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Investment, industrial strategy and corporate governance

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The supply and coordination of investment in physical capital, organisation, infrastructure, skills, and innovation is part of industrial strategy. For convenience I will call all these activities 'investment' as they tend to be conceptually similar, and are often related at the macroeconomic level if only because a deficiency in one (such as skills) may impact on another. There is no exact consensus on how these decisions should be taken in a mixed economy. The relative advantage of market and planning will depend of the conditions of the time. For example, when there is a great deal of technological or demand uncertainty, or where public interest is involved, greater weight may be put on pooling information and coordinating individual investment decisions.

The potential blunders that our governments make have to be balanced against the narrow vision of the market, which is better at reacting to existing demand than imagining new needs. This is why major innovations such as the internet, transport, electronics and novel pharmaceutical advances have often benefited at the outset from major programmes of public research and standard setting. In today's world, innovations produced by the major corporations are increasingly incremental, even where advanced original science is employed. Adaptation to new opportunities by private corporations are insufficiently incentivised because, for transformative systems, many of the costs and benefits of innovation accrue to other parties as spillovers (externalities). This chapter explores this issue, and considers how UK industrial strategy can induce an investment-led economic model through corporate governance reform.

Coordinating investment

A recent All-Party Parliamentary Group report concluded that 'the UK currently lacks a coordinated and coherent approach to identifying its potential vulnerabilities, and developing long-term strategies to mitigate them' (Manufacturing Commission, 2015: 10). This is not surprising – economies that are primarily market-oriented often lack the political will to consider alternatives. Criticising this, Richard Nelson of Columbia University argued for a loosening of the boundaries between public and private. In his view, 'a wide range of human activities that employ a large share of the economy's resources diverge from what is considered standard economic activity' (Nelson 2002: 242) and that the role of non-market governance structures has been 'repressed in much of the current discussion of economic organization (2002: 212). This suggests a dilemma at the heart of economic development of advanced nations where the market form is ill-adapted to solving some problems and, due to insufficient belief in public provision, these concerns become orphaned. The result is that value lies unlocked not just for these activities themselves but for market activities that might feed into them.

In the terminology of business strategy, there is scope for a 'shaping' approach, in which industrial planning is more pro-active than re-active. Well-positioned firms occasionally get the chance, under fluid technology and demand, to reorganise a whole industry on proactive lines, as HP did with printing, or Fedex with delivery, or the modern network firms with search, transport and accommodation. But sometimes change takes place over such a long time and large scale that it cannot be easily pioneered by even the largest firm – and sometimes it could be undesirable and undemocratic for that to occur. In these circumstances, public or private-public partnerships may be useful, and the opportunities stemming from such undertakings can then stretch back over a long supply chain through services, products, capital goods, design and R&D. Coordination and planning of investment has already occurred in the case of renewable energy, but could usefully be employed in helping the emergence of new industries and innovative solutions that will feed into supply chains for social needs such as housing, care and health and education.[1]

Under-investment in the UK

Weak market signals can delay the adaptation of the industrial structure, but there are also other forces constraining private firms. Low investment has been a perennial issue for the UK, which invests less than comparator countries. This has often been discussed as if it were a temporary problem. The idea that corporations consistently under-invest because of some *systematic* failure of policy or governance disappeared with the rise of liberal market views many decades ago. A former Deputy Governor of the Bank of England remarked towards the end of the Thatcher administration that any required resurgence in investment would arise automatically since there was no obvious market failure involved (see Driver and Temple, 2014: 50). Of course, this did not happen then, and we are still waiting for such a resurgence.

Even modern-day Keynesians have tended to see no long-run problem with the market level of investment (no supply constraint), focusing instead on a possible demand deficiency. There may be an occasional worry about the adequacy of finance for investment particularly for small and new firms but this is a footnote pointing to an anomaly rather than a systematic failure. Such insouciance is at one level surprising. The record of investment in the UK has been consistently poor both absolutely and in relation to comparative economies, and especially so in the current context. Five years after the onset of the financial crisis, the Bank estimated that each employee was operating with five percent less capital than would have been the case had the economy been on its pre-crisis path (see Driver and Temple, 2013). The second five years since the crisis has been even worse for investment; recent survey evidence from the Bank shows one third of firms saying that they invest less than appropriate, compared with only 2 per cent that were overinvesting (Salaheen *et al.*, 2017).

Of course, the UK economy has suffered exceptional difficulties in the last decade due to the exposed position of its international banks and the self-imposed burden of uncertainty induced by Brexit. But it would be wrong to think of the pattern of low investment as something that only began with the financial crisis. Low investment both relative and absolute has characterised the UK economy for half a century, to the extent that is has come to be accepted as a national norm. Nor is under-investment confined to fixed capital: OECD data show that business financed R&D as a percentage of GDP has been much lower in the last two decades than before then.

