Workers on Boards

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This is taken from my response 16/2/17 to the UK government's Green Paper on Corporate Governance. The full response is at http://bit.ly/AlexCorpGov.

1. Question 7: How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened?

1.1 I strongly support stakeholder engagement but not board representation. For ease of exposition I will refer to worker representation, but the same arguments apply to other stakeholders.

1.1.i Gorton and Schmid (2004) find that German firms, where one-half of the supervisory board contains workers, trade at a 31% valuation discount to those with one-third representation.

1.1.ii Faleye, Mehrotra, and Morck (2006) study US firms where employees own a large stake and are thus involved in governance. Such firms "*invest less in long-term assets, take fewer risks, grow more slowly, create fewer new jobs, and exhibit lower labour and total factor productivity*." The finding of *both* lower productivity *and* fewer new jobs is consistent with (the opposite of) pie-enlarging. If firms are unproductive, they are unable to create new jobs.

1.1.iii Masulis, Wang, and Xie (2019) also study US firms where employees own a large stake, and examine the consequences for M&A. Their voice *"entrench[es] incumbent managers only when employees are well treated. When employees hold larger equity positions, acquirers make more unprofitable acquisitions, but are less likely to receive disciplinary takeover bids … when employees hold large voting blocks, potential worker-management alliances can exacerbate manager-shareholder conflicts and facilitate managerial extraction of private benefits."*

1.1.iv I have seen "evidence" that employee representatives on boards are perceived favourably by other board members. Almost all of the papers cited are unpublished. Moreover, other board members' perceptions are less relevant than productivity, growth, and job creation. Making other board members happy is not sufficient if it does not feed through into these outcomes.

1.2 In addition to evidence on worker representation/control, there is evidence that measures to protect workers make them worse off, by leading to the protection of existing jobs rather than the creation of new ones, the substitution of capital for labour, or stifling business growth and thus job creation.

1.2.i Agarwal et al. (2016) study the largest public workfare programme in the world and show that it reduced permanent employment by 10%. Firms respond to the restrictions by mechanization.

1.2.ii In an extremely highly-cited paper, Botero et al. (2004) study employment, collective relations, and social security laws in 85 countries and find that heavier regulation of labour is associated with lower labour force participation and higher unemployment, especially of the young.

1.3 Directors' fiduciary duties under Section 172 of the Companies Act are to have regard to workers. While "have regard to" is accused of being weak, since shareholders still have primacy, Edmans (2011, 2012) shows that treating workers fairly improves long-run stock returns. Thus, even if directors hypothetically cared only about shareholders, it would still be in their interest to take workers into account.

1.3.i Indeed, companies are *already* voluntarily improving employee well-being. Starbucks, Wal-Mart, and JP Morgan have all recently increased worker pay, without legislation. Companies pay to partner with the likes of Blueprint for Better Business, Tomorrow's Company, and Big Innovation Centre, to implement purpose. According to a senior executive, "Social purpose is deeply in the C-suite. Everyone – but everyone – is seriously thinking of purpose." There is far more to be done, but we are moving in the right direction.

1.3.ii In addition to the above recent examples, Marks & Spencer has prioritized employee well-being since the 1930s; Unilever has run the Lamplighter programme since 2001 to promote worker (mental and physical) health, nutrition, and well-being, and had various prior initiatives.

1.4 It is difficult for a worker representative to "represent" all workers. A worker representative cannot be representative. Workers comprise different pay grades and locations; many decisions (e.g. automation) may benefit one group (e.g. IT workers) at the expense of others (e.g. manual workers). In contrast, shareholders are generally aligned as all benefit from improved long-run value.

1.5 Worker representation is not a panacea. The worker representative is one of many board members. If the firm has a culture of treating workers poorly, it will ignore the worker representative, or many decisions will take place outside the boardroom in "backroom" discussions. Other firms have a culture of treating workers well despite no worker representative. Thus, firms should focus on culture change throughout the organisation, rather than the superficial solution of putting a worker on the board.

1.6 One claimed advantage of worker representation is that workers could see inside a boardroom, and that this transparency would reduce the perception of business as untrustworthy. However, there are much more effective methods of increasing transparency in ways visible to all workers (and indeed all stakeholders), not just to the worker representative. For example, many companies are reporting on many measures of stakeholder performance in their annual report.[1]

[1] See, for example, Marks & Spencer's Plan A report.

The Investor Forum is encouraging companies to hold Stewardship & Strategy Forums, the minutes of which could be made public.[2]

1.7 Under shareholder governance, there is a clear criterion to determine payments to stakeholders – market prices. Since stakeholder governance fails to define a clear objective, it provides no guidance how to make trade-offs among stakeholders, and so decision-making becomes a political process. Denis (2016) argues, "*If management is to ignore market values ..., by what alternative means should they determine how much value to take away from one set of stakeholders (the shareholders) and give to another set of stakeholders (the employees)? … There will be at least as many different opinions about this as there are types of interested parties. Whose opinion will prevail?*" Firms consult customers (through market research), but do not put them on the board; the same approach should be taken for all stakeholders.

1.8 Erroneous arguments for worker representation are as follows:

1.8.i Workers are aligned with the firm's long-term interests. But workers can immediately leave, whereas large shareholders cannot do so without lowering the stock price.

1.8.ii Workers will consider other stakeholders. Shareholders are the bottom-line claimant, and so harmed by poor treatment of workers, suppliers, customers, or the environment. Workers are not the "bottom-line" claimants and are not always affected by the stewardship of other stakeholders. For example, workers may oppose the closure of a polluting factory, or oppose the Night Tube even if customers support it.

1.8.iii Shareholders are diversified but workers are not, and thus workers care more about long-term value. This argument is conceptually incorrect, and confuses the return of a stock with its risk. Improving long-run value raises the long-run return of a stock. All shareholders, regardless of whether they are risk-averse or risk-neutral, benefit from an increase in long-run value. Workers' risk aversion means they may prioritise risk reduction over value creation. Long-run investment – including the creation of new jobs – involves significant risk. Shareholders will make these investments if they increase long-run return, but workers will be more concerned about preserving their existing jobs. This may explain the findings in paragraph 1.1.ii.

1.9 We must be very careful not to significantly reduce shareholder rights, as this may make it even less attractive to equity-finