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# Rewiring Capitalism After Covid-19

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## Executive Summary

- In the wake of the coronavirus crisis, a severe recession is looming, threatening a return to mass unemployment not seen since the early 1980s. The government has responded with a comprehensive, whole economy rescue package to try to buy time for companies to survive until economic activity returns to something closer to normal. Most of this support during the acute phase of the crisis is time-limited, and we now are moving into a second phase – a recovery phase – as the state begins to withdraw emergency measures and seeks to restore the economy to health. Securing a strong recovery to minimise the damage from the pandemic is a central priority.
- But this report argues that returning to the status quo ante will not be enough. The past decade of sluggish productivity growth and mounting public disquiet with the behaviour of some companies has caused prosperity to stagnate and shaken confidence in the market economy.
- Against this backdrop, massive state intervention to sustain jobs and businesses during the crisis has underlined the important role of government in protecting and nurturing the market economy, and the reciprocal responsibilities of businesses to society. However, it would also be wrong to conclude, as some will no doubt do, that the experience of the crisis shows that the state should necessarily have a permanently expanded role in the economy.
- Rather it should play its role better. We therefore argue that a third, more long-term, reform programme is also required. Its twin focus should be on tackling the “productivity puzzle”, which has seen the rate of UK productivity growth slump to a 250-year low, and restoring the frayed relationship between business and society. This can best be achieved by a rewiring of, rather than a revolution in, British capitalism.
- A failure to tackle the anaemic productivity growth seen in the years since the financial crisis would condemn the UK to a slower recovery than is necessary to raise incomes and generate the tax revenues to stabilise the public finances.
- But the productivity problems that have emerged in recent years are also linked to a wider set of challenges that have eroded public trust in business. Many companies pursue “fragile” business models based on low wages, insecure employment and low investment. This is undermining public trust in business.
- A leading cause of these problems in recent years has been a lack of private-sector investment. This has partly been due to a tendency for firms to take on too much debt, which tends to exacerbate corporate myopia. But it mainly owes to excessive short-termism with regard to investment among many companies that is rooted in corporate-governance arrangements and the structure of equity markets.
- Shareholder value maximisation is the animating feature of sections of British capitalism. It prioritises the interests of shareholders, and relies on performance metrics that incentivise short-termist behaviour. Many observers therefore attribute the UK’s woes to what they see as the inherent shortcomings of this approach. Some other approaches to solving short-termism emphasise the importance of companies having a purpose beyond profit maximisation and/or enacting “stakeholder”

arrangements such as putting workers on company boards. But these risk, respectively, becoming an ineffective public-relations exercise, or creating competing interests inside the company rather than tackling the underlying problem. In fact, the shareholder-value approach comes in different forms around the world, with the British variant characterised by a damaging lack of effective stewardship over companies by overly dispersed shareholders. This is not the only way.

- Instead, by addressing some of the shortcomings of the British corporate-governance environment, we can foster a model of “stewardship capitalism” that takes a longer-term view and works more in the interests of shareholders, employees and wider society. Four concrete steps are needed:
  1. Increase the number of blockholders with large enough ownership stakes to give them an incentive to engage with managers. This should be done by allowing dual-class shares, relaxing disclosure rules and encouraging formation of long-term capital trusts.
  2. Tackle the unequal tax treatment of debt and equity that biases companies in favour of the former and encourages them to over-leverage.
  3. Revise the Companies Act to allow firms to replace short-termist shareholder value maximisation with other strategies that maximise investment and corporate responsibility.
  4. Increase the supply of “patient capital” to give firms access to classes of owners, such as long-term oriented sovereign-wealth funds, which are prepared to offer proper stewardship.

# Introduction: Covid-19, Investment and Trust. What Is at Stake?

As we enter a new phase of living alongside Covid-19, the focus of policy is set to shift from the medical to the economic emergency and the part business needs to play in the recovery. There is a lot that needs addressing, for the overall impact of Covid-19 is not just the shock of the pandemic itself. It is the interaction of this with the consequences of an accumulation of vulnerabilities that have built up in the economic system over the past couple of decades and are now magnifying the pandemic's impact.

Two of these vulnerabilities stand out most of all. First, the Covid-induced recession comes on top of an unprecedented slump in productivity growth since the financial crisis. Second, this has been accompanied by faltering trust in business over a series of high-profile corporate failures (BHS, Carillion, Thomas Cook), some unedifying scandals (Boohoo's Leicester sweatshops), concern over tax evasion by multinationals and high executive pay often unjustified by performance.

This matters hugely. Increasingly, commentators are linking anger over the failure of the market economy to improve the living standards and life chances of the majority with the populist wave sweeping through Europe, India and the Americas.<sup>1</sup> The shock of Covid-19 and its disproportionate impact on the young and low-paid reveals the social consequences of a preference among too many firms for overly short-termist business models built on fragility, low wages and minimal investment.

Change may now be afoot. The colossal scale of state intervention in the economy has revealed the extent to which business relies on the government to support the market economy. Vast sums pledged to help business ride out Covid-19 will increase the burden on future taxpayers. These citizens are entitled to assurances that the economy is working in their interests, and it is the responsibility of the current government to ensure this. Covid-19 therefore presents both a rationale and an opportunity to make overdue legal, policy and institutional reforms to the way companies are owned and governed and the way they operate.

The fundamental problem that needs addressing is that the UK's model of capitalism embodies an extreme application of the Milton Friedmanite imperative of maximising "shareholder value".<sup>2</sup> Ignoring Friedman's stipulation that profit-maximisation need not, and should not, be at the expense of society, this interpretation prioritises the interests of company owners above all others. Moreover, because of the way the UK's financial and corporate-governance system is structured, it fosters dispersed and unengaged ownership of companies. Managers of these companies are, in turn, incentivised to pursue short-termist business models which are careless of the needs of society.

Decisive action now to tackle short-termism will help ensure that the post-Covid recovery is strong, sustainable and equitable. It will also restore faith in markets as the main engine of wealth creation.

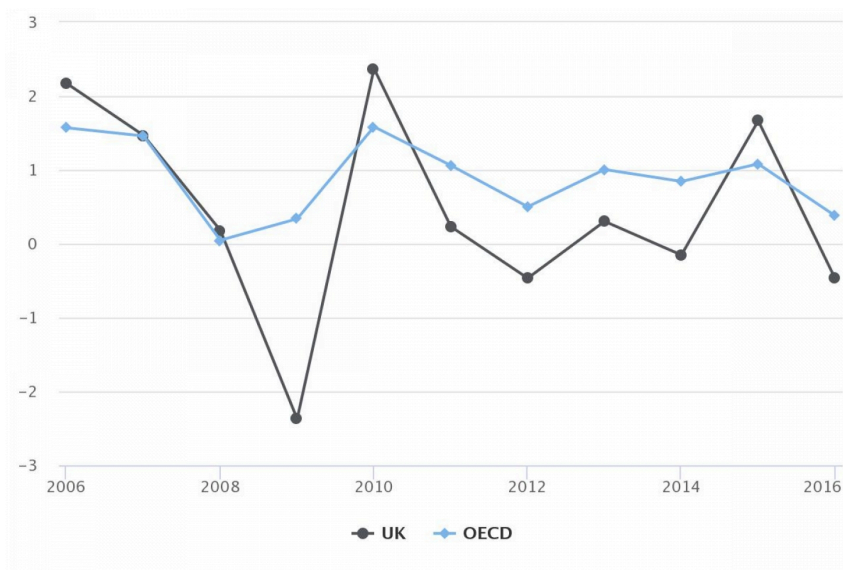
However, reforms need to be done carefully and targeted at underlying issues contributing to low investment and corporate malfeasance. Uncertainty about the individual and collective response to the Covid-inspired lockdown gives this crisis the potential to be uniquely destructive. It also raises the risk of poorly targeted government intervention that skews incentives and prevents the economy from righting itself. What is needed is decisive but time-limited action to enable key businesses to survive while attending to some deep-seated problems with the UK's model of capitalism itself.

We identify at least two distinct phases of policy so far, and suggest that a third is necessary and ought to be in gestation:

1. The initial priority has been supporting cashflow and employment to buy firms time to get through lockdown. While extremely costly, this is worth doing as it will lessen the permanent damage to the economy that will leave us less prosperous in the long run. Nevertheless, while some business-relief measures could potentially remain indefinitely, the bulk of direct support for consumption and employment is set to be wound down over the late summer and early autumn. After that, broad strategic choices need to be made about the shape of policies for what comes next.
2. Attention is therefore now turning to the second phase of the response as the state begins to withdraw its financial lifeline from the private sector. The Treasury is drafting wide-ranging plans, dubbed "Project Birch", to rescue strategic firms at risk of collapse.<sup>3</sup> However, this needs to be done carefully and with a clear exit strategy in mind. Indiscriminate bailouts will favour larger, better-connected firms, leading to market concentration which stifles competition. This risks locking in low productivity for years to come at a time of rapid economic adjustment. From here on, the role of government should be primarily to offer macro-economic support and policy certainty while underwriting predominantly market-led restructuring.
3. These actions may help get us through the immediate crisis but are not enough to prepare the country for what is to come. Covid-19 also opens a window of opportunity to make lasting reforms to the underlying infrastructure of the economy that will make the market work better and restore public trust in business. The focus of this paper, therefore, is on what should be a third reform phase, which addresses deep-seated problems with the structure of UK capitalism itself.

The past decade has exposed two interconnected problems with UK capitalism: inadequate investment, which contributes to low productivity growth; and some questionable business models, which undermine public trust in the market. The rest of this section explores these in more detail and pinpoints their common cause: excessive short-termism.

