exists because, even if the firm is successful in its product development effort, future reductions in product prices and increases in factor prices that are beyond its control may lower the returns that can be generated by these investments. Finally, even if a firm can overcome technological and market uncertainty, it still faces competitive uncertainty: the possibility that a competitor will have invested in a strategy that generates an even higher-quality, lower-cost product, and as a result the firm may be unable to access a large enough extent of the market for its products to transform the high fixed costs of its innovative investment strategy into low unit costs, and hence profits.

Nevertheless, if a firm is to have the opportunity to profit and grow through innovation, it must invest in the face of uncertainty.
When successful in overcoming technological, market and competitive uncertainty, the business enterprise can share these gains as returns to those economic actors who risked their money and effort in contributing to the innovation process. Who are these economic actors who invest in the innovation process with a view to gaining returns in the future that are by no means guaranteed?

MSV assumes that it is only shareholders who make investments in the business enterprise without guaranteed returns.
All other economic actors, it is argued, have received a guaranteed market-determined price for their productive contributions. But agency theory does not have a theory of the value-creating enterprise, and as a result it makes fundamentally flawed assumptions about who bears risks in, and who should get rewards from, the innovation process. In practice, the application of MSV's policy prescriptions for distributing corporate cash to shareholders results in value extraction by those who have had little if anything to do with value creation, resulting in income inequity and employment instability.

Taxpayers often invest in the innovation process without guaranteed returns.
Many of the critical productive inputs related to physical infrastructure and human capital that the business enterprise utilises are made available through government spending, often in the form of public goods financed by tax revenues and government debt. Even the largest and most powerful business enterprises rely on government investments in physical and human resources to generate competitive products. In addition, business enterprises often receive government subsidies and procurement contracts that assist them in the development and utilisation of productive resources.

Tax systems can be structured to ensure that taxpayers reap the returns on past investments in innovation if and when they are successful. Some or all of these tax revenues can be used by government agencies to fund the next round of innovation. But MSV ideology claims that only shareholders take risks and hence only shareholders have claims on profits. Financial interests, including business executives, seek lower tax rates to incentivise financial wealthholders, including public shareholders, who supposedly take all the risk of investing in innovation. By securing lower tax rates, financial interests can extract value that taxpayers' investments helped to create.

Workers often invest in the innovation process without guaranteed returns.
The most critical investments that a business executive makes are in integrated skill bases that can engage in collective and cumulative learning, and thereby generate the high-quality products that are essential for competitive advantage. Investments in organisational learning in the past can enable the company that develops and utilises productive resources to generate profits in the present.

As members of integrated skill bases, workers regularly make productive contributions to the companies that employ them through the expenditure of effort beyond those levels required to lay claim to their current pay, but without guaranteed returns. Any employer who seeks to generate higher-quality, lower-cost products knows the profound productivity difference between employees who just punch the clock to get their daily pay and those who engage in organisational learning to make productive contributions through which they can build their careers and thereby reap future returns in work and in retirement. Yet these careers and the returns that they can generate are not guaranteed. If these workers are laid off, or their wages and benefits are cut, financial interests can extract value that these workers helped to create.

As risk bearers, therefore, taxpayers whose money supports business enterprises and workers whose efforts generate productivity improvements have claims on corporate profits if and when they occur. MSV ignores the risk-reward relation for these two types of economic actors in the operation and performance of business corporations. Instead it erroneously assumes that only shareholders are 'residual claimants' who have the right to determine how a company's profits are distributed.

The irony of MSV is that the public shareholders whom agency theory holds up as the only risk-bearers in the economy typically never invest in the value-creating capabilities of the companies in which they hold shares.
Rather, they invest in shares outstanding on the stock market in the hope that the shares will rise in price. And, following the directives of MSV, a prime way in which corporate executives fuel this hope is by disgorging the so-called 'free' cash flow to shareholders. In the

United States, as the prime example, from 2001 through 2013 companies in the S&P 500 Index (which account for more than 70 per cent of the capitalisation of companies in the United States) spent about $3.6 trillion buying back their own stock, the prime purpose of which has been to manipulate their companies' stock prices. That was in addition to about $2.4 trillion spent on dividends. Together buybacks and dividends absorbed over 90 per cent of corporate earnings, leaving little to be allocated to new investment in productive capabilities or higher standards of living for corporate employees.

If sustainable prosperity is what we want, we need to rid ourselves of MSV as the dominant ideology of corporate governance. To go beyond shareholder value, we need a theory of innovative enterprise.

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CHAPTER 13
The need for corporate diversity

Jonathan Michie

The 2012 Report from the Ownership Commission lamented the lack of corporate diversity within the UK economy, and called on government to take action to promote a more corporately diverse economy, including through the promotion of 'mutuals'. Mutuals, broadly defined, are companies owned not by private individuals or families nor by external shareholders, but by their members, where these will be their customers, their employees, or other groups such as producers or the local community – or indeed by some combination of such stakeholders.

The UK's 2010–2015 Coalition Agreement committed the government to bringing about a more corporately diverse financial services sector, including through promoting mutuals.

The reality has been disappointing. The financial services sector is no more corporately diverse today than when the coalition government made its pledges in the Coalition Agreement of 2010. Quite the contrary: the situation has actually become worse rather than better; as reported below, new research demonstrates that the financial services sector is even less corporately diverse in 2014 than when the government pledged to deliver diversity.

Well before the problems of the Co-operative Bank, the coalition government had reneged on its commitment to promote corporate diversity in the financial services market, including by promoting mutuals, through its refusal to return Northern Rock – which had been a successful mutual prior to demutualising, and which then failed as a private bank – to the mutual sector. The disposal of Northern Rock was generally reported as having been a sale to Richard Branson, but in reality 44 per cent went to the American leveraged buyout investor, Wilbur Ross – and all at a loss to the taxpayer. (For a detailed analysis of Northern Rock, and the potential to have returned it to the mutual sector, see *Michie and Llewellyn* 2010.)

