"We have a once in a lifetime chance to renew our idea of what a company is for…"

REINVENTING THE FIRM

William Davies

DEMOS

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William Davies
August 2009

Foreword

This September marks the anniversary of the collapse of Lehman Brothers, when the world's biggest bankruptcy plunged the financial markets into freefall and more than £50 billion was wiped off the FTSE 100 index in a single day.

Thankfully, economic Armageddon has been avoided. As stability has been returning to the financial system, it is human nature to hope that normal service will be resumed and that our economy will return to the benign conditions that prevailed before the credit crunch. Yet many of the economic assumptions of the past 20 years have been decisively swept away.

Capitalism is not in meltdown but it is at a critical juncture, as William Davies argues in this significant contribution to the debate about the future of the firm and its relationship with society. For many years it has been the received wisdom that the pursuit of 'shareholder value' was the best way to motivate management and maximise value for shareholders. The crisis has exposed the weaknesses of the drive for short-term maximum gain.

It is only now that the urgency of addressing the banking system has abated that business leaders, policy makers, commentators and citizens have begun to reflect on what alternative types of capitalist structures might be more inclusive of all stakeholders, be more resilient in the long term and reduce the risk of future crises.

Greater diversity in the way companies are owned and run should be welcomed. As this report highlights, there are multiple ownership models and corporate governance structures that can generate wealth as well as positive benefits for society and shareholders alike.

Employee ownership is one solution to the problem of building a more sustainable economy built on long-term foundations. That does not mean blunting the entrepreneurial spirit – far from it. Employee ownership can also help fulfil the increasing desire we have for more influence in our work, reflecting the greater choice we have come to expect in our personal lives, so as to unleash our potential and productivity.

The UK employee-owned sector is worth £25 billion annually and is a growing force in the economy. It has the potential to contribute significantly to the long-term well being of employees and communities as well as to greater social cohesion.

That is why the John Lewis Partnership is proud to have supported this project – and why we welcome Demos' call to government to highlight employee ownership and take the lead in providing incentives and removing barriers to the growth of the sector.

Employee ownership may not be right for every business but it has worked for the John Lewis Partnership for 80 years. I believe it can help us to build an economy in which employees and others have a real stake, and in which success is judged not just by short-term returns but by long-term sustainable performance.

Charlie Mayfield is Chairman of the John Lewis Partnership.

Introduction

The economic crisis that peaked with the banking meltdown of autumn 2008 has been accompanied by some striking renunciations of faith. In October of that year, Alan Greenspan, former Chairman of the US Federal Reserve, declared that 'the whole intellectual edifice' on which financial regulation had rested had collapsed, meaning that he had been 'partially wrong' in his policy decisions.[1] The following March, Jack Welch, the former CEO of General Electric and poster child of the 'shareholder value' movement, admitted that 'shareholder value is the dumbest idea in the world'.[2]

Greenspan's confession made greater headlines, but Welch's was no less significant. The shareholder value creed – the belief that a company's primary purpose is to maximise its value for the benefit of external shareholders – was as much a part of the neo-liberal 'intellectual edifice' as Greenspan's belief that financial markets are self-correcting. The creed, embodied by Welch and articulated in Alfred Rappaport's 1986 book *Creating Shareholder Value*, derived from a very limited understanding of what a firm is. At its heart, the shareholder value philosophy presented firms as comparable to any other economic object that could be owned, traded, invested in and profited from. From this perspective, the price of a firm's stock was the best and most complete representation of its true value, and satisfying shareholder interests was the overriding goal of management.

This perspective blankly ignores a number of critical aspects of how firms work and succeed. It fails to address the fact that the value of a contemporary business consists largely of intangible assets, rooted in people, relationships, intellectual property (IP) and reputation, none of which is easily captured in the quantitative calculations of external investors. Treating these assets like physical items of property – tradable, dispensable, swiftly exploitable – can do great damage to their long-term value, as so much evidence on mergers and acquisitions suggests.[3] Most significantly, the shareholder value perspective excluded what JK Galbraith referred to as 'power, the great black hole of economics'.[4] Firms differ in how they distribute power internally, with management, employees, shareholders, customers and other stakeholders all requiring some form of recognition and reward for their on-going commitment to the collective venture. There are *political* choices to be made.

Once this is acknowledged, two things follow. Firstly, that the *range of models* for a firm's ownership and control is far broader than the shareholder value movement ever accepted. This report aims to highlight the diversity of ownership and governance structures that has been largely forgotten about over the last 30 years. This is a celebration of organisational pluralism, and a call for more of it. Politicians, managers and business experts need jolting from the financial and organisational monoculture of recent times.

Secondly, it follows that the politics of the firm *does not take place in a vacuum*. Many of the dominant social, economic and political challenges that Britain will face over the coming years can be exacerbated or alleviated depending on how companies behave and are organised. In addition to producing wealth, firms have a profound influence on well-being and on the fabric of civil society. Different types of organisation produce different levels of inequality and fulfilment in people. It has long been convenient to ignore this, and leave firm structures out of public debate about our society and political economy. The next chapter contains evidence of four areas in which dominant practices and assumptions about the firm are contributing to social, economic and political malaises.

Why now?

The banking crisis represents the most explosive example of how the shareholder value model failed, both as a mechanism for accountability and for value creation. But just as there are those who believe that the fundamentals of the financial system simply need tweaking, there are those who hope that a new improved version of the shareholder value ideal will be sufficient for the post-2008 era. Perhaps greater transparency, shareholder activism and corporate social responsibility are required to offset the risks associated with the arms-length, rapid turnover ownership model. Given that every holder of a private pension or ISA is, indirectly, a 'capitalist', then maybe the system simply needs to be made to work *even harder* on behalf of these ultimate owners.

This report takes a different view. Times of crisis never leave things as they were, but produce a different future out of the wreckage of the past.[5] Most of the ingredients of the next epoch of economic structures are already present, but will be pieced together anew by a combination of economic, cultural, social and political forces. As far as the ownership and governance of firms is concerned, it would be absurd to suggest that the publicly owned and traded company, with a managerial eye on its share price, is about to go into terminal decline. But at the same time it would be unimaginative and historically naïve to believe that it must necessarily remain the dominant fixture of any capitalist economy.

Capitalism is at a critical juncture, and so is our politics. The fiscal environment is suddenly very different from what it was, and a general election is coming in 2010. Regardless of their exact spending plans, all three parties are conscious of the fact that the creation and distribution of wealth and well-being is not entirely within the state's control. People must be supported, encouraged and empowered to form the social and economic relationships that they desire, such that the state is not society's dominant source of collectivism and security. It is peculiar in this respect that politicians do not have more to say about alternative ownership and organisational structures, which can often exert a significant and positive influence over social outcomes, relieving the strain on the state. New Labour has been prepared to support and celebrate 'social enterprise' as a decentralised force for good in society, which points to the available role for government in nurturing alternative forms of economic organisation, but been strangely silent on the structure of mainstream profit-making bodies.

This economic and political context creates an exciting opportunity to rethink the firm, its ownership, its management structures and its mechanisms of accountability. What's more, in a situation of some turbulence, we have an opportunity to expand our analytical framework beyond narrow economic concepts of allocative efficiency and performance to include broader social and political considerations. While doing this, we get to address the question of what form of *autonomy* we want in our economy.

Autonomy is a helpfully ambiguous value, straddling economics and politics. There is ample economic evidence concerning the benefits that worker autonomy can deliver to business performance, meaning that there are tangible economic reasons for managers to empower and liberate their employees. A particular idea of consumer autonomy, meanwhile, is at the heart of how markets are designed and regulated. But there is also an emerging *political* framework that seeks to deliver greater autonomy in our economic lives (including in our workplaces) as a component part of a society less liable to domination.[6]

Economic and political accounts of autonomy are not reducible to each other, and can potentially come into conflict. For instance, a firm that sought to empower employees purely as a means to extract greater effort and productivity from them could be accused of excessive work intensification, and would scarcely be satisfying the democratic requirement for non-domination in the workplace. On the other hand, a firm that privileged workplace democracy at the expense of productivity would be failing in an equal and opposite sense. The task, this report argues, is to build firms with a suitable balance between economic and political forms of participation, liberty and empowerment. In the best cases discussed in this report, this balance is struck in such a way as to uphold both sets of priorities.

The shareholder value era had its own answer to this question. Finance should have the maximum freedom and power to dictate how companies were run. Employees should be governed by managers and managers dictated to by shareholders. In fact this model was never honestly realised, as the next chapter will demonstrate. Behind the rhetoric of shareholder value was the autonomy of senior executives to inflate their remuneration with stock options and to pursue short-term routes to profit maximisation.

In the coming years, Britain must experiment with new models of the firm, resting on different varieties of economic autonomy. The most sustainable, engaging and productive forms of future economic organisation will only emerge thanks to a plurality of organisational forms and business models. These will produce new accommodations between our society's respective economic, social and political priorities. As Geoff Mulgan notes of the current crisis:

in some sectors the slump will give new momentum to the old idea that workers should employ capital rather than vice versa…. In other sectors, too, there has been a long-term trend towards more people wanting work to be an end as well as a means, a source of fulfilment as well as earnings.[7]

Possibilities are now broader and the isolation of economics from sociology and politics is less plausible.

This report has a particular focus on employee ownership as a model of the firm, specifically because this appears to offer an optimal model of autonomy, combining high levels of economic performance with politically progressive forms of accountability and governance. The virtue of employee ownership straddles economic and political rationales. As we will see, there is no single template or creed underpinning employee ownership, but instead various financial, managerial and cultural ingredients that are recombined in a variety of ways; there is no employee ownership 'movement'. 'Public interest companies', 'social enterprises', cooperatives and mutuals are additional important parts of Britain's industrial and post-industrial make-up. They offer diverse means of producing, serving, employing, cooperating and owning. What's more, with sufficient imagination and expertise they can be combined to form new, hybrid models.

Outline of the report

The report is structured as follows. Chapter 1 discusses four dimensions of the UK's critical situation, each of which strengthens the case for exploring new models of ownership and corporate governance. Firstly, there is the banking crisis, which highlights the problems of accountability associated with dominant ownership structures. Secondly, there is a competitiveness crisis, inasmuch as Britain cannot continue to rely on financial services and the housing market as its primary sources of prosperity. This poses questions about the organisations and policies that will support long-term wealth creation in the future. Thirdly, there is the fiscal crisis that imperils progressive ends unless new, non-state-oriented routes to social and economic security can be found. Fourthly, there is a moral crisis, associated with spiralling inequality and a sense of an illegitimate 'winner-take-all' ethic at work in contemporary capitalism, which is then compensated for by an unsustainable culture of debt-fuelled consumerism. Company structures and practices are not innocent in this regard.

Chapter 2 explores ownership and governance of firms in greater detail. It challenges the narrowly economic vision of ownership as the right to control and profit from an asset. Instead it looks at the firm as a political entity, whereby various intangible assets – people, knowledge, relationships, reputation – are organised into some sort of power structure. On closer inspection, to claim that anybody completely owns such assets makes little sense. Alternative political-economic means of organising them are worth considering, and the chapter presents evidence on the plurality of ownership and governance forms in the UK today, highlighting their respective merits. It also points towards emerging foundations and techniques of cooperation that look set to grow over the coming decades.

Chapter 3 presents an examination of employee ownership. It looks at the forms of employee ownership that are possible, including 'direct' share ownership, worker cooperatives and employee benefit trusts. These have both democratic and economic merits, as a basis for empowerment and for greater productivity. There is good reason to believe that the two can reinforce one another, in a virtuous circle of political-economic autonomy.

Chapter 4 delves further into employee ownership, with case studies of three employee-owned firms. These have all been either founded or converted in the last ten years. The firms have been selected to highlight the diversity of the sector and the multiple reasons that exist for employee ownership, and potential benefits that stem from it. The implications are drawn out, and located within the crises described in chapter 1.

Chapter 5 outlines an agenda to diversify Britain's corporate governance and ownership practices. This is a curious policy challenge, since much of the innovation that occurs in this territory cannot be anticipated or prescribed by government. Accountants, lawyers and business schools all have a role to play in broadening assumptions about the optimal ownership and governance structures of organisations. Businesses and owners must also rethink the firm. But government can lead in highlighting the range of options and using the tax system to both highlight and incentivise them.

1 The four horsemen of the financial apocalypse

Consider a scenario. The world power at the epicentre of the global economy finds itself struggling to maintain its economic competitiveness, as two overseas rivals emerge to exploit their own local advantages and economies of scale. The struggle to maintain global power and dominance over the economic system places increasing strains upon the public finances of the state at its centre. A financial shock occurs, triggering a deep and lengthy recession across the capitalist world. The recession leads to the decline of previously successful ways of organising industry, but also opens up possibilities for new forms of production harnessing new technologies. As the new organisational forms emerge, so new skills, professions and values develop to harness and humanise them. In the decade that follows this economic slump, one particular model of the firm spreads with astonishing speed. It goes on to become the dominant productive force of the new century.

This scenario occurred between 1873 and 1903. The world power was Britain, the two competitors Germany and the USA, the financial shock the collapse of the Vienna stock exchange and the new technologies electricity, steel and petrochemicals.[8] But it is the ascendant organisational model that concerns us here: the publicly owned business corporation.[9] Britain's industrial dominance had rested heavily on one particular model of the firm, namely small-scale producers owned by families and industrial entrepreneurs, trading between each other and exploiting a global empire. Foreign rivals sought to compete collectively through forming cartels and trusts, but many of these were outlawed in the USA and Germany during the 1890s. Instead, both countries witnessed a vast wave of mergers, the result being the large, hierarchically organised, professionally managed firm with which we are familiar today.

And in the USA, ownership of these firms was distributed amongst public shareholders.

Any firm is a cooperative of one sort or another. In the case of the publicly owned corporation, it is notionally a 'capitalist cooperative', a large number of individuals and institutions who pool their capital to take collective ownership of a firm and vote on its direction. This distributed ownership model, facilitated by stock markets, allows firms to grow at a speed and to a scale that was previously unimaginable, creating new possibilities for investment and production. It also requires a class of professionals who are delegated to take control of these vast bureaucracies on behalf of the owners. A hierarchical, deferential culture and ethos is also needed, through which these professionals can direct skills and labour in the most efficient manner possible.

To be successful, a model of the firm must not only be efficient, it must fit with the culture, politics and value system of the society in which it sits. The growth of the publicly owned corporation in the late nineteenth century is partly explicable in terms of the cost advantages that large hierarchies then possessed over Britain's decentralised market system. But it was also validated by a particular vision of cooperation, rooted in professionalism, a bureaucratic ethos, an expanding state, and excitement about the possibilities offered by far-reaching, vibrant financial markets.[10]

The evolutionary perspective

Over a century later, and immersed in our own economic crisis whose duration is still unclear, the question is whether this is still the model of economic cooperation that suits us. Is it necessarily the case that ownership of companies should be distributed across external shareholders to whom dividends are paid? Is the separation of ownership and control that was the cornerstone of twentieth-century corporate governance necessarily best? Does the subservience of employees to professional managers fit with the expectations of people in twenty-first century Britain? Are we content with the notion that firms are primarily accountable to stock markets? Should the government's attitude to industrial organisation only focus on how it affects the welfare of consumers? This chapter suggests that the answer to these questions may, in various circumstances and for various reasons, be 'no'.