**Figure 1 – Labour productivity annual growth rate**



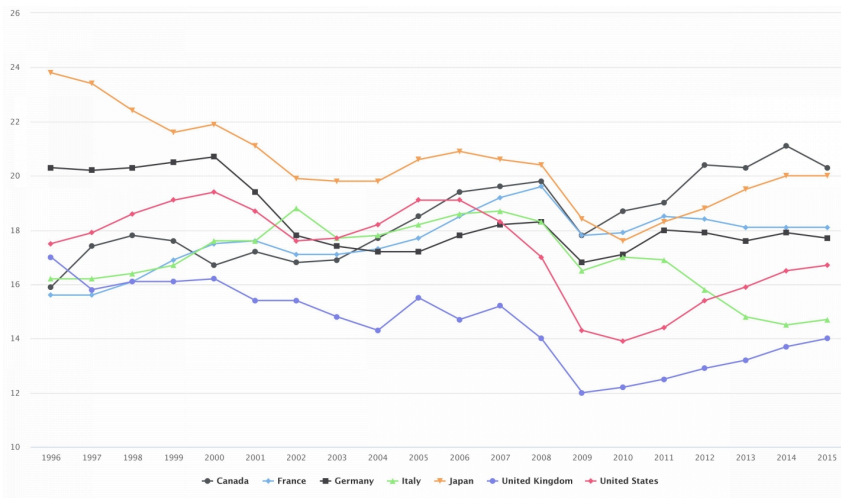
Source: OECD

### The Productivity Puzzle and Weak Investment

The critical economic issue over the past ten years has been the “productivity puzzle” which saw, in the decade since the financial crisis, the UK experience the weakest period of productivity growth in 250 years. UK labour productivity is just 3.6 per cent higher than in 2010 (Figure 1). Weak productivity growth is down to worse performance across a range of sectors important to the UK economy.<sup>4</sup> It is estimated to have cost the average worker £5,000 in lost wages and reduced GDP.<sup>5</sup>

One of the main causes of low productivity is too little investment by private companies. The UK has the lowest percentage of non-government investment in the G7 and spends less than most EU countries on R&D (Figures 2 and 3). This is despite near zero real interest rates since the 2008 crash, making it historically cheap to borrow. The precise contribution of low investment to weak productivity growth is a matter of conjecture. However, the ONS notes that since 2012, the UK has experienced significant “capital shallowing”, where the growth of capital has been slower than the growth in hours worked.

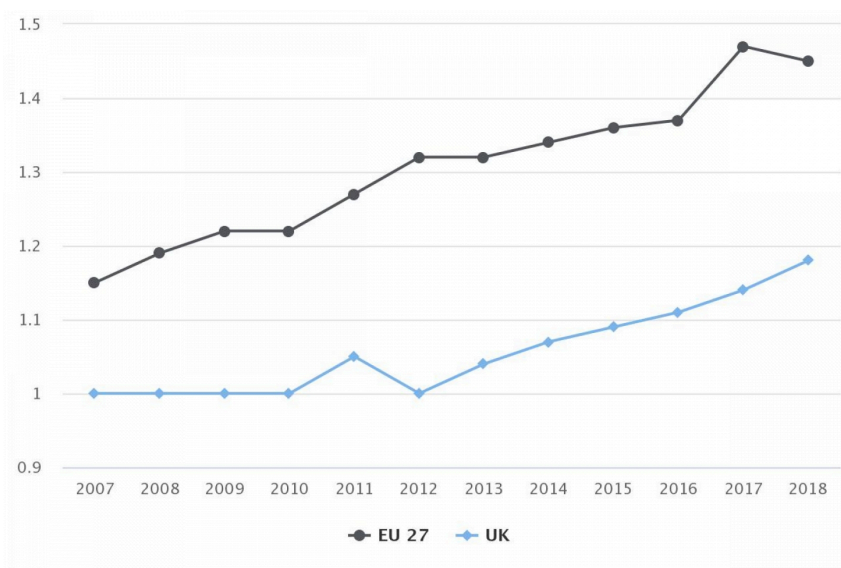
**Figure 2 – Non-government expenditure on gross fixed capital formation as a percentage of GDP**



Source: OECD

As our recent paper on public debt set out, a prolonged downturn will inflict permanent damage to the productive capacity of the economy and worsen the already grim outlook for public finances. A failure to restore productivity growth to its pre-financial crisis trend or better will exacerbate this problem further by undermining GDP growth and tax revenues in the future.<sup>6</sup> Business investment, already low by international standards, is likely to fall sharply (Figure 4). The Bank of England has warned that investment and productivity are set to slump as firms rebuild their balance sheets.<sup>7</sup> Indebted firms will be reluctant to invest, which both reduces GDP today and damages the economy’s long-term growth potential.

**Figure 3 – R&D spending by business as percentage of GDP**

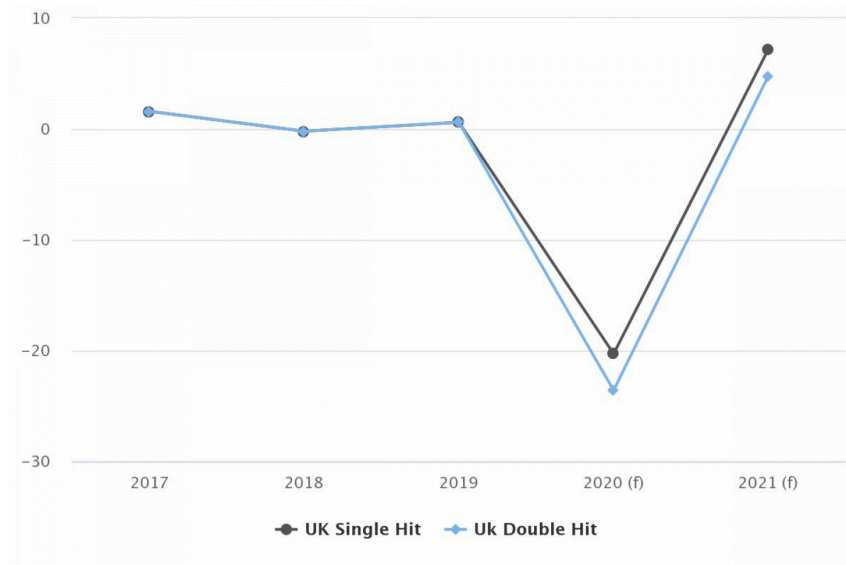


Source: Eurostat



As well as hampering the recovery from recession, underlying productivity and investment issues will also leave the UK ill-equipped to thrive in the growth industries of the future, particularly technology sectors and the knowledge economy. Structural economic change is heightening the importance of intangible assets such as intellectual property. These are non-physical, knowledge assets that are intrinsically difficult for investors to value and collateralise, hence there is a general tendency to under-invest in them. <sup>8</sup>

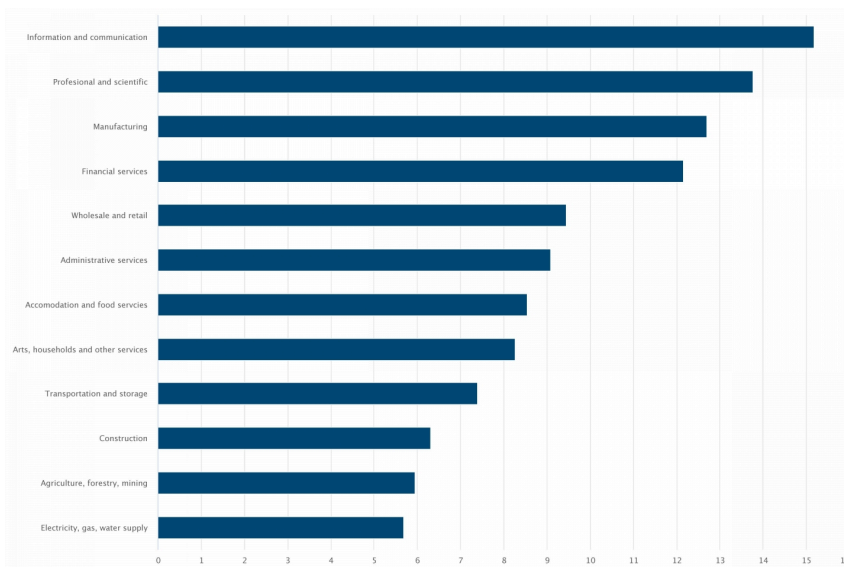
**Figure 4 – Forecast percentage change in investment (GFCF)**



Source: OECD World Economic Outlook, June 2020

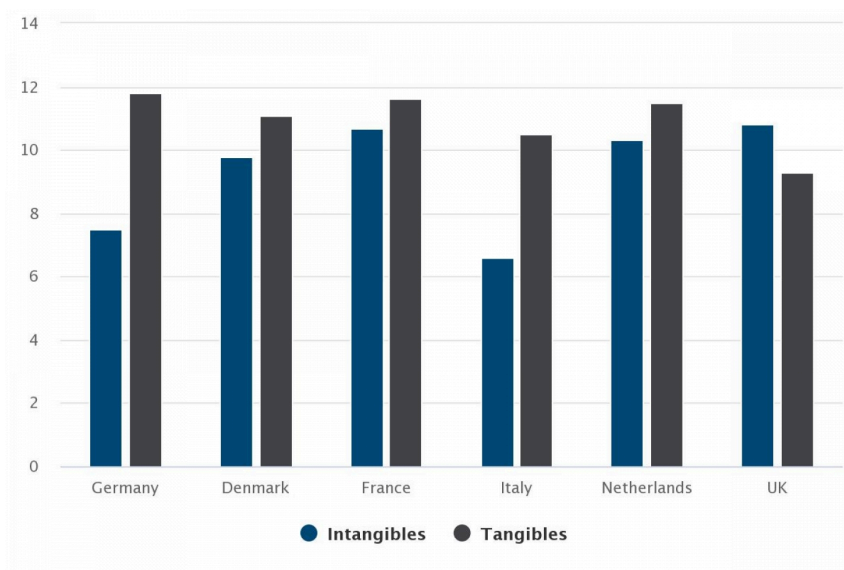
The key issue here is that intangible assets are particularly important for the services-dominated UK economy (Figure 5), magnifying the problem of low investment. Indeed, the UK is the only major European economy where intangible investment outweighs that in tangibles (Figure 6). An inability to resolve the under-investment problem therefore risks leaving the UK on the starting blocks in the race to develop knowledge-intensive industries of the future. This will be particularly damaging because the way to ameliorate the economic destruction wrought by Covid-19 is to accelerate the redeployment of productive assets to new industries with high growth potential.