The Michie-Oughton index of corporate diversity

We need a more corporately diverse economy, including a more corporately diverse financial services sector. The UK economy is peculiar not only in having a relatively dominant financial services sector and a correspondingly weak industrial sector (on which see *Kitson and Michie* 1996), but also in having such a lack of corporate diversity within the financial services sector itself. In other countries there is generally a strong co-operative and mutual sector, whereas in the UK that sector was hugely damaged by the 'demutualisation' of the member-owned building societies, which were turned into private sector banks following the UK Building Societies Act 1986 – thus weakening the mutual sector and reducing the degree of corporate diversity. It was argued that becoming shareholder-owned banks would strengthen these companies. Yet not one of them has survived as a separate company. Every one either failed or was taken over by a larger private bank – thus reducing corporate diversity even at the level of number of competitors, let alone the more fundamental aspect of having competition from alternative corporate forms. (On the need for a more corporately diverse economy, and in particular a more corporately diverse financial services sector, see *Michie* 2011.)

The coalition government of 2010–15 pledged to bring about a greater degree of corporate diversity within the financial services sector:

> "We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry."
> (*HM Government* 2010)

But even had it been serious, how would the electorate or anyone else know whether it had succeeded in meeting this goal, when it did nothing to measure the degree of corporate diversity within the financial services sector? The failure of government to measure corporate diversity within the financial services sector led to the Oxford Centre for Mutual & Employee-owned Business undertaking this task itself – as described, discussed and reported on in detail in Michie and Oughton (2013). We developed an index of diversity in financial services – the 'Michie-Oughton Index' – which we constructed from creating four sub-indicators or indices, which measured in turn:

1) Ownership diversity

A key distinction is between the shareholder-owned banks on the one hand, and the mutual and co-operative banks on the other. These different categories of institutions have different ownership structures, business models and modes of behaviour (as reported by, for example, *Heffernan* 2005, *Hesse and Cihak* 2007 and *Ayadi et al* 2009, 2010). The first of these sub-indicators thus created a new measure of ownership diversity, which we based on the Berry index of diversification and the Gini-Simpson index of bio-diversity. It measures the extent of diversity in ownership types – banks, mutuals and the government-owned NS&I – where each of these types has discernibly different objectives so that there is diversity in behaviour.

2) Competitiveness

There has been a long-standing recognition that the UK's banking sector has been peculiarly dominated by a few large banks (see *Baer and Mote* 1985, *Vallascas and Keasey* 2012, 2013, *De Jonghe* 2010, *Independent Banking Commission* 2011, *HM Treasury* 2012, *Beck* 2008, *OECD* 2011, *Vives* 2011). This has been a concern because of a lack of competition, including over the servicing of particular markets, such as long-term financing for small and medium sized enterprises. In addition, this concentration has led to the 'Too Big to Fail' problem of large banks that can speculate on the markets, where success feeds straight through into increased bonuses, but failure will likely be met with taxpayer-funded bailouts. Our second indicator is thus designed to capture the extent of competition and is based on the inverse of the Hirshmann-Herfindahl index of concentration.

3) Balance sheet structure/resilience

In the years preceding the 2007–08 international financial crisis, there had been a degree of convergence in the funding models used by financial institutions, with banks shifting their funding models from retail deposits to wholesale funding. This trend was noticeable across several countries, including the UK, the US and Germany. It has been identified as a major contributory factor towards the international financial crisis (on which see *Bologna* 2011 for an analysis of US bank failures, *Norden and Weber* 2010 for an earlier review of funding models used by German banks, and *Le Leslé* 2012 for an analysis of the European bank funding models. Our third indicator was thus designed to measure diversity in balance sheet structures, and resilience across the sector.

4) Geographic spread

The geographical concentration of financial services can have both direct and indirect effects on the performance of an economy. Direct effects are related to the employment and income generated in the sector and its geographical spread or concentration. Indirect effects spring from the pivotal role that the financial services sector plays in providing finance to industry and consumers, which in turn has a significant impact on the development of the non-financial sector and the housing market. Our fourth indicator thus seeks to capture the extent of geographic spread and the regional concentration of financial services.

These indicators are combined into a single index – the Michie-Oughton 'D' Index – that measures diversity in financial services. Michie and Oughton (2013) report the movement in this index from the years 2000 through to 2011. The index shows a marked decline in the run-up to the 2007–08 international financial crisis, followed by more significant falls during both 2008 and 2009. Since then the index has remained more or less flat. As a result, we are no closer to creating the conditions – of diversity – that have been identified as constituting an important component of avoiding a repeat of the international financial crisis. The Michie-Oughton index provides for the first time a measure of corporate diversity in the financial services sector, and offers policy-makers a means of tracking movements in the degree of corporate diversity in the financial services sector.

Policy implications

The Michie-Oughton 'D' Index needs to be calculated and reported periodically over time by the National Statistical Office, so an improvement in the index can be an explicit goal of policy, for which there should be cross-party support and, with public institutions such as the Bank of England and local authorities, encouraged or if possible required to assist in delivering on this goal of enhancing the degree of corporate diversity.

In terms of promoting corporate diversity itself, a number of policy measures could and should be pursued. The first is to ensure that the political commitment is made and honoured – so that, for example, when opportunities arise such as with Northern Rock having moved to the private banking sector and failed, where it should have been transferred back into the mutual sector, this does indeed become the default approach, rather than selling off to the private sector. Following on from this, the unthinking bias in favour of the plc model needs to be challenged and rooted out – across politics, the civil service, public institutions and regulators, and indeed across the private sector itself. This last point leads on to a further problem, which is that when owners of private and family-held companies are considering succession planning, the advice from financial advisers will be that this needs to be done by floating on a stock exchange, or a 'trade sale' to an existing private or plc company. Rarely if ever will the option be admitted of selling the company to the existing workforce (and possibly customers, suppliers and the local community). This can be done by the owner selling the shares to a trust that holds the shares in the interests of the employees – preferably in the interests of future employees as well as current, as with the John Lewis Partnership. The trust can borrow funds to compensate the former owner, and that loan is paid off over time from the company's profits (in effect from the dividends that would have been paid on the shares).

One additional specific reform that needs to be made is to enable cooperative banks to be launched and run in the UK, for which there is currently no provision, unlike in most other advanced industrial countries where co-operative banks play a useful and important role, not least through providing competitive pressure on the private banking sector to up its game in customer provision and support. This failure of the UK's corporate arrangements is the reason that, unlike our competitor economies, the UK has (or had) only one co-operative bank, and more crucially is the reason why that was not organised as a cooperative but was rather a plc, wholly owned by the Co-operative Group. The existing state holdings in the banking sector, brought about by the failure of the private sector banking model, should also be used proactively to create a range of new public and mutual financial institutions at local, regional and national level.