Despite the flinty disregard of some economists and policy-makers for this reluctance to invest, there have been periodic outbreaks of doubt and unease. Reviewing trends in the UK economy, a different Deputy Governor of the Bank asked publicly about the ‘puzzle’ of low investment (Gieve, 2006). How was it possible for the UK to have the lowest whole-economy investment spend since the 1960s, given the historically high ratio of financial surplus to GDP and unprecedented low borrowing costs? Such expressions of concern have multiplied in recent years, but if opinion is changing it is only because chickens have truly come home to roost. Near-zero productivity growth for a decade has so alarmed policy circles that even orthodox commentators have ended up calling for more investment, even if there is little idea of how to bring this about or why the problem has occurred.

Corporate culture, corporate governance, and investment

The proclivity of corporations to invest capital depends on the corporate culture that it adopts. This varies across firms but is influenced by institutional features – regulation, takeover codes, company law and codes of conduct that concern the duty of directors and the rights of different types of investor. This complex of institutions is known collectively as ‘corporate governance’, and it affects the balance of power between the various parties or ‘stakeholders’ involved with a company’s activities such as investors, managers and workers. When a firm’s corporate governance is attuned mainly to the interests of investors it tends to invest less capital (Bauer *et al*., 2008). Some interpret this as a reason for celebrating a form of governance that gives priority to investors as it amounts to a strict monitoring of the investment spend. But of course this argument only works if investors are seen as reliable, far-sighted and neutral judges of collective economic opportunities. This is the position of the influential economist and commentator Lawrence Summers, typified by his defence of current arrangements for corporate governance in companies like Amazon which, according to Summers (2018), trade at huge multiples to current profits because of credible long-term plans. But this argument is weak. Technology companies are trading on the basis of their monopoly power, which allows them to plan ahead.

While the economics profession by and large denied any supply side problem of investment – and ignored adverse effects stemming from corporate governance – other business-oriented commentators were more prescient. Pioneering voices such as Will Hutton (1996) in the UK, Margaret Blair (1995) and William Lazonick (2018) in the United States focused their attention on the institutions that initiate and authorise investment decisions in the modern economy. They argued that the system of stock market capitalism had changed in the last decades of the twentieth century. Before that, shareholder power was diffuse and rarely seen as a constraint on managers’ plans for investment and innovation. From around the 1980s onwards, under pressure from globalisation and footloose finance, managers came to accept that they needed to be responsive to shareholder concerns. Under a new framework of ‘shareholder primacy’, serious power was gradually transferred into hands of shareholder representatives and shareholder primacy became a distinct mode of governance.

The new system was trumpeted as one that could direct the allocation of capital to where it was most needed – taking it from firms with excess cash and investing it in new enterprise. In the heady years of globalisation it was even argued that country growth rates depended on how developed their financial systems were, especially stock markets. Such a view has been knocked sideways, by crises of speculation in emerging markets, by the dot.com crash at the beginning of the century, and later by the huge mis-allocation of finance that characterised the years leading up to the financial crash. Macroeconomists have at last begun to recognise that financialisation has costs as well as benefits. Furthermore, serious quantitative work has now identified shareholder primacy-based corporate governance as a clear cause of under-investment, alongside more traditional ones of lower competition (Gutiérrez and Philippon, 2017).

Shareholder primacy, investment and stakeholder solutions

The Shareholder Primacy system of corporate governance prevailing in the UK and other stock-market oriented economies assumes by default that the interests of shareholders are normally coincident with the general good. This system has evolved as a muddled response to the problem that company managers may have interests distinct from owners, and may engage in self-serving activity. But why should shareholder interests be dominant anyway? Elsewhere I have laid out at length the tortuous logic that is supposed to justify this, but here I will just say there is *no* good reason (see Driver and Thompson, 2018). A different system of *stakeholder capitalism* where power is shared with workers and other interested parties works perfectly well in some parts of the global economy and there are examples of non-shareholder enterprise in all economies. Shareholder primacy as a governance system is neither rational nor reasonable. Shareholders have their own legitimate interests, like all other stakeholders, but these should not be equated with the ‘common good’. The system is not reasonable because the steps taken to align manager and owner interests are often counterproductive with all sorts of unanticipated side effects on the general economy. One example is the system of rewarding chief executives with extraordinary incentive pay linked to the current or near-term value of the company’s shares. Systematic distrust of such managers, exacerbated by the governance system itself, leads shareholders to prefer signals of performance in the form of early and constant pay-outs of cash, which simultaneously enrich senior managers but make it difficult for firms to invest and grow.

The incentive for managers to under-invest is now one of the most discussed topics in the financial press. Not only do many business executives worry about pressure from owners to return cash, but leading financial executives castigate their own industry about the same thing. At the same time, normally sober academics, central bankers, consultancy companies and politicians have been convinced of the message. The City firm Ernst and Young says that investors prefer ‘cash cows to capex’ (see Atkins, 2015) while Credit Suisse (2015) has identified ‘a noisy campaign by activist investors’ for a shift in capital allocation away from investment and towards buybacks and dividends.

What is it exactly these critics think is the nub of the problem, and how do they propose resolving it? These are important questions because, while it is sometimes good to be at least half-right, the cure can often be as bad as the disease. The orthodox critique is that shareholder capitalism’s shortcomings stem from poorly-designed incentives that allow managers to undermine a well-functioning system of shareholder primacy. At least the first half is correct. Managerial pay is out of control. And we have to respect the informed view of direct participants in the financial markets, such as Andrew Smithers (2013), who argues that current incentives encourage managers to pull money out of productive uses to engage in financial games. It is worth asking, however, whether there is *any* system of high-powered financial incentives that could not be gamed in some way by informed executives. Again, there are some orthodox commentators who agree with this, and seek other solutions to counter the pressure for low investment. Some argue that shareholder power would become functional if it were more concentrated; others that shareholders themselves are long-termist, but are let down by the layers of complex and costly intermediates between them and firms; still others want to confer more voting power on long-horizon shareholders, to create new classes of committed shareholders, or to put conditions on activist manipulation. Each of these positions has some merit. But each also seeks to tweak the version of shareholder capitalism that emerged forty years ago, rather than renewing it fundamentally.

There is something in modern financialised capitalism that constrains investment to be lower than warranted. One route to fundamental reform is to dilute the power of shareholders in favour of other stakeholders (see Driver and Thompson, 2018). In the US, Senator Elizabeth Warren has introduced a Bill into Congress to enforce a 40 per cent stakeholder representation on company boards – something that has been attacked by Harvard Professor Mark Roe (2018) as if it were a fatal disease: ‘The Act’s effects are easily predictable: capital would be trapped in large companies and mis-invested. Smaller companies would be deprived of funds, and wealth would be transferred from public investors to corporate insiders.’ Yet there is no consistent body of evidence supporting a negative net outcome for stakeholding governance. To the contrary, informed opinion and empirical research in contexts such as Northern Europe generally finds that profitability is maintained under such systems while they tend to be less unequal and with higher skill levels that the UK model (see Driver and Thompson, 2018). The more relevant question concerns how easy it is to incorporate aspects of these systems in an historically different context. But some counterweight to shareholder power is now urgently required.

Conclusion

Investment is an important part of industrial strategy, since markets are less good at anticipating need than in responding to existing demand, given the coordination of effort and the sharing of costs and benefits that are involved. This feature of markets, which is particularly important at time of fundamental technical or organisational change, explains to some extent the current low investment rate by private industry. A second powerful influence is the prevailing system of corporate governance. Shareholder primacy is inherently biased against re-investment, and puts persistent pressure on firms to return cash to investors. It is unlikely that this corporate governance effect is remediable except by drastic reform of the balance of power within corporations.

Notes

1. The need for addressing links between market and non-market issues is evident in the wish list for government action that accompanied the recent submission by the CBI for the 2017 Spring Budget. Of the thirteen key recommendations, four concerned education, skills, and employee well-being, with a further three concerning inputs from infrastructure, energy and research. But the need for a rethink of public-private interaction and boundaries is not commonplace. As noted by the *Financial Times* columnist Martin Wolf (2018), '[t]he financial crisis was a devastating failure of the free market that followed a period of rising inequality within many countries. Yet, contrary to what happened in the 1970s, policymakers have barely questioned the relative roles of government and markets'.

2. See Gieve, 2006. It may be asked whether this paradox is such a puzzle, given the prevailing culture of ideas. The macroeconomics that UK students learned from textbooks – and presumably that which their professors believed – claimed that low capital investment was irrelevant to the country's problems. Among the reasons given for this was that jobs could not be created by investment but only by labour market reform. Indeed some even suggested that investment could be positively harmful in that the costly installation of fixed capital guarantees an increase in workers bargaining power against the owners who have sunk this capital (see Driver and Temple, 2014, especially chapters 2 and 4). Other economists downplayed any investment problem by claiming that intangible capital compensated for lower fixed investment. But included in intangibles is rent-seeking, advertising and fictitious goodwill that is never depreciated.

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