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Fixing the Corporation: a Management or a Governance issue?

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11.1 Introduction: what needs fixing?

Global competition and consequent financial deregulation ended the era of manager-run capitalism in the 1970s (Chandler 1992) and ushered in a half century of structural change and recession prone economies. Large corporations in countries with important stock-markets, pressured by lower returns, responded to this environment with experimental adaptation. In the initial phase, high corporate debt was promoted as an antidote to opportunistic managers (Jensen 1993) but attendant bankruptcies downgraded this as a primary method. Later, in the 1990s attention turned to aligning manager and owner interests with huge increases in high powered pay for CEOs whose job turnover increased by a factor of five before the end of that decade; expected tenure, not just in the US, but globally, is now just five years. Managers have become less autonomous and strongly focused on the share price (Roberts et al 2006). This has encouraged the corporate culture that prevails today especially in Anglophone countries where the strategy function is subordinated to finance and where the firm's main intent is on delivering near-term pay-outs to owners (Lazonick 2008). Early hopes that this culture could be changed by engaging large investors (Black 1997, Myners 2001) evaporated as ownership became dominated by institutional asset managers with diversified portfolios and expertise in remote monitoring. At the macro level this reinforced the drive for pay-

[1] I am very grateful to Paul Temple, Grahame Thompson, Bob Hancké and John Child for comments on an earlier draft and to David Schofield for providing insights into managerial hierarchies.

out, low re-investment, and a consequent increase in insecure work, all of which contributes to the productivity stagnation "puzzle". This characterisation of corporate life is not a partisan – and perhaps not even a minority - view. It may not often appear in the textbooks but it is accepted in large part by mainstream industrialists, central bankers; regulators; government advisors; fund managers; media correspondents; and academic economists.[2]

To be sure, a consensus on analysis does not necessarily extend to agreed solutions. Nevertheless at least in the space of academic and policy studies, it is no longer quite true that "Shareholder primacy" is "…*widely viewed as the only intellectually respectable theory of corporate purpose*" ; increasingly it is recognised that there is no one-size-fits-all model (Stout 2011). Multiple perspectives and indeed the nuances of multiple legal jurisdictions are now recognised as legitimate areas of study (Aguillera et al 2012; Allen 2005). Increasingly too it is recognised that Corporate Governance extends beyond the traditional principal agency concern of monitoring compliance. Rather it is seen as a broad system of determining where control should lie from a perspective that minimises not just standard resource costs but also the costs implicit in bargaining or enforcing the distribution of any surplus.[3]

In Section 11.2 of this chapter I show that the case for shareholder primacy – singular control by shareholders - is both contradictory and short of evidence. Nevertheless, the theory limps on like its actual counterpart for want of a serious alternative. Rival models to shareholder primacy are still in the experimental stage. While alternate systems exist for whole countries (Germany and some of

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[2] For a representative set of mainstream commentators who share at least some of these views see: Former Rolls Royce CEO, Rose (2007) ; Bank of England Director, Haldane and Davies (2011); Former Financial Regulator, Turner (2012); Government Advisor and Academic, Kay (2012); City Financier, Smithers (2013); Global Asset Manager, Fink (2014); CNN Gobal Economic Analyst, Foroohar (2016); Business School Academic, Mayer (2013)

[3] Some supporters of shareholder primacy concede this. Zingales (1998:498) views Corporate Governance as "the complex set of constraints that shape the ex post bargaining over the quasi rents generated by a firm" (p.498). Similarly Tirole (2001:4) defines it as the "design of institutions that induce or force management to internalise the welfare of stake-holders".

Northern Europe) or as particular exemplars (cooperatives and mutual societies) their specific environments contribute to their success, making it difficult to draw general lessons.

In this chapter I address two specific problems of liberal market economies that can be attributed, at least in part, to shareholder value. These are, first, a lack of employee engagement and second, constrained investment and innovation. To address these problems I set out two alternative approaches as "Management Led Stake-holding" versus "Governance Led Stake-holding" though the split is not a clean one. The first approach relies on management practices to encourage worker engagement, though to be effective it requires changes to the *scope* of governance. The second approach aims to redesign governance structures in a stake-holder direction but it relies heavily on management involvement in that process. These alternative approaches – in both of which management and governance are intertwined - will be discussed respectively in Sections 11.3 and 11.4 for the reader to judge their merits.

11.2 Shareholder Primacy: justifications and rebuttals

Supporters of shareholder primacy defend it as synonymous with efficient allocation of resources. The claim is valid if all parties other than shareholders engage with the firm on free and full contracts that specify every eventuality. But that argument – sometimes referred to as "residual claims" with "complete contracts" - leaves little to debate because when stake-holder interests are fully defended by contract, shareholder value *tautologically* equates with collective interest since there is no other variable interest to consider. There is no room for governance at all if there is no issue over how to divide the quasi-rents or excess over cost that the firm makes possible and that cannot be replicated in the market by individual agents (Zingales 1997). Beyond that criticism, those distrustful of fully efficient markets may think that the conditions under which contracts such as wages are bargained are themselves dependent on governance forms.