In addition to promoting corporate diversity, and thereby providing a competitive challenge to the private financial services sector, the private sector itself needs to be better regulated, with 'Too Important to Fail' banks being broken up – creating further opportunities for creating a rich ecosystem of new financial institutions that includes public and mutual companies at local, regional and national level.

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CHAPTER 14
Workers' voice in corporate governance

Frances O'Grady

In recent years trade unions have consistently argued that the UK's future prosperity will rest upon securing a substantial shift towards a stronger and more resilient economic model, where long-term investment, high productivity and fair wages provide the basis for sustainable growth.

This step-change in the UK economy will require fundamental reform of corporate governance. If we are to shift our economy away from a continual race to the bottom - where workers pay the price of low value business models with deteriorating terms and conditions – and take a high productivity approach to growth, we need to change the way in which corporate decisions are made and the priorities on which they are based.

In the UK, corporate governance and company law put the interests and rights of shareholders at their heart; indeed, shareholders are the only stakeholder group with significant rights in relation to how companies are run. Shareholders elect company directors, now annually at the FTSE 350; they vote on resolutions and can file resolutions at company AGMs; they can convene EGMs; and they have had an advisory vote on remuneration reports since 2003 and now have a binding vote on remuneration policy. Shareholder representatives can and do engage regularly with company boards, using meetings, letters and phone calls to make their views known. This engagement is seen as exerting a discipline on company boards which makes it an essential part of our corporate governance system; thus a common response from Government and others in response to corporate misdemeanours is that 'it's a matter for the company and its shareholders'.

In the market for corporate control, shareholders again hold all the cards. Despite the major impacts that mergers and takeovers can have on all company stakeholders, and indeed the company itself, the decision as to whether a merger or takeover goes ahead rests with shareholders alone.

The most fundamental right that shareholders enjoy is that, under UK company law, directors' duties require them to promote the success of the company for the benefit of its shareholders as their primary aim. In so doing, directors are required to have regard to the long-term consequences of their decisions, the interests of employees, supplier and customer relationships, and community, environmental and reputational impacts, in an approach known as 'enlightened shareholder value'. However, these factors are to be considered in so far as they contribute to shareholder interests, rather than in their own right.

However, changes in the patterns of share ownership in recent years present major challenges to the reliance on shareholder rights and oversight within the UK's corporate governance system. Institutional investors such as pension funds and insurance companies that have an interest in long-term investment returns hold a declining share of UK company shares – down from over 40% in 1998 to less than 11% today. In contrast, over half of UK shares are now held by overseas investors.

Barriers of language, culture, proximity and availability of information all make it harder for investors from outside the UK to develop the kind of engaged relationships with UK companies that are required if the UK's corporate governance system is to work as intended. The dominance of overseas investors in the UK stock market also reduces the extent to which national societal expectations on issues such as executive pay will have an impact on companies via their shareholders.

But engagement between UK investors and companies is also problematic. In contrast to individual shareholders, institutional investors generally hold highly diversified portfolios, holding shares in hundreds, if not thousands, of companies. This means that for institutional investors, the sheer number of companies whose shares they own presents considerable practical obstacles to the quality and quantity of their engagement. The other side of this coin is that the shareholders of a large listed company will number in the thousands if not the tens of thousands, which creates difficulties for a company that wishes to engage its shareholders in discussion about long-term strategy.

There is a yet more fundamental problem with the current system. The justification for requiring directors to prioritise the interests of shareholders was that in the long-term the interests of shareholders converge with those of other stakeholders. According to this argument, requiring directors to prioritise shareholder interests should also encourage them to take a responsible approach to stakeholder relationships and wider company impacts.

However, this convergence of interests between shareholders, the company and other stakeholders only holds true if shareholders are long-term investors whose economic interest in a company is in receiving dividend payments over a significant period of time. If, on the other hand, the shareholder is a short-term share trader whose economic interest is in selling the company's shares for more than they bought them for, their focus will be on short-term strategies to boost the company's share price, regardless of the impact on long-term, organic company growth. In this case, the investor's interests will not coincide with those of other company stakeholders, nor, crucially, with the long-term interests of the company itself. If the investor is shorting the stock, their interests will actually be diametrically opposed to those of other company stakeholders, including long-term shareholders, and indeed the company, as they will stand to gain if the company's share price falls. In this scenario, it is impossible to justify why shareholders are the group whose interests companies are required to promote, and why shareholders have the ultimate say over how companies are run.

Increasingly, even so-called long-term investors rely on strategies based on share trading, rather than long-term shareholding, to generate income from share ownership. Investors' increasingly short-term approach to their shareholdings and reliance on strategies based on share trading cuts a deep hole in the UK's corporate governance system and leaves the arguments for enlightened shareholder value in tatters.

The TUC believes that directors' duties should be reformed so that directors are required to promote the long-term success of their company as their primary duty. Serving the interests of shareholders and the stakeholder groups currently included in directors' duties should be secondary to this central aim. In addition, shareholders' corporate governance rights should be subject to a minimum period of shareholding of at least two years.

However, the TUC believes that the time has come for the UK to go further and to recognise the interests and rights of other stakeholders in corporate governance, and in particular those that companies often say are their greatest asset: their workforce.

In the UK, workers leave their democratic rights at the door when they enter the workplace. Despite the fact that those in full-time employment spend a large proportion of their waking hours at work, workers have no automatic right to influence the decisions that are taken there. In the UK, many workers are not even informed or consulted in advance about changes to workplace strategy or organisation. Reform to strengthen workers' voice at work is long overdue. We believe that all workers should have the right to be consulted collectively on matters regarding their workplace. In addition, workers in the private sector should have the right to be represented on company boards.

There are strong economic and social arguments for such change. In contrast to short-term shareholders, the interests of workers are well correlated with those of the company they work for. As any union representative knows, the best employment security for their members is long-term company success. Effective mechanisms for workers' voice can help companies to prioritise long-term, organic growth over short-term financial engineering. Workers also bring to the board in-depth knowledge of the company they work for and the environment in which it operates, making them well-placed to contribute to strategic and operational decisions.