As the nineteenth century example indicates, economic crises are complex events. They may be sparked by a slump in one particular market, but can only be thoroughly understood with a much broader perspective. Historians will note that the current crisis was initiated by defaults on American sub-prime mortgages in the run up to summer 2007, but will want to go further and understand the culture, psychology and politics that underpinned the perilous attitude to credit and the veneration of financial services that grew over the preceding decades.

Chris Freeman, an evolutionary economist, and Francisco Louca argued that each epoch of economic history is characterised by its own distinctive settlement between five 'semi-autonomous' spheres of progress, namely science, technology, economics, politics and culture.[11] These spheres bleed into each other and take time to re-settle after moments of upheaval. Sometimes there is no discernible relationship between two separate crises, and yet when they coincide they amount to more than the sum of their parts – think of how the combination of Sir Fred Goodwin's pension and the MPs' expenses scandal seemed at the time like symptoms of a single disease.

Yet as the now-famous Rahm Emanuel line, 'you never want a serious crisis to go to waste', implies, there are positive aspects to crises. Just as a variety of cultural, moral and political factors may contribute to them, so their outcomes can represent cultural, moral and political progress. The economic slump of the 1970s was not caused by the cultural upheavals of the 1960s, but the economic model that emerged – privileging consumerism, individualism and rising female employment – incorporated a 1960s value system within it.[12] Understood literally, a 'crisis' is simply a turning point whose outcome can be good or bad. When rethinking the firm in the current climate, we have the opportunity to consider multiple ways in which existing structures fail to satisfy us, not only on an economic level, but also on a broader cultural and political one. The intention here is to outline four inter-related crises in which the dominant model of the firm is implicated.

#1: The banking crisis and the firm

The shareholder value creed was a particularly acute attempt to assert the power of financial capital over industry, making return on investment the single benchmark against which all of a firm's managerial, technological and employee actions could be measured. It is therefore heavily ironic that the model's shortcomings and the myths on which it rested were eventually exposed most graphically within the financial services sector itself.

If the model had worked correctly, the shareholders that owned Britain's banks would have defended the value of their equity by holding management accountable for their decisions, and in turn management would have held employees accountable for the dealings that were being done on the bank's behalf. It transpired from 2007 onwards that bankers had been engaged in actions that were destroying the value and long-term viability of banks, and that there were no adequate accountability mechanisms available – or being used – to discover or thwart this.

As Martin Wolf has pointed out, bankers in stock market-listed banks have a strong incentive to take risks with unusually high stakes, especially where they are being remunerated with stock options.[13] They share in all of the benefits of rapid growth, but are protected from the small risk of a meltdown by the principle of limited liability. And yet the TUC's research on the voting behaviour of institutional investors showed they presented no obstacles to the remuneration packages that led banks towards such high stakes strategies.[14] RBS's ultimately disastrous £50 billion takeover of ABN Amro in 2007 went similarly unopposed. The discovery that many banks are considered 'too big to fail' only exacerbates the problem of individual incentives for risk heightening.

It was of course the hedge funds that correctly identified the huge risks to which the banks had become exposed, and began to short-sell them into oblivion. As controversial as this was, it represented a greater force for transparency than anything that was being imposed by the supposed 'owners' of the banks. All the short-sellers were doing was correctly identifying the stock market's delusions and exploiting them. As the financial journalist Chris Dillow has pointed out, the fact that hedge funds weathered the storm better than banks is an indication of their superior ownership and accountability structure, in which the professional investor's own wealth is often at stake in their decisions.[15]

Building societies have suffered due to their close relationship with the property market, but they were never liable to fail in the dramatic fashion of the shareholder-owned banks. It is not simply that regulation prevents them from becoming involved in the types of speculative activities that the banks were engaged in (at least not to the same extent), but that their ownership and corporate structure gives them a lower appetite for risk.[16] As mutual societies, they exist for the core purpose of delivering a service to their members, not chasing a profit. Even if they were permitted to engage in risky investment banking activities, it is not clear that it would be in their interests. Equally, save for the demutualisation wave of the 1980s and 90s, these organisations are not constantly for sale in the same way as a stock-market-listed bank; indeed, ownership is not technically transferable at all.

Contrast this with the spate of huge takeovers performed by RBS, achieved thanks to share price inflation, which led it to become the fifth largest bank in the world, before the 2008 calamity of the largest reported loss in British corporate history.[17] Such rapid growth would be unthinkable for a building society, but then so would such rapid decline. The fact that it is demutualised former building societies such as Northern Rock that have been amongst the worst victims of the financial crisis only heightens the tragedy of allowing Britain's financial sector to become dominated by this pursuit of shareholder value. Ultimately, shareholders – and of course the British taxpayer – were the victims of a creed that purported to put them in charge.

One important conclusion that can already be drawn from the financial crisis is that over-reliance on a single model of ownership and corporate governance in the financial sector increases systemic risk.[18] The *Financial Times* was alert to this in an editorial as far back as 1999:

> *A pluralist approach to ownership is conducive to greater financial stability. With their contrasting capital structures, banks and building societies balance their risks and loan portfolios differently. Systemic risk is therefore reduced.*[19]

The demutualisation wave that followed the 1986 deregulation was fuelled largely by greed on the part of those wishing to take control of the institutions involved and a short-termist psychology amongst members who were encouraged to view them as an asset to be unlocked. The fact that value was locked into them can now, in retrospect, be viewed as a virtue and not a failing. As chapter 5 will outline, there is now a strong case for remutualising former building societies and finding ways of locking value into financial institutions once more. The argument made here is simply that the presumption that corporate assets are worthless unless they are tradable has been made to look extremely short sighted by the financial crisis. This lesson has implications beyond the financial sector for how we consider firms in general.

#2: The competitiveness crisis and the firm

The importance of housing and financial services to the British economy grew progressively throughout the 15-year boom that followed the 1992 recession. Financial and business services produced almost a third of UK GDP in 2006, more than twice the contribution of manufacturing.[20] Our economy is now more dependent on financial services than those of the USA, France, Germany or Japan, whereas in 1992 it was the least dependent of any of these nations.[21]

The property bubble, supported by speculation and a quantity of debt greater than the country's entire GDP, not only fuelled growth in the construction sector but unleashed a wave of consumption that increased the rate of economic growth further.[22] The risks involved in this 'consumer Keynesianism' were a great deal more transparent and manageable than those being taken by the financial innovators in the City, but it is impossible to generate wealth on the basis of credit for ever, no matter how much credit there is around. At some point, Britain was going to have to confront the awkward questions of how, where and by whom its prosperity was to be generated in the twenty-first century.

In the wake of the financial crisis, Peter Mandelson has seized the opportunity to call for a new era of 'industrial activism', following an epoch in which the very idea of governments having a policy on production was treated as a taboo. As Mandelson explained, industrial activism

means being pragmatic about the ability of markets to enable companies and people to succeed in a rapidly changing global economy. Policy should be activist in the sense that it recognises that government can and must complement market dynamics to get the best outcomes for our society and economy.[23]

Elsewhere, he has spoken of the need for government to consider the potential to support industry with its procurement decisions and for policies to put Britain at the forefront of a 'new green industrial revolution', based around low carbon technologies. Further sectors that have been identified as worth nurturing include hi-tech manufacturing, aerospace, automotive, biosciences, precision engineering and creative industries.

Yet the financial crisis continues to drag down the very industrial sectors that offer hope for the future. Sustainable energy companies are struggling to get the finance they need.[24] This is on top of Britain's persistent productivity lag, associated with comparatively low rates of business investment and private sector R&D.[25] With the credit market still badly damaged by the banking crisis, government is increasingly willing to step in to support the formation of new businesses. There is still further scope for publicly owned banks to be used in a more strategic fashion, to support the types of sectors with long-term viability. Government may resist the idea of 'picking winners', but it now recognises the need to help grow high productivity sectors.

A great deal is changing, not only in the assumed relationship between government and market, but also in the attitude of policy makers towards individual sectors of production. The government can no longer afford to be agnostic on how and where wealth is produced. Mandelson gave a striking indication of the shifts in political economy when he went so far as to outline this new activist agenda to the City.[26] Quite aside from the banks' dramatically self-destructive behaviour, the status of finance in our economy and society will have to alter to become less autonomous, less short-termist and more alert to industrial and political priorities. Government ministers have delivered this message repeatedly to the City, emphasising that both boards and investment funds need to become more expert in long-term wealth creation.[27]

A tension between the immediate interests of financiers and those of producers lies at the heart of capitalism.[28] Financial psychology and culture prioritise fast, monetary returns; productive psychology and culture prioritise longer-term processes of technological investment, implementation and innovation. Different varieties of capitalism involve different relative weightings between the two. In Peter Hall and David Soskice's famous dichotomy, 'liberal market economies' such as Britain and the US tend to grant greater power to finance over industry, while 'coordinated market economies' such as Germany tend offer more equal status to both.[29] To say that Britain may have to pay greater attention to its productive sectors is not to argue that finance must become entirely subservient to industrialists nor that neo-liberalism is about to be undone with a return to 1970s planning. It is simply to point out that Britain's famed financial services may have done an excellent job of self-expansion over the past 30 years, but have been less successful at supporting the long-term needs of industry and innovation.

All of this heightens the case for new financial, governance and ownership models, which place long-term productive purpose at their heart, and not just return on investment. Venture capital is not working in Britain, either in financial terms or on the terms of the innovators who depend on it. The argument against the short-termism of stock markets is well rehearsed, although it is important to remember their strengths in particular forms of growth and risk-taking. Part of the new industrial activism must be not only the search for greater sectoral diversity in the UK economy, but also greater diversity of ownership, financing and models of governance. Now is not the time to shift from a 'liberal market economy' to a 'coordinated market economy', but to ditch the assumption that Britain has or requires a single governing 'variety' of capitalism at all.

#3: The fiscal crisis and the firm

One further irony of the crisis is that after 30 years of neo-liberal governments promising and failing to reduce the size of the state, it is only with the demise of neo-liberalism that real shrinkage can now honestly be expected to occur, for better or worse. The fiscal and monetary stimuli that followed the banking rescue package may have averted a depression, but nobody would claim that this level of public borrowing and spending were sustainable macroeconomic policies for the long term. Few doubt that public spending will have to fall from 2011 onwards, perhaps by as much as 10 per cent. If this crisis presents a 'left wing moment' as some have claimed, it is being experienced under harsh 'right wing' fiscal conditions, although the argument for higher taxes may yet attract political support. As Demos Director Richard Reeves has argued, 'progressive austerity' must now be the goal, in which enduring progressive goals must somehow be pursued while spending less public money.[30]

What does this have to do with the organisation of the firm? At least two things. Firstly, in an era of smaller government, it becomes more important that non-state-based sources of security and community are safeguarded and encouraged. Prior to the twentieth century era of the social democratic state, there were various non-state vehicles developed for progressive purposes. The cooperative and mutual movements of the nineteenth century set about delivering services and economic security to their members. Republican thinkers such as Stewart White argue that this liberal-left tradition needs rediscovering and celebrating, for the self-government that it offers.[31] White's argument is not framed in economic terms, but Britain's current fiscal situation adds to the urgency of reconsidering mutuality as a source of social and economic security.

This argument must not be used as a fig leaf for the state's abandonment of the poor. And yet it needs highlighting that if policy choices are framed only in terms of 'progressive state vs conservative market', the former is already under excessive strain, and greater nuance is required. A more progressive and pluralist model of market actors will help here.

Away from the state's core responsibilities to those most in need, progressive austerity *does* require cuts to be made, and it is here that organisational and ownership models are implicated in a second way. Public services sorely need to become more productive, regardless of who owns the delivery vehicle. Some arms of the state will need to be shrunk or sold. The politics of this will be complicated and painful. But again, the stark choice between the state and market is too simplistic, exaggerating the capacities of states to deliver public goods and under-estimating the latent potential of non-state actors to do so.

As will be detailed in chapter 2, public services are already being effectively delivered by various bodies not technically owned or controlled by the state, including Foundation Trust Hospitals, employee-owned health service suppliers and public service broadcasters. The Liberal Democrats have promoted such a model for the Post Office for some time. From the point of view of public service and public interest, there are important distinctions between profit-*maximising* firms, profit-*making* firms and not-for-profit enterprises. If the state is to shrink in certain areas, the structure and ownership of the firms that move into its place become matters of urgent political priority.

These arguments will be met with cynicism by some progressives. After all, the claim that public and private sector organisations are substitutable or identical has tended to mean only the former being modelled on or replaced by the latter. The New Public Management movement of the 1980s and the PFIs and public private partnerships of the 1990s were all about seeking to drive private interests, private methods and private profit making into the public sector. It has been 30 years of one-way traffic.

It is now time for the reverse to happen. If it is not solely the state's responsibility to uphold the public interest, or to correct 'market failures', we will need more private organisations that are imbued with public purpose or, in the jargon of economists, generate 'positive externalities'. The *principle* of a public private partnership or public interest company is a good one. But after an era of public services being remodelled around the private sector, it is now time to consider how private organisations might be designed with a greater sense of public service. Challenging our ingrained assumptions about the necessarily profit-maximising nature of private organisations is part of that.

#4: The moral crisis and the firm

Rising income and wealth inequality are inescapable features of recent British social history. According to one OECD study of 15 leading industrial nations, between 1979 and 1999 Britain's income inequality rose faster than any of the other nations studied, including the USA.[32] Moreover, if the effects of taxation and redistribution are factored out, Britain's inequality is now at a higher level than in the USA, implying that markets and firms in the UK are producing unusually unequal outcomes in income.[33] The Institute for Fiscal Studies suggests that the Labour government has done a reasonable job in limiting these trends, most notably in its second term, but also finds that income inequality is now higher than at any point since at least 1961.[34]

The story of wealth inequality is no less troubling. While one in five British households own no assets whatsoever, one sixth of the nation's assets are owned by just 3 per cent of households.[35] Things have been getting worse: in 1986 the bottom half of the population held 11 per cent of the liquid wealth of the nation, but just 20 years later this had fallen to

1 per cent.[36] For those who view a degree of asset ownership as a precondition of active, engaged citizenship, Britain faces a severe problem of a large dispossessed, marginalised minority.

A growing body of economic and psychological evidence pinpoints tangible effects this has on individuals – on their happiness, well-being and relationships and on community formation.[37] This is not only something that afflicts those at the bottom of society, although both absolute and relative poverty are associated with many of the worst of these effects, in crime, health, social capital and mental health. As Richard Layard and others have demonstrated, a culture of growing inequality affects the happiness of all members of society. Income is a surprisingly weak determinant of happiness, at least above around £25,000, while a culture of atomised aspiration and envy causes stress and community breakdown.[38]

The question is posed once again – what does this have to do with the ownership or organisation of firms? A great deal. In general terms, these trends are associated with the rising status of finance capital in society and over firms. Studies have shown that income levels at the very top of the British labour market rise and fall in line with the stock markets.[39] There is also evidence showing that societies with more stock-market-led economies produce higher levels of inequality.[40] Meanwhile, inequality within firms has been rising, with average ratios of boss-to-worker pay in the FTSE 100 at 66:1, based on salary alone.[41] But if stock options and other incentives are included, this rises by half as much again, to 98:1.

The spiralling pay packages for those at the top of firms is therefore heavily associated with use of stock options to remunerate management, a key plank in the vision of the shareholder value-oriented firm. Externally owned firms, it was reasoned, suffer from what economists call a 'principal agent problem', where the split between those owning the asset and those controlling it leads the latter to exploit it in their own interests, not those of the owners. Use of stock options, whereby a staff member is given the right to purchase company shares at a fixed and typically meagre price at a time of their own choosing, is thought to align the two interests, giving managers a major incentive to grow the share value of the firm.