I examine next the different ways in which shareholder primacy has been defended in the literature, noting some critiques.

11.2.1 Agency theory and its relevance

Agency theory is based on potential owner-manager misalignment due to difficulty in monitoring complex executive actions and outcomes. Excess capital spending by self-seeking executives is a central concern in finance theory (Jensen and Meckling 1976). Proposed remedies include reduced autonomy for executives by keeping the company starved of cash – this can be implemented for example by high leverage and steadily increasing dividends (Easterbrook 1984) or other shareholder-friendly arrangements that are facilitated by shareholder primacy forms of governance. This defence of shareholder primacy is at least a consistent theory; Stout (2002) dubs it the "best of the standard arguments". The (complex) message is that shareholder primacy is " a *second-best solution* that is good for all the stake-holders in the firm, because it limits what might otherwise be the runaway agency costs that might be incurred by all if directors were not held to a clear and easily observed metric of good corporate governance." Stout herself responds to this by suggesting that shareholders actions belie any deep belief in their own primacy as an effective form of governance. When firms incorporate or engage in IPOs their investors are happy to choose less shareholder friendly forms of governance because they need to encourage ex-ante commitments of skills and resources (Stout 2002, 2011).

A broader critique is that the relevance of agency theory is an empirical issue. Agency concerns may need consideration where there is weak legal investor protection, where managers are insulated from competition, too cosy with government, or simply excessively incentivised to divert funds to their own pocket. But it tends to present itself as a general theory and is used as a badge of right-thinking by supporters of shareholder primacy, particularly in the field of finance. The most forceful critique of agency theory dominance tends to come from scholars knowledgeable about firm behavior e.g. scholars in industrial organization (Demsetz 1997); those working within the Resource Based View (Barney and Clark 2007) or Dynamic Capabilities (Helfat and Teece 2010). What differentiates these alternatives from agency theory is the purpose of the firm "…instead of

conceptualising the firm as an institution that exists because it hinders something such as opportunistic behaviour, it is rather seen as existing because it promotes something namely the production of new options" (Foss 1998 p.15). Ironically, the originators of agency theory themselves noted that eliminating agency bias might cost more than its benefits (Jensen and Meckling 1976:328) but this message was rarely repeated and was subsequently ignored by epigones.[4] The proof of the agency pudding should surely be apparent by now if it exists. Early work on governance predicted that the adoption of shareholder-friendly rules would unlock value wasted in operational inefficiencies. It is possible to find support for this in some contexts. However, literature studies and meta-studies of links from governance to performance show ambiguous results - at least for countries with an already functioning governance system.[5]

11.2.2 Access to finance on good terms requires control rights for investors.

The basic issue here may be put bluntly: "Would equity investment make sense if shareholder interests could easily be drowned out by the voices of other interests? " (Barker 2014). Those answering in the negative argue that control rights should be concentrated in the hands of the party whose incentives are such that they will not otherwise supply the most valuable input (Tirole 2001). Put differently, control should be given to whoever will maximise total wealth net of any damage they may have to inflict to preserve their own interests. Inevitably, there is a need for prior judgement in such a theory and the controversial assumption often made is that access to equity finance is *the* crucial problem for the firm. Shareholder reluctance to invest is in turn explained by insecurity and fear of expropriation by other parties. Economists have long made the case that shareholders lack protection because "capital is easy to misappropriate" and that non-shareholder interests have the greatest capacity to harm other parties (Holmstrom and Tirole 1989). This is echoed in Tirole (2001): while shareholder rewards (such as dividends) are generally transparent, it is easier to disguise other distributions to employees and consumers (p. 28). In an earlier but less

[4] I thank Robert Wessels of Groningen University for an enlightening talk of this point.
[5] Some overviews are given in Dailey et al 2003; Van Ness et al (2009); Dalton and Dalton (2011); Belloc (2012); Driver (2012)

formalised account, Williamson (1985) also regards shareholders as special because they are less protected than other stake-holders, who are covered by explicit contracts that are renewed and negotiated regularly whereas stockholders invest “for the life of the firm” (p. 304). In the event of bankruptcy, other contractors have first claim on any assets and in the case of suppliers such as labour they are free to reallocate their skills which will at least partially be preserved unless they are completely firm-specific. This asymmetry means that both on grounds of fairness and efficiency in attracting investment funds, shareholders should have a controlling voice because they are most exposed to damage. Edmans (2017) repeats these notions arguing that workers are free to move while “large” shareholders cannot sell without lowering the share price.

Many will find these claims unconvincing or exaggerated. It needs to be asked whether investors face higher proportional risks than other parties and whether they are the least likely party to abuse their position. Labour market studies show that workers tend to lose a sizeable proportion of their (undiversified) income on redundancy, even where there is no general downturn, whereas shareholders have liquid and diversified portfolios; indeed that is why shareholders are prepared to bear more firm-specific risk. Although workers may be protected from negative shocks by redundancy pay and public support, shareholders too have protection under limited liability. The view that employees have more scope than investors for rent-seeking is a standard view in the economics literature and indeed it follows from the view that shareholders cannot rent-seek since they are entitled to all rents. However agency concerns certainly exist in respect of the long chain of intermediaries involved with institutional investment (Kay 2012). Even beneficial investors may suffer from “agency” failures in that regulation favours vested interests (Pagano and Rossi 2009). After the financial crisis of 2008 there has been increasing acceptance that regulators have had “the wrong agents in our sights”. [6] Investors have special interests that have been served by manipulation of financial benchmarks and non-transparent activities. Shareholders can count too on political

[6] Jessica Einhorn, former managing director of the World Bank (FT letters 20.3.2009).

support as witnessed by policies to protect them after the financial crash. UBS have estimated that post-crash returns for high-wealth trusts are approximately 20 times standard cash savings rates. These considerations and historical time-series data on the distribution of income and wealth suggest a rethink of the notion that shareholders as a class are more vulnerable than other parties.

As for the practical argument that shareholders need reassurance, that is of course true but does it require unitary control rights? And how important in any case is the equity finance function? Shareholder primacy was feted just as the importance of outside finance from public equity markets diminished sharply in advanced economies. Net equity withdrawal has characterised the corporate sector of the US and the UK in recent decades (Clarke ed. 2004). The case for stock-market finance may have some traction in regard to developing economies or to start-up companies but even here the evidence is mixed as to whether the size of equity markets is positive for growth.[7] Even in the US in times of maximal capital raising, the share of financial allocation through new IPOs or venture capital is a very small fraction of the total with non-financial corporate IPOs never raising more than $50bn in any year since 2000 (OECD 2015). And much of venture capital is not directed towards innovation while much of equity finance is only available for liquid investments that does not always suit innovation investments (Lazonick 2010). Econometric evidence shows that in recent years US R&D for large firms has not been constrained by external finance (Brown et al 2009).

11.2.3 Stock-markets reallocate resources most efficiently under technological change.

This argument holds that, even if stock-markets contribute no net resources, shareholder primacy ensures efficient and rapid *re-allocation* of capital across firms and sectors. In this view the appropriateness of any governance system is contingent on current economic challenges. This notion of contingency was highlighted by Boatright (1994) who noted that that before the 1970s, the

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[7] An econometric report from the Bank for International Settlements found that the finance sector crowds out real sector growth:" …financial growth disproportionately harms financially dependent and R&D-intensive industries" (Cecchetti and Kharroubi 2015, p.i). For a variety of earlier studies with conflicting views, see Engelen 2004; Allen 2005; Deakin 2013).

"steady erosion of shareholder power" had not "occasioned much concern" (p. 405). He claimed that shareholder orientation was particularly suited to the period since the 1980s that coincided with liberalised capital markets, but he failed to pin down the exact conditions why that should be so. Hellwig (2000) and Holmstrom and Kaplan (2001) address exactly this question in an innovative argument. The case for internal reallocation of finance within firms versus external stock market reallocation - long debated in the finance literature – is argued to be specific to the technological regime. Under fast structural or technical change the potential for relatedness may diminish, lessening the attractiveness of internal allocation. Such arguments lead to a contingent explanation for increased shareholder orientation: "When it comes to moving capital long distances from declining industries to emerging industries", markets do it more effectively than managers (Holmstrom and Kaplan p. 137).[8] They identify such radical technical change with the period around the turn of the century and the dot.com boom. At that time belief in the "new economy" – and in the efficiency of stock-markets – was as elevated as the stock-market itself. Subsequently, it has been somewhat tarnished by the irrational exuberance of markets in re-allocating capital and many years of poor returns from actively managed funds. There seems little systematic evidence that externa fund allocation is consistently better than internal allocation, even under rapid technological change. The financial economists Allen and Gale (2000) have suggested that under radical change in products and prices, it is difficult for the market to know which managers are appropriate to select so that "…the effective absence of discipline through takeovers may not be a drawback" (p.64). In this framework it is not the stock-market but rather the product market that is the key to reallocation of resources.[9]

[8] The above view can be grafted onto a "varieties of capitalism" approach (Hall and Soskice 2001). Empirical research is, however, undecided on these issues. Some studies have rejected a general mapping from a governance system to a technological regime (Akkermans et al. 2009). There are many exceptions that need explaining such as the relative success of bio-technology under Germany's stake-holder model (Kaiser and Prange 2004, Jong 2009).

