Oxera

Agenda

Advancing economics in business

How might alternative ownership models benefit economic growth and stability?

In 'A Long-Term Focus for Corporate Britain', Vince Cable, UK Secretary of State for Business, Innovation and Skills, asks: 'is there more to be done to secure the growth we need?' While recent policy debates in this area remain largely in the context of the shareholder model, what do alternative ownership models have to offer? Can diversity in ownership models, and a broader view of a firm's economic value, benefit economic growth and stability?

In the aftermath of the recent global financial crisis, policy-makers have asked what steps can be taken to prevent a recurrence. Short-termism is a common theme in these debates. Put simply: prioritising the present over the future can lead to unfavourable long-term outcomes.

At the end of 2010, the UK Department for Business, Innovation and Skills (BIS) launched a consultation inviting submissions from across the corporate world and beyond on the consequences of short-termism in Great Britain. 'A Long-Term Focus for Corporate Britain' asks whether:

> the system in which our companies and their shareholders interact promotes long-term growth—or undermines it.[1]

The European Commission has been asking similar questions, stating in a Green Paper in 2010 that:

> Corporate governance is one means to curb harmful short-termism and excessive risk-taking.[2]

Largely absent from the debate is the question of whether the type of firm ownership can make a difference. Do different models lead to different outcomes? And is a plurality of ownership models beneficial?

This article discusses the relevance of ownership models to the debate on short-term incentives and long-term growth. Having examined the shareholder model in the context of the BIS debate and more generally, the concept of a stakeholder model and its variations is explained. The article considers whether this model can bring something new to the debate surrounding the long-term benefits.

Corporate Britain in the long term

In launching its consultation, BIS is questioning the goal of securing long-term and stable growth in the economy, and the relationship between economic growth and the roles of investors and management. The question was set in the context of the UK's existing corporate governance framework, where the separation of ownership and control in business and the 'shareholder' model are predominant. This typically involves shareholders or investors who own the company, and a board of directors who are entrusted to manage and control the company. While it makes sense to explore this framework, few questions were raised by BIS about the framework itself.

Of the questions put forward by BIS (see Box 1 below), many relate to the role of shareholders. This is particularly important in the UK, where the corporate governance framework is said to put more emphasis on the views of shareholders and their engagement compared with other countries.

One line of questioning taken by BIS concerns the changing nature of the UK equity market. This tracks changes in the market over time and considers their repercussions. The equity market has become increasingly concentrated over the past few decades, with the shareholders typically now being mainly pension funds, insurance companies and other collective funds. In 2008, institutional and overseas investors accounted for around 80% of all UK share ownership—around double the level of 40 years ago.[3] Undoubtedly, the investment strategies and quality of engagement by these large institutions now play a stronger role in determining the incentives and behaviour of companies, and the economy as a whole.

If investors' preferences become increasingly driven by short-term value and changes in the share price, this

Box 1 'A Long-Term Focus for Corporate Britain: A Call for Evidence'—selected questions

The BIS consultation puts forward some questions about the shareholder model of business ownership, in four areas.

Boards of directors

- Do UK boards have a long-term focus, and if not, why not?

Shareholders' role in equity markets

- What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?
- What are the most effective forms of engagement? Is short-termism in equity markets a problem, and, if so, how should it be addressed?
- What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?
- Are there agency problems in the investment chain and, if so, how should they be addressed?

Director remuneration

- What are the main reasons for the increase in directors' remuneration? Are these appropriate?
- Are shareholders effective in holding companies to account over pay? Are there further areas of pay, such as 'golden parachutes', that should be subject to shareholder approval?

Takeovers

- Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

can push management towards focusing on these factors, rather than on longer-term strategy. Factors such as holding periods by investors declining over time, and the frequency of trading increasing, indicate that this may indeed be the case.

From the submissions to BIS, it appears that these issues rang true with many respondents. More sceptical responses highlighted that the scale of these issues and the tangible consequences for growth and stability are much harder to identify. The response from the John Lewis Partnership highlighted the narrow focus of the consultation (see Box 2 below).

To consider how alternative models may be relevant to the debate on growth and stability, the shareholder model and its potential drawbacks are outlined briefly below.