As a number of critics of shareholder value have argued, taken too literally this practice achieves the opposite of its intended outcome. Bosses who are granted large stock option packages are effectively being given shares at a knockdown price, inflating the share price, then selling for a vast personal profit. The option is a one-way bet: there is no risk attached to this reward, because if the share price drops they can simply decline to exercise the option. It is no surprise that some institutional investors are growing tired of these remuneration packages, which divert money away from both the business and the shareholders into the pockets of management. It is not clear that the beneficiaries are necessarily taking anything like the level of risk that might justify such extreme rewards.

The financial crisis exposed many such management practices to a public moral outcry. The scandal of Sir Fred Goodwin's RBS pension and the controversy over his successor's options-based £9.6 million annual pay package raised public and political concern about the naked unfairness at the heart of British firms. The financial sector may offer an acute example of the capacity for inequality that firms can unleash in the name of pleasing shareholders, yet these levels of income inequality are not restricted to finance. In 2007, for example, Giles Thorley, the boss of Punch Taverns, paid himself £11,276,000 or 1,148 times the average wage of his staff, to run a company that was heading towards significant losses.[42]

Trends in the nature of work and production also appear to be exacerbating inequality in the UK. As the value added by 'human capital' – skills, expertise, know-how and creativity – rises, so the rewards to the highly educated begin to pull away from the rest. In certain circumstances, markets for knowledge and intangible assets produce 'winner take all' outcomes, whereby an ever-smaller minority of individuals or producers receive a rising share of wealth. The notion of the 'war for talent' propagated by McKinsey in the late 1990s pitted employers against each other in a zero sum game to acquire highly skilled, supposedly footloose individuals. Just as the shareholder value creed represented companies as constantly for sale, so the 'war for talent' rhetoric implied the same of sought-after skills. The trends exhibited by Premiership football clubs and players – zero loyalty, maximum greed – have been played out in professional services firms and creative industries around the world.

Firms in the 'coordinated market economies' of Japan and Germany do things very differently. Management personnel tend to be promoted from within the firm, and the overall ratio of pay between those at the top and those at the bottom is far lower. Economist Ronald Dore has suggested that where managers have worked their way up and seen the firm's social infrastructure from other perspectives, they identify more closely with their staff and the long-term interests of the firm, which constrains their own personal financial ambitions.[43]

If there is a positive outcome to the moral crisis of British capitalism, it will be the restoration of some stigmatisation of spiralling inequality within firms. As for the use of stock options and other forms of profit-sharing, there is a great deal to be said in their favour, as chapter 3 will explore. Equity-based remuneration could potentially play a role in alleviating inequality, not only in income but in assets. But as the pay ratios cited above testify, it is presently being used as a mechanism to greatly increase the amount of inequality occurring within companies. The promises of financial participation and ownership have only been delivered on to a small fraction of the British public.

2 In praise of pluralism

Ownership is an inherently ambiguous concept. Individuals may feel some sense of ownership towards things that are not legally theirs, such as a local pub, just as they may feel very little sense of ownership towards things that technically belong to them, such as a buy-to-let property. Many philosophers and psychologists have begun their investigations of ownership from the recognition that people feel their body is 'theirs', and from this there stem various other forms of ownership over tangible and intangible goods.[44] A single concept conceals a wide variety of different freedoms, obligations, legal mechanisms, assumptions, norms, institutions and embedded relationships.[45] It is simplistic in the extreme to view ownership only as a binary, 'mine or yours?' issue.

Yet a prevalent view of firm ownership represents things in just such simplistic terms. The OECD argues that 'ownership consists of two main components: the right to income and the right to control'.[46] By this account, if something is 'mine' I am entitled to control it as I wish and to benefit from it financially. Applied to firms, this then produces the vision discussed in the previous chapter, that they exist to be exploited and disposed of according to the choices of their shareholders.

What the previous chapter sought to show was that this vision has failed in a number of respects, on its own terms as much as the public's. It did so because it not only ignored the ambiguous character of ownership in general, it ignored the complex realities of firms as social, economic and political entities, embedded in particular cultures. Quite evidently, companies are not assets that *can* be financially exploited and controlled like other forms of property, at least not without severely deleterious consequences for themselves and for society. We need to rediscover and celebrate the plurality of ownership options, each of which represents a different way of combining economic, social and political priorities. These can coincide in the same economic system, and sometimes in the same hybrid organisational entity.

This chapter intends to do two things. Firstly, it describes *what firms are*, in explicitly political terms. Firms, it is argued, can only truly be understood in terms of the power relations that produce and sustain them. They are intangible entities consisting chiefly of intangible assets, and therefore cannot be fully owned, but only governed in some way or other. Secondly, it outlines alternative forms of organisation, in which power is more dispersed amongst multiple stakeholders, with equity investors either absent, better engaged or less dominant. This includes various types of mutual organisation, some of which are profit-making, and various emerging organisational forms that could expand under the next phase of capitalism.

The politics of the firm

Let's start with the simple assumption that companies *do* exist for the purpose of serving the economic interests of their legal owners. Ensuring that companies are organised around this principle is, after all, the central task of most corporate governance models. Where firms are new, small or under-developed, the problem is a relatively simple one. A firm is likely to be initially founded, managed and owned by a single individual or family, such that ownership and control are combined in a single set of hands. As the previous chapter noted, this was the vehicle for Britain's early industrial leadership, and it continues to make a significant economic contribution today. According to two recent studies, family-owned businesses account for close to 60 per cent of world GDP and 31 per cent of UK GDP.[47]

Many of these firms may not genuinely be considered 'capitalist', in the sense that their activities may not be serving the interests of 'capital' in any clear way. A shop that is handed down from one generation to the next, without any debt attached to it, can be run as the shopkeeper sees fit, with any profits going to the shopkeeper or being reinvested in the business. If the owner-manager decides that he wants to expand the business, he has the choice of accumulating his own reserves to do this or going to a bank. The debt finance offered by a bank serves as a capitalist means of expanding in size, potentially increasing profits, but without relinquishing ownership or control of the business, so long as the repayments on the debt are maintained.[48] More importantly, it is a basis on which businesses can be launched in the first place.

This type of scenario fits quite easily with a simple legal-economic vision of ownership and control. The right of the individual or family to control and extract revenue from their assets, such as property and equipment, is not hard to defend. But at the same time, this comparatively simple model of the firm sits uneasily with the presumption that ownership is a narrowly economic phenomenon. If the founder or inheritor of a business chooses to retain complete ownership and control of the firm, this may be because it is highly profitable; but it is just as likely to be because they view it as having a more complex value and set of values than can be captured in its market worth. On the other hand, they may choose to split 'ownership' and 'control' by appointing a management team, recognising that others are better qualified to handle the assets in question. But then the concept of ownership starts to fracture.

This is where intangible assets come in, which leads unavoidably to questions of power. The individual or family that builds a successful business is really accumulating a set of intangible assets – most notably a brand name, a reputation with customers, a stock of knowledge, access to capital and a suitably trained workforce. The company's market 'value' might account approximately for these factors, but they are difficult things to price because they are not really *owned*. As Charles Leadbeater puts it, 'knowledge resides in people. People cannot be owned. Therefore companies do not own their most valuable assets.'[49] Investing in, developing and harnessing these assets requires complex social and political arrangements.

The most famous theory of the firm presents it as a political response to a particular economic problem. Writing in 1937, Ronald Coase argued that firms arise to the extent that they do in order to overcome some of the inevitable inefficiencies involved in coordinating labour and skills via markets.[50] Tangible goods can be owned and distributed via markets with comparative efficiency. Labour, on the other hand, can only be *hired* and has the unusual economic characteristic that it can *speak*. Contracts must therefore be far more complex, covering far more possible contingencies, which raises the 'transaction costs' involved in negotiating and fixing them.

It is far more efficient, Coase reasoned, to organise people in hierarchies, whereby an individual is paid for a fixed period of time (a wage), but without the contract specifying *exactly* what they must do in return. Instead of either hiring on a task-by-task basis or specifying each task in advance (each of which is impracticably inefficient), the institution of the firm grants the employer *authority* over the employee, who is then expected to obey them within the limits set down in the contract.

The intangible asset in this instance is social and human capital. But other intangible assets also create problems that invite political responses. A brand and its associated reputation need protecting in various ways. Industries that rely heavily on intellectual property (IP) require firms to defend this 'property' in various ways, such as copyright, trade secrets, digital rights management and licensing. The lengths they go to in looking after IP – and the failures they encounter along the way – should alert us to quite how unlike conventional property it is. A software firm does not literally *own* the code it produces any more than it *owns* the employees it employs. But through various legal and technical mechanisms, it seeks to control who is able to gain access to it.

In what Jeremy Rifkin has dubbed the 'age of access', assets are not valuable because they are legally owned by us but because they are *available* to us.[51] In this respect, a loyal customer base is an asset that has to be strategically nurtured and defended. This is supposedly achieved with the customer's consent, thanks to good service and advertising, yet with the rise of service contracts and advertising that targets the unconscious, firms have opportunities to constrain customers as well. The exertion of power over others is central to how capitalism operates, and much of what passes under the category of 'ownership' is in fact the freedom and power to dominate others.

A political vision of the firm is troubling inasmuch as it challenges the sunnier liberal economic view of individuals freely contracting with one another as they choose. The state is an accomplice here, providing the employment and intellectual property law that stands behind the orders issued by businesses. The French sociologist Jacques Donzelot identifies a crucial moment in the development of French capitalism as occurring in the mid-nineteenth century, when the French government granted factory owners the effective power to police and discipline their labourers during the working day.[52] Of equal importance to this day, the state has to ensure that individuals are educated in a way that is compatible with the needs and ethos of employers.

In fact it is only thanks to a particular legal fiction that a firm is able to appear as an entity separate from its founders, creditors, managers and employees in the first place. The principle of limited liability, which emerged in the mid-nineteenth century, designates a firm as an independent entity that can receive investment and be liable for risks. But it is legally distinguishable from the people who own shares in it. This fiction is necessary to protect shareholders from being liable for its debts in case of bankruptcy, but it has had the bizarre side effect of creating a view that an association of people can be treated like an item of physical property.

This metaphor of association-as-property has created a second form of power relation, as discussed in chapter 1. The hierarchically organised firm becomes subservient to the interests of external asset holders or purchasers, which itself exacerbates the internal hierarchy of management over staff. The original justification for equity investment is that it enables firms to externalise risks around a larger number of people, and thereby to pursue more innovative, higher growth strategies. The firm gains access to a far larger pool of capital, while the public get to share directly in capitalism's remarkable capacity for wealth creation. The PLC model originally represented a particular accommodation between the needs of the public and those of industry. As we will touch on in the next chapter, stock markets have long held out the political promise of an inclusive, asset-owning democracy.

With the rise of institutional investors and the pursuit of shareholder value, democratisation of corporate ownership has turned to centralisation, albeit in the name of several million pension and insurance policy holders. Only 15 per cent of UK shares are directly held by individuals today, down from over half in 1963.[53] Over the same period, institutional share ownership has risen from 25 per cent to 70 per cent.[54] The simple concept of ownership, that makes sense in the case of a shopkeeper's relationship to his shop, is transported into an entirely alien landscape of vast corporations, which require complex chains of hierarchy and accountability to be controlled. As John Kay has argued, a leap of logic occurs, in which legal ownership of a company share (the right to control and benefit from a slice of risk capital) is equated to ownership of the company itself (the right to dominate a complex socio-political entity).[55]

Even more recently, a range of other 'owners', intermediaries and financial voices has emerged, in the hope of influencing and dominating firms further. Each of these relates to management in different ways, over different time horizons, from the pension holder who saves over several decades, to the private equity investor who engages with a firm over a few years, to the pension fund manager following quarterly reports, down to the hedge fund manager seeking to exploit sudden, short-term movements in stock prices. The think tank Tomorrow's Company presents an impressive examination of the full spectrum of company owners, evaluating the different forms in terms of the 'stewardship' they offer a company. As it argues, the rise of institutional investors and private equity creates additional distance between the suppliers of capital and companies themselves. As the report *Tomorrow's Owners* puts it:

With every new intermediary in the value chain that links savers to investment performance, there is an inevitable erosion of the sense of stewardship. In the global investment landscape, the value chains are *now heavy with intermediaries, some of whose motives are unclear and some of whose activities can be destructive to long-term wealth creation and sustainability.*[56]

The concept of 'stewardship' helps to differentiate between different forms of equity capital, in terms of its sympathy and patience with businesses. Yet it still presents the firm primarily as a simple object with a legal owner, then examines the nature of the relationship between the two. This misses the various social, psychological and political dimensions of ownership, which enable a firm to cohere as an entity at all. The variety of ownership forms goes further still, once one considers the plurality of intangible assets and governance structures that characterise a firm.

Varieties of ownership

The first question is whether dominant networks of ownership and investment can be influenced to achieve this greater pluralism. Ethical investment funds, in which savings are only put into equities of companies with good environmental and social records, are already popular in Britain. Triple bottom line accounting, where companies report on their environmental and social performance alongside their financial performance, is voluntarily practised by firms seeking to create publicity around their ethical principles. These sorts of codes of conduct work with the grain of existing investment and accounting practices, seeking to subtly alter management incentives so that non-financial goals are pursued in addition to profit.

Some would like to see the democratic potential of stock markets exploited more fully. Institutional investment vehicles have considerable power over companies, and could be harnessed to serve the broader social and political interests of those whose money they are responsible for. In *The New Capitalists*, Stephen Davis, Jon Lukomnik and David Pitt-Watson argue for a new era in which the broader, longer-term social and economic interests of pension-holders are transmitted into the governance of companies. They believe that 'institutional owners accountable to their savers push corporations toward sustainable prosperity through responsible management'.[57] Similarly, Tomorrow's Company seek greater 'stewardship' from external owners, in which they take a more active, long-term role in supporting successful companies.

If the civic potential of private pension-holding can be exploited, there is no limit to what political ends can be pursued in this way, at least where a large constituency of people has an interest. While the firm may remain a hierarchical entity, control over it can be democratised via the political power of 'citizen-savers'. Trade unions are alert to the potential that their members' private pensions could exert over capitalism.[58] Meanwhile a number of projects, such as Enhanced Analytics Initiative, seek to help fund managers factor in the non-financial 'externalities' associated with their investments.

It should be noted here that there are other types of shareholder that are neither the imagined 'individual shareholder' that held sway during the 1960s nor the 'institutional investor' that dominates today. To be a shareholder is also to be a member with a vote, which carries intrinsic democratic value, though there are also varieties of share, as described in Table 1. A founder may retain a large share of a quoted company, with a 20 per cent block-holding representing a 'controlling interest'. Some individuals may choose to own shares in a company simply because they are closely affiliated with it in some other way. As we will discuss in the next chapter, share ownership by employees has an appeal, helping to align the interests of management and employees. However, while it may be considered desirable to engage more people in share ownership *per se*, this does not address the issue here of how to generate greater plurality in how firms are financed and governed.