[9] Other research has qualified some pre-conceived ideas on stock market efficiency. Fang et al (2014:2123) conclude that stock liquidity (tradability of stocks) has a negative effect on innovation possibly because it makes firms prone to short-term takeover pressure. See also Chapter 8.

11.2.4 Control rights should belong to a disinterested (but shareholder-oriented) party.

A novel argument for shareholder control is that control rights should belong to whichever group has *least* involvement with the firm's operations and has least control over specialisation of the firm's assets. Granting control rights to those such as managers or knowledge workers who hold human capital would have negative effects because they would exploit their own potential for rent extraction (Zingales 1997). Rather, it is "...shareholders, precisely because of their remoteness from the production process [that] may be in a better position to make decisions that are in the best interests of the firm" (Rajan and Zingales 1998, p. 424). Note the contrast between this and other shareholder primacy views that champion active involvement by shareholders, or block-holder control by illiquid investors.

The argument for remote control by shareholders is in tune with the popular notion that shareholder primacy increases risk taking – here interpreted as specialisation - and that other stake-holders will prioritise other interests such as job preservation. But, put like this, the Zingales argument already recognises that risk is shared between parties and it is unclear how it can then be Pareto optimal to cede risk choice to one party. Because that issue is unresolved, the proposal itself for assigning control is not established with any clarity; in Zingales (2000) control is suggested to lie with the shareholder but in Zingales (1997) control is to lie with a third party such as an independently constituted board, which is surely a surrogate for *shared* control.

11.2.5 Summing up the lack of argument

The arguments just outlined for shareholder primacy are far from compelling. They do not form a basis for allocating sole control rights to shareholders. For one of the most powerful ideologies of modern time, shareholder primacy now appears, as one of its chief practitioners was later to put it, "one of dumbest ideas in the world" [10]. Alternative approaches exist - two varieties of which are

[10] The former General Electric chief [Jack Welsh] told the Financial Times the emphasis that executives and investors had put on shareholder value, which began gaining popularity after a speech he made nearly thirty years previously, was misplaced" *Welch condemns share price focus*, FT March 12, 2009 https://www.ft.com/content/294ff1f2-0f27-11de-ba10-0000779fd2ac

discussed in the following sections. As indicated in the introduction the question here is not posed in a normative ethical context but addresses the narrow issue of whether these reforms could boost productivity either by increasing the level of worker engagement or by increasing the level of firm investment and innovation. So far there has been only limited discussion on the relative merit of these approaches.

11.3. Management led stake-holding and worker engagement

The Management Led Stake-holding approach (henceforth MLS) gives a leading role to senior management in developing links with employees to improve their commitment to the firm's collective effort. It has similarities with a standard principal-agent approach but is qualitatively different in having a focus not just on top management, but between top management and other employees including middle management. This has been expressed as an idea of a double agency relationship; in addition to the standard one there is a need to consider a second one "… between corporate management and the employees of a firm, including middle managers, who execute its plans and policies." (Child and Rodrigues 2004: 143) [See also Chapter 9].

The MLS approach is premised on the modern firm having changed fundamentally from a reliance on fixed capital towards intangibles and skills (Kanter 1999).[11] A move away from continuous dedicated careers in favour of general marketable skills, makes it more difficult for firms to ensure an appropriate level of *firm-specific* investment and organizational capital. The exercise of authority – the basis of the firm in transaction cost economics - is itself problematic where effort is knowledge-based, non-transparent and perhaps collective. Firms' responses to this include attention to internal

[11] There is no consensus as to whether this is a mirage. R&D levels are not rising in major economies faster than GDP. Science and Technology workers are not increasing as a proportion in a number of countries. The ratio of stock market value to fixed asset value has been shown to be mean-reverting and has fallen from its dot-com high.

labour markets, supportive management and the design of work processes (Shuck and Wollard 2010; Shuck et al 2011].

One influential model envisages a process whereby individual managers at various levels incentivise subordinates by rationing access to complementary assets such as the manager's own knowledge base or contact group. The resulting arrangement is seen as a "nexus of investments" i.e. a firms "organizational capital" (Zingales 2000 p.1646). What is said to be distinct about this theory is that information and routines are rather spread downward in the organization, so that hierarchical control is weakened.

