IPPR Commission on Economic Justice

Corporate Governance Reform

Turning business towards long-term success

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Summary

Reforming corporate governance is critical to addressing the UK's longstanding economic weaknesses. Britain's poor performance on investment, productivity and inequality stem in part from how – and in whose interest – British companies are governed. Tackling these will require more than tinkering. Instead, a fundamental shift in how British companies are governed is needed. A modern economy requires productive, purposeful and long-term-oriented companies, founded on a partnership between shareholders, management and workers. Reform of corporate governance should be aimed at achieving this.

This conclusion is based on three key propositions:

1. **The British model of corporate governance contributes to Britain's economic problems.** In giving overwhelming primacy to the rights and interests of shareholders, the way British companies are governed is a factor in our low rates of investment and productivity, high rates of pay inequality and the low level of public trust in large businesses.
    - **The primacy of shareholder interests has contributed to the growth of short-termism in British businesses.** As the average length of shareholding has fallen – from six years in the 1950s to six months now – a misalignment of incentives and behaviours has been created between companies, their shareholders and financial intermediaries.
    - **This is manifested in a decline in investment and a rise in the proportion of earnings distributed to shareholders, with poor long-term results both for savers and companies themselves.** Between 1990 and 2014, the proportion of discretionary cash flow returned to shareholders (including dividend payments and share buybacks) from UK non-financial corporations increased from 39 per cent to 46 per cent. Only around 25 per cent of finance raised by companies is now spent on investment.
    - **The exclusion of employee voice from corporate governance has contributed to Britain's productivity problem.** Employee engagement is a key factor in raising productivity, but has been a consistent weakness in British management culture.
    - **This model of corporate governance has contributed to a culture of rising executive pay unrelated to firm performance.** Over the last 20 years the value of the FTSE 100 has barely risen, while executive pay has increased by more than 400 per cent. Between 2010 and 2015 alone, the average pay of FTSE 100 company directors increased by 47 per cent, while average employee pay rose by just 7 per cent.

2. **Exclusive shareholder-based governance is not well founded in either theory or practice.** Most leading European economies give greater voice to key stakeholders, including employee directors on company boards and in the remuneration process.
    - **Companies are not legally 'owned' by their shareholders.** Rather, they are incorporated bodies which bring together a range of stakeholders – owners and suppliers of capital, labour, suppliers and customers – for the purpose of enterprise. There is no reason in law why shareholders alone should have control rights over the company.

- **The transformation in the character of share ownership has weakened the claim that shareholders should have exclusive oversight of the company.** A large majority of shares are now held by investment funds and overseas investors, often for very short periods of time (some for only milliseconds), with no attached intentions or responsibilities relating to the control or stewardship of the company.
- **Shareholders' control rights cannot be justified on the basis that they bear the most risk.** Shareholders can diversify their risk by having a broad portfolio of assets. Employees' risk in relation to the company is significantly greater.
- **The shareholder primacy model fails to recognise the critical role played by labour within a firm.** Employees are core constituents of the process of production, with long-term and largely exclusive contractual commitments to the company. In terms of formal participation and governance rights for employees the UK comes sixth from bottom among EU countries. Analysis of governance systems in the EU28 shows a positive correlation between governance systems which include employees, and stronger performance on productivity, business research and development (R&D) expenditure and lower inequality.

3. **Three key reforms would improve economic performance, reduce inequality and build public trust in business.**
   These reforms would help build purposeful companies that aim to create long-term value for the benefit of all their stakeholders, not just their shareholders.
   - **Directors' duties in company law should be reformed.** Section 172 of the Companies Act 2006 should be amended to make explicit that it is the promotion of the long-term success of a company that is the primary duty of its directors. The law should make clear that the interests of shareholders, while critical, do not necessarily take priority over the interests of employees or responsibilities to other stakeholders.
   - **Employee representation should be embedded in corporate governance, including elected worker directors on large company boards and representatives on remuneration committees.** At least two members of the board, and preferably one-third of the total, should be elected worker directors, with similar representation on remuneration committees. To ensure compliance this should be implemented through legislation, though an alternative option would be reform of the corporate governance code and its application to both listed and private companies.
   - **A Companies Commission should be established to oversee and strengthen corporate governance standards among both listed and private companies.** An independent regulator with investigative powers and legal remedies would help restore public trust in major businesses. The commission could be either an entirely new body, or build on the Financial Reporting Council, which currently oversees the governance code.

Reforming corporate governance is not a panacea on its own for Britain's economic weaknesses. But rewriting the rules that govern how firms operate is a crucial step towards building a more productive economy that works for everyone.

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain

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