While institutional investment via the stock market has risen over the past 30 years, it has been challenged over the last decade by a rival form – private equity. These funds buy large shares of a company directly, not mediated by the stock market, giving the buyer certain powers over how the company is run. This may be to help the company grow rapidly (as with venture capital) or it may be because it appears to be under-performing

Table 1 **Varieties of shares issued**

Ordinary shares	Have no special rights or restrictions. They have the potential to give the highest financial gains, but also have the highest risk. Ordinary shareholders are the last to be paid if the company is wound up.
Preference shares	Typically carry a right that gives the holder preferential treatment when annual dividends are distributed to shareholders. Shares in this category have a fixed value, which means that a shareholder would not benefit from an increase in the business's profits. However, usually they have rights to their dividend ahead of ordinary shareholders if the business is in trouble. Where a business is wound up, they are likely to be repaid the par or nominal value of shares ahead of ordinary shareholders.
Cumulative preference shares	Give holders the right that, if a dividend cannot be paid one year, it will be carried forward to successive years. Dividends on cumulative preference shares must be paid, despite the earning levels of the business.
Redeemable shares	Come with an agreement that the company can buy them back at a future date – this can be at a fixed date or at the choice of the business. A company cannot issue only redeemable shares.

and has greater potential for profit. Some private equity funds are themselves listed on the stock market, such as 3i. Of the largest 100 British companies not listed on the stock market, 39 have private equity investment, more than half of which had previously been listed.[59] The growth in private equity in the UK means that it now represents a significant challenge to the dominant, quoted company model of the firm: some three million people, or 16 per cent of the private sector workforce, now work for firms controlled by private equity.[60]

In the UK, return on investment for conventional private equity funds is 11.8 per cent a year, compared with 4.5 per cent for venture capital.[61] Evidently creating value in new ventures is a much greater challenge than extracting it from established ones. However, effective and patient venture capital is necessary to address the competitiveness challenges discussed in the previous chapter.

Could private equity be put to purposes other than maximising return on investment? Certainly private equity funds differ in their specifications of how high that return should be and over what time horizon it should arise. Tomorrow's Company identify that private equity is 'potentially the ultimate in shareholder stewardship' – but the keyword there is 'potentially'.[62] Funds which pursue a vision of sustainable, prosperous organisations with long-term investment horizons represent a very different form of capitalism than those which spread themselves thinly over hundreds of start-ups or buy large companies in order to asset-strip them. Britain currently has more venture capital as a proportion of GDP than the USA, Germany or France, but it is not clear how well it is supporting long-term business generation.[63] The average period of investment of these funds is currently four years, but the question is what sort of governance and expertise they contribute during that time.[64] Too often equity is provided on the condition of substantial control, but only exercised with that limited time horizon in mind.

How far private equity can be used to pursue non-financial goals depends on the investors and companies concerned. Community Interest Companies were established in 2005 as a new organisational form, which existed to serve some community purpose, but which could still sell shares and return a dividend, capped at 5 per cent. Assets are locked in to the company, to prevent it being bought and sold for greater profit. Helping social enterprises and not-for-profit organisations gain access to equity finance, with the greater growth potential that it holds, has been a long-standing objective for many working in this area. Various 'social venture capital' funds now exist, such as Bridges Ventures and Triodos Opportunities Fund, which exist to help profit-making social enterprises expand. There is even an argument for establishing a separate stock exchange for social enterprises.[65] We will return to this issue as a policy challenge in chapter 5.

Yet a far more radical break from the conventional understanding of company ownership, be it public or private equity, is where neither the company nor its shares can be bought or sold at all. This is a form of organisation that can be loosely referred to as a mutual, and it challenges many contemporary assumptions about the meaning and value of ownership. Mutuals are societies, trusts or cooperatives that own assets and are run on behalf of their members. Table 2 lists the dominant types of mutual in the UK, along with their economic and membership sizes.[66] The rules governing these associations differ depending on their goals, as the next section will explore. But one thing that they hold in common is that, while members are the owners of these organisations, they cannot sell this member-ownership, save where there is some strategic demutualisation, as occurred with ten of the largest building societies during the 1980s and 90s.

The obvious limitation of this form of ownership is that expansion occurs almost entirely through bank loans or retained earnings. Yet hybrid options are feasible, that give some access to equity finance, but within the strictures of a mutual structure. Building societies now offer Permanent Interest Bearing Shares (PIBS), which are tradable on the stock exchange but which pay out interest, rather than a share of profits. Equally, a portion of a company's equity may be held in trust, while the rest may be directly owned by shareholders. Hybrid models of cooperatives are emerging, in which 'investor-members' get to supply equity capital, which appreciates over time and can be sold internally, but without granting increased voting rights.

The Baxi Partnership offers a further hybrid option, dedicated to creating and supporting employee-owned companies. Baxi manages a £20 million endowment, which it uses to finance employee buy-outs and employee-owned start-ups. It provides advice for companies and entrepreneurs establishing themselves as employee-owned, but does not seek to

Table 2 **Breakdown of mutual organisations in the UK**[67]

Sector	Number	Members	Employees	Revenue (£s)	Assets (£s)
Building Societies	55	23,038,000	51,578	4,700,000,000	360,000,000,000
Friendly Societies	200	6,000,000	4,600	2,271,005,984	17,500,000,000
Mutual Insurers	33	10,564,159	20,102	3,458,468,000	77,000.000,000
Co-operatives	2,753	9,008,221	159,434	20,123,892,555	6,518,625,537
Credit Unions	480	733,093	1,079	30,909,000	558,000,000
Housing Associations	1,879	5,328,335	143,654	10,800,000,000	52,477,000
Leisure Trusts	120	*	26,000	620,000,000	
Football Supporter Trusts	155	115,941	11	5,211,935	5,297,546
GP Co-ops and Mutuals	40	*	8,000	150,000,000	
Cooperative Trust Schools	1	*	140	6,400,000	
Clubs and Societies	10,000	9,000,000	25,000	463,000,000	219,915,731
Employee-Owned Businesses	200	*	110,000	25,000,000,000	
NHS Foundation Trusts	89	1,120,000	294,610	16,162,000,000	14,562,000,000
Total	**16,005**	**64,907,749**	**844,208**	**83,790,887,474**	**476,416,315,814**

influence their direction or investment decisions in the way that conventional venture capitalists might. Viable, profit-making companies receive equity investments from Baxi of greater than 50 per cent share, but the value of that share does not grow. Instead, a return on the investment (equal to a proportion of the company's value added) is paid back to Baxi, and the equity is gradually bought back by the employees over time. This way the £20 million endowment is preserved and grown.

The membership and governance of any mutual depends on what it has been established to do. One thing that is clear is that none of the organisations categorised in Table 2 exists purely to make a profit, although some of them – including employee-owned businesses – do return a dividend. But as we have seen, it is relatively difficult to view *any* organisation with *any* ownership structure as existing purely to make a profit, and to do so is destructive. Despite the rhetoric and pursuit of shareholder value, the inescapable fact remains that a company consists of hierarchies, relationships and intangible assets that evade the narrow, legal-economic definition of ownership. This helps to explain why treating companies as tangible property, and buying and selling them as such, produces such poor economic results – it fails to take seriously the curious nature of the firm as a social, political entity.[68]

A form of ownership that cannot be sold may frustrate some of our short-term economic impulses, and flies in the face of financial orthodoxy, but sits much more closely with the ambiguities of ownership and firms discussed in this chapter. As much as we may want to have private, transferable, legal ownership of intangible assets, it is not possible. The psychological dimension of ownership therefore becomes all the more important where goods are shared, relational and intangible. In this respect, mutual-type ownership structures are a more honest, and therefore more sustainable, basis on which to cooperate and organise, not only in pursuit of public and charitable goals, but in pursuit of private ones too. There is no automatic reason why firms owned in this way should be less hierarchical or less profitable than firms owned by shareholders. But the absence of financial pressures and the recognition of an organisation's social complexity creates tremendous opportunities for alternative purposes and freedoms to arise. These are facilitated and safeguarded by governance structures.

Varieties of purpose, varieties of governance

Remove the demands of financial markets, and an exciting question arises: what is a company for? As we have already discussed, this is an unavoidably political question. In the first instance, a firm is a hierarchical entity that exists to exert an element of control over the various intangible assets that it depends upon to sustain itself as a producer or service supplier. This includes knowledge, employees, IP, creditors, suppliers and loyal customers. But in whose interests?

The motivation behind founding and growing firms is more complex than the pursuit of profit alone, although some reward is expected for the risks involved. We will see examples in the next chapter of entrepreneurs who specifically sought to create something more valuable and enduring than a mere money-making machine. Especially in more 'coordinated market economies', this vocational approach to business can often be found in very large companies, where senior management have been promoted from within and have an intimate understanding of the processes, technologies and traditions that enable the firm to pursue its institutional purpose. One of the many risks taken in the run up to the financial crisis was when bankers abandoned a vocational attachment to the core purpose of a bank in favour of financial 'innovation'.

Firms may require a degree of hierarchy in order to coordinate their activities and to avoid the 'transaction costs' of constantly resorting to market contracts. But there are two ways in which the power of managers can and should be challenged.

Firstly, there is a political argument for installing democratic structures within firms, in order to ensure that they serve the interests of their constituents. This typically involves the creation of two boards, one containing managers or executive directors who are responsible for day-to-day decisions, the other containing trustees and elected representatives who are responsible for upholding the interests of the organisation's members. In this respect, the formal separation of 'ownership' and 'control' remains in place, at least inasmuch as the 'owners' (in this case whoever the members are) do not directly control the organisation. However, the 'owners' have to be consulted periodically and on issues concerning the long-term direction of the firm, and there are varying degrees of overlap between the two boards.

This is a renowned feature of German corporate governance, where firms rely more heavily on bank loans than on equity finance. The non-executive board will typically feature representatives of banks, employees, employers associations and unions. In the case of cooperatives, the members are those people who choose to trade with the cooperative, who purchase an ownership stake for a nominal fee, then elect representatives to the board. Where public services are run in this way, the non-executive board will contain representatives of the users of those services, as occurs with Foundation Trust Hospitals. There are a number of precedents of other public services being run by mutuals, with 600 cooperative schools in Spain dating back to the 1930s, and there is scope for expansion in the UK.[69] Employee-owned public service providers, such as Greenwich Leisure and Central Surrey Health, have also emerged in recent years.

The design of governance follows from the central purpose of the organisation in question. Yet it does not help to view this in a very strict sense – to install a narrowly-defined social or economic purpose in place of profit-maximisation may be to replace one simplification with another. The virtue of democratic governance structures is that they enable debate, ambiguity of purpose and plurality of voices, at the very top of an organisation. Chains of accountability are important, but it is dangerous to view them as absolute. One of the great virtues of cooperative governance structures is not that they enable companies to be run *purely* in the interests of consumers or *purely* in the interests of employees, but that a variety of ethical and social factors can be fed into decision making, for which the membership may not be technically responsible. Environmental concerns would be one such example.

The second way in which management power can and should be challenged concerns the cultural and economic aspects of the intangible assets that they are overseeing. The culture of advanced capitalism has changed substantially since Coase's time, and the model of the despotic, hierarchical firm no longer works to the same extent. The decline of manufacturing and Taylorist management means that flexible production, creativity, human capital and collaborative working are now at the heart of our economy. This is partly about the shift to a 'post-Fordist' economy built around service industries and fast-changing consumer desires, which are satisfied symbolically as much as objectively. But it needs acknowledging that it has been thrust upon firms by employees as well. As Paul Miller and Paul Skidmore found in a previous Demos report:

Employees want more human organisations with greater autonomy and flexibility. They want an experience of work that is aligned with their values. They want a workplace forged in the image of their identities, not a workplace that tries to define them. They want organisations that can let go, and grant them a greater say in how things are run.[70]

Employees who are listened to in this way may be a fortunate minority, but the point still stands that the expressive, consumer ethos that has transformed our economy in recent years also penetrates the workplace.

There is a robust economic case for granting employees greater autonomy in the workplace, for instance through increasing their task discretion.[71] It is estimated that one-third of British productivity growth and half of labour productivity growth between 2000 and 2005 was due to investment in various intangible assets, rooted in people.[72] Employees hold knowledge and information that is crucial to the economic success of their firm, and this cannot be utilised effectively if their relationship to management is purely one of subservience. The political character of the firm has had to change out of economic necessity, and will have to change further if Britain's enduring productivity deficit is to be eliminated. An empowered workforce is now a productive asset.

But there are additional reasons to oppose excessive workplace hierarchy that are not reducible to the productive gains that can be made. There are moral and political arguments for granting employees power over their working practices. Republican political theorists criticise certain elements of capitalism for the lack of control and meaning that it grants workers. Thinkers such as Nien-He Hsieh and Stuart White turn to democratic governance structures such as cooperatives as a means of redressing this. While there are tensions between the needs of capital and the positive freedoms of the workforce, Hsieh believes that 'it is possible to imagine work that meets the criteria of meaningful work within the context of the employment relationship'.[73] Political empowerment matters at the level of the individual and the task, as well as at the level of the firm and society.

This links to a moral argument about the nature of work and the importance of self-expression. The sociologist Richard Sennett has written of how the modern workplace destroys the capacity for human beings to tell a coherent story about their lives and to develop the capacity for craft.[74] In this respect, Sennett holds the post-bureaucratic, flexible workplace partly culpable for preventing individuals from growing expert in particular crafts or identifying with their work over time. It should be acknowledged that an 'engaged' and consulted workforce *may* opt for repetition, security and gradual skill development, and not endless flexibility and change. Another way of framing Sennett's argument would be that contemporary workers don't feel adequate ownership over their work – the psychological dimension of ownership that evades economic or legal categories.

The psychology of work and ownership rebounds back on measured outcomes for employers and society. According to the World Health Organisation, stress at work is associated with a 50 per cent excess risk of heart disease and a range of other mental and physical health risks.[75] Worryingly, the number of people in Britain who claim to be working 'very hard' or 'under a great deal of tension' has been rising steadily since the 1980s.[76] The risk with focusing on 'employee engagement' in purely economic terms is that some workers may be more autonomous, but also more stressed and unable to distance themselves from the workplace when they want to, as some evidence has confirmed.[77] One recent study has actually shown a *decline* in the number of employees in the UK who feel that they have a great deal of influence over their work.[78]

The opportunity offered by firms that do not identify as profit maximising (which is not the same thing as profit making) is that work may be more rewarding, meaningful and autonomous. If one thinks of the various intangible assets that are organised to produce a firm, each of these *potentially* carries intrinsic value, and not only instrumental economic value. Customer service, creativity, cooperation between colleagues, innovation, investment in knowledge, public service and much else are all phenomena that *can* be valued intrinsically, rather than mobilised as a means to generate profit. A society that wants more of these things – for whatever reason – needs to produce the structures that will produce and defend them. Economists tend to describe such side effects as 'positive externalities', add-ons to the more primary mechanisms of exchange and competition. Why not consider them as goods in and of themselves? This may involve founding cooperatives, trusts and societies that exist for an explicit purpose. But in the first instance it depends on reducing or redirecting the power of financial markets over firms.

The future of cooperation?

The evolutionary perspective on the firm sees it as drawing on and contributing to its own particular social, cultural and technological contexts. As these contexts change over time, so structures of cooperation and production change with them. If all firms are cooperatives of one sort or another, albeit with different ways of recognising this, it is worth considering the emerging forms of cooperation in 2009, within which may lie the seeds of future models for the firm or alternatives to it.

Over recent years, the internet has facilitated an entirely new solution to Coase's problem. Rather than organise assets within a hierarchical structure, with people hired on a regular wage, they can be brought together on a project-by-project basis, dispersing in between. Firms have already learnt the art of 'just in time production', but we are now witnessing the rise of the 'just in time producer'.