It is possible to generalise the idea of firm-specific commitment beyond the idea of skills acquisition. Any form of with-held commitment whether in the form of aversion to firm-level training or a lack of loyalty and engagement, or simply disinclination to share information, can be conceptualised in this way. And the proposed solution under the MLS approach is the same:

" [The] single biggest challenge for the owners or top management today is to manage in an atmosphere of diminished authority. Authority has to be gained by persuading lower managers and workers that the workplace is an attractive one and one that they would hate to lose. To do this, top management has to ensure that work is enriching, that responsibilities are handed down, and rich bonds develop among workers and between themselves and workers." (Rajan and Zingales 2004:87)

But can it be expected that shareholder-oriented management will follow this path? It is unlikely to be *generally* true that "Poor treatment of workers, suppliers, customers, or the environment all harm the long-run stock price" so that "… shareholders and workers are "aligned in the long-term" (Edmans 2017: Section 3). Even in circumstances where a bargain is possible between the parties it may not be true that the two sides have aligned interests. Indeed Edmans worries that workers will be unprepared to take risk and that their "…representatives may be concerned with safeguarding existing jobs rather than creating new ones." It is not clear how the argument then transits from the

possibility of bargaining to the paternalist claim that shareholder-oriented management will be the best for all parties.

That said, there will be many work situations where it is in shareholder interests to make concessions to employees such as theorised in the economists' notion of an "efficiency pay" rate higher than the market rate. The scope for bargaining comes from evidence that an implicit contract between worker and organization acts as a form of psychological ownership and tends to increase effort and performance (Gruman and Saks 2011). Emotional attachment to the organization based on a sense of shared values and exchange seems to promote good performance; there seems to be a positive significant relationship between employee trust and workplace performance (Halbesleben 2010; Yalabik et al 2011; Brown et al 2015); [See also Chapter 9].

Nevertheless, the facts is that the organizational trajectories that would embed trust, as predicted by Zingales and others, have not all been borne out in recent decades. To be sure there has indeed been a cull of middle management (delayering) with fewer intermediaries and more direct reporting to the CEO. (Powell 1997; Littler and Innes 2004). As a result, managerial workloads have increased, targets have been stretched, and competition for promotion has increased. This could imply empowerment of a sort, were the increased pressure matched by more autonomy over work objectives. However, this has neither been the objective nor the outcome of delayering; insecurity has risen and trust has fallen and there "is little evidence of middle managers gaining autonomy" (Morris et al 2008 p.705). Even senior managers who report directly to the CEO appear to lose their own professional voice (Jacoby 2005). Empirical work using the British skills survey (Felstead et al 2007) notes that "the rise in skills among employees over the last two decades has not been accompanied by a corresponding rise in the control they can exercise over their jobs…For example the proportions reporting a great deal of influence over how to do tasks at work fell from 57 percent in 1992 to 43 percent in 2001, where it remained in 2006" (p.xii). The comparative UK-French study

reported in Conway et al (2008) while confirming that firms may be interested in motivating and training employees noted that “they are less willing to give them a voice in the way work is organised” (p.663). In brief, organizational change within the firm has not to date provided a solution to the lack of engagement and potential underinvestment in firm-specific non-contractible input. The incidence of enrichment and engagement seems to have stalled or even reversed (Rayton et al 2012). The level of decentralised decisionmaking that Zingales thought to be a necessary pre-requisite for engaging the workforce does not seem to have happened. Any bargain that has been struck between the parties seems to be a narrow one that does not extend to increased participation that has been argued to the key to enhanced performance.

There are different ways of rationalising why an apparent win-win of the MLS approach is difficult to achieve despite considerable lobbying for it by well-intentioned supporters. Even where exemplars exist of a virtuous circle of trust and performance it is not clear that it can be generalised since there may be only so much market space for fair-dealing that translates into improved brand image or good labour relations. One other crude headwind against a culture of reciprocity is that technological advances in monitoring makes it easier now to resolve disputed issues by hierarchical control. This may reinforce existing tendencies in the corporate form towards centralised authority.

Governance also matters in this regard. For engagement to be effective it has to be based on bi-lateral trust between managers and subordinates. Some see this as arising naturally in a virtuous circle as parties adapt to past signals. But forward-looking signals also matter and can be derived from a game-theoretic awareness of the time-varying rewards from breaking trust for each party, even where each has cooperated until now. (Baker et al 2001). In the specific case of workers capacity to trust management, the latter’s reward from reneging on agreements is hard to gauge under shareholder control, thus engendering distrust. A shareholder oriented form of governance confers only limited autonomy on management to honour agreements; rather these can be over-

ridden by board decisions that change strategy or even ownership. A manager, no matter how senior, has no authority to make long-term promises in today's capitalism. Indeed today's executives envisage themselves as working "within the assumptions of agency theory …" (Roberts et al 2003 p.290). That is why there are clear limits to the MLS approach and why it is important also to consider the design and structure of the governance system.

11.4. Governance led stake-holding

As argued in Section 11.3, the enforcement of implicit contracts may more properly be seen as part of the Governance Led Approach to stake-holding (henceforth GLS). It is a *governance* issue because managerial efforts to promote implicit contracts may be fruitless without a supporting governance framework that makes any commitment credible by the allocation of control rights to all investing parties. Property rights theory – sometimes referred to in this context as team production theory - provides a useful grounding for this issue and generates an argument for broad stake-holder control (Driver and Thompson 2002; Asher et al 2005). The essential claim is that unless control rights are shared there will be underinvestment in human capital. Property rights is not the only basis for GLS but I will begin with a discussion of this theme.

11.4.1. Governance and property rights

Agents – seen as rational and perhaps opportunist - seek control rights to protect their interests. Property right theory suggests that incentives to invest in irreversible or sunk resources, be they tangible or not, cannot be fully provided by contract since it is impossible to foresee contingent events and/or impossible for courts to adjudicate on internal firm matters. Given these incomplete contracts, incentives are best provided by the anticipated effects of control rights over sunk assets, with these rights being negotiated before the investments take place (Hart 1996). Without control

rights, sunk cost investments such as firm-specific training will not be undertaken efficiently by the contracted agent because they will anticipate being exploited. As observed by a noted stake-holding theorist, Margaret Blair, this challenge requires an inclusive approach and a change in performance metrics.

"… there are likely to be a number of parties who have made... firm specific investments [that] are at risk in the same way equity capital is at risk...[Management] should focus on maximizing total wealth-creating potential of the firm, not just on the stake held by shareholders' (1996, p. 13).

Blair accepts that contracted wages may already be fairly set by including an element of compensation for workers implicit return on their "capital". The point, as with Hart (1996), is not one of fairness but of efficiency. That part of workers' sunk costs undefended by contract will constitute an undiversified risk that may be borne inefficiently and result in under-investment unless employees are granted control rights. Alternatively a trusted "independent" third party – arguably a properly constituted Board of Directors – could be charged with protecting stake-holder interests (Blair and Stout 2001).[12] In this GLS view, control rights whether exercised through direct worker representation on the board or through proxy membership with a truly independent board should encourage employee's willingness to acquire firm-specific skills and to increase engagement and commitment.

The property rights approach addresses what is known in economics as a "hold-up" e.g. where employees making firm-specific commitments – rather than acquiring general or marketable skills - are exposed to being exploited by those with control rights over the co-specific assets of the firm. It is unclear whether this is just of academic interest or whether it has practical importance. Economists see hold-up problems as "…of central concern to business people" (Holmstrom and Roberts 1998 p.80) and they are said to affect the incentives to innovate (Gambadella 2008).

[12] Zingales exaggerates somewhat the implications of the property rights view by suggesting it "logically to imply a Marxian position of worker control" (2000 p.1639); as noted earlier he has himself supported the idea of an independent board.

Analogously, any firm-specific commitment by employees entails a hold-up by shareholders since the underlying theory assumes no re-negotiation is possible when unforeseen outcomes arise. As a rational thought argument, this theory of governance has found wide interest and even acceptance in mainstream economics and has been featured in virtually all prestigious law journals. However, organizational theorists such as Williamson (2002) have been consistently sceptical about hold-up theory seeing it as excessively abstract, especially as it ignores outcome uncertainty and the possibility of an ex-post bargained resolution. Others argue that the effects of hold-up are exaggerated and that they may be dwarfed by mundane management coordination issues or issues of trust (Hart 1995 p.88; Coase 2006). Indeed seminal thinkers on property rights theory have recently rethought its foundations to offer an alternative theory where re-negotiation of contracts is possible in the light of unforeseen outcomes (Hart and Moore 2007). One of the very few empirical studies of the effect of hold-up on investment finds just a small difference in the responses of firms willing to use a first-best specialised asset under long-term contracts as compared to those who were currently using it with short-term contracts (Lyons 1996). If a similar finding also applies to decisions by employees in regard to their commitment it would imply lower gains for this version of GLS than sometimes envisaged.[13]

A weakness of the property rights argument is that it offers little by way of detailed implementation guidance. It is unclear under which conditions direct employee representation – effectively a tradeable veto - is required as opposed to a neutral board which might offer weaker protection such as ex-post compensation? Solutions may of course be context specific; "…membership of the board and strength of voting rights should reflect the degree of specificity, the concessions needed to encourage participation, and the degree to which the party can stabilise the environment, for