**Figure 5 – Intangible investment as a share of adjusted gross value added by sector in 2016**



Source: ONS

**Figure 6 – Tangible and intangible investment as a share of GDP in 2013**



Source: Eurostat

### Collapsing Trust in Business

These failings lie behind the sluggish prosperity growth of the past decade. But they are also bound up with some poor corporate behaviour that has contributed to an erosion of trust in the market economy. Prior to Covid-19, debate was already raging about whether the UK’s model of capitalism worked properly for wider society and was optimal for fostering sustainable long-term growth and prosperity. Public faith in business naturally fell sharply after the financial crisis. But it was damaged further by a

number of corporate scandals, such as BHS and Carillion, as well as concern over excessive boardroom pay for often mediocre financial performance.<sup>9</sup>

Disquiet about corporate behaviour resurfaced during the pandemic over the behaviour of Leicester-based clothing suppliers to the retailer Boohoo. It was reported that they were paying workers below the minimum to work in dangerous conditions in order to service the company's fast fashion business model of cheap, disposable clothing.<sup>10</sup> While this is an extreme example, the episode exemplifies some of the consequences of the low-investment economy, with a business model reliant on paying extremely low wages, rather than investing in developing the skills and productivity of its workforce. Such a short-term, low-investment, low-wage model may enrich owners very effectively but is far less beneficial for its workers, local communities and the environment. The allegations against Boohoo and its suppliers provide an extreme example, but the controversy still resonates with many who see it as emblematic of deeper problems lurking in UK capitalism.

A focus on cost-cutting rather than investment appears to have encouraged growth of the “gig economy” via an employment model that keeps many workers on insecure contracts with few benefits, leaving them economically vulnerable and dependent on the state. The rise of the “precariat” exemplifies how this economic model has placed much of the burden of economic and labour-market risk on workers, producing debilitating insecurity for increasing numbers of people.<sup>11</sup>

The social costs of this economic model have been ruthlessly exposed by Covid-19. According to research by McKinsey, workers most affected by the Covid-19 shutdown are disproportionately those already paid the least.<sup>12</sup> This comes on the back of years of low wage growth, with typical incomes in low- to middle-income households lower now than in 2004 to 2005.<sup>13</sup> The *Financial Times* (FT) argues that these developments raise serious questions about the degree of economic polarisation that has taken place.<sup>14</sup>

Failure to address this has undermined political support for wealth creation through the market, particularly among the young. Surveys show more than half of Britons feel that the way business operates is bad for society. Asked why, the most common answer, given by more than two-thirds of respondents, was that companies thought profit was more important than looking after people. Most respondents said they wanted politicians to work in tandem with business to solve the problems facing the economy and society.<sup>15</sup>

To some, the highly interventionist response to Covid-19 therefore heralds a permanently greater role in the market for a newly activist state. Calls for using the new leverage to sequester assets and impose continental-style “stakeholder capitalism” – involving significant worker control of businesses – are getting louder. Many commentators argue that business owes society for the bailouts and should

henceforth behave with special reference to social concerns and economic fairness, enforceable through a new social contract.<sup>16</sup>

Notably, these sentiments are not confined to the left. Prominent critics of the current state of UK capitalism also include former Bank of England Governor Mark Carney, who has argued that an economic model based on short-term profit maximisation will be unsustainable post-Covid.<sup>17</sup> The *FT* has repeatedly criticised overly fragile business models vulnerable to disruption and unable or unwilling to offer security to their employees.<sup>18</sup>

These critiques have bite. Too many firms now in trouble during Covid-19 have been run in ways that exposed them to procyclical risks in downturns, ignoring the lessons of the financial crisis. Society suffers when short-termist companies choose low-wage, low-productivity business models as this shifts risks onto their employees and ultimately the welfare system, leaving taxpayers to pick up the tab during a crisis. Rent-seeking and cost-cutting by some firms are therefore not just a problem for the people who work there, or the communities they serve, but for the country as a whole. This is why an economic problem (low investment) has become such a burning political one (distrust in the market economy).

Politically, the government will now be under enormous pressure to stick to its “levelling up” agenda, which entails widening growth and job opportunities across the country that have arguably narrowed in recent years. To make progress it needs to act to force companies to jettison business models based on low labour costs and move towards a high-wage, high-productivity economy instead. Or, to put it another way, to replace a zero-sum, “pie-splitting” mentality with a “pie-growing” mentality that shares out more of the gains from business.<sup>19</sup> People want a socially responsible capitalism. Crucially, that is the same type of capitalism that invests in workers and R&D for better growth.

To summarise, Covid-19 did not cause the problems of low investment and fragile business models outlined above. Rather, it is a powerful shock to an already dysfunctional system that exposes the consequences of these failings for all to see. These revolve around the problem of short-termism, which incentivises fragile business models based on low investment, and have socially and economically corrosive effects that ultimately destroy faith in the market economy. Left unaddressed, these will weaken or delay the recovery from the effects of lockdown, and may ultimately foster political movements hostile to wealth creation through the market.

But before policymakers can begin crafting solutions, it is necessary to understand the root causes of short-termism, which are addressed in the next section.

## Why Reform Now?

Many of these problems with sections of UK business, notably their endemic short-termism, have been known about for a long time without ever being successfully addressed.<sup>20</sup> So what is the rationale for tackling them now when they have proved intractable in the past?

An important reason is that crises are often a very good time to tackle difficult problems and make deep-seated reforms. The phrase “never let a good crisis go to waste” may be an over-used cliché, but there is solid evidence from history that emergencies like Covid-19 offer valuable windows of opportunity to make big policy shifts, as established protocols break down and resistance to change is stifled.

While some progress can be achieved through incremental change, societies and economies often evolve more fundamentally through sharp breaks in existing practices caused by exogenous shocks. These are then followed by decades of stasis as people adjust to the new reality and new institutions form to manage the status quo. During the calmer phases of such cycles there is a status-quo bias against change due to uncertainty about the winners and losers of reform, and so even reforms that benefit the majority may be rejected by voters and blocked by vested interests.<sup>21</sup>

The turmoil of the Great Depression in the early 1930s produced the New Deal and a permanently greater role in the economy for government. Later, the exhaustion of the post-war economic “Golden Age” gave rise to decades of liberalisation following the oil shocks and exchange-rate turbulence of the 1970s.<sup>22</sup> Margaret Thatcher used this opportunity to overthrow the old economic order in the midst of a deep recession in the UK in the early 1980s. She did this not just by deregulating the market but by using the machinery of government to make it work better.<sup>23</sup>

But if major reform was not enacted following the financial crisis of 2008 to 2010, why expect it after Covid-19? The answer is that they are clearly different crises. The “Great Recession” that followed the Lehman Brothers collapse stemmed from a credit crunch that began in the financial sector and then spread to the real economy. Subsequent reforms were therefore confined to finance as this was widely assumed to be where the problem lay.

This time around, the economy faces a more widespread, and far bigger, shock from the Covid-19 lockdown, which comes after a decade of weak productivity and wage growth. Unemployment peaked at 8.4 per cent in Q4 2011, whereas the OECD now forecasts the UK jobless total to rise to 11.7 per cent by Q4 2020, or up to 14.8 per cent in the event of the second peak of infections.<sup>24</sup> For comparison, during the Great Depression of the 1930s, unemployment reached 15.4 per cent but took several years to get there. Facing an unprecedented, economy-wide shock, and with an epochal rise in unemployment in prospect, there is a clear opportunity to mount a restructuring to attend to the economy’s underlying flaws.

Governments are in a strong position to shape such restructuring if they are prepared to be bold. Thanks to its strategic position as the central agent in the economy, the state plays a powerful coordinating role and can underwrite and socialise the costs of transition. Raghuram Rajan, the former president of the Indian Central Bank, has urged the Indian government to seize the opportunity of Covid-19 to make deep-seated reform to the country's taxation and regulatory system.<sup>25</sup> This paper is calling on the UK government to be similarly ambitious in solving short-termism in parts of business that rob the economy of innovation and dynamism. This will also help to rebuild trust in business and markets, which are the main engine of growth.

Politically, there is already widespread acceptance of a major role for government through fiscal activism, supporting companies and subsidising employment. If anything, it may be more difficult to find arguments to limit, rather than justify, further intervention. Hence, it is particularly important that anti-market solutions are not allowed to gain traction at a time when market-led restructuring and fast GDP growth are needed. Instead, by showing vision now, the government can build an economy that will foster sustainability, help with the levelling-up agenda and make sure the new jobs that need to be created are well-paid, highly skilled and productive ones.

### **What's Driving Short-Termism?**

This section examines the causes of business short-termism. Its main argument is that short-termism is largely a rational response by company managers to incentive structures embedded in the organisation of UK capitalism. This argument is unpacked in six stages:

First, we argue that short-termism has its roots in the dominance of “shareholder primacy” doctrine, which prioritises the interests of investors and relies on performance metrics that exaggerate short-termist bias. Next, the paper examines the current debate on tackling this – the “purposeful company” and “stakeholder capitalism” agendas – which each try to dilute the influence of shareholders over company boards by introducing alternative imperatives and countervailing interests. The third section shows that it is the widely dispersed ownership of companies that is really at fault as this hinders the exchange of information between investors and managers needed to foster effective stewardship. The impact of technology in exacerbating this is also dealt with. Finally, the additional role of debt in fuelling short-termism is considered.

The problem of business short-termism has been the focus of a great deal of interest over the past decade. An important point to make initially, therefore, is the need to distinguish between surface and fundamental problems with UK business. For example, when examining the causes of the apparent detachment of business from society, it is often observed that the UK has the lowest rate of business investment in the OECD but tops the league for share buybacks and other devices for maximising shareholder reward.<sup>26</sup> Companies, it is alleged, are increasingly vehicles for wealth extraction rather than creation.<sup>27</sup> But, despite some high-profile scandals and corporate failures recently, UK firms are not

corrupt by international standards.<sup>28</sup> Nor are they, on average, especially badly managed.<sup>29</sup> A recent empirical study for the Department for Business, Energy and Industrial Strategy (BEIS) also debunks suggestions that executives enriching themselves through share buybacks and high pay are the main causes of low investment.<sup>30</sup>

This suggests that the corporate failings we see – low investment and business models that lack resilience – are not mainly due to incompetence or avarice but have their root in deeper, structural failings in UK capitalism. The real and fundamental problem with sections of UK business is a pervasive myopia that sees too many firms prioritise short-term returns over more socially useful investment offering longer-term, but uncertain, payoffs.

Myopic, short-term, profit-oriented firms will pick low wages and zero-hours contracts as their employment model over fostering a secure and highly productive workforce. Such strategies are bad for society and, in the long-term, bad for business as well, as they undermine faith in the market.

Under-investment would be less of a problem if other sources of long-term, “patient” finance for investment were widely available to firms. But, although the UK has the largest venture capital industry in Europe, it is still far smaller than the US. On the other hand, the UK also lacks a tradition of “relational banking” (small, commercial banks that develop long-term, insider relationships with companies) and major state investment banks found on the continent.

The short-termism problem has proved an extremely difficult nut to crack as it is not a straightforward policy failure but instead is a structural issue embedded in a set of formal institutions (company law, the structure of equity markets, rules on takeovers, executives’ remuneration and the tax regime with respect to debt) as well as informal ones (management and accounting practices and attitudes to company stewardship).

### **Short-Termism and Shareholder Primacy**

An increasing number of analysts now argue that a principal ingredient in short-termism is over-enthusiastic application of Milton Friedman’s theories of ‘shareholder primacy’. Andrew Smithers, a prominent City economist, argues that the UK’s underlying productivity weakness stems from chronically low business investment, which first began to slide from around 2000 after a decade in which shareholder-primacy doctrine had grown to dominate boardrooms and corporate-governance rules.<sup>31</sup>

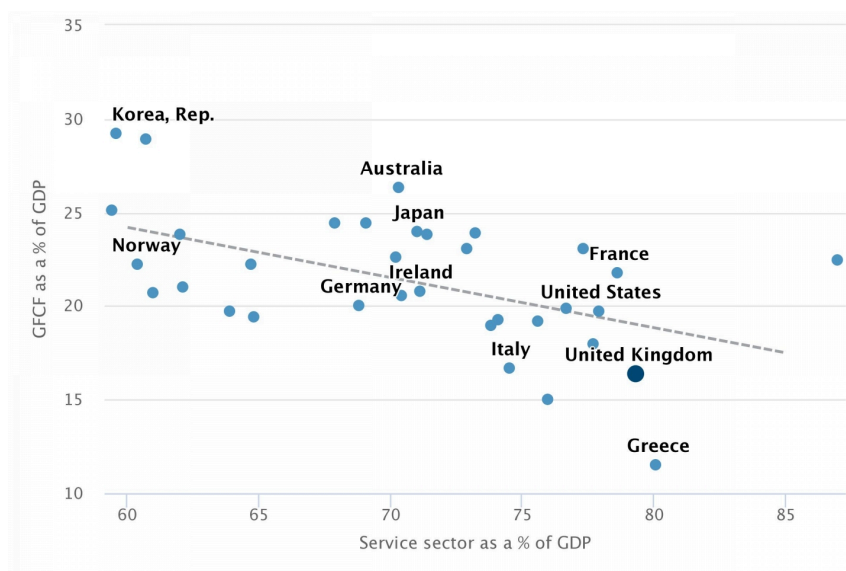
Shareholder primacy holds that shareholders are the beneficial owners of companies and managers simply their employees. Maximising shareholder value is therefore the sole purpose of a business and the primary duty of executives, rather than any wider responsibilities towards workers, communities or other stakeholders. The operating assumption behind shareholder primacy is that markets will discipline managers via the performance of the firm against investors’ targets.<sup>32</sup> But this rests on the assumption

that markets are efficient at conveying information about performance between companies and attentive owners. However, basic metrics for conveying this information, like earnings figures and share prices, have proved to be imperfect measures of performance that are heavily biased towards the short-term.<sup>33</sup>

But how do we know that under-investment is due to short-termism, rather than a dearth of suitable investment opportunities? A testable proposition arising from the question of whether short-termism stops firms investing is if shareholders are applying overly high discount rates to their market valuations – in other words, whether they are being excessively myopic about the likely payoff from future investments. Sure enough, using an asset pricing formula, Andy Haldane of the Bank of England finds significant evidence of investor short-termism in the US and UK between 1995 and 2004. This caused excessive discounting – taking an overly pessimistic view of the expected return on an investment – to be applied in eight years out of the ten covered by the study.<sup>34</sup>

One explanation sometimes given, though, for the UK’s lacklustre investment performance is that there is naturally less investment going on in service industries than manufacturing, as they are less capital intensive, and the UK has one of the largest service sectors in the world. To answer this, an ONS analysis regresses the share of services and manufacturing in GDP for the UK and other countries against their investment (GFCF) activity. The study clearly shows both the UK’s manufacturing and service sectors are below the trend line (Figure 7 plots this for the service sector).<sup>35</sup> In other words, there is less investment going on than would be expected given their relative shares of GDP.

**Figure 7 – Share of services in GDP against GFCF**



Source: ONS

Much recent academic research also shows that under-investment is concentrated in publicly quoted companies.<sup>36</sup> If so, this would further reinforce suspicions that the shareholder-value model is to blame



for this problem. Sure enough, testing this with UK data, Haldane finds that, on average, private firms have much larger stocks of fixed assets that will grow the business in future relative to turnover compared with comparable public ones, consistent with private firms reinvesting more of their profits in fixed assets.

### **Diagnosing Short-Termism: Purposeful Companies and Stakeholder Capitalism**

All of this strongly suggests that a large part of the under-investment problem lies in how public markets shape the incentives of company managers. This realisation has generated a great deal of debate about how to improve things.

Prior to Covid-19, there were two main schools of thought with regard to reforming business: the “purposeful company” agenda backed by some of the more thoughtful sections of business, and “stakeholder capitalism”, a more robust alternative involving employee ownership and putting workers on company boards. We examine each of these in turn.

Aware of public anger, some major companies were already pledging to temper their pursuit of profit with more “purposeful” strategies that seek to minimise harm to societies by holding themselves accountable to a wider range of actors besides shareholders.<sup>37</sup> This is welcome and should obviously be encouraged. However, not all firms will follow the lead of some of the major companies and investment funds (with valuable consumer brands to protect) vocally declaring purposeful strategies.<sup>38</sup> Others will see it as a convenient bandwagon to climb onto while doing little to change their business models.<sup>39</sup>

Various iterations of stakeholder capitalism have therefore also been mooted. All the three main UK political parties have at some point advocated putting workers on company boards, a key stakeholder tenet. Theresa May pledged to do this on the steps of Number 10 on becoming prime minister, although the idea was dropped from the Conservatives’ 2019 Manifesto. (In the US, Elizabeth Warren, the former presidential candidate, made instituting stakeholder capitalism a key plank of her platform.<sup>40</sup>)

Stakeholder arrangements are particularly popular on the left because of their association with the wealthy but egalitarian social-democratic economies of continental Europe. The essence of the stakeholder theory of the firm is a moral view that *all* groups with a legitimate interest in a business have the right to benefit from its operation, and it should not be left to the market to determine how these benefits are distributed among them.<sup>41</sup> Stakeholder capitalism is therefore different from the purposeful company agenda as it is more concerned with the distribution of the benefits from the company’s activities than determining what these activities are.

But, while more purposeful companies are probably a necessary, rather than sufficient condition for rewiring capitalism, stakeholder arrangements could actually damage UK business. Comparisons with successful stakeholder economies are often misleading. There are myriad reasons why countries like

Germany are successful that have nothing to do with worker-directors – their excellent vocational training regimes and dense systems for knowledge transfer among companies, for example.<sup>42</sup>

Many UK firms do well in global high-technology sectors that require managers to spot opportunities early and have the agility to exploit them without needing to appease multiple stakeholders. Stakeholder capitalism would be unlikely to work properly in the UK and would instead place roadblocks in the way of businesses attempting to compete in fast-moving global markets.

Nor does it rule out corporate misbehaviour. Workers, as well as the government of Lower Saxony, were well-represented on Volkswagen’s supervisory board. But this didn’t stop the German auto giant from cheating on emissions tests for diesel cars for years before being exposed in 2015.<sup>43</sup>

Stakeholder arrangements such as worker-directors can expand the range of interests represented on company boards to include its workers, which is not necessarily a bad thing. But it seems unrealistic to expect that these will steer the board to pursuing the wider interests of society as opposed to narrower objectives, for example higher pay and better working conditions for insiders. The approach that is needed is to make the structural changes necessary so that pursuit of profit works in the interests of all stakeholders: shareholders, employees *and* wider society.

Unfortunately, neither the purposeful company agenda nor full-fat stakeholder capitalism seem likely to deliver this. The former, because it will lift some, but not all, boats. The latter, because it introduces unnecessary rigidities into an economic system that thrives by being nimble and flexible. Solving the problems of UK shareholder capitalism requires a clear-eyed focus on the incentives operating on owners and managers and on what may inhibit engagement between the two. A critical issue, explored next, is the wide ownership dispersion of UK firms, responsible for the phenomenon of “ownerless” companies.