Incentives in the shareholder model

The relationship between ownership and incentives is commonly assessed in the widely understood 'principal–agent' framework. The principal–agent problem arises when there is a separation of ownership and control. In a nutshell, problems can arise where the incentives of the principal (eg, a business owner) are not aligned with those of the agent (eg, a business manager).

When the incentives are successfully aligned—for example, through appropriate executive remuneration and well-monitored management—this model has proven to be powerful. Management will act in a way that maximises profits for the investors and owners of the firm.

A misalignment of incentives, however, can have important repercussions. Consider the following example. Management, through a misalignment of incentives, may adopt strategies designed to secure its own position. These strategies might be inconsistent with a strategy for maximising the firm's long-term value. For example, management may take conservative investment decisions in good times (to limit downside risk) while taking excessively risky decisions in bad times in an attempt to deliver good performance. In the extreme, if the entire economy followed such a strategy, it is fairly reasonable to expect increased cyclicality and instability.

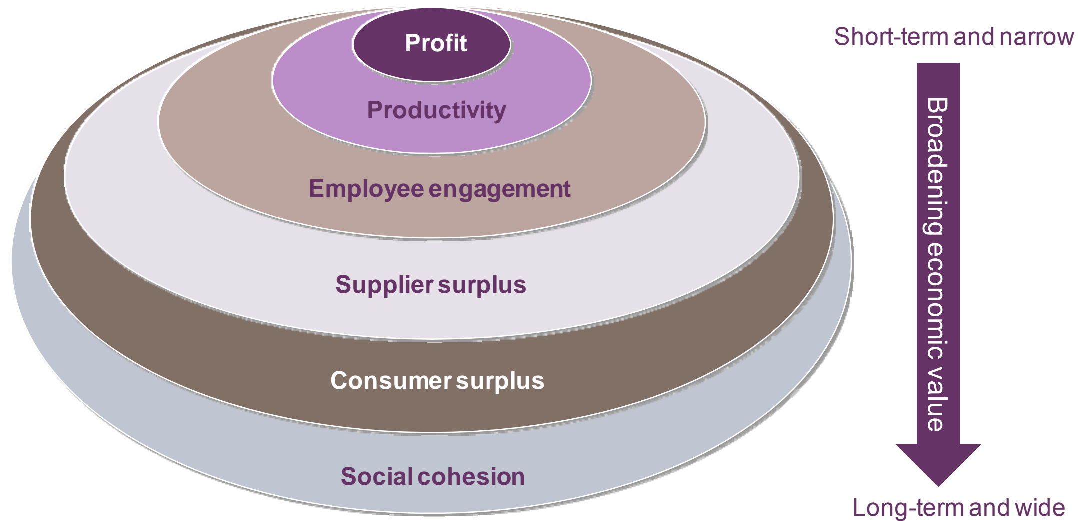
The extent of the principal–agent problem can vary according to the precise structure of the shareholder model adopted. It can be more acute in the diffused shareholder ownership model (where the firm is owned by numerous small shareholders), but relatively muted where there is one large shareholder (eg, a family owner or an institutional investor). Despite these nuances, the fundamental issues remain: investors and management are likely to have different incentives, and there is no guarantee that either set of incentives will be at the socially optimal level.

While more can be done to adjust the structures and incentives in this model, a more fundamental change might offer better outcomes for growth and stability. BIS has implicitly questioned the nature of firm ownership by examining the dynamics of the UK equity market. Yet a broader inquiry might have looked beyond the equity market for alternative models.

Alternative ownership models: the stakeholder model

As a broad alternative to shareholder models, the stakeholder model encompasses the concept that those other than the equity-holders are relevant to the company. This distinction is not new—for example, it was recognised in an OECD report of 1999.[4] The stakeholder model places more emphasis on the contribution that stakeholders can make to long-term performance and shareholder value, as illustrated in Figure 1.

Figure 1 Broadening the definition of a firm's economic value



Source: Oxera.

The shareholder model typically involves a narrow focus, primarily on a firm's profits, driven by internal productivity (the centre of Figure 1). By contrast, stakeholder models take a wider view and can incorporate all stakeholders who are linked to the firm's behaviour. This has the benefit that, by internalising the considerations of all stakeholders, the potential for misalignments between parties is reduced. Counterbalancing this is that it can be difficult for a corporation to fulfil, or prioritise between, the wider objectives of these different stakeholders.[5]

In the simplest case, employees may be given a more active role in the company; for example, through voting on company decisions. The furthest extension of employee engagement would be employee ownership—as exemplified by John Lewis Partnership in the UK (see Box 2).

Extending the stakeholder model can mean bringing suppliers and consumers closer to the business. Building strong supplier networks, for example, might be achieved through encouraging longer-term relationships. As the OECD notes:

> Often, the competitiveness and ultimate success of the firm will be the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Therefore, it is in the interest of the shareholders to take account of other stakeholders, and to promote the development of long term relationship, trust and commitment amongst various stakeholders.[6]

Box 2 John Lewis Partnership: an employee-owned business

John Lewis Partnership, a retail business with 70,000 employees, is the largest employee-owned company in the UK. All employees—also referred to as 'partners'—are beneficiaries of a Trust that owns the firm. The governance of the firm is delegated to the chairman, who is accountable to a 'Partnership Council', most of whose members are elected by the employee–partners. In terms of remuneration, employees are paid annual bonuses in proportion to their salary. This company-wide employee remuneration structure is similar to the management remuneration packages that aim to encourage employees, as partial owners of the company, to exert more effort to improve the company's financial performance.

As highlighted by the submission of John Lewis Partnership to the BIS consultation, a study by Matrix Evidence suggests that employee-ownership structures lead to increased performance and stability at the firm level. At the employee level, the benefits include increased staff motivation and engagement, as well as better financial outcomes for employees.[1] Another study by the Cass Business School, commissioned by John Lewis Partnership and based on an in-depth survey of senior executives and analysis of the financial data of over 250 companies, supports the results of the Matrix study. Additionally, the Cass study suggests that employee-owned businesses may contribute more to the broader society through higher rates of employment, higher resilience or lower risk of business failure, and higher value-addition to output and human capital.[2]

[1] Matrix (2010), 'The Employee Ownership Effect: A Review of the Evidence', March.
[2] Lampel, J., Bhalla, A. and Jha, P. (2010), 'Model Growth: Do Employee-Owned Businesses Deliver Sustainable Performance?', January.

The final extension of Figure 1 is to bring society closer to the company. This very wide view of a firm, incorporating the concerns of all stakeholders, can mean representing the views of local society in the firm's decisions.

Broadening the view of a firm in this way could be thought of as simply recognising the external impact that firms have. This is a well-explored area of economic theory.[7] However, the idea extends beyond this: by internalising these wider aspects of a firm's impact, the overall benefits to the firm could exceed the sum of the parts. Academic evidence of these benefits has been growing, and suggests that this approach to firm ownership has the potential ultimately to benefit economic growth and stability.[8]

Interestingly, similar debates outside of BIS and the European Commission have also raised these ideas. First, during last year's UK general election, the 'Big Society' concept was born, which aims to promote a decentralised and bottom-up approach in the public sector. Part of this involves supporting co-operatives, mutuals, charities and social enterprises. The principles behind it are similar to the stakeholder model: engaging society (the outer rings of Figure 1) can have benefits above and beyond pure cost savings. Ideas of this nature have been popular in sociology for some time.[9]

The second field is the financial services sector. Following the outcome of the 2010 UK election, the coalition government stated:

> We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.[10]

Picking up on this commitment, a report by the Centre for Mutual and Employee-owned Business puts forward a strong argument that discussions on ownership structures should be about more than simply extending firm value or supporting alternative businesses models.[11] Its argument is that it is the diversity in business models that is beneficial to the economy. In other words, it is not to say that the stakeholder or mutual model is universally superior to the shareholder model but, rather, that the benefit lies in having a mixture of different business models. Such a mixture can promote diversity in risk appetite, incentive structures, policies and practices, management practices, and behaviours and outcomes. It may lead not only to more competition, but also to more diversity in that increased competition.

The Centre for European Policy Studies concluded similarly in 2010, noting that:

> The most important conclusion is that the current crisis made it even more evident than before how valuable it is to promote a pluralistic market concept in Europe and, to this end, to protect and support all types of ownership structures…[12]

While these specific proposals are being put forward in the context of the financial services sector, such benefits may arise in other sectors as well. Furthermore, there is evidence to suggest that increasing diversity in the financial services sector may itself support diversity in other sectors.[13]

A more comprehensive application of these ideas in all sectors may contribute to the long-term growth and stability that BIS desires. These benefits may accrue through three channels:

- a stronger alignment of incentives;
- the wider economic benefits that these models can confer;
- the diversification of ownership models in the economy.

Concluding remarks

The desire to promote long-term growth and stability in the economy has prompted a series of debates, which, in the main, examine the existing framework of corporate ownership: what can be done to tweak the interaction between investors and management? In parallel, there is some interest in exploring models of ownership outside the predominant shareholder model.

Alternative ownership models have the potential to help to promote long-term sustainable growth. This can be through incentivising longer-term horizons, the creation of economic value by broadening the view of a firm, and by increasing the level of competition between ownership models. While certain firms have been successful under these ownership models, the challenge remains over how to incentivise their adoption. Firms will not adopt models that do not generate greater economic benefits. These economic benefits must also be able to be captured by the firm generating them—and this is unlikely to be the case for any benefits that accrue to society as a whole.

If these benefits are material, can be quantified in a robust manner, and exceed their costs, this might suggest a greater role for public policy, but quantification remains a challenge. While evaluating the productivity effects internal to the firm might be straightforward, effects that accrue outside the firm are less so. Yet if the benefits as a whole remain uncertain and unknown, promoting the benefits of alternative ownership models may be questionable.

[1] Department for Business, Innovation and Skills (2010), 'A Long-Term Focus for Corporate Britain: A Call for Evidence', October, p. 5.
[2] European Commission (2011), 'Green Paper. The EU Corporate Governance Framework', April, p. 2.
[3] Investment Management Association (2010), 'Asset Management in the UK 2009-2010', IMA Annual Survey, July.
[4] OECD (1999), 'Corporate Governance: Effects on Firm Performance and Economic Growth'.
[5] Ibid.
[6] OECD (1999), op. cit. See also Mayer, C. (1996), 'Corporate Governance, Competition and Performance', *OECD Economic Studies,* **27**, pp. 7–34.
[7] See Coase, R.H. (1937), 'The Nature of the Firm', *Economica,* **4**, pp. 386–405.
[8] See Knack, S. and Keefer, P. (1997), 'Does Social Capital Have an Economic Payoff? A Cross-Country Investigation', *The Quarterly Journal of Economics*, **112**:4, pp. 1251–88.
[9] Putnam, R. (2000), *Bowling Alone: The Collapse and Revival of American Community*, Simon & Schuster.
[10] HM Government (2010), 'The Coalition: Our Programme for Government', Cabinet Office, London.
[11] Michie, J. (2010), 'Promoting Corporate Diversity in the Financial Services Sector', Centre for Mutual and Employee-owned Business, Kellogg College, University of Oxford, September.
[12] Schmidt, R.H., Carbó Valverde, S., Rodriguez Fernandez, F., Ayadi, R. and Arbak, E. (2009), *Investigating Diversity in the Banking Sector in Europe: The Performance and Role of Savings Banks*, Centre for European Policy Studies, Brussels.
[13] Gagliardi, F. (2009), 'Financial Development and the Growth of Co-operative Firms', *Small Business Economics: An Entrepreneurship Journal*, **32**:4, pp. 439–64.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

Other articles in the August issue of *Agenda* include:

- **a Sky-high damages claim: assessing the harm from a loss of customers**
- **private labels: a useful ingredient in the food industry?** ***Dr Frank Bunte, University of Wageningen***
- **uncertainty and long-term projections: a framework for postal sector demand** ***Frank Rodriguez, Oxera Associate, and Soteris Soteri, Royal Mail Group***

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com

© Oxera, 2011. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.