This was initially witnessed in the early 1980s with the birth of open source software projects. The rise of 'social media' and social networking sites over the last decade has meant that work, information-sharing, creativity and creation of intangible assets can occur without people first being organised into cooperative units. Individuals can participate in these activities as it suits them, and others can contribute, join in or benefit as and when they please. As Clay Shirky says, we can now 'organise without organisations'.[79]

The one condition on which this model of cooperation depends is that the whole notion of economic 'ownership' of intangible assets is abandoned once and for all. This does not mean that there is no control involved. On the contrary, open source software and open access cultural content depend on legally binding licences to restrict certain types of use, such as those that would privatise, commercialise or lock up the assets in question. For instance, a range of Creative Commons licences can be added to copyrighted material, to specify the precise ways in which it may or may not be used. One might say that where mutuals have their value *locked in* to them, open networked collaboration practices make sure that value remains *locked out* of any private hands or organisation. If most firms seek to defend their intangible assets as a 'private good', and mutual societies do so as a 'club good', then open networked collaboration does so as a 'public good'.

These networks are capable of replacing some of the functions of traditional firms. They enable information-sharing, community formation, low-budget R&D and so on, but without any management at all. There are some businesses that are directly threatened by this new model of cooperation, especially those businesses that rely on collecting and selling codified information. Many newspapers and magazines profited hugely from selling box advertising space, a market that has now been effectively replaced by free websites such as Gumtree. On the other hand, it may be that traditional organisations can *gain* from enabling open, networked association to flourish within them, as Peter Bradwell and Richard Reeves have argued.[80] The fact that these networks are not coordinated by prices or wages does not mean that they are not productive economic agents.

By the very nature of such associations, they are ill-suited to generate revenue, save through exploiting their public character and selling advertising space. For this reason, there are very few examples of such structures providing a basis for secure employment. Examples do exist of contingent labour being organised by new online networks, such as Amazon's Mechanical Turk and Slivers of Time, which mediate between potential employers and potential employees, to provide chunks of work split into individual tasks. School of Everything mediates between potential teachers and potential learners, taking education and training outside of the school, university or business. What these examples indicate is that, in Coase's terms, the 'transaction costs' of buying and investing in labour have fallen substantially, and we are consequently that much less reliant on hierarchies as a means of organising our productive assets.

This form of association discards the sense of membership that mutuals and orthodox firms rely on. Barriers to entry are virtually non-existent and the benefits cannot be contained, making them difficult vehicles for private investors to support. Where they have no fixed costs or wages to pay, this is not a problem. At present, 'organising without organisations' is presenting a very real problem to traditional firms which do have overheads, especially newspapers. But where open networks themselves have overheads, they are often dependent on charitable donations or some other third party support. Wikipedia and mySociety, for example, are founded as charities dependent on donations. Channel 4 has now established a fund, 4iP, to support more such ventures, some of which are revenue generating, but not all.

If mutuals take one step away from capitalism by abandoning profit-maximisation, then these networks take another step again, by abandoning the use of prices and wages. In this respect they often disrupt other firms more than they can replace them. But if open networked collaboration cannot quite replace the firm as the basic social unit of capitalism, does it have any potential to replace existing mechanisms for coordinating financial capital? Already there is a small-scale alternative to banks and building societies in the form of Zopa, which brings together lenders and borrowers online to bypass intermediaries. Individuals trust others to repay loans on the basis of independent credit ratings, achieving better rates of interest than banks or building societies are able to offer. Borrowers can access up to £15,000.

Applying a similar principle to equity investment is problematic, for the simple reason that a higher level of expertise is required. A peer-to-peer venture capital model can be imagined in which hundreds of users buy shares in a start-up not mediated by the stock market, but the viability of a new business is not something that can be easily understood by amateur investors or communicated via a simple rating system. On the other hand, it would appear that the internet significantly lowers the barriers to the creation of new consumer cooperatives or collectively-purchased assets. If participants in an online network all desire something, such as more renewable energy, then they ought in principle to be able to agree to pool their money as a form of equity finance.[81] Abundance, a new venture coming out of the innovation unit of Imperial College Business School, Design London, promises to support exactly this, coordinating amateur investors to purchase wind-farms collectively and receive a return. Then there are smaller-scale examples of social media being used for collaborative purchasing. The mySociety website Pledgebank has been used in this way, for instance with the successful pledge 'I will donate $20 to purchase a new energy-efficient refrigerator [for a local social enterprise] but only if 49 other people will do the same.'

The problem these associations have is that they struggle to appoint decision makers or to overcome their defining feature, which is the freedom for people to exit and enter from one moment to the next. A mutual establishes a set of democratic rules that everyone then consents to. Power becomes centralised, but on the understanding that it is used within a constitutional structure. Open collaborative networks, on the other hand, have certain individuals who are more powerful than others (the highly connected, the initiators, the brokers) but little sense of legitimacy surrounding these individuals, and therefore little obligation for others to obey them. The bodies providing the 'constitutions' of the new associations tend to be private companies – Facebook, Google, Zopa etc – and their rules are currently established as they please. If a new *democratic* mutualism is to arise from any of this, and not merely a new informational mutualism, then this problem will have to be overcome.

3 A better model of the firm

Capitalism is always a curious mixture of liberalism and despotism. It grants freedom, equality and participation with one hand, while it imposes orders, hierarchy and inequality with the other. We barely notice that we live schizophrenic economic lives, in which half our waking hours are spent being indulged and obeyed as sovereign consumers, while the other half is spent being ordered around as employees. But in neither case are we treated as responsible adults. To live responsibly, both as consumers and as workers, would mean exercising economic freedom with a sense of the stakes involved. The liberal and the despotic elements of capitalism would be brought a little closer together, so that freedom was never untrammelled and power never unaccountable.

At the centre of an argument for employee ownership is a subtly different vision of how economic power should be organised and utilised. Managers possess a greater sense of accountability to the employees who own the firm, while employees acquire a greater sense of responsibility for the assets that they are tasked with using and developing. An alternative form of autonomy is at work, that is very different from that demanded by the investors and executives that control listed companies.

There is a rich tradition of employee ownership, much of which is distinctly British. Given the 'path dependency' of how national economies evolve, this matters. Workers' cooperatives have prospered in Britain since the nineteenth century. Between the 1930s and the 1960s, the Liberal party expended considerable energy defining a political economy that was neither capitalist nor socialist, but granted freedom through ownership.[82] And use of employee share ownership plans is known to be more popular in English-speaking 'liberal market economies'.[83] In many cases, this tradition is the counter-movement against the more ruthless,

Table 3 **Definitions of employee ownership forms**[84]

'Employee ownership'	Employees own more than 50 per cent of the shares, either directly or indirectly
'Employee share ownership'	Employees own some shares in their firm directly
'Workers' co-operative'	Employees own firm indirectly as members, not as shareholders, with rights to be represented at board and/or management level
'Co-ownership'	Employees hold substantial minority stake of more than 25 per cent

short-termist aspects of British capitalism, which explains part of its appeal here. But in the context outlined in chapter 1, there is a good case to normalise many parts of this agenda.

This chapter examines employee ownership in detail, including workers' cooperatives and other forms of financial participation such as employee share ownership. Table 3 offers clarification on how these terms are used, although there is considerable overlap between them. There is ample evidence that, structured well, employee ownership can create a uniquely virtuous circle between workplace democracy and productivity.

There is one crucial technical distinction that needs to be explained and stressed at the outset. This is the distinction between 'direct' and 'indirect' employee ownership. *Direct* employee ownership means employees purchasing or being given shares, a practice that governments have sought to encourage with tax incentives, as discussed in the next section. *Indirect* employee ownership means a firm's equity being placed in trust or other type of mutual society, which acts on behalf of all employees, and distributes profits amongst them. This distinction has very important implications for how risk and reward are distributed within firms. For example, the common critique that employee ownership increases the economic risk faced by staff, by making their savings and jobs dependent on a single entity (the 'eggs in one basket' argument), only applies to direct ownership. Firms such as the John Lewis Partnership, which operate with indirect employee ownership structures, do not require – or for that matter permit – staff to invest any of their own money at all.

A common assumption, even for some who promote workplace democracy, is that it is necessarily traded off against productivity. There may be extremes and certain industries where this is the case – extreme forms of workplace democracy *may* leave no scope for managerial discretion, while there is no doubt that productivity *can* in many industries be achieved through increased managerial domination. Any mutual organisation must somehow balance its commitment to member representation as a political good with a support for efficient management as an economic good. The most representative governance structures are not necessarily the most effective or efficient, but then the most effective and efficient are not necessarily the most fair. This problem is grappled with practically when mutuals and employee-owned firms set about establishing or re-establishing their constitutions, most tangibly in the balance of power between the board of directors and the board of member representatives or trustees.[85] The appeal of employee ownership is that the democratic and economic benefits of mutualism can start to reinforce one another. Let's look at these in turn.

The democratic gains

One political curiosity of employee ownership is that it has been claimed as a goal by both left and right. The left has viewed it as a cooperative, ethical alternative to exploitation by capital, while the right has viewed it as a means of diffusing industrial disputes and a way of bringing the interests of labour into line with those of management. But whether it be capital that becomes more amenable to labour or vice versa, the central point is that dispersing ownership and governance rights throughout the firm creates a greater sense of *legitimacy* about the decisions that are taken. This is partly because participation in decision making is higher, but also because the decisions that are made are more ethical, factoring in a broader set of interests.

The most prevalent form of employee ownership in the UK is employee share ownership, a form of direct ownership. At the absolute minimum, employee share ownership can occur without any significant governance implications at all. After all, an employee is free to buy stock in any company, including their own. However, successive governments have used tax incentives to increase employee share ownership, starting with Save As You Earn in 1980, followed by the Company Share Option Plan in 1995, then by the Share Incentive Plan in 2000. These are described in table 4. In Britain, around 20 per cent of workplaces currently use some type of employee share ownership scheme, covering 32 per cent of all individuals in employment.[86]

There is an ideological component to these plans. The USA has a long tradition of viewing share ownership as an important component of its democracy, the twentieth century equivalent of land ownership. Starting with Louis Kelso in the 1950s, then picked up by Senator Russell Long in the 1970s, the case has been made for drawing all members of society into the stock market. As Jeff Gates, the heir to this tradition, argues, the problem with contemporary capitalism is that it 'is not designed to create capitalists but to finance capital'.[88] Capital ownership needs dispersing in the form of shares. The British Conservative government was sympathetic to this project over the 1980s and 90s.

But equally the 'liberal republican' tradition views broadening asset ownership as an important precondition of a participatory, empowered citizenry.[89] Rather than capital being taken into the hands of the state, where it retains much of its monopolistic capacity to dominate, it must be dispersed and made more subservient. In the case of worker cooperatives, such as the famous Mondragon retail and finance network in Spain, this occurs through 'labour hiring capital' rather than 'capital hiring labour'. The principle of profit-sharing is an additional liberal republican means of tempering the power of capital. As Stewart White points out, initially this concept rested on the notion that both labour and capital have an 'income right' –

Table 4 **Varieties of tax-advantaged employee share schemes in the UK**

	How it works	Uptake
Save As You Earn (SAYE)	The company grants a three or five year share option, often at a price discount of up to 20 per cent, to employees who commit to save regular amounts of up to £250 per month. When the option reaches its term, the employee can decide whether to exercise the option, using the savings to pay for the option, or simply withdraw the savings if the option is not worth exercising.	The scheme is popular in public companies, providing a risk-free savings and investment opportunity for employees. Around 780 companies operate SAYE schemes, including two-thirds of FTSE 350 companies.[87] However, the scheme has been criticised for not creating long-term employee ownership because many employees choose to sell shares immediately or soon after exercising their options.
Company Share Option Plan (CSOP)	Like SAYE, except the company can choose which employees may benefit, there is no requirement for a savings contract, and the size of the option can be up to £30,000. Any gains made by the employee are taxed as capital gains, not as income, which would be the case with 'unapproved' types of option scheme.	Commonly used by public and private companies to incentivise management and executive level staff, though there is no reason why the scheme cannot be operated by companies for all employees. Over 10,000 companies operate a CSOP or its small company equivalent, the Enterprise Management Incentive (EMI) scheme.
Share Incentive Plan (SIP)	A flexible scheme in which the company may award employees free shares worth up to £3,000 per annum and/or may invite employees to buy up to £1,500 of shares from their pre-tax earnings, often sweetened by the company with matching free shares on a ratio of up to 2:1. To claim all the tax benefits, the employee must usually hold the shares for five years.	Since its introduction by the Labour government in 2000, this has now overtaken SAYE as the most popular scheme, with around 940 schemes in operation.

return on investment is capital's 'wage'.[90] Profits are therefore shared between capital and labour, recognising the equal contribution of each. This principle has long been observed in France, where profit-sharing has been common since the 1840s, and is currently a statutory obligation for all companies of more than 50 people. Liberal republicans may well commit to employee share ownership on this principle.

Within the firm itself, there is compelling evidence that employee share ownership produces greater commitment between employers and employees. Studies in the USA found that firms with high levels of employee share ownership also experienced higher levels of identification with the workplace and job satisfaction.[91] Moreover, this appears to be relatively unaffected by the number of shares owned – the mere fact of being an employee-owner, rather than just an employee, has positive psychological implications. This is further proof that ownership is not something that can be easily reduced to the legal-economic rights to a dividend and to control.

On the other hand, one of the central findings of research on this topic is that behaviour does not change unless financial participation is accompanied by other forms of participation in decision making. From an economist's point of view, this is because employee share ownership is a form of collective profit-sharing, and so requires a sense of the collective in order to have any effect. From a democratic and social point of view, this is a virtue, not a defect. Once there is greater identification with a workplace and colleagues, various other positive spillovers tend to occur. In a survey of employee-owned and co-owned businesses in the UK, it was found that 84 per cent of these companies view better employee relations as one of the benefits while 81 per cent view more ethical behaviour as a benefit.[92]

Employee share ownership (ie direct ownership) does, nonetheless, have certain limitations as a basis for empowerment and democracy in the workplace, or in society for that matter. Firstly, as an opt-in, individualised scheme, it only includes those who feel able to afford it. Unsurprisingly, evidence shows that participation in such schemes increases with wages, hence it potentially adds asset inequality to income inequality.[93] In the extreme cases of executive stock options discussed in chapter 1, it can exacerbate inequality severely. A convincing argument can be made that low income individuals should put their savings anywhere but in their own firm, as this makes them doubly vulnerable to it failing.

Secondly, employee share ownership rarely amounts to a new form of governance, even if it does produce higher employee engagement. In this sense, it satisfies the economic need for greater autonomy and engagement at work (as evidence in the next section shows), but may not satisfy the political need. Direct ownership of shares, in contrast to mutuality, may not in itself represent any form of challenge to existing hierarchies, whether it be the power of management or the power of capital. Where employees own a significant amount of a company (25 per cent is the level at which it becomes defined as 'co-owned') then this changes. The US mechanism of an Employee Stock Ownership Plan exists to progressively increase the employee stake over time, covering all employees collectively, potentially to the point where the firm is entirely employee-owned. UK tax-incentivised schemes operate individually, and while they count as a form of 'shared capitalism' in the sense of collective performance-related pay, they are unlikely to produce an outcome in which the managers are genuinely accountable to employees.