### **Companies and Short-Term Investing**

If the shareholder model is to blame, then why do UK firms invest so much less than American firms when both countries have corporate-governance systems geared towards delivering shareholder value? Business investment by both private and public US firms is higher than in most other OECD countries and way ahead of the UK (see Figure 3 above). This disparity further narrows down the list of possible culprits for the under-investment problem as it suggests that nationally specific features of the UK’s shareholder model are responsible for excessive short-termism.

Ideally, of course, financial systems include a mix of both long- *and* short-term investors. There is nothing necessarily wrong with investing for the short-term. Liquid stock markets with a lot of active buyers and sellers of shares can be valuable in allocating capital to where it is most needed. Meanwhile, long-term investing has been implicated in stock market bubbles. The dotcom boom of 2000 was

arguably inflated by a market too willing to value firms with no immediate earnings as great investment prospects.

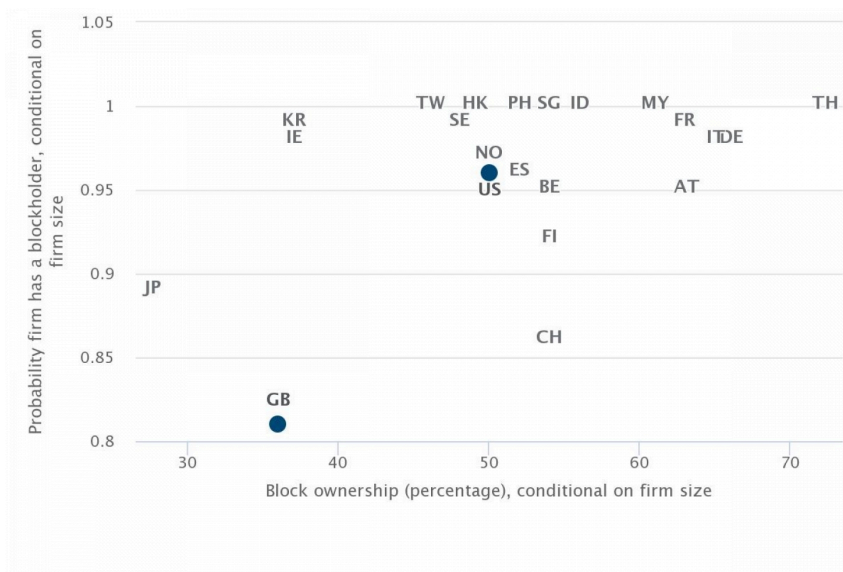
The critical thing about shareholder's time horizons is that these determine the level of engagement they seek with company managers, and more engaged shareholders are more willing to tolerate short-term underperformance for long-term gain. This is important, as investment is usually booked as a cost in companies' accounts, even if it contributes to the long-term value of the firm so, in principle, more engagement could be a necessary condition for long-term investing.

A distinction should therefore be made between engaged owner-shareholders and shareholders as short-term investors. The former is prepared to assume a "stewardship" role over firms they invest in by overseeing the strategy and conduct of managers through exercising Voice (engagement); the latter is mostly interested in earning a return on their investment and will Exit (sell up) if financial results disappoint.

Clearly, therefore, a country seeking to maximise business investment to correct low productivity will want to encourage the former group as much as possible. In other words, it will want to replace shareholder capitalism with what has been dubbed "stewardship capitalism".<sup>44</sup> However, the UK's notably low level of business investment, together with strong evidence that myopic attitudes are concentrated among public firms, suggests a financial system that does a poor job of dividing groups of shareholders into: 1) those whose investment strategies hinge on exploiting short-term share price gains and are uninterested in long-term performance; and 2) more patient investors prepared to risk short-term losses for long-term gains.

What seems to be happening instead is that the way the system operates creates an unusually large third group of *potential* long-term investors who nevertheless act myopically (but rationally) by shunning risky investments with long-term payoffs in favour of short-term gains as this is the optimal strategy in the UK's version of shareholder capitalism. In other words, they belong in group 2, but default to group 1.

**Figure 8 – International comparisons of ownership dispersion and blockholdings**



Source: Faccio and Lang 2002

Of course, no financial system is free from such adverse selection. But analysis by the Big Innovation Centre suggests that the UK's structural bias towards short-termism owes to an extreme application of shareholder primacy to its corporate-governance system.<sup>45</sup> Far from being comfortably in the mainstream of Anglo-Saxon shareholder capitalism, the UK is in fact a corporate-governance outlier, which contributes to weak engagement between owners and managers (Figure 8).<sup>46</sup>

A key feature of the system is the extremely fragmented ownership of public companies. In the UK, the majority of equity is held by financial institutions, mainly pension funds and life insurance companies, whose interest in making a steady return from company dividends is balanced by the need to spread investment risk among many small shareholdings.

According to Lord Sainsbury, the former science minister, because of the way the financial services industry is structured, many managers of UK pension funds charge high fees and invest short-term in order to “beat the benchmark”, while failing to perform stewardship.<sup>47</sup> A key reason for this is a lack of scale. The average of the UK's 5,794 funds has 1,800 members (but two-thirds of funds have fewer than 1,000) and manages £200 million of assets. On the other hand, Dutch pension funds manage a similar size of total assets (£1.3 trillion, compared to £1.5 trillion for the UK) across only 308 schemes.<sup>48</sup> The small scale of UK pension funds means they cannot buy significant stakes in companies and so spread risk instead, reducing opportunities for stewardship. Many of these funds have also outsourced their investments to specialist asset managers, a large proportion of which are based overseas.

This distance between owners and the managers of the companies they invest in erodes trust and increases the cost of monitoring and control, discouraging long-term engagement between the two sides. The wide ownership dispersion and growth of intermediaries means even diligent investors may lack

the ability, or inclination, to closely monitor the long-term strategies of managers as this information is costly to acquire.

Lacking detailed inside knowledge of company strategy, and seeking short-term gain, minority shareholders can be intolerant of long-term investments with uncertain payoffs and so tend to judge the success of their involvement with the firm on narrow, monetary terms instead. Wide ownership dispersion therefore fosters “ownerless companies” in the hands of unengaged shareholders. Faced with potentially profitable but risky investment prospects, these investors all too readily default to a strategy of “Exit without Voice” as they lack reliable information about the long-term plans of company managers. The next section explains why information is so important in determining investor engagement.

## Information and Engagement

The Kay review of equity markets was the last official review to look seriously at the structure of equity markets.<sup>49</sup> Kay addressed the question of ownership dispersion but suggested that the critical issue in under-investment and growth of intermediation was a paucity of trust, not a lack of information specifically, and advocated an Investors Forum to resolve this. Kay pointed out that shareholders in the UK have access to a wealth of financial information about company performance. Besides real-time data on share prices available to anyone with a smartphone, public companies are obliged by law to publish bi-annual or even quarterly earnings reports. What more information could investors possibly need?

The flaw in this reasoning may be that it is not necessarily lack of information per se, but a lack of the right kind of information that will enable investors to evaluate the risks and rewards of investing, particularly in intangibles. Economists make a crucial distinction between *information*, which is codifiable and hence can be easily packaged and conveyed to others, and *knowledge*, which is rooted in an implicit, or *tacit*, understanding and is much more difficult to communicate.<sup>50</sup>

Lack of engagement between owners and managers due to ownership dispersion makes it very difficult to reliably convey detailed, tacit knowledge about future plans. Firms may be afraid of sharing sensitive information about their long-term strategy through public channels as it could weaken their competitive position. Investors pondering whether a company is a good longer-term investment will instead focus on publicly available information such as quarterly reports and share prices. But these are short-term, backward-looking, indicators that may not fully reflect the underlying value of the business.

The sheer amount of data available could even be part of the problem. By one estimate, 90 per cent of all the world's data has been produced in the previous two years.<sup>51</sup> Some analysts argue that the proliferation of data makes it hard for companies to inform investors about developments relevant to

their business. They also lack the ability to prevent false or conflicting information from being reported, so risk losing their ability to shape perceptions among stakeholders and the public about their brand.<sup>52</sup>

Accordingly, accountants report that sell-side analysts pay little attention to narrative reporting and are interested almost entirely in numbers.<sup>53</sup> Discontent with the performance of expensive, managed funds is fuelling the popularity of passive investment funds where ownership is even more disengaged.<sup>54</sup>

Ultimately, intermediation and the extension of the investment value chain means fund managers are increasingly overloaded with the wrong kind of information, discouraging stewardship.

### Technology Exacerbating Ownerlessness

Trends in technology may be exacerbating this problem. High-frequency trading (HFT), where shares are traded electronically at lightning speed by algorithms, and exchange traded funds (ETFs), which retain a human element for the moment but are structured to closely track an index, obviously create even greater distance between owners and managers. No hedge fund manager relying on HFT techniques is likely to show up at an investor meeting, for example. The inexorable growth of Vanguard, the \$6 trillion US asset manager that offers low cost, index-tracking ETFs to retail investors, is sparking fears that its dominance is distorting markets and weakening stewardship.<sup>55</sup>

As artificial intelligence (AI) and machine learning (ML) make further inroads into market operations and business intelligence, their effect may well be to further increase the distance between investors and managers. The plethora of information, coupled with the ever-decreasing cost of AI and ML, is likely to further increase the returns to versions of HFT that place a negligible value on face-to-face engagement with managers.