One of the justifications sometimes given for prioritising shareholder interests in corporate governance is that shareholders carry the greatest risk in relation to companies. However, this is contradicted by reality, whereby institutional shareholders hold large portfolios of shares precisely to spread their risk. Workers, on the other hand, invest their labour, skills and commitment in the company they work for and cannot diversify this risk. If this investment goes wrong, for any reason, they and their families pay a heavy price – the loss of employment and loss of income, skills, opportunities and often health that this can bring. If carrying risk gives rights to representation and protection of interests, this supports the case for workers' voice in corporate governance.

In much of Continental Europe, worker representation on boards is an accepted and valued part of how companies operate. In 19 European countries, including many of Europe's most successful economies such as Germany, the Netherlands, Austria and Denmark, workers have the right to be represented on company boards. In 14 of these countries, these rights are extensive, in that they apply to the majority of private companies (in the other five they are limited mainly to state-owned companies). Significantly, they apply in countries like Sweden that have a unitary board system (ie, a single board of directors) like the UK, as well as in countries like Germany that have a two-tier board system (ie, with an executive management board and a supervisory board which is almost entirely non-executive). They also apply in a growing number of countries that allow companies to choose between the two board structures.

The value of worker board representatives is recognised by company representatives and other board members. For example, a survey of Swedish companies showed that 61 per cent of managing directors found the impact of worker board representation at their company positive, with just nine per cent finding it negative. Company Chairpersons had a still more positive view, with 69 per cent describing the impact on their company as positive and just five per cent finding it negative (*Levinson*, 2001). Another study based on interviews with worker board representatives in 13 countries presents a picture of worker representatives making a genuine difference to the way in which decisions are made. The author concludes that 'employee representation contributes towards a more broadly based corporate strategy by ensuring that it takes into account at an early stage the views and interests of organised labour' (*Gold*, 2011).

Research shows that countries with high standards of workers' participation – meaning widespread rights and practices on board representation, workplace representation and collective bargaining – score more highly across a range of important measures, including R&D expenditure, employment rates, educational participation among young people and educational achievement among older workers than countries like the UK with low workers' participation standards. What is more, these countries achieve both stronger economic success and a more equitable economic settlement: poverty and inequality rates are both lower than in countries with weaker workers' participation rights (*Vitols*, 2010). This evidence should surely be of interest to policy makers and all those with an interest in the social and economic performance of the UK.

There is no one model of workers' representation on boards across Europe, and there are variations in how worker representatives are nominated and elected; which companies are covered by requirements; and the proportion or number of worker representatives per board. This is not something that lends itself to one size fits all, but there may nonetheless be elements from different existing systems that could be combined with new provisions to create a workers' participation framework that was uniquely suited to the UK.

Some UK companies are leading the way. First Group has had an employee director since the company was created in 1992. Martin Gilbert, outgoing Chair of FirstGroup, has described the presence of employee directors on the FirstGroup board as "invaluable" (*Gilbert*, 2013).

While worker board representation would be a big step in the UK, there are important precedents for workers playing this sort of role. For example, in trust based pension schemes, there is a legal requirement that one third of the trustees should be elected by and from scheme members – ordinary workers, in other words. These member-nominated trustees have to get to grips with large amounts of complex, technical and financial information and work alongside the employer-nominated trustees, with whom they share the same fiduciary duty to serve the interests of scheme members. The valuable role played by member-nominated trustees in running pension schemes has been recognised by scheme members, employers and pensions specialists alike.

Member-nominated trustees make use of training and support, some of which is provided by the trade union movement. If worker board representation were to become a reality in the UK, the TUC would work with other organisations to provide training, support and networking opportunities for worker representatives to enable them to fulfil their role effectively and with confidence.

The TUC believes that corporate governance reform and measures that bring the perspective of the workforce into business decision-making are essential to create a high investment, high skill and high productivity economy. Putting such changes in place will require political leadership and determination to tackle vested interests. There is now a unique opportunity, created by the financial crisis and its fallout, for far-reaching reform to change the balance of voices and interests recognised in the UK's corporate governance system. Let us not waste this opportunity!

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CHAPTER 15
Is corporate governance what is wrong with our economy?

Vicky Pryce

It is fashionable to put the blame for the spectacular crash and also the slow recovery following the financial crisis of 2008 on lax governance arrangements and cultures in organisations that put short-term gain ahead of long-term sustainability. But is that right?

In truth there is a lot in it. In listed companies the separation of ownership from management inevitably gives rise to a 'principal/agent' problem. It can lead to a misalignment of objectives that could then result in management putting its own interests ahead of those of the company's long-term shareholders. This of course has given rise to a number of possible remedies such as: increasing shareholder activism by legislating to give extra rights to shareholders so they have a direct vote on issues such as board remuneration and strategic plans; granting special voting rights to long-term investors; expanding share ownership across the organisation and on the board; having more women and employee representatives on the board and increasing the proportion of independent non-executive directors (NEDs)s; and improving the NEDs' quality and providing extra support to them to better monitor companies' performance.

Few of these ideas are new. Progress was being made in many areas before the crash. But the fall-out from the crisis suggested that perhaps that progress had simply not been sufficient to prevent excessive greed and too much risk-taking to the detriment of employees, consumers and citizens.

Clearly we want companies to grow and succeed and to do so sustainably and for the good of the economy and society at large. After all, they are the main creators of wealth and jobs and the state depends on them in order to continue to provide the 'public' goods the population demands. If the system fails, the whole country suffers. But is the answer better governance or is it something else?

In an important new book on the crisis, *Fragile by Design*, Charles Calomiris and Stephen Haber argue that in fact what brought the crisis about was a collusion between businesses, regulators, politicians and the general public's hunger for cheap housing and other credits which created the various financial structures that encouraged the excesses we saw at the time and whose reverberations are still being felt at present. It wasn't just greed, although it played its part. It was instead a reflection of a societal agreement that then went spectacularly wrong. It was a failure, therefore, of 'governance' in the wider sense.

But some changes at the margin might make things better in the future. We know for example that shared ownership, like at John Lewis, can work. It gives people a sense of belonging and a united goal and sharing profits more widely assists productivity by improving morale, increasing employee retention and reducing absenteeism. It is thus a good thing per se. But employee share ownership remains rare and is difficult to enforce across all companies. Mutuals are also limited to the sectors in which it is possible for the structure to survive but those have problems too and in no way guarantee good governance, as the recent problems with the cooperative movement have demonstrated. There are good case studies from professional service firms that are run as partnerships and where risk is shared more widely across the organisation. Arguably their governance structure allows for better decisions to be made as all aspiring and current partners have a vested interest in the longevity of the company they have joined. The dedication and loyalty of their employees, on whom a lot of their profits depend, is a must and that forces them to put in place much of what we now have come to define as aspects of corporate social responsibility.

But such organisations, although increasingly important for the viability and competitiveness of the economy, still have a tendency to focus on annual profit distributions. It is also a fact that firms with a large internal ownership tend to raise less capital, with the result that there is less investment for the long-term – and with it less innovation, all of which is bad for the growth of the economy. Sadly, also, that ownership model was incapable of saving Arthur Andersen, which was perceived to have contributed to the Enron scandal and which led to the eventual demise of both companies.

Aligning the owners' and managers' objectives by giving board members shares does not solve the problem either, as the emphasis all too often continues to be share performance rather than long-term sustainability. Reported profits are automatically hit if a firm invests, so there is less incentive for capital spending and R&D. Moreover, the granting of share options in particular has led to perverse outcomes, with many examples of boards opting for instant gratification through ill-judged acquisitions that boost share prices in the short-term rather than for careful and targeted longer-term investment and expansion of productive capacity.

So where do we go from here? Policy Exchange has argued that the answer lies in greater diversity among independent directors on boards and calls for an independent nomination committee with shareholders sitting on it. I would go further and suggest stakeholders more widely, including employees.

Economic and management literature in this area suggests that, although there are costs associated with diverse boards, the benefits include better access to unique information, different viewpoints to come forward, less 'groupthink' and more debate (*Ferreira* 2010). As such, diverse boards should improve directors' ability to discharge their main duties as is required by the 2006 Companies Act (*Valsan* 2013). And a more diverse and representative board can also help the company exercise another of its duties, which is to take into account the interests of shareholders as a more diverse board can help correct some of the biases and prejudices that would have been there (*Langevoort* 2011). But directors drawn from a wider spectrum that reflects society as a whole may lack the experience that would be needed to make them effective on a board and they will need to receive appropriate training so they that their contribution matters to the way a company performs. But whoever they are, once on board they should be held to account a lot more often. It is absurd that NED performance is rarely monitored until there is a scandal. So the idea of better NEDs is not a bad one. But the literature fails to find a clear-cut case between independent NEDs and performance.

More active shareholders is also a welcome idea and we have seen some good examples, encouraged by legislation, of shareholders now throwing out remuneration recommendations and voting down strategic plans. But this is still rare. Many shareholders these days are passive international institutions, such as sovereign wealth funds, with little stomach for direct interference. Indeed in the period from 1998 to 2008, UK long-term shareholding in listed companies such as individuals, charities, churches, pension funds, investment funds and unit trusts declined from 95 per cent to 69 per cent and short-term shareholdings by banks, hedge funds and other financial and non-financial institutions rose from 3 per cent to 31 per cent. Longer-term shareholders who might care about the stewardship of the underlying assets are being increasingly drowned out by those who have very little interest in them or in how they are actually managed for the long-term by the board. Their interest is mostly for the share price to shift in the right direction and for short-term gain and that is miles away from the recommendations of the Walker Report, which calls for longer-term governance and stability. Even the supposed 'strategic investors' are rarely strategic. It is worth remembering that they have often had the finger pointed at them as being responsible for exerting pressure on boards, asking for better returns at a time of low interest rates, triggering a number of ill-judged acquisitions by firms such as RBS that have often ended spectacularly badly.

It is very hard to see what will change the inherent short-termism of the markets. Quarterly reporting, triggered by that very change in the ownership structure, is here to stay and pressures on CEOs will remain. Money is moving around globally looking for yields. Only private companies seem to be able to decide their own futures and invest long-term – and perversely the private equity governance model itself may not be as bad as other alternatives.

We must have legislative changes that make long-term thinking and reporting obligatory. But regulation alone is not the answer. It tends to breed a culture of avoidance, with businesses focusing on getting round the rules where they can rather than on how business is done. What we need to go hand in hand with legislation is a change of culture that obliges companies to expect to be held accountable by all their stakeholders, such as employees, customers, suppliers and the community. From the scandals we have seen recently, it is really about how a company behaves when no one is watching. At the moment the answer to that would seem to be 'pretty badly'. Let's change that, but from within. Companies that understand that 'good business' will be rewarded with loyal customers will do better in the long-term. Changing the governance structure can help up to a point ; but it is only if the culture permeates through the organisation that change can really happen.

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CHAPTER 16
The change in management behaviour

Andrew Smithers

There has been a major change in the way senior managements in the UK and US are paid. Their total pay has rocketed and most of it now comes in the form of bonuses and similar add-ons rather than basic salary. This has changed the incentives of senior executives and has therefore changed their behaviour. As the purpose of incentives is to change behaviour, this should have come as no surprise. Unfortunately it has been such a surprise to economists that they have, for the most part, failed to notice the change and its impact. The change in management behaviour has been a very bad development both for the economy and for the longer-term interests of shareholders.

The interests of managers were formerly very different from the interests of shareholders. The aim of the new incentives, which have developed over the past 15 years, has been to moderate this and "align the interests of managers and shareholders". Unfortunately the chosen method had the exact opposite result from the one intended. The damage has not only driven an even greater wedge between the interests of managers and long-term shareholders but has also had a marked adverse impact on the economy.

Managements operate in an uncertain world but they have to take decisions and these are determined both by their guesses about the future and the incentives that they have. Managements are therefore largely concerned with balancing the different risks that they face. One of the greatest risks for a company is losing market share to its competitors. The two most obvious ways to do this are to push up prices too far, so that competitors can offer more attractive terms to customers, and to invest less than other companies, who are then in a position to reduce their relative costs of production. The long-term interests of the company therefore favour a high level of investment and caution with regard to pricing.

While these are the risks faced by companies, those faced by management are very different. Companies last much longer than the jobs of CEOs. The key risk for senior managers is that they will not receive huge bonuses during the relatively short time that they are likely to hold their jobs. These bonuses are usually linked to short-term changes in profits, reflected in earnings per share or return on equity. The greater the bonuses, the greater the incentive for managers to favour actions that boost short-term profits at the expense of the longer-term future of the company and its shareholders.

Companies have a great deal of short-term monopoly power. It is not easy for their corporate customers to change their suppliers in the short-term other than to a marginal extent; but, once new suppliers have their foot in the door, they are in a good position to increase their share. Managements have therefore considerable opportunity to boost profits in the short-term by increasing prices but, when they do this, they increase their companies' long-term risks of losing market share. Companies have a choice between spending money to buy back shares or investing in new equipment; the former push up earnings per share in the short-term and the latter in the long-term. An increased attention on management bonuses will therefore reduce investment and increase profit margins.

The value of bonuses also rises with the volatility of profits as published by companies. This applies in terms of both option theory and in its practical applications to modern management remuneration. Bonuses are like options: the rewards only add to the income of the beneficiaries; they suffer no penalties if the profits fall short of targets. Option values, such as those in the famous Black-Scholes model, depend on the volatility of the underlying profits, not on their growth.

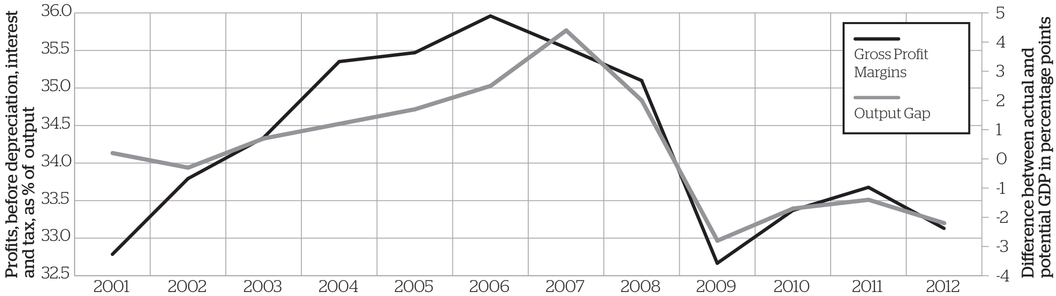
Management bonuses work in the same way. When new CEOs are appointed, they will wish to show that profits on their arrival are very low and the company will then show lots of 'write-offs'. These will not only depress the published profits when they are made but they will also artificially boost future profits. Write-offs are not just an admission that profits have been overstated in the past; they are a promise to try to overstate them in the future. The same approach will be taken even by those CEOs who contrive to survive a sharp fall in profits. They will write down profits and turn to their remuneration committees, arguing that incentives that are out of reach will provide no incentive. This will usually be accepted as a reasonable argument and the target for bonuses will be 'rebased'.

The impact of modern management remuneration systems will thus be threefold: investment will be lower than it would otherwise be; profit margins will be higher; and the published profits of companies will be more volatile than the profits would be if they were not manipulated and resembled those published in national accounts. These are both the results that we should expect and the results that we observe.

Chart 1 compares the UK profit margins with a measure of the level of spare resources in the economy, known as the output gap. A rise in the output gap corresponds to less spare capacity. As the chart shows, profit margins have risen and fallen with changes in the output gap, which is to be expected as unused resources encourage greater competition. While the fluctuations in profit margins have moved with changes in the output gap, there has also been an upward trend. Margins were higher in 2012 (the latest figures available) than they were in 2001; while over the same period there has been an increase in the amount of spare resources in the economy.

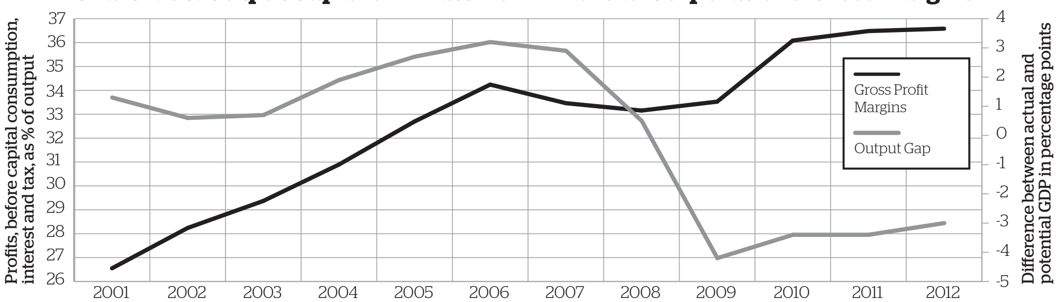
Chart 2 shows the same data for the US. There has been an upward trend in both UK and

Chart 1. UK: Output Gap and Private Non-Financial Corporations' Gross Margins



Data Sources: ONS BB (FBDA & NRJK) and OECD Economic Outlook Vol. 93.

Chart 2. US: Output Gap and Private Non-Financial Corporations' Gross Margins



Data Sources: NIPA Table 1.14 and OECD Economic Outlook Vol. 93.

US margins, though the dampening effect of the output gap has been much weaker in the US than in the UK. Since 2001 profit margins have risen, despite the opening up of a large output gap.

The behaviour of profit margins in both the UK and the US fits therefore with the change that we should expect due to the change in management incentives.

Chart 3 compares changes in the output gap with changes in the level of business investment. Compared with the changes in Chart 1, this shows a similar but weaker tendency for investment to fluctuate with changes in the output gap and an even more dramatic change in the trend. Investment has fallen by more than three percentage points of GDP (i.e. by nearly a third of its level in 2001).

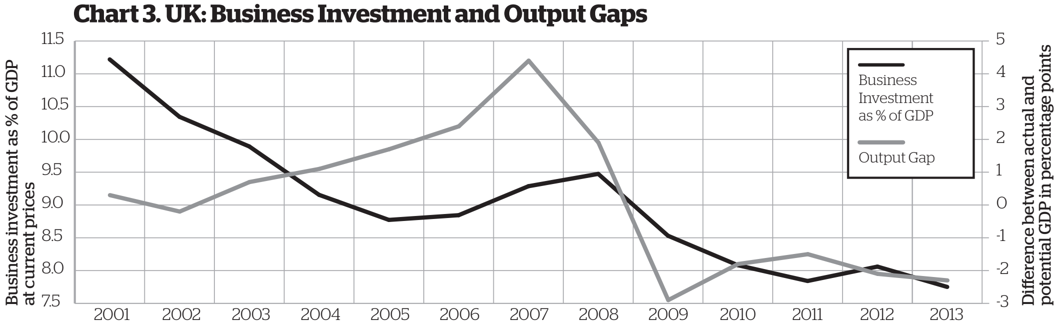
Chart 4 shows the relationship between business investment and the output gap in the US. The fluctuations have been similar but, unlike the UK, there is not a clear trend as investment has fallen in a similar way to the rise in the output gap. The evidence that investment has suffered in the US in a similar way to the UK is, however, available from other data. An important paper (*Asker et al* 2014) has shown that the US corporate sector is almost equally represented by quoted and unquoted companies but, in recent years, the unquoted sector, which is far less affected by the new and perverse management incentives, has invested twice as much as the quoted sector.

The behaviour of profit margins in both the UK and the US fits therefore with the change that we should expect due to the change in management incentives.

The third change we should expect from the change in incentives is for the profits that quoted companies publish to be much more volatile than those shown in the national accounts. Unfortunately there are no suitable data on published profits for the UK. In the US the volatility of profits published by quoted companies included in the S&P 500 Index was virtually the same as those for the economy from 1952 to 2000. Since then the volatility of the former has seen a dramatic five-fold jump.

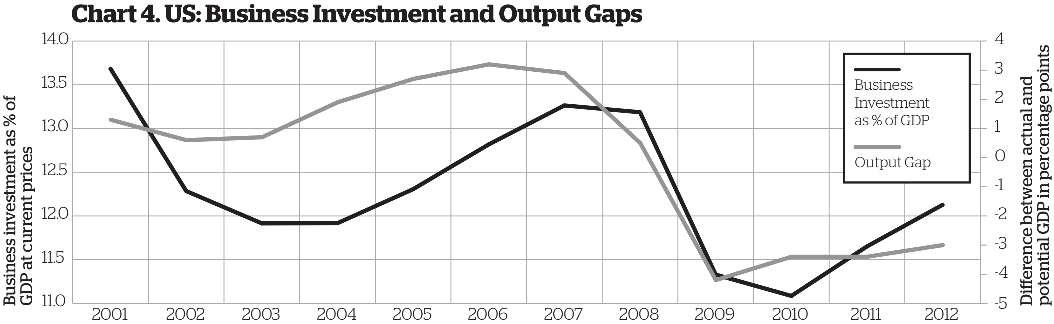
One impact of these changes has been a dramatic fall in labour productivity. Productivity has been very poor over the past three years in both the UK and the US. GDP per hour worked has fallen by 0.3 per cent per annum since Q1 2010 in the UK and risen by 0.5 per cent per annum in the US. Over the previous 15 years productivity in the UK had risen by 1.9 per cent per annum and in the US by 2.0 per cent per annum. It is common to read that this deterioration is 'inexplicable'. It is, however, so readily explicable that it should have caused no surprise. It is the natural result of the change in management incentives. The cost of capital to

Chart 3. UK: Business Investment and Output Gaps



Data Sources: OECD Economic Outlook Vol. 93 and ONS via Ecowin.

Chart 4. US: Business Investment and Output Gaps



Data Sources: NIPA Table 1.1.5 and OECD Economic Outlook Vol. 93.

companies has fallen to around its lowest-ever level. Short-term interest rates are near zero and bond and equity markets are at near record highs. Without the change in management incentives, this would surely have produced a surge in investment. But the cost of capital to management is very different from its cost to companies and so, when demand rises, managements prefer to employ more labour rather than more capital, with the result that productivity falls.

The change in incentives has also had a deleterious impact on fiscal policy. Budget deficits are needed to prevent recessions when the private sector wishes to save more than it wishes to invest. Keynes assumed that this wish for excess savings was a temporary phase that would soon end when entrepreneurs recovered their animal spirits. Unfortunately the new incentives, by boosting profit margins and depressing investment, have rendered the excess savings of the business sector a structural rather than a cyclical phenomenon. It will therefore be extremely difficult to bring the fiscal deficit under control unless we change the perverse incentives that have made a large deficit necessary.

For living standards to rise, GDP has to rise faster than the growth in population. This can be achieved only if productivity stops falling and starts to rise. It is unlikely that this can happen unless there is a large rise in business investment. Modern management incentives are therefore a major hindrance to any rise in real wages, as well as making it hard if not impossible to bring the budget deficit down to a sustainable level. It is therefore surely essential that we take steps to change the perverse management incentives that cause these problems.

The changes in behaviour that we should expect to result from the change in incentives are those that we observe. It is therefore sensible to ask whether we really want lower investment, higher profit margins, poor productivity and volatile profits. If we don't, then we should seek to change the incentives that are currently given to senior management.

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CHAPTER 17
Danish industrial foundations

Grahame F. Thompson

In December 2011 the *Financial Times* carried a report on Danish industrial foundations (*Jack* 2011). This is one of the very few popular presentations dealing with industrial foundations available in English, which remain relatively unknown even in the academic literature. Industrial foundations (from now on IFs) can be found in several national contexts but they are concentrated in northern Europe – in Germany, Sweden and above all in Denmark. Exactly how to define an IF is, of course, problematic but in a moment I outline the central features of the Danish IF organisational structure and its significance. Some have viewed philanthropic institutions like the Wellcome Trust, the Ford Foundation, Bertelsmann and Robert Bosch as typical foundations, but these display varying features, not all of which meet the general conditions typifying IFs. The Indian Tata Group is also considered an IF despite continuing strong family involvement in key aspects of its governing structure (*Thomsen* 2011). The nearest contemporary equivalent in the UK context would be Scott Trust Ltd, the owner of the Guardian news media group.