There are alternative, more radical forms of employee ownership that produce an altogether different set of relationships. These rest on various forms of *indirect* ownership, and follow the mutual model discussed in the previous chapter. A firm is established either as a workers' cooperative, in which every employee buys an equal share for a nominal price, or is owned by an employee benefit trust on behalf of all employees. Employees become owners (otherwise known as 'partners' or 'members') when they join the firm, but they do not contribute capital. Equally, they are unable to extract their stake or increase it. Since they do not directly own any of the company, they do not take any shares when they leave. As with all mutual models, the assets are locked in to the firm.

As owners of the firm, employees receive a dividend payment, reflecting the profits made that year. They also have a right to representation at board level. In cooperatives, this is dictated by the cooperative constitution, while other employee-owned businesses tend to design their governance arrangements themselves. The trustees of an employee benefit trust represent a second board, to whom senior management are ultimately accountable. The trust will have a declared purpose, which will be to govern its assets in the best interests of employees. If employees believe the business is not being run in their interests as owners, they have real, statutory power to take their concerns to this non-executive board, who then have the right to refer this to management.

It is important to note that the interests of these employee-owners do not militate against profitable activities in any way – far from it. The task of the trustees is to ensure that managers are doing a good job, on behalf of the employee-owners, who will want to see profits. But the definition of what good management looks like is enriched and the employment relationship more balanced, quite simply because managers are accountable for the power they hold.

The civic and social virtues of employee-owned businesses are difficult to specify with hard evidence. Customers appear to appreciate the ethics of employee-owned firms, which is one of the most commonly cited benefits associated with the structure.[94] They have the additional 'democratic' virtue, at least in comparison to share ownership schemes, of including all members of a workplace. How profits and voice are distributed depends on the constitution that is being used. But the possibility of power and financial reward being retained by a minority at the very top becomes inconceivable. This is an alternative to the 'winner-take-all' model of the firm.

There is another reason to favour this model for those who view firms as part of the patchwork of civil society. A major area of growth in employee ownership over recent years has been where family-owned companies and partnerships face the problem of business succession following the retirement of the existing owners.[95] The dominant solutions to this problem – a sale to a competitor, a private equity buy-out or floatation on the stock market – may return a higher price to the sellers, but they threaten the enduring social and cultural values that define a firm. For owners who view firms as more complex entities than a market valuation can reflect, shifting ownership into an employee benefit trust ensures that the integrity of the firm can survive over generations.

The political theorist Edmund Burke argued that society is more than a contract between its existing members – it is a contract between the living, the dead and the unborn. Citizens and governments need to see themselves as inheritors and protectors of a legacy. This is also one of the most compelling ethical reasons for adopting employee ownership via a trust: managers and employees pay heed to the fact that they are the beneficiaries of a legacy, which needs preserving beyond their own tenure. This is an obstacle not to innovation (as we will explore next) but to the short-termist churn of financial markets, which fail to price intangible assets appropriately and therefore cannot be relied on to preserve their value.

The productivity gains

The economic evidence on the effects of employee ownership is remarkable. An Employee Ownership Index has been produced by law firm Field Fisher Waterhouse since 1992, tracking listed companies with significant amounts of employee ownership. The index out-performs the FTSE by an average 10 per cent annually.[96] Treasury-commissioned research on the government's employee share ownership schemes found that, in the right circumstances, they delivered a 5 per cent productivity increase.[97] These findings are confirmed by a number of other studies, both in the UK and in the USA.[98]

Governance and participation aspects are crucial here. One thing that all studies in this area stress is that share ownership (or, for that matter, other forms of financial participation) only has discernible productivity effects when it is combined with other forms of participation and employee engagement strategies. The issue scarcely needs stressing where employee benefit trusts or cooperatives are concerned, as these automatically introduce their own participative governance arrangements. For example, the productivity effects of granting share options to management is negligible, but increases markedly when these schemes are extended to all staff in a workplace.[99] This is not only a fillip for workplace democracy, but also a fairly damning indictment of shareholder value-oriented practices.

It is important to understand why these effects might arise, which will bring us back to questions of power and democratisation. It is clear that employee ownership brings higher levels of commitment from staff, manifest in lower levels of absenteeism and greater willingness to take on responsibility.[100] It stretches the time horizons of employees as much as managers. A simple economic analysis of this would suggest that employees have a direct incentive to raise their performance if they know that they will share in the profits via the share dividend.[101] This is not unlike the supposed case for paying executives in stock options, which is that it creates a direct incentive for them to increase profits and share price. But a simple economic explanation would also suggest that *shared* capitalism, that is any scheme in which pay is related to collective performance, would lead to free-rider problems, where individual employees reduce their effort in the knowledge that their behaviour alone will not affect their bonus. Yet research on this issue of 'shirking' under shared capitalism finds no such thing.[102]

So what is going on? The concept of 'high performance work systems' goes some way to explaining it: combining varieties of workplace participation is known to produce higher rates of innovation.[103] A workplace is a complex social and cultural ecology. Much of what is invested in and 'produced' in twenty-first century Britain is intangible, and its quality depends partly on the relationships it is embedded in and the subjective evaluations of those who pay for it. Coase saw hierarchies as the only alternative to markets in situations where the latter were inefficient. But hierarchy is a clumsy tool with which to manage the post-industrial workplace, where it is the effort, commitment and innovation of employees that create competitive advantage. Unhappy, unmotivated staff are a significant and costly problem for managers, especially where they voice this by leaving a company.

Employee ownership, combined with elements of workplace democracy, offers a distinct response to these challenges that goes beyond anything that can be achieved through tweaking human resource management (HRM) practices. Firstly, it makes explicit the psychological contract between management and employees. Both parties to any employment relationship have founded reasons for suspicion – management suspect that employees are not contributing as much as they could, while employees suspect that management are not being as honest about their motives and strategies as they could be. HRM policies focus on improving the quality of this relationship, but rarely address the authenticity of employees' concern: that the company is being run in the interests of shareholders, not them.

Employee ownership and representation address this in a sincere fashion. Offering employees a constitutional right to share in profits and participate in decision making begins as a signal from management that they are committed to dialogue and collaborative working, not simply to the extraction of greater effort. As the case studies will show, management operates in a more transparent fashion when the employees not only have rights to representation, but also have a vested interest in the performance of the firm. Employees, meanwhile, have a stronger sense of psychological ownership over assets of which they are the legal owners and intangible assets to which they contribute and from which they benefit. Surveys show that employee-owners take greater care with their work, hold management to account for decisions, and have a higher propensity to share knowledge.[104]

Profit-sharing in the form of an annual dividend payment performs a critical role, but not one that can be easily understood via the narrow economic concept of 'incentives'. The dividend payment signals something about the power structures at work in the firm and the commitment of employees and management to it. Receipt of an annual dividend is something that management and employees have in common. The fact that it covers all staff (at least where indirect ownership is used) makes it a democratising force, in marked contrast to how stock options are used at the very top of many listed companies as a force to *increase* the divide between management and shop floor.

Appropriating Ronald Coase, the previous chapter described the firm as a political response to an economic problem. This economic problem is that firms need to buy something that they cannot own and that can speak, namely labour. The solution in Coase's time was to run the firm like a dictatorship, in which employees relinquish power over their working day in exchange for a regular wage. This model first ran into problems during the 1970s, when it became clear that flexible, flatter organisational structures were more competitive than rigid, hierarchical ones. The growing significance of intangible assets makes management-as-dictatorship less and less viable. British firms have been struggling with the transition out of top-down hierarchy ever since, with varying degrees of success.

The democratic, employee-owned firm takes the principle of participation and dialogue and instates it as a constitution. The shift from industrial hierarchies to post-industrial collaborative structures cannot be achieved through rhetoric and HRM alone; it needs companies that are designed along different lines. Public services should take note as well. If the firm is a political response to an economic problem, the way in which *power* is legitimated and held to account within firms becomes a matter of economic and political urgency.

Opportunities for growth

Co-owned businesses (where employees have a stake anywhere above 25 per cent) are currently worth an estimated £25 billion to the UK economy.[105] Some of the larger ones, such as John Lewis Partnership and Scott Bader, were converted to employee ownership thanks to the equity being given away by the family owners several decades ago. Others were either founded or converted more recently, taking advantage of tax breaks on employee benefit trusts that have since been terminated (discussed in chapter 5). This is in addition to the extensive use of employee share ownership schemes, which a fifth of firms are now using.

Business succession is a major factor in the sector's growth. All three of the firms in the case studies presented in the next chapter are either concerned about or grappling with business succession, and see employee ownership as a solution. A 2001 survey indicates that around 30 per cent of business closures in the UK can be seen as succession failures. Selling a business is one solution, but often only produces efficiencies where the new owner strips its assets and shrinks it. Value is removed, not added.

How much room for further growth is there, and in which sectors might we expect it? Viewing the international picture, mutuality in general tends to be dominated by a handful of sectors.[106] Banking and insurance lend themselves to mutual models, where policy-holders, savers or borrowers have membership rights. Many of the world's largest cooperatives are in the agricultural sector. As far as employee ownership is concerned, retail and hospitality are areas where it is a significant force, unsurprisingly since customer care is cited as one of the main benefits of this ownership structure. Italy is home to a third of Europe's majority-employee-owned businesses (established as worker co-ops), and retail represents a large proportion of these.

One area with largely untapped potential for greater employee ownership is professional services and knowledge-intensive industries. These are types of business where the cooperation, commitment and innovation of employees are most important. The firm is little other than its 'human capital', and there are strong social and economic reasons why employees might expect to share in the profits of their skills. Many professional services firms, such as lawyers, accountants and architects, are currently established as partnerships, where a small minority of senior professionals have ownership and control of the firm, selling their stakes on when they leave.

Employee ownership potentially offers a different settlement to such firms. Already there are examples in professional services, such as Martin Currie investment management in Edinburgh and Make architects in London. Rewards at the very top may not be quite as great as those available to partners or founders of rival firms. Nobody retires with several million pounds. But staff turnover is lower and knowledge-sharing is higher. Where knowledge is the stock in trade, social structures must be designed to recognise this fact.

The practice of luring skilled workers with the promise of stock options became something of a joke in the wake of the dotcom boom, once it became clear that most of the options were worthless. But there is still scope for equity to play a far more significant role in employment relationships and contracts. Will Hutton has suggested that companies struggling in the recession should offer their staff shares in exchange for a pay-cut.[107] We saw evidence in chapter 1 that equity-based incentives had the effect of vastly increasing the amount of inequality within FTSE 100 companies. It is worth trying to imagine what it would mean for such remuneration schemes to be used with the opposite effect.

It seems that employee ownership can be especially worthwhile in those areas where the level of a firm's performance is for whatever reason unavoidably in the hands of employees. It is this that makes it a possible component of future public service reforms, especially for provision of care. Already, the major political parties are eager to involve social enterprises in the delivery of public services, while Foundation Trust hospitals are now running effectively as independent mutuals, owned by their local communities. Examples of employee-owned public service outlets are rare but generally impressive. Greenwich Leisure is owned and run by its staff, operating seven formerly publicly-owned leisure centres, with an annual turnover of £45 million. Sunderland Home Care has a turnover of £2 million, and is now being replicated in other cities. Most strikingly, annual staff turnover at Sunderland Home Care is below 5 per cent, compared with a national average of 20 per cent among care workers.[108] And Central Surrey Health is owned by its 780 staff, consisting mainly of nurses and therapists.

The central argument in favour of employee ownership of public service providers is the same as it is for commercial entities. A virtuous circle of representation and productivity can be achieved, to win greater commitment and responsibility from both management and employees. As Charles Leadbeater has argued:

Staff in co-owned public service organisations frequently say they are willing and able to 'go the extra mile' to deliver a better service for people. The public sector will need more of that spirit. That is why promoting greater co-ownership should be a strategic priority for the next phase of public service renewal.[109]

With this in mind, Jo Ellins and Chris Ham have outlined a number of ways in which employees can be given a greater stake in NHS bodies, from simply drawing them closer into decision making, through to reforming Foundation Trust hospitals with a degree of employee ownership built in.[110]

The concept of co-ownership may prove to be the most significant in future. Ownership of an organisational entity can be shared between various stakeholders and governance structures can be developed to reflect this. Founders or family-owners may wish to retain a large stake, consumers can be given a voice and dividend as in a consumer cooperative, and some equity can be sold to private shareholders. As long as the employee share is big enough to ensure representation and a significant incentive, it need not be as much as 50 per cent. Moreover, the leading examples of the co-owned model, such as Arup and Mott MacDonald, indicate that the model can scale globally very effectively. New hybrid models are constantly being developed, and this experimental approach to the ownership and governance of firms may prove to be the most fruitful for generating greater pluralism, engagement and productivity in the years ahead. It requires imaginative and well-informed accountants and lawyers, and patience while members and managers are familiarising themselves with new structures – despite initial misgivings, five years on, Foundation Trusts are deemed a great success.

4 Inside the employee-owned firm

When those in positions of control seek to give power away, there is invariably a risk attached. The transition out of hierarchy can be disconcerting for all involved, and there is no certainty as to where things will end up. There is compelling economic evidence that the productivity effects of financial and democratic participation in the firm are very positive, but this does not mean it is simple to establish. This challenge is no bad thing. If, as Richard Reeves and Philip Collins argue, 'the good society is messy and unpredictable because it vests power in people', then this must be somehow reflected in the firms that such a society supports.[111]

Many of the firms that adopt alternative ownership and governance structures feel that they are doing something unusual, and sometimes receive stark warnings from their professional advisers. Public understanding of employee ownership tends to rely heavily on leading examples, primarily the John Lewis Partnership, the largest employee-owned business in the UK and one of the 20 largest cooperatives in the world of any form.[112] Other examples, such as St Luke's advertising agency and Loch Fyne Oysters, have been celebrated in specially dedicated books.[113] It is exciting to imagine what might happen, should government and expert bodies set about publicising and supporting alternative models for the firm. For the moment, however, the sector is being expanded thanks to the imagination and far-sightedness of founders and managers of businesses.

To understand a bit more about how this takes place, we will now look inside three of these firms, drawing on interviews with senior management and focus groups with staff. Each of these has either been founded as employee-owned in the last decade, or has recently converted to employee ownership. The first two are cases of indirect ownership, while the third is of direct ownership. Certain commonalities will arise, which will be drawn out and discussed later.

The creative professionals: Make architects

Lord Norman Foster is the most famous name in British architecture, having been responsible for many of the most striking construction projects of recent years, including London's GLA building, the Gherkin and Millennium Bridge. He founded Foster + Partners in the late 1960s, retaining majority ownership and control of the firm until 2007, when he sold a large minority stake in the business to 3i, the private equity fund. Behind Foster's name, however, is a very large practice of some 1,000 employees, including the architects who design these buildings in his name. Until 2003, one of the most senior and respected of these was Ken Shuttleworth.

Shuttleworth left Foster + Partners in 2003 in order to set up his own practice. But being already 51, the question of how the firm would out-live his management seemed unavoidable. Architects' practices are typically founded as partnerships by somewhat younger architects, and are then held together by the unification of ownership and control. As the partners near retirement, the question arises of who is to take over both the ownership and the control of the practice. There is no perfect answer here.

Appointing new partners from within requires the selected individuals to take on very high levels of debt to buy out their predecessors. The replacement of one elite group of owners by another can also have unfortunate consequences for workplace politics. In-fighting and suspicion over who is to succeed the partners can undermine cohesion and productivity. Having spent years or decades working in a practice owned by a small coterie of senior managers, architects find that the biggest rewards at the end are of a winner-take-all nature. This can have a perverse effect on the psychology of employees who are in direct competition for these positions for many years. Their alternative option is to leave and found their own practice.