Even where (human) investors retain the instinct to seek out long-term value, share-trading apps enhance Exit options and lower the transaction costs for this by making it ultra-easy to sell shares. This further erodes any incentive to engage with managers, as Voice tends to be enhanced where options for Exit are “sticky”, not where they are absent or abundant.<sup>56</sup>

Of course, technology such as share-dealing apps provide more financial information for investors, but in a more easily digestible format than before, so the overload problem might be surmounted. But, again, it is not going to be the kind of private information necessary for building dialogue and trust with managers about their long-term plans for the company. Accounting standards, which have failed to keep pace with the growing importance of intangibles, risk being left even further behind by technology.<sup>57</sup>

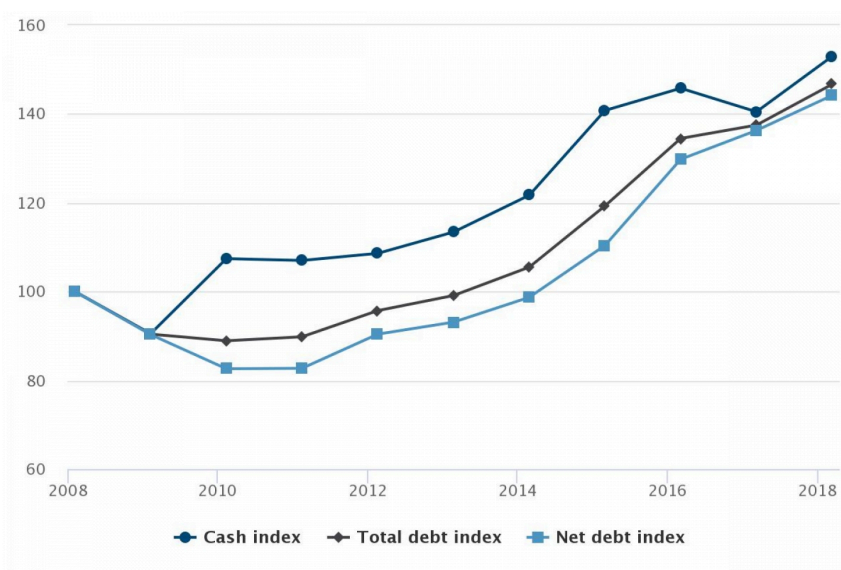
Nevertheless, the UK is not the only economy where application of technology may inhibit Voice and discourage stewardship. Are other factors at play here?

## Debt and Short-Termism

Another contributor to short-termism and low investment is over-reliance on debt. A preference for debt over equity finance is associated with short-termist business models. It is perversely encouraged by favourable treatment from the tax system as dividends are paid out of taxed profit but interest payments are deducted from taxable income, which amounts to a subsidy to take on debt. Over-leveraging exposes the company to liquidity spirals and procyclicality and is increasingly being recognised as a serious risk.<sup>58</sup>

Debt is a growing problem. Borrowing by UK firms rose for the eighth consecutive year in 2018-19 to £443.2 billion – a 75 per cent increase over seven years (Figure 9). Unlike the productivity and investment issues, the UK is not an international outlier on corporate debt levels (Figure 10). But it is a potentially serious issue in a low-productivity, low-investment economy as high debt makes financial systems fragile and encourages financial engineering over investment.

**Figure 9 – Debt and cash positions for UK non-financial corporations, indexed to 100 in 2008/09**

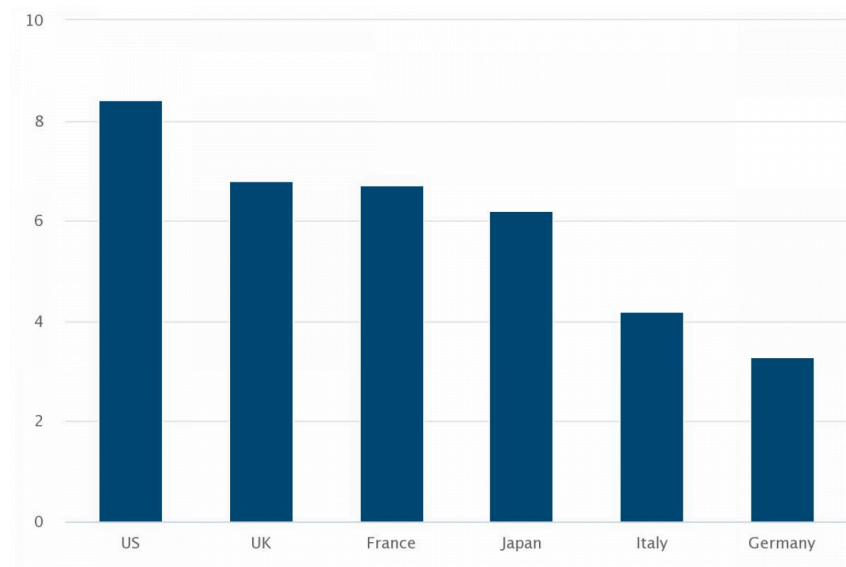


Source: Link Asset Services

Numerous studies find a negative correlation between debt levels and investment by firms. The OECD argues that productivity growth depends in part on the outcome of research, innovation and product development. All of these require longer-term risk-taking for which equity capital is better suited than debt.<sup>59</sup> The more leveraged a firm, the more its managers concentrate on making regular interest payments on the debt, and thus the greater the resulting focus on short-term strategies for cash generation at the expense of long-term investment.<sup>60</sup> International evidence suggests this is a particular issue for high-growth firms.<sup>61</sup>

The Kay review of short-termism in equity markets noted the decline in equity as a source of funding for UK listed companies and a reduction in the number of firms listed on UK stock markets, attributing this to a growing preference for debt.

**Figure 10 – Debt to surplus ratio for non-financial corporations, 2018**



Source: OECD

The pandemic exacerbates problems for companies with highly leveraged balance sheets. It is estimated that a 25 per cent decline in revenues shifts the average firm from a 16 per cent operating profit to an 18 per cent operating loss.<sup>62</sup> Firms are likely to respond to ensuing cashflow pressures by taking on yet more debt. Moreover, the current bailout structure is based on loans and so inadvertently worsens the debt problem.

The *quality* of debt issued also raises macro-stability concerns which, in the long run, is also bad for investment as firms will not invest in a volatile economic climate. The proportion of risky, sub-investment-grade debt (rated below BBB) has risen from 8 per cent to 50 per cent in the past 20 years.<sup>63</sup> Prior to Covid-19, the OECD was already warning that swollen corporate debt levels could cause a new financial crisis.<sup>64</sup>

Overall, therefore, weak incentives for stewardship capitalism combine with other causes, such as a preference for debt over equity, to create a perfect storm of factors that make short-termist business models unduly attractive to companies. How can this be tackled effectively?



## Solving Short-Termism

Policymakers have been aware of these problems for some time and have correctly diagnosed a prime cause of short-termism as the lack of incentives for shareholder engagement with company managers.<sup>65</sup> There is also an increasing acknowledgment of the contribution of the tax system to over-leveraging.<sup>66</sup>

On ownerless companies contributing to a lack of engagement, two main strategies have evolved for resolving this. The preferred route so far has been regulation to foster stewardship via codes of practice. But this has been hampered by a paucity of hard levers to achieve this and opposition from financial institutions happy with the status quo. An alternative is the creation of mutual commitment devices and improvements to the flow of private information about long-term strategies between managers and potential long-term investors. We examine these in turn.

### The Corporate Governance Code

The current Corporate Governance Code detailing good practice by managers was set out in 1992 following publication of the Cadbury report.<sup>67</sup> Two key things to note about the code which have attracted voluble criticism are that it consists of principles, rather than detailed rules, and is strongly voluntarist in nature.

The code does, at least, define the purpose of corporate governance, which is to “facilitate effective entrepreneurial and prudent management that can deliver the long-term success of the company”. Follow-up legislation has also clarified the role of company directors vis à vis shareholders. Section 172 of the 2006 Companies Act requires that they act in the best interests of the company’s members (its shareholders) while also having regard to other stakeholders. But critics argue this is too lax as stakeholders’ interests are still subordinated to those of shareholders.<sup>68</sup>

The Kay review of short-termism identified the UK Stewardship Code – the part of UK company law concerning principles that institutional investors are expected to follow – as the key vehicle for fostering a more expansive form of stewardship that would focus on long-term, strategic issues as well as day-to-day corporate governance.<sup>69</sup>

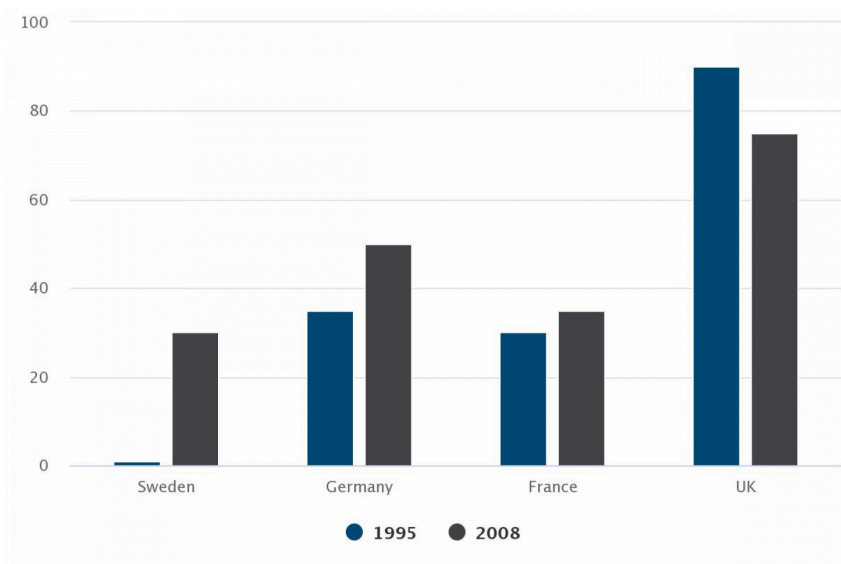
However, the Stewardship Code, which is overseen by the Financial Reporting Council (FRC), was criticised as ineffectual in a 2018 review for the BEIS.<sup>70</sup> John Kingman, chairman of Legal & General and the review’s author, observed that the FRC was effectively a private institution with no statutory basis that did little to encourage stewardship.