[13] Liebeskind (2000) looks at employee stock-based pay and board representation in new biotechnology firms. She finds that the extent of employee protection through these mechanisms in this sector is no greater than for the median newly listed firm. The explanation offered is that any particular need for employee motivation in this sector is offset by employees' need to limit financial risk and also by a need to preserve incentives for financial investors. On the other hand many new economy firms such as Google and Linkedin have pursued dual class share offers which virtually disenfranchise public shareholders (Stout 2011)

example by risk-bearing" (Lan and Heracleous 2010). A different suggestion is that direct control rights are needed where "employment law or customs entail low labour market protection and/or where labour turnover is high" (Boot and Macey 2002, p. 383). But that view fits uneasily with the property rights approach that has always viewed well-compensated knowledge work as the area where with-holding of stake-holder effort is most feasible (Osterloh and Frey 2006).

Heterogeneity of interests within the firm may increase the necessary amount of bargaining among employees; some may wish to protect against future redundancy and others may prefer to trade that risk for current compensation. GLS with employee representation can be criticised on the grounds that stake-holders would be unable to bargain efficiently, creating rent dissipation (Hansmann 1996; Hellwig 2000). Nevertheless, it may also be noted that shareholders too have heterogeneous concerns, depending for example on how diversified they are; which complementary strategic investments they have; and what their time horizon is.

The balance of advantage between direct employee representation and a neutral board is unlikely to be absolute and will hinge on whether supporting institutions for direct representation exist. These might include established channels to choose employee representatives such as wide trade union or works council coverage; a culture where both stake-holder and shareholder delegates are capable and informed, not overly partisan and prepared to represent a shared, forward-looking strategy; a presumption of less externally mobile labour markets than in liberal market economies (or an efficient state-led system of training) thus favouring specialist skill formation; and limits on the market for corporate control. This formidable list suggests that prior effort in institution building and acculturation is needed to prepare the ground for stake-holding in practice. It may be that part of the MLS agenda, discussed in section 11.3, would assist in this preliminary step. In particular, MLS arguments can be used to support demands for more downward information flows on training and other strategies which can create conditions for informed debate. In the UK at present fewer than a

quarter of top UK companies reveal such information on training despite it being of vital importance for the workforce (CIPD 2017).

11.4.2 Governance, organization and information.

As noted earlier, the property rights basis for GLS rests on an individual rational choice perspective. This has been criticised by organizational theorists who see stake-holding as a means to facilitate organizational learning and innovation in a collective sense (O'Sullivan 2000). The implication of this critique is that stake-holding should be *selective* in order to avoid a conservative resistance to change. Rather, control rights should be shared with those agents in the firm who can act as strategic managers and "…who possess the cognitive capabilities to allocate resources to the innovation process…"(Lazonick 2010, p. 335). This view of employee voice as necessary to compensate for the remoteness and lack of strategic knowledge by the board is a cogent argument for stake-holding (Osterloh and Frey 2006; Deakin 2013). It is given added force under the corporate governance reforms that have tended to replace knowledgeable insider executives with external directors in some cases leaving a highly incentivised CEO as the only executive on the board, supposedly charged with presenting the operational and strategic view. There is an inherent problem with that situation in that such senior executives are now divided personalities. Whatever their attachment to the company future, their personal fortunes are aligned not just to the share price but to increased volatility of the share price which they can take advantage of to exercise their share options in the increasingly short timespan that they are in charge.

Shareholder friendly corporate governance codes such as those in the UK recommend that external directors of large companies should constitute at least half the board membership. This only makes sense when the company itself is transparent and can be bench-marked easily against others so that

strategy can be easily devised and monitored. It makes no sense when external directors do not understand the operations, culture and strategy of the board they sit on and are not familiar with the technological trajectories of the company divisions. Governance codes are more concerned to specify the requirements of boards to meet with shareholders than to acquire detailed knowledge of the company. Indeed, close knowledge of the company would be difficult given that externals typically combine several such commitments (Froud et al 2008).[14] Empirically too, there is little robust evidence of external directors improving performance. In the financial crisis of 2008 a study of UK banks found "no relationship between the relatively high proportion of independent directors and bank performance." (Ladipo and Nestor 2009). The UK Institute of Directors (IOD 2015) found that that the percentage of NEDS had a moderate *negative* correlation with perceived board effectiveness as an aspect of governance as judged by IOD survey of members. A balanced assessment is given in Ayuso and Argandoña (2009).

Previous research has shown that "independently minded" top ranking executives - who joined the firm before the current CEO was appointed - can act as a countervailing power imposing strong discipline on their CEO, even though they are formally under his authority (Landier et al 2005). However, simply reverting to an executive dominated board is unlikely to help. In the current climate of high powered pay, the independence of any senior board executives may not be assured. Rather than eliminating the agency problem, a high-powered incentive structure results in "exacerbating those concerns when managerial reward structures are linked to movements in reported EPS [earnings per share]" (Dhanani and Roberts, 2009: 104; Driver and Guedes 2017)".

[14] A frank concession to this view has been put by Digby Jones, the colourful former head of the British employers' organization the CBI: *"[non-executives] are not there to be executive directors and do their job for them. Or to be shadow auditors and go through the contracts and schedules line by line… there are limits to what they can realistically be expected to do." (The Times, Nov. 6th, 2006). In a similar vein, The Financial Conduct Agency also recently opined that Tesco plc board members could not be expected to know about hundreds of £m of profit overstatement at Tesco Stores.*

In this context, stake-holder representation can be valuable in two respects – augmenting information flows and correcting the short-term focus that leads to low investment and R&D (Gutierrez and Philippon 2016). Information problems for firms do not solely consist of flows between the senior management team and the board, but also between divisional or middle management and the centre because of the lack of a common knowledge base or technical language. Stake-holding representation by managers below the most senior level provides useful information on operational and technological issues – information that may sometimes be with-held unless they are part of the discussion [See chapters 9 and 10].

The career spans of managers below the top team are longer than that of the CEO and thus they will be concerned to take a longer view even at the expense of the share price which reflects public information only. Furthermore, lower level managers on the board can provide a monitoring function, constraining the extent to which top management can collude with the board in short-term boosts to the share price. This preference for internal over external monitoring has found some support even from some of those wary of shared control rights (Hellwig 2000; Fauver and Fuerst 2006).

Peer monitoring has also been endorsed in orthodox finance contributions but unfortunately in a way that strips it of any content. It has been suggested for example that employee monitoring is a useful adjunct to corporate governance as their interests are "largely aligned with good firm performance and fair treatment of all stake-holders" (Berglöf and Claessens 2004:34). These authors however are expressing the narrow view that interests are only aligned because labour is mobile, thus giving them outside options and rendering any control rights unnecessary. This approach is formalised in the theory of "internal governance". Subordinate managers have power and can influence the CEO to focus on the long run so that good governance will simply happen. "None of this needs any coordination on the part of employees or any appeal to the board of directors, nor does it require external governance" (Acharya et al 2011:704). Sadly this Panglossian

conclusion is several removes from reality. It repeats the mistakes of the Zingales approach outlined earlier in assuming that what is desirable or negotiable will happen without institutional support and coordination, and assumes that employee influence occurs without any formal expression.

Empirical evidence is broadly supportive of the view that employee representation on boards can improve performance but there is a raft of rival and conflicting evidence on the generality of any finding. This is not surprising where there are so many plausible control variables to consider and where performance can be measured by a financial or an operating yardstick, or by a stake-holder metric like employment. It is instructive, however, that executives and board members with experience of stake-holding are often positive about the effects of employee board representation.[15]

11.5. Concluding remarks

Arguments for Shareholder Primacy are deeply flawed but that does not imply that companies in liberal market economies will readily deviate from this norm. For reformers, the question is what is feasible and which alternative is likely to work tolerably well.

The advantage of implementing Management Led Stake-holding is that it can be initiated, if not completed, with minimal structural changes to formal governances. As argued earlier there is the potential for a win-win programme of good labour practices and corresponding worker engagement. It is argued that the process could be implemented as part of a cultural movement for better work relations aided by customer awareness and perhaps given impetus by future demographic changes that may tighten the labour market. However, MLS is unlikely to make headway without the type of supporting governance reforms suggested in the companion chapters in this book, including a clear legal framework for takeovers so that managers' promises would be more credible.

[15] One German study found considerable support for board-level codetermination among individual firms but continued opposition from the federations, whose views seem part of a political strategy (Paster 2012).

The Governance Led Stake-holding approach argues that control rights for non-shareholders are needed, either directly or by proxy. But the choice of how shared control is implemented needs careful consideration. We know that employee representation can work well in some contexts but we know less about the exact nature of the social glue and informal conventions that underpin this and that are likely to be more important than the prescriptive codes themselves. Without first having first strong employee organizations, general representation may prove a hollow achievement.

One compromise solution is, initially at least, to confine board employee representation to strategic executives below the level of top management. These would be capable of providing detailed inside information beyond financial metrics and could perform a valuable peer monitoring role. Crucially these members would also have a longer term interest in the firm's success compared with the top management team whose tenures are shorter and whose self-interests depends more on near-term results. There is no reason to suppose that executives below the top team are any less informed or any more mis-aligned with company success than either liquid short-term shareholders, non-executive directors, or even longer-term block shareholders. Tilting the balance away from uninformed external members and towards not-so-senior management could be an acceptable testing ground for a broader degree of stake-holding for which institutional supports still need to be built.

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