I concentrate on the Danish position in what follows since IFs are of central importance to that economy and provide a good illustration of their features, their strengths and their weaknesses. IFs are estimated to have employed over 300,000 workers in 2012 (100,000 in Denmark – about 5 per cent of total domestic employment and 8 per cent of private employment). As far as their contribution to GDP is concerned, this was between 5 and 10 per cent. And they offer a unique blend of commercial and philanthropic activity and their unusual ownership and governance structure contrasts starkly with the typical Anglo-American shareholder-owned company form. In outline IFs are institutions that 'own and control' commercial companies and businesses in the form of a trust that cannot be revoked and which must use any surpluses generated for philanthropic purposes. In the Danish context they embody several key features (*Thomsen* 2012, *Hansmann and Thomsen* 2013):

1) Creation by donation.
This usually involves the founder entrusting the foundation with the ownership rights to a business in a single event. It is a gift transaction that is irreversible (this distinguishes them from US style family trusts). Subsequent to this additional gifts may be given and additional funds generated by retaining accumulated revenues.

2) Independence.
The foundation is a private institution with no owners and no members as such. They are 'self-owning, self-managing and self-perpetuating bodies' (providing they continue to be financially viable). The key feature of its legal personality is a clear separation between the personal economic affairs of the founder and those of the foundation. The foundation becomes a 'not-for-profit organisation' in as much as any surpluses it makes above some percentage, agreed at foundation to augment investment in the company, must be used for charitable purposes.

3) Governance by charter.
The foundation is formally governed by a charter, defining its purpose and organisational form. This is set up by the founder and can contain purposes like running for the benefit of the arts, R&D or pure charity, supported by revenues beyond those deemed necessary for reinvestment in the business. More generally, the charter may specify that the foundation acts to the benefit of the company, the employees or the national interest. It may require the foundation to maintain a majority ownership of the company and include specific rules as to the composition of the foundation board. The foundation is run by the board that self-appoints its members, and usually has representation on the company board (though not as the CEO) .This is all supervised by government.

4) Government and board supervision.
The foundation board acts at its own discretion subject to rules set out above and supervision by some government bodies. Audited accounts must be submitted like joint stock companies. The governmental foundation office can intervene in extreme cases and even replace the board. However, the foundation board is able to challenge bad business decisions only under very strict conditions laid out in the charter (which can allow for the calling of emergency general meetings) or informally (e.g. getting together over lunch) or at the annual general meetings of the company.

5) Ownership and Control.
The foundation may be the sole owner of a business, in which case the company and the foundation board members could be identical. If it is just a majority owner of the company, with minority shareholders, the company could be incorporated separately and listed on a stock exchange. The company is legally responsible to all the shareholders, but the foundation as majority owner possesses controlling influence, which it may, or may not, chose to exercise. Often Danish foundations retain a voting majority by controlling 'A-shares' (which are rarely traded), while 'B-shares' in the company are traded normally on stock exchanges but have no, or limited, voting rights. Foundations can take over other companies if the charter allows this and incorporate them into the foundation.

In 2012 there were nearly 1,400 foundations in Denmark embodying these features, but not all of these were IFs. Most were 'Ordinary' foundations operating in non-commercial areas like voluntary societies, small-scale publishing, running museums, political campaigning, etc. Other IFs were small commercial enterprises, not very significant economically though part of a thriving SME culture in Denmark. The majority of these foundations were to be found in the tertiary sector (80 per cent) and within this mainly in finance, insurance and real estate activities (52 per cent) (*Thompson and Mortensen* 2009). But it is the large IFs that have attracted the most attention, and their activity is quite diverse. Many of the most significant international Danish companies are owned by IFs: Novo Nordisk, AP Moller-Maersk, Carlsberg, Lundbeck, Leo Pharma, Vestas (*Thompson and Kaspersen* 2012). The top 100 foundations accounted for 93 per cent of total IF equity and the top 10 for 74 per cent (*Thomsen* 2013).

The ownership and control feature of IFs outlined above is important. Broadly, the division of equity into ownership A shares and traded B shares goes against the sentiment of the equality of 'one share one vote' and all the commercial practices that typify an Anglo-American business environment. The foundation owns the A shares, which have voting rights, while the general financial system owns the B shares, which have no such rights. It shields the commercial companies from 'the market for corporate control': under normal circumstances it is impossible to take over a foundation-owned company. The foundation can trade its 'A' shares if it wishes (to raise capital, for instance) but this will only dilute the controlling influence so it seldom happens and only in extreme circumstances. As reported in the FT article, all this encourages 'patient capital' and a vision for the longer term:

> "We can plan for the long-term," says Mr Rasmussen, chairman of the Leo Foundation, which owns Leo Pharma. "It's an ideal model for the pharmaceutical industry, where there will be ups and downs, and you need to be left in peace to do the development work. If we reported to the stock market every quarter, it would really disrupt the calmness." (*Jack* 2011).

In addition, the philanthropic purposes legislatively attached to IF expenditure mean there are very significant funds available for research activity and other socially beneficial purposes in Denmark that are not directly dependent upon public funding. This makes a huge difference to the research environment and the general civic culture of the country. What would otherwise be expenditures heavily constrained by austerity measures are largely still available via private philanthropic means. The continued existence of this source of funding both encourages a longer-term perspective on social development and adds to the success of the Danish Model (*Lykketoft* 2009). And in addition to IFs there is a thriving cooperative movement in Denmark, with several of its largest companies being run as coops. But coops can be dissolved and have members who receive a dividend. IFs cannot be dissolved voluntarily and do not pay a dividend to members because they have none.

Might there be some downsides to this model? What it replaces are all the incentives for efficiency and profitability usually associated with the profit maximisation corporation: a not-for-profit organisation with little pressure from potential takeovers might be thought to lead to complacency, low productivity and a declining return on assets. But, in fact, the reverse seems to be the case. Market valuation of IF owned companies has been buoyant, sales have seen a strong growth (*Thomsen* 2013) and the profitability of IF-owned companies is if anything better than that of the traditional shareholder-owned competitors (*Thomsen and Rose* 2004). These companies have ridden out the financial crisis rather well and continue to expand abroad – while maintaining their headquarters and most R&D within Denmark.

A Danish IF is a type of charitable trust that has a legal personality in its own right – it can sue and be sued. This is unlike charitable trusts in the UK, where it is the trustees that are legally responsible and have to exercise due diligence. Thus without a thorough reform of UK charity law (and company law) it would be difficult to transfer an IF organisational structure to the UK. This is independent of the political obstacles to such a move. But the contrast it makes to a shareholder-owned environment is sobering and telling.

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