Accordingly, the Code was relaunched in early 2020 with tighter rules on disclosures and more focus on “outcomes rather than policy statements”.<sup>71</sup> But the jury is still out on whether the new version will be

any more effective. A big problem with any code of practice lacking hard sanctions is that it is essentially gameable if it fails to change the underlying incentives facing investors. As these investors are highly dispersed and face collective-action problems over monitoring, they are not naturally predisposed towards stewardship. As the Investment Managers Association told the Kay inquiry, asset managers see their main role as making risk-adjusted returns for their clients. Their expertise lies in stock-picking, not engaging with managers.<sup>72</sup>

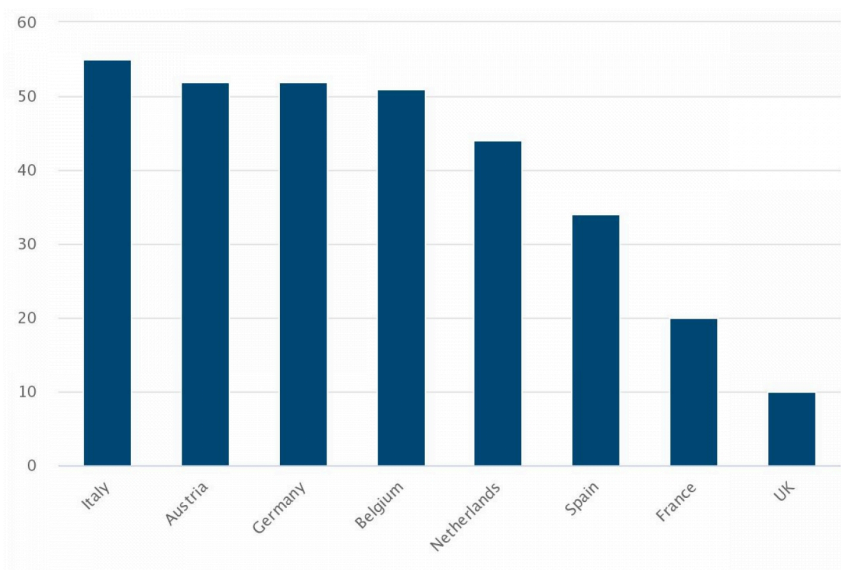
BlackRock, the world's largest fund manager, warned a parliamentary inquiry that enhancing the code would not necessarily lead to more engagement with firms because asset managers would always put their clients first. If their clients have no financial interest in engagement, then engagement is not going to happen.<sup>73</sup> It is difficult to see how a code, however toughly worded, can alter this if it doesn't address fundamental, structural problems responsible for sub-optimal behaviour in the first place.

**Figure 11 – Percentage of top 20 firms without a blockholder owning greater than 10% of shares**



Source: Beramendi

**Figure 12 – Median size of largest ultimate outside voting block for listed industrial companies**



Source: Becht and Roell

### Blockholdings of Committed, Long-Term Investors

An arguably more effective way of cementing engagement between company owners and managers is by directly tackling the ownership dispersion problem mentioned in the “What’s Driving Short-Termism?” section of this paper. A good way of doing this is to encourage more “blockholdings” – groups of committed investors whose significant shareholdings mean they have significant “skin in the game” and therefore have more to gain from exercising stewardship.

A corollary of its extreme ownership dispersion is that the UK has fewer firms with significant blockholdings compared with other countries (Figure 11)<sup>74</sup>, and where they exist the median size of blockholders tends to be smaller (Figure 12)<sup>75</sup>. Blockholding is very common in continental European companies.<sup>76</sup> Even in the US, most public companies have one or more large-percentage shareholders and so the ownership concentration of US corporations is, if anything, more similar to other countries than to the UK.<sup>77</sup> This may explain why US firms invest a lot more than UK firms even though the two countries have the shareholder model in common. The reason for the divergence between the US and UK shareholder systems is due to greater pressure from owner-founders in the US to retain more control.

But if information asymmetries are behind the lack of engagement between investors and managers that is fuelling short-termism, then what evidence do we have that more blockholdings are the solution? Some empirical studies have noted that not all public companies are myopic when it comes to intangible investments. Companies with more institutional investors<sup>78</sup> or more concentrated ownership<sup>79</sup> appear to invest more and do more R&D.

Holders of significant blocks of shares are more sophisticated investors who are prepared to expend the effort to uncover private information about fundamental value unavailable to others with shorter time horizons. This could be information about new investments or projects that managers are reluctant to reveal through public channels because they are concerned about the effect on investor sentiment.

Instead, blockholders tend to use private discussions with management or the board to exchange tacit knowledge about investment prospects. These typically occur behind the scenes and are unobservable to outsiders.

Such blockholders could be important company stewards as they have the strongest incentives to gather the kind of private information relevant for intangibles that is especially important for long-term investment. They have more invested and at stake, so the trade-off for them between effort (the gathering of information about the long-term strategies of the firm) and reward (a potentially more profitable investment) favours active monitoring of management. With more blockholders, companies are better able to segment their investor base in order to improve dialogue with key investors regarding long-term value creation. <sup>80</sup>

Encouraging blockholdings is backed by academics such as Professor Alex Edmans of London Business School, as well as the British Academy project on purposeful companies and the Big Innovation Unit. Academic research since the Kay review only strengthens the case for blockholdings. In an extensive review of the literature and evidence on blockholdings, Edmans and Holderness report that they are correlated with lower executive pay levels, higher investment levels and lower accounting fraud. They argue that these benefits accrue because blockholders have access to superior, private information about company strategies. <sup>81</sup>

Progress on achieving long-term Environment, Social and Corporate Governance (ESG) goals is also enhanced by collaboration between prominent groups of international investors with common ownership of several companies, and the chances of an investor doing this rises according to the size of their blockholding in the firm. <sup>82</sup>

Warren Buffett is a good example of a blockholder. The veteran, and highly successful, US investor typically buys blocks of shares in companies he believes have long-term potential. Buffett famously remarked that the ideal holding period for a share is eternity – the ultimate long-termist approach.

Buffett is not a particularly activist investor. The “Sage of Omaha” invests in companies with strong market positions and effective management, then lets their bosses get on with it. But what he shares with other blockholders is an investment mindset that favours companies with long-term strategies typically based on: a skilled workforce (which is good for human capital and workers themselves), more capital investment and R&D (which will help productivity) and more awareness of the importance of their brand (so they will respect the environment, pay their taxes and show restraint on executive pay).

Buffett's large stakes in these companies give him an interest in seeking out long-term value; and as a major shareholder, managers of these firms have a strong incentive to keep him well informed about their plans. In other words, they are anything but ownerless.

Blockholders with long-term perspectives may also be more tolerant of businesses with what Professor Colin Mayer calls "idiosyncratic capital".<sup>83</sup> These are firms with an unusual business model that is difficult to classify – a square peg in a round hole. For success, they rely on ideas and knowledge that is intrinsic to the success of the firm but not available to outside investors.<sup>84</sup> Hence, this could entail them dipping below the radar of short-term investors, even though they are capable of long-term value creation.

Cadbury's milk chocolate and the Ford motor car are examples of products of idiosyncratic value. In both cases, their founders struggled against sceptical shareholders and only got their way by keeping a controlling stake in their company.

A possible drawback of concentrated ownership is that, in resolving the agency problem, they create a second conflict in that the interests of holders of blocks of shares may conflict with small shareholders. Historically, UK regulators have taken this problem more seriously than others in providing significant protection for minority shareholders. The suggestion of the Kay review that these had gone too far and should be relaxed appears to have been vetoed by investment managers, and policymakers need to look again at this.

Likewise, excessive leverage may also have been fostered by misaligned public policy. Companies for some time have been encouraged to take on excessive debt through its unequal, and overly favourable, treatment in the tax system compared with equity. The urgent need to get cash to companies affected by Covid-19 risks further increasing indebtedness. To avoid serious problems further down the line, governments need to act to correct these anomalies in the tax system.

Overall, it seems highly likely that the extreme ownership dispersion of UK public companies – coupled with the problem of excessive debt – is a critical issue that will need to be overcome in order for businesses to maximise investments, particularly in critical intangibles. The next section examines some policy changes to deliver this.

# Policies for Long-Term Stewardship Capitalism

To briefly recap, the key problems with the UK's capitalist model are: shareholder value maximisation underpinned by overly short-termist performance metrics; extreme ownership dispersion, which inhibits the exchange of tacit knowledge about investment intentions between owners and managers necessary for proper stewardship; and a tax system that favours debt over equity. Neither the purposeful company agenda, nor stakeholder capitalism, address these issues head on. What else can policymakers do to tackle them?

We suggest a set of reforms in four areas. First, encouraging more concentrated ownership of listed companies. Second, removing various legal and institutional barriers to stewardship and changing how company performance is measured. Third, removing incentives to issue debt rather than raise equity capital. And, fourth, encouraging other sources of long-term, “patient” capital supportive of stewardship, such as sovereign-wealth funds.

## I. Encouraging stewardship through more concentrated ownership

*Regulators should encourage private and family companies to list and reduce the impediments to forming controlling blocks of other shareholders.*

The Big Innovation Centre has suggested that the Financial Conduct Authority should facilitate block formation by relaxing disclosure requirements, bringing them into line with the EU and US, and allowing them to receive inside information where this facilitates engagement. Small shareholders should also be barred from voting with borrowed stock. This device is often used to swing important votes and gives an excessive amount of power to short-termist investors with small stakes in companies.<sup>85</sup>

Rules to encourage blockholdings should also seek to foster idiosyncratic capital by allowing entrepreneurs with a singular vision to keep control of the businesses they have created while they pursue their goal. In the US, dual class shares at the IPO stage are more common than in the UK, and a number of technology companies – including, Facebook, Google and LinkedIn – have used the device to allocate extra voting rights to their founders. UK founder-entrepreneurs should be allowed to do the same as, while such concentrated control does not guarantee success, it is more conducive to longer-term thinking.