The difficulty of achieving succession from one set of partners to a new set means that it is often tempting to put the business on the market. Floatation, private equity buyouts (as with Foster + Partners) and trade sales are all effective means for the partners to cash in their stakes and solve the problem of selecting the next generation of partners. But they come with few guarantees about how the business will be managed, invested in and preserved in future.

It was with all this in mind that Shuttleworth sat down with advisers in 2003 and took out a blank piece of paper. As Barry Cooke, who was to become his financial director, remembers it:

Ken drew a little sketch of a concrete bunker without a keyhole but a key sealed inside and said what I want to do is to take ownership of this business out of my hands and put it in this concrete bunker to be absolutely bomb proof. It cannot be got at. It cannot be manipulated by future generations or by myself.

He was also aware that anyone he wanted to attract to the business would be taking a risk by leaving a job elsewhere, which needed recognising in some way. This was in addition to his concerns regarding the politics of partnership and succession in the years ahead.

Shuttleworth and Cooke were aware of employee ownership as a model – particularly having worked on projects with Arup – and asked their advisers to explore the options in this area. In 2004, Make architects was founded as a limited liability company, with a share issued to each of two trustees of an employee benefit trust. Shuttleworth and Cooke appointed themselves trustees initially, and have informally identified who their successors will be for these positions. The trust sits alongside an executive board of four directors.

Seeing as every employee, without exception, is also an owner, they are referred to internally as ‘partners’, and welcomed as such when they join. Make grew extremely quickly, comprising 140 employees (or partners) by the end of 2007, and is currently rated as one of the highest performing firms in a severely deflated industry.[114] Profits have been high, and while a great deal of these are currently ploughed back into the business, surprisingly large profit share bonuses have been distributed. According to the informal constitution designed by Shuttleworth, the majority of an employee's annual bonus is set as a proportion to their salary. The remaining portion is determined by a secret ballot, in which all employees are able to allocate six votes, recognising the contribution that colleagues have made over the year. These are added up, and additional bonus payments made in proportion to votes received. This applies to every employee without exception.

In terms of governance, the firm does not use any formal mechanisms for employee representation. The trust exists to ensure that management act in the interests of employees, which includes the necessity of making profits. Since the same individuals sit on both the trust and the directors' board, there is no clear governance separation here between the management and ownership bodies.

The ownership structure produces very high levels of transparency and flat management structures. A weekly all staff meeting involves discussion of accounts and the opportunity to debate the performance and direction of the firm. In the absence of senior partners, for whom the architects would otherwise be working, hierarchies are weak and more responsibility for projects is devolved to the architect concerned.

Many partnerships are characterised by a split, whereby the partner-owner takes responsibility for the commercial side of the firm and all its projects, while the designers are paid for their drawing skills as highly skilled labourers. A wedge is driven between the financial and the creative side of the business, with the result being that the designers can often be accused of lacking business sense, while the partners can be accused of living – handsomely – off the creativity of others.

The devolved, team-based management structure of Make involves more architects taking responsibility for winning business and handling clients. This has notable productivity benefits. Fewer administrative staff are required to integrate different elements of the firm's activity, as a broader sense of responsibility is at work and projects are run holistically; clients get to deal directly with the actual designer on a project, knowing that they also have an economic stake in the company's success. Architects typically work long hours under pressure. And where some practices have to deal with staff turnover of as much as 30 per cent annually, Make's turnover is remarkably low. This makes investment in training and other intangible goods, such as giving employees paid leave to do volunteering work, substantially less risky from a business point of view.

The recession has hit architecture worse than any other profession in the UK.[115] With projects drying up, Make made two rounds of redundancies in late 2008 and early 2009. Employee ownership clearly cannot defy a recession. The only benefits that the structure can bring in such circumstances were the following. Higher levels of transparency, with accounts shared internally, meant that economic risks could be perceived and discussed from an early stage. The economic situation is discussed openly and frankly, where every member of a workplace has equal ownership rights. Friday meetings were used to invite anyone considering a sabbatical to step forward. Individuals who were made redundant left with proper compensation as partners of a practice, and not simply employees at the whim of management.

The family business: Parfetts cash and carry

In the late 1970s, Steve Parfett was on the graduate recruitment scheme at Waitrose. His father had a background in running cash and carry businesses, and he suggested to Steve that they start a new firm together. Parfetts cash and carry was founded in Stockport in 1980, employing ten people, and turning over £1 million and a small profit in its first year. Over the next 28 years, it would grow to six depots around the North West of England, employing 650 staff and turning over £259 million annually. The industry typically works with high turnover, low profit margins and tight cost control. The company's gross profit margin is currently around 6.5 per cent.

Parfett Sr had retired in 1989, leaving Steve and his brother to run the business. By 2006, Steve himself was considering what would happen after he retired in 2012. The family's younger generation did not seem especially interested in taking over the firm. The obvious solutions were a private equity buy-out, management buy-out or – most plausibly – trade sale to a competitor. The family was not particularly keen on any of these, so Steve began to consider the model he had come across at Waitrose, part of the John Lewis Partnership.

Advisers were suspicious of the model, because they knew little about it other than the John Lewis example. But after taking advice from John Lewis and the Employee Ownership Association, and paying an auditor to assess options in this area, a solution was found. An employee benefit trust would be established, which would purchase the company with a bank loan secured against the firm's assets (mainly property). An independent evaluation was carried out, valuing the firm at £48 million with £40 million of assets, and the family agreed that they would sell to the trust for the price of the assets alone.

The sale is taking place in two stages. A £20 million loan was taken out in 2008, to purchase 55 per cent of the company on behalf of employees, which will take 15 years to pay back. The other 45 per cent of the company equity will remain with the Parfett family, until a later date when it will either be purchased with retained earnings or with more debt.

Having taken legal advice on the issue, the family decided that it would be easier to sell the company to the employees without consulting them first. But this then meant that they had the difficult task of explaining what was taking place to the employees at the six depots. A communications strategy was launched, in which senior management went round and explained the model to all staff in groups of 15–20. Initial understanding of the model was poor, though there was immediate relief amongst staff that the news was not of a sell-off.

It was clear to the Parfett family that employee ownership had governance implications, and was not simply about equity and dividends. As Steve Parfett puts it:

It's absolutely essential to shift power as well as equity. Everyone told me, you really have to mean it. As a team we're all committed to it. It's *not just a legal or financial exercise, we need to get everyone to buy into it.*

Steve and his co-directors faced the challenge of designing a governance structure that acknowledged the rights of employee-owners, while also exploiting the potential for performance improvements. The structure is loosely modelled on the John Lewis example. Each depot elects a Branch Council of up to seven members, which meets twice a year with the Parfetts directors. Two members of each Branch Council also sit on a Central Council, which meets biannually and elects a representative to the board of trustees. The board of trustees sits in parallel to the board of directors, although two directors sit on both.

This is all set out in a constitutional document that outlines the corporate purpose, and which is distributed amongst all staff. As this document puts it, the Parfetts philosophy is

to continue to grow a successful and profitable business, incorporating the values and ethics of an employee owned company, and to encourage a collective responsibility, that recognises the importance of the welfare and development of both employees and customers.

Engagement with the structure varies tremendously across the workforce. Some have made an effort to get to grips with structure and stand for election. As one check-out staff-member (who reported that he had not read the constitution, as it was not for him) put it, ‘I wasn’t very interested in it at first, but the longer I’m here the more I think I might get involved. Put myself down for the council or something.’ Many start to take a greater long-term interest in the direction and performance of the company. Others view the new governance arrangements as obscure, and continue to fear the disruption that they expect Steve Parfett’s retirement will cause.

Most staff feel that the new structure is not working as well as it needs to, and feel that it is a challenge for them and for management to sort this out. The anxiety about the transition is having positive spillovers, as consultation and transparency is increasing to deal with it. Inevitably, there is a limit to how much democracy is desirable before it creates a sense of a 'talking shop' – some staff report that the councils are too big and meet for too long. Low-level grievances exist, for instance that the elections are a popularity contest and that the Central Council is too full of 'ties' (as in the garment). But this is all part of the difficult process of empowering employees, many of whom are in comparatively low skilled work.

This is a curious transition in some respects. As one employee put it, 'The model was attractive to us because it didn't represent an enormous change from how the business had been run under family ownership.' The employees felt that they would continue to be valued, just as the family felt that the business they'd built would survive. One of the most tangible aspects of employee ownership will not be operating for a number of years: dividend payments will only begin once the debt has been paid off. Employees already get a Christmas bonus of an additional week's pay, which persists under employee ownership. Other than the bedding in of the new governance structures, not a great deal has changed so far.

But once the last family members retire, the debt is paid off and the democratic practices are embedded, the culture and the politics of the firm will surely be very different. The director who stands to succeed Steve Parfett as managing director is aware that he will have much higher accountability to his employees than the founders of the business ever had.

The human capital collective: Quintessa Consultants

David Hodgkinson is a scientist who has worked at the interface of science and nuclear policy since the 1970s. In 1987, he was invited to establish the environmental consultancy division of a company called Intera Information Technologies, to specialise in advising governments on nuclear energy. He did so, and it grew rapidly, to his great satisfaction. He saw that there was real value in

creating something from nothing. One day you have an idea, a year later you're paying people, they're paying their mortgages, you have something tangible.

By 1997, his division had offices around the world, employing 70 expert staff. But after twelve years developing the business, it was sold to Enviros. He decided to start all over again, but in such a way that the same outcome could not arise.

In 1999, Hodgkinson re-mortgaged his house to finance the founding of Quintessa, initially retaining 100 per cent of the equity. He was adamant that the company was not going to admit equity finance from outsiders who did not respect the long-term integrity of the firm. At the centre of his vision of the firm was the expertise and talent of those he intended to hire, and the ownership and governance structure would stem from this. Furthermore, anyone who did join his new business would necessarily be giving up secure employment elsewhere and taking some risk, especially when Quintessa was in its early stages.

With this in mind, he decided to offer equity stakes in the business to employees, of which there are now 22 in the UK and 10 in Japan. As he explains:

Employee ownership was chosen primarily for cultural reasons. Certainly within a company of talented individuals, it's only right that it is employee-owned.

Those who joined him immediately were given larger shares than those who arrived later, with Hodgkinson now holding just over half of the equity. The shares pay a dividend, and in addition an annual bonus is paid to all staff, but neither of these is very large as a proportion of total remuneration. Shares cannot be sold, except back to the firm on departure, whereupon they are valued by outside accountants.

The company now has an annual turnover of £2.4 million, and its sales and profit growth are higher than the largest competitor in its field.[116] Additional data are unavailable, but management report no recorded absenteeism and only one member of staff has ever left during the firm's ten-year history.

A company of this size and nature has clear opportunities to be run in a cooperative fashion – there are company directors, but no managers as such. Having out-sourced most of their administrative functions, nearly all of the staff are scientists and mathematicians, who might otherwise be working in academic jobs. They share a common vocation to employ their scientific expertise in a responsible, commercially competitive fashion. As one director explains, 'it's a quasi-academic, quasi-commercial environment.' An informal ethos of collaboration permeates the firm, with a strong recognition that there is more to work, to business and to science than making money.

The most important function of employee ownership is that it represents an obstacle to excessive interference or exploitation by outside financiers. Hodgkinson has received around ten offers to sell the company, which he has declined. Many of the directors and staff have worked for companies with external shareholders, and witnessed the pressures that they can exert over a company's direction. The business is profitable, but not governed by the pursuit of profit. As one employee puts it,

We can afford to take a longer-term view, which is relevant to how we work as individuals. We can go through a quiet patch, or invest in ourselves, but as long as the company is sustainable, we can do that.

Given their dedication to highly specialist fields of knowledge, the intangible assets that are being invested in and drawn on cannot have a price put on them, so the company is not for sale. This is the factor that Quintessa staff are most adamant about. The dividend payment on shares is more significant symbolically than economically, and none of the staff feels that it is necessary as an incentive to work hard or well. Meanwhile, the firm has little need of outside capital, given that its directors have little desire to expand the business much further, and it is accumulating cash, which may contribute to buying Hodgkinson's shares from him at a later date.

Quintessa will face a business succession issue when Hodgkinson retires in 2014 or thereabouts. His shares will have to be bought from him at some stage. Quintessa directors are considering shifting ownership towards a trust-based model (indirect ownership) though they worry about the tax disadvantages, as discussed in the next chapter. This is something that remains to be worked out.

A different political economy

These case studies were chosen for their diversity, so as to give an indication of the flexibility of ownership options and plurality of benefits. Parfetts is in a relatively low-skilled sector, while the other two examples employ highly skilled professionals. Make distributes large sums of profit, which has a major impact on the psychology of its employees, while the other two do not attach great significance to the dividend. Quintessa has explicit ethical, even ideological reasons for valuing this ownership model, whereas the other two are more focused on long-term profitability. Parfetts has taken great pains to establish a new, representative governance structure, based on a formal constitution, whereas the other two firms have allowed greater participation to permeate their culture in less formal ways. But it is possible to extract some commonalities.

Firstly, these case studies give an insight into the psychology of ownership, which plays out in what others might term 'financial literacy'. Chapter 2 cited the standard definition, as given by the OECD, that ownership is made up of the right to control and the right to a dividend. It was argued that ownership is more complex than this, especially where there are intangible assets at stake, which cannot be *entirely* controlled or privatised. The owners in these three cases are given not only a set of rights, but also certain responsibilities for the firm. The notion of transparency suggests that they have new freedoms to peer inside the firm's workings, which is true; but they also have a great deal more financial information thrust upon them, whether they like it or not.

In some respects, being subservient in the workplace is a comfortable if frustrating condition. The opaqueness and dishonesty of management is a good excuse for not participating further. The firms described in this chapter remove this excuse, by disseminating information about their accounts and plans for the future. In the case of Parfetts, where staff are not professional experts, they were largely unfamiliar with the technicalities of corporate governance, business planning and accounting. But all staff are being encouraged or dragged into considering these issues, because as owners they have a responsibility to know more about them. In the case of Make, financial and creative responsibilities are handled simultaneously by the same individuals, meaning that architects become literate in financial and business issues at a much earlier stage of their careers. They share directly in the business rewards for their creativity, but they also take greater responsibility for winning business and satisfying commercially-minded clients.

Secondly, these examples give a close-up view of how democratic and economic accounts of autonomy can reinforce one another. As the previous chapter outlined, it is not implausible for the two to come into conflict. Excessive worker control *can* lead to productivity problems.[117] Pushing too much responsibility for business performance onto employees *can* lead to stress and unhappiness.

In the case of these businesses, employees recognise the benefits of being in a relatively secure environment, with less hierarchy than would be the case under different ownership models. They are less at the whim of shareholders or the managers who strive to satisfy them. In the case of Parfetts, this had long been the case, with the family viewed as benign patrons, but employee ownership represented an equally benign alternative to takeover by a rival firm. From this position of relative security, satisfaction and voice, greater effort and innovation comes more naturally, with less resentment or stress. Contrary to what is often assumed, risk-taking and innovation can occur within stable secure environments, just not where this is achieved through strong hierarchy.

Finally, we can see in these examples that the appeal of this model cannot be easily categorised as either economic or ethical. It is a different means of organising power within the firm, with different consequences for the distribution of risk and reward. It can properly be described as a different political economy. In knowledge-intensive sectors, it has particularly striking implications, reducing the 'winner-take-all' elements of many professional services firms, which effectively enable a minority to profit hugely off the knowledge of the majority.