It has also been suggested that large institutional investors with portfolios spanning significant common owners with long time horizons could be legally mandated to collaborate in getting public firms to focus on ESG goals as part of their core mission and purposes of the organisation.<sup>86</sup> In the US, for example, the three largest index investors in the US – BlackRock, State Street and Vanguard – have engaged

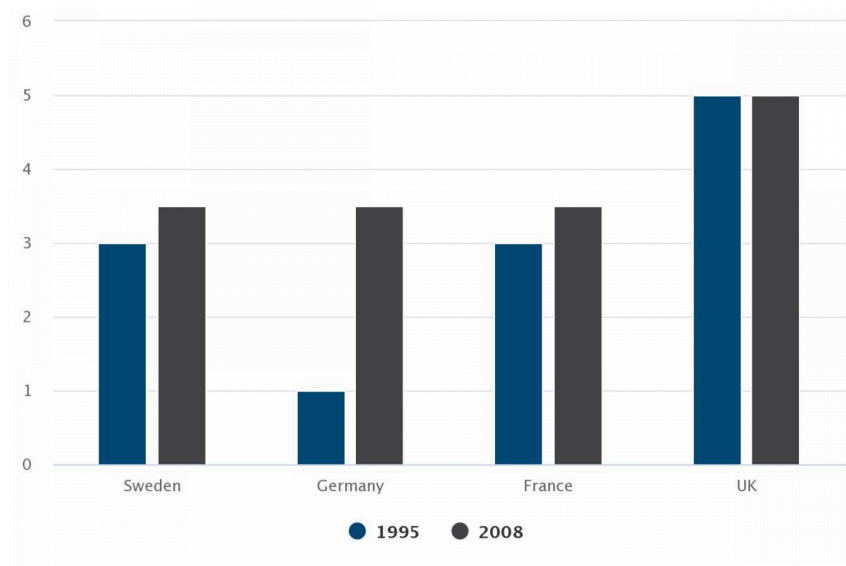
positively with the management of large firms over ESG issues as they have significant overlapping shareholdings.

Long-term capital trusts (LTCTs) have also been mooted as a way to incentivise pension funds to collaborate on stewardship. These are “funds of funds” that pension funds, and other asset owners, can invest in. The way pension funds are structured at present mitigates against stewardship as risk diversification and the small scale of funds discourages concentrated ownership, which is a precondition for stewardship.

Merging pension funds could be difficult, however, and so an all-party parliamentary group has suggested LTCTs as an alternative.<sup>87</sup> These would provide stewardship of the companies, as they would have larger stakes, and would also be in a position to block hostile takeovers if these did not offer long-term value creation. Trade unions could also take more direct control of their members’ pension assets rather than delegating these to professional asset managers, as the Trade Union Congress (TUC) has urged.<sup>88</sup>

Finally, small (“minority”) investors enjoy an unprecedented level of legal protection in the UK. This is usually justified as preventing managers or larger shareholders from overriding their interests, but it may encourage small and highly liquid shareholdings as opposed to larger, controlling blocks of shares that would encourage stewardship (Figure 13).<sup>89</sup> These protections could be watered down or removed.

**Figure 13 – Shareholder protection index: 0 to 5 = highest**



Source: Beramendi

## 2. Reforming the corporate governance regime

*Rules on a range of corporate-governance issues should be recast.*

The creation of larger, more engaged shareholdings and moves to allow collaboration between owners will create incentives for greater stewardship. But there currently exist impediments to the exercise of this, and this should also be attended to.

For example, the sections of the UK Companies Act (2006) that deals with shareholders' interests currently fail to protect companies that deviate from shareholder value creation. The act could be rewritten to specifically encourage them to pursue long-term value creation through investment. <sup>90</sup>

The purposeful company agenda, which could potentially form an important part of the stewardship capitalism we want to see, could also be strengthened and made more widespread. This could be done by allowing for more shareholder votes, including on social issues such as worker's conditions and the firm's carbon footprint, and make it easier for shareholders of listed companies to pre-commit the company to a broader corporate purpose.

Andrew Smithers has also suggested forcing companies to replace a high share price and profitability with improvements to firm productivity and creation of human capital as the main yardsticks for executive remuneration.

## 3. Discouraging debt

*The corporate tax regime should be changed to equalise the currently unequal treatment of debt and equity finance.*

At present dividends are paid out of taxed profit but interest payments are deducted from taxable income. This amounts to a subsidy to load up on debt – the negative consequences of which are discussed earlier in the paper. Equity is a better financing instrument for long-term, high-risk investments, as well as for investments with uncertain payoffs. But uncertainty over Covid-19 will likely have negatively affected firms' appetite for long-term equity capital, and IPO activity has dwindled significantly.

Tax incentives are not the only reason for the increase in corporate debt, as prolonged low interest rates have also played a part. In a low-interest-rate environment, people and companies are encouraged to take on debt, which is destabilising.

However, since it is going to be some time before interest rates normalise, the tax treatment of interest coupons and dividends should in future become neutral by taxing profits before deduction of interest. To



aid the transition for highly leveraged companies, the overall corporate tax rate could be reduced, with extra allowances for investment in productive assets, as the City commentator Richard Bronk has suggested. Exceptions should also be made for the financing of working capital since high stock levels also help corporate resilience.<sup>91</sup>

#### 4. Increasing the supply of “patient capital”

*The UK should attract more capital from long-term-orientated sovereign-wealth funds prepared to exercise stewardship over companies they invest in.*

The government’s 2017 review of patient finance led to a number of reforms in that year’s Budget, including more capital for the British Business Bank. But the sums are still small and mostly directed at startups and SMEs rather than established firms. An alternative is to encourage more investments from sovereign-wealth funds (SWFs).

SWFs are the world’s largest set of international investors and providers of patient capital, managing around \$8 trillion of assets in 2018.<sup>92</sup> To their advocates, SWFs have a long-term orientation, can push for public goods (like environmental sustainability) and offer counter-cyclical investment strategies important in building resilience to crises. Crucially, they can also play a positive role in corporate governance as their large size allows them to take significant blockholdings in a number of individual companies while still spreading their risk.<sup>93</sup> Norway’s NBIM (set up to invest its North Sea oil wealth) is an example of the type of SWF that should be actively courted. It is the world’s largest SWF and commits to improving the corporate governance of the companies it invests in.

However, SWFs are diverse. A key distinction is that they can offer patient capital that is either passive (where they support the board, but without demanding a say in the company’s management) or active (where they provide stewardship as a blockholder). Germany has tended to use SWFs as a tool for corporate governance to support the long-term orientation of its companies. Germany actively encouraged investment by SWFs during the 2000s for this purpose, even though it was running a vast trade surplus and was awash with capital. The strategy for this was a combination of informal measures (coalitions of government, business associations and leading firms actively courting stewardship-minded SWFs to partner with) and formal ones (a 2009 Foreign Investment Act allowing restrictions to be placed on large foreign ownerships of major companies when the government deemed there to be no stewardship benefits).<sup>94</sup>

The UK, on the other hand, has generally gone out of its way to attract the former type of SWF, which are more likely to seek out companies as part of shareholder value strategies to push up the share price. The UK possibly lacks the coordinating capacity between business and the state needed to duplicate Germany’s strategic approach. But at the company level, the job of boards keen to attract stewardship-

minded SWFs could be made easier by allowing them to offer “loyalty” shares giving greater voting rights to investors holding shares for, say, more than two years and/or those playing an active stewardship role.

An alternative would be to set up a UK SWF. This could be done through investing the funded segment of state pension contributions (as with Japan) or Social Security (US). One suggestion is that it could act through bodies like the British Business Bank, the National Fund and the Crown estate.<sup>95</sup> A UK SWF, acting through these intermediaries, could theoretically offer much needed stewardship for the firms it invests in as well as additional capital. However, it would also take a long time to reach the critical mass necessary. Another drawback might be a lack of independence. A UK-based, state-backed entity could be prone to acting as a politicised tool of industrial policy rather than the neutral provider of engaged capital that is needed.

## Conclusion

Covid-19 has underlined the mutual interdependence of business and society. Much of the time this relationship is positive-sum and benefits society. Many companies have behaved and performed admirably during the crisis – from the speed and agility with which AstraZeneca has pulled out all the stops to develop a vaccine (which it proposes to distribute for free), to Primark and other retailers turning down government furlough money they are entitled to.

But other episodes, such as the Leicester sweatshops and BA's cost-saving ruse to fire and then rehire staff on inferior contracts, have demonstrated the gulf that still exists between the realm of ESG monitoring and purpose statements adorning corporate websites, and the more prosaic reality of labour market precarity and fragile business models experienced by too many people in this country. The preceding decade of sub-par productivity growth has shown how bugs in the software of UK capitalism came together in overly short-termist business strategies that failed to substantially lift productivity and real wages before the crisis and, if left unaddressed, will hamper the recovery after it.

With the economy at a critical juncture, and the government now effectively in charge of vast swathes of the private sector, there is a clear opportunity to rethink and recast how UK capitalism relates to society and how firms must approach investing for the long term.

Post-lockdown, the country needs strong economic growth. This requires resilient, forward-looking companies prepared to invest in training and developing the products and services of the future. Critically, this is also what society wants – businesses that are socially responsible and invest in their workforces, rather than equating efficiency with low labour costs and cutting corners.

Failure to tackle the productivity and investment failings described in this report will entail a weaker and more protracted recovery than is required to restore living standards and bring the public finances under control. The crisis therefore presents an ideal opportunity for the “rewiring” of UK capitalism that is essential if we are to avoid the sluggish economic performance of the last decade, but starting from an even lower base.

Short-termism has been the focus of much government action, and has prompted considerable attention from policymakers and think-tanks. Much reform so far has been incremental, such as strengthening the Corporate Governance Code. While undoubtedly necessary, this is unlikely to shift the dial very far on investment so long as many shareholders are incentivised to be Exit-oriented.

Changing these incentives, by reducing the extreme ownership dispersion that discourages owners from engaging with managers, is needed to get them to back more investment-intensive corporate strategies. Success in this will restore the tarnished legitimacy of the market economy. Interventions to this effect have been proposed in the past, but the measures taken are often piecemeal or fail to address underlying,

structural problems. This paper calls for simultaneous action across a number of policy domains to address these issues and presses the point that Covid-19 has opened a window of opportunity to make these reforms a reality.

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