Employee ownership can certainly deliver higher productivity and job satisfaction. What it is unlikely to deliver is a vast windfall of wealth for a small minority of individuals. The

Parfett family will extract £40 million from their firm, but only after building it over 30 years, and even then this is less than the market valuation of £48 million. Ken Shuttleworth is by far the greatest beneficiary of Make's ownership and governance model (remember that dividends are proportionate to salary), but he will not be able to sell a controlling share to a private equity company as Norman Foster did. David Hodgkinson will eventually extract his shares in Quintessa for a large sum of money, but for half as much as he might have done.

None of these individuals is a philanthropist, such as the ones that gave away ownership of John Lewis Partnership or Scott Bader. They are each very wealthy and their businesses are profitable. The trade-off that is made is between viewing a firm as an item of property to be traded, versus viewing it as a complex social entity consisting of intangible assets to be organised, invested in, profited from and enjoyed. Where the latter is prioritised, ways must be found of locking value into the firm, just as better ways *should* have been found to lock value into former building societies.

5 Enabling a new model of the firm

The financial crisis and subsequent recession made establishing a new regulatory framework into a priority, particularly in the financial services sector. A new political economy seems imminent, built on a reworked relationship between the state and the market and on new sources of wealth creation within the market. The government has important choices to make in determining which organisational forms and economic practices are to grow in the wake of the current crisis. As the evolutionary economist Carlota Perez argues:

It is not enough to define the criteria for good regulation, it is also crucial to define the criteria for a whole set of other policies that must accompany the treatment of finance in order to guide market behaviour in the direction that is most beneficial for all (including an effective and profitable financial world).[118]

Unsurprisingly given the urgency of the financial situation, little thought has yet been paid to the types of institutional structures that will sit at the heart of the next wave of capitalism in Britain or elsewhere. The regulatory imperatives, focused firstly on restoring the functionality of banking and secondly on reducing systemic risk, have taken rightful priority over the broader, longer-term questions of the socio-economic ecology of the future.

As chapter 1 stressed, times of crisis open up opportunities to factor in broader cultural, political and technological priorities into economic designs. Crises are not only moments for the conflicts within capitalism to be dealt with, as Karl Marx argued, but also opportunities to address conflicts between a variant of capitalism and the civil society in which it sits. While the principle of the firm's accountability to shareholders will and must survive, there is scope to temper this with the addition of accountability to other stakeholders, and also to nurture other models of the firm altogether.

Employee ownership and mutuals are only one part of any vision of Britain's economic future, and will not single-handedly resolve the four crises outlined in chapter 1. On the other hand, alternative models of ownership and control can make a positive contribution to addressing the four crises discussed in chapter 1.

#1: The banking crisis

Britain needs to pursue diversity in the way that its financial services are controlled and delivered. While the pursuit of very high returns, achieved through *proportionately* high levels of risk-taking, has its own legitimate place within the overall ecology of the financial services industry, greater pluralism is needed. The government has a one-off opportunity to deliver some of this, as it currently owns large shares in former building societies such as Northern Rock.

A return to mutualism is now necessary, with asset locks properly constructed to avoid another wave of demutualisation. Simpler, lower-risk banking is not possible where banks are focused on their share price, which leads to the loss of accountability. For those individuals who feel most alienated from gargantuan and unaccountable financial institutions, the future may involve a return to even more traditional forms of credit and debt, such as credit unions, Zopa's peer-to-peer model, or collective equity investments facilitated by the internet.

#2. The competitiveness crisis

We have seen convincing evidence that employee ownership leads to improved business performance. It is a structure that appears well suited to innovative and knowledge-intensive businesses, where information-sharing and employee commitment is key. Where indirect models of ownership are concerned, they defend long-term investment in human and social capital from the short-term demands of external shareholders. In which case, the obvious question is – why aren't there more of them around? Part of the explanation lies in the lack of suitable financing options. Venture capital and other forms of private equity are scarcely any more sympathetic to the long-term challenges of value creation than institutional investors. Establishing employee ownership is heavily dependent on debt finance and specialist equity funds such as Baxi Partnership.

But the overwhelming reason why this model isn't more prevalent is that it is inadequately understood by managers, policy makers and legal and accountancy professionals. Employee ownership tends to be associated either with distribution of shares and options (which is one way of extending ownership, but a comparatively weak and exclusive one) or it is associated with worker-managed co-ops, which summons up visions of 1970s inefficiency. The full range of mutual and co-owned structures is not properly appreciated, and their productivity benefits are over-looked. This needs to change.

#3. The fiscal crisis

Those who work for employee-owned firms recognise that they are more transparent, civic-minded and committed to high levels of service.[119] They generate positive externalities, in the form of happier, healthier employees and surrounding communities. This is why firms' internal dynamics and governance structures matter politically. Sustaining progressive goals and social cohesion through an era of lower state spending requires careful thought about the social effects of decentralised economic institutions. Why is it that talk of community and devolution of power always gravitates towards the third sector and social enterprise? There are choices to be made about how profit-making, economic institutions are to be structured as well.

In addition to this, the scope to employ employee-owned and hybrid models in the delivery of public services needs to be explored further, and the productivity benefits evaluated. There are various areas of public service, such as Royal Mail, Network

Rail and Forensic Science, where hybrid models of ownership and control – drawing multiple stakeholders into a single structure – offer solutions.

#4. The moral crisis

Chapter 1 outlined a range of evidence, demonstrating the contribution that the shareholder value paradigm has made to Britain's growing inequality. Inequality is not simply a product of amorphous 'market forces' or 'globalisation', but a symptom of the choices we make about the organisation of risk, reward and power within our dominant economic structures. In their landmark analysis of inequality, *The Spirit Level*, Richard Wilkinson and Kate Pickett conclude that democracy and greater equality *within* the workplace is one of the best hopes for limiting or reversing the broader societal trends of the last 30 years. The authors have since established the Equality Trust, which proposes that

greater economic democracy is essential in order to transform our economy, reduce income differences by bringing pay differentials under democratic control, redistribute wealth and create the foundations for a healthier, happier and more sustainable society.[120]

This is an area where political engagement is most important. We have overwhelming evidence of the malign effects of inequality. We also know that many of these effects, especially regarding health and mental health, fall to the government to act upon.

There is no clear established evidence regarding the pay differentials under alternative models of ownership and corporate governance, but two things are clear. The use of stock options, concentrated in a small minority of hands, does nothing for business performance, but does a great deal to exacerbate already high levels of inequality. Secondly, employee representation, which leads to accountability of management to staff, *at the very least* opens up an avenue for debate about remuneration practices within the firm.

An agenda for the firm

With these points in mind, there are various things that can be done to inject much-needed diversity into Britain's conventional models of ownership and control.

Altering tax incentives

Tax incentives are by far the most powerful of the government's tools for influencing company ownership and financial structure. As we saw in chapter 3, there are already a number of widely used employee share schemes that are encouraged through tax advantages. Tweaking the tax system not only creates narrowly economic incentives to distribute ownership, but also performs a 'signalling' role in alerting and educating businesses, accountants and lawyers about new schemes.

The most significant impediment to the growth of employee-owned businesses, at least where indirect ownership is concerned, is the 2003 reform which removed tax advantages from the creation of employee benefit trusts (EBTs), save where shares were then transferred to employees. This was done because the existing scheme was being abused as a form of tax avoidance. But as the managers of the case-studied firms stressed repeatedly, this makes the indirect ownership model significantly less attractive. The Employee Ownership Association has put forward a proposal in which the existing (tax advantaged) Share Incentive Plan (SIP) could be expanded to include EBTs.[121] Given the clear social and economic advantages of indirect ownership forms over direct forms, as discussed in chapter 3, any politician or policy maker seeking to support growth in this area should treat this as the highest priority.

The cost of restoring the tax advantages to EBTs is estimated by the Employee Ownership Association at £51 million. Obviously the Treasury will want to know where else this money could be found. Current tax advantaged share schemes cost the exchequer an estimated £1.2 billion and If the government were to back the EBT model, the money could be saved by reducing the advantages of the SAYE or EMI schemes.[122] The SAYE does not incentivise long-term shareholding, because it is most widely used in listed companies where employees can dispose of their shares as soon as they exercise their option. The EMI scheme, aimed at small businesses and start-ups, is now so successful that it is unusually costly to the Treasury, averaging £28,000 per employee. Money could be diverted from either of these into EBT tax advantages, while EMI's continuation could be made conditional on the creation of EBTs.

Restoring and defending mutualism in banking

The government should heed the proposals being made by the new Centre for Mutual and Employee-Owned Business at Oxford University, to consider re-mutualising Northern Rock. HM Treasury/UFI has various options for divesting its current stake in the bank, but only a return to a mutualised building society model will offer any greater diversity and stability to the financial sector as a whole. Mutualisation must be defended with secure asset locks, to prevent future demutualisations after the present banking crisis has passed.

Facilitating finance for mutual and employee-owned business

Businesses that are only indirectly owned (ie do not have shareholders) face difficulties getting access to finance. They are either dependent on debt finance from banks, or on niche areas of private equity financing such as Baxi Partnership. At present, banks do not properly understand the employee-owned model, and too many venture capitalists associate it with social enterprise, and therefore with non-profit-making ventures. Aggressive venture capital practices are, in any case, unsuited to this sector, as one of its main virtues is that these businesses are run in pursuit of *long-term* business performance, drawing on expert *insider* management knowledge.

The government should intervene financially to support growth in the sector. It could do so via Regional Development Agencies, enterprise capital funds, the Post Office and its influence over the banks in which it has major stakes. There is no reason to believe that a dedicated public venture capital fund for mutuals and employee-owned businesses, run along similar principles to the Baxi Partnership, could not yield a return to the taxpayer. The market failure here is in equity finance for organisations that are profit making but not profit maximising, and operate according to longer financial time horizons than orthodox venture capital and private equity can currently support.

Piloting mutualised public service providers

Innovation in the public sector must include innovations in organisational forms. Independently managed public interest companies – such as Foundation Trust hospitals and Channel 4 – are already recognised public service providers. There is a compelling case for the NHS to contract with employee-owned and co-owned businesses in the delivery of care services. Hybrid organisations, co-owned by government, employees and users, are viable models that need piloting in areas of health, education and transport.

Spreading the benefits of share ownership

As chapter 3 explained, Britain has had a succession of schemes to encourage share ownership amongst employees, dating back to the Thatcher government. However, equity-based remuneration remains something of an elitist benefit. It is difficult to imagine it ever becoming a force for greater equality, because the low-paid cannot afford to divert nearly as much (if any) of their income into shares as the highly paid. Moreover, those who rely on week-to-week wages should not have their remuneration diverted into year-to-year equity schemes.

That said, the government should look into ways of extending participation in such schemes, as a way of spreading asset ownership. Extending schemes to *all staff*, with a guarantee that wages will not be cut, could be a statutory requirement for firms seeking to benefit from the tax advantages of SIPs, SAYE or CSOP. The government should also consider the Employee Share Ownership Plan (ESOP) model in the USA, in which employee savings and pensions are put into the firm in order to grow a *collective* employee stake in the business. The ESOP model is vulnerable to the charge that it puts all employee 'eggs in one basket', and should be treated with some caution, as the bankruptcy of ESOP-owned United Airlines suggests. The French example dating back to Charles de Gaulle, where profit-sharing is mandatory for firms above 50 employees, is another means of increasing cooperation between capital and labour.

At present, external investors in small businesses and start-ups are being subsidised by the taxpayer, thanks to the EMI. Meanwhile, capital gains tax relief for internal investors in start-ups only applies to those owning more than 5 per cent of the equity. By spreading these forms of tax relief to include *employees* willing to invest small amounts of risk capital in new ventures, the government can encourage a different approach to start-ups, in which the risks and rewards are more evenly distributed. Risk-taking and entrepreneurship can exist within the firm, and not only via more arms-length relationships. The cases of Quintessa and Make give a sense of the impact this can have. The cost of this could also be covered by restricting the reach of the EMI scheme.

The agenda for professional services

Many of the obstacles which restrict the growth of employee ownership are due to inadequate expertise in this area. Lawyers and accountants work around the assumption that such businesses are inefficient or not-for-profit. The Centre for Mutual and Employee-Owned Business intends to educate future business leaders on the reality and merits of alternative models. But professions and professional services firms have an important contribution to make. The potential benefits of this model within professional services mean that, for instance, an employee-owned law firm would be able to demonstrate and communicate the viability and productivity potential of a flatter structure. One of the best signals that alternative models are to be taken seriously would be for a major professional services firm to convert from partnership to an employee benefit trust model.

Celebrating new models

Politicians and policy makers can support the sector by giving it the recognition and clarity of analysis that it deserves. There are still a number of basic misunderstandings in this area. Most commonly, as cited above, the profit-making, indirect ownership model is overlooked in favour of employee share ownership on the one hand (typically recognised as a form of collective profit-sharing) and the cooperative movement or social enterprise on the other (typically recognised as less business-like). Equally, the 'eggs in one basket' argument, that employee ownership is excessively risky, is applied inappropriately, often drawing on American examples of ESOPs.

Government can signal support for this sector via the tax scheme and by privileging mutual and employee-owned models when it contracts with the private sector, as described above. But politicians could also offer more vocal support and clarity regarding the various options. One of the first things that a sympathetic government could do in this area would be to commission in-depth, comparative quantitative research on the relationship between ownership models and various externalities, such as the health, well-being and civic engagement of employees. Qualitative evidence would suggest that listed companies do worse in this area than alternative ownership models, because of their focus on share value. If this is backed up by quantitative evidence, this would suggest that Britain's overall political economy is not nearly as efficient, *in the aggregate*, as the gurus of shareholder value would have us believe.

Establishing and converting more firms to these models

At present, founders, managers and owners of firms who wish to establish employee ownership are reliant on their own imagination and a few sources of information. The case studies in chapter 4 suggest that the model is still perceived as somewhat unusual. However, entrepreneurs and businesses facing succession issues are strongly encouraged to consider alternatives to floatation, private equity buyouts and trade-sales, for all the reasons contained in this report. Anyone minded to do this is encouraged to contact either the Employee Ownership

Association (www.employeeownership.co.uk) or Baxi Partnership (www.baxipartnership.co.uk).

Managers and owners confronting a problem of business succession or considering a transition to employee ownership should refer to publications *Employee Ownership as a Solution to Business Succession* and *Shared Company: How employee ownership works*, both of which are available on the Employee Ownership Association website.

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The financial crisis has called into question many of our core assumptions about economic structures, governance and institutions. But there has been little attention paid to the basic unit of economic collaboration and production: the firm. In recent decades Britain developed a corporate monoculture in which the 'shareholder value' creed treated firms simply as the property of their shareholders, to be traded, exploited and disposed of in pursuit of profit.

Government policy making has done little to call this culture into question, depriving our economy of a richer vision of what a good company is and what it can do. This crisis is a chance to ask deep questions about our firms: how can they meet social and political as well as economic goals? How can firms be modelled so that not only shareholders but employees, the economy and society profit?

Many of these models already exist. Mutual and employee-owned models of business operate with longer time-horizons, achieving higher levels of performance and customer satisfaction. They nurture greater power for individuals over their economic lives and increase the accountability of managers. This report argues it is time to bring these models out of the wilderness and into the debate about where capitalism goes next. Presenting a wide range of quantitative data alongside three new case studies of employee-owned firms, it offers a new vision of economic autonomy where democratic companies drive a happier and more sustainable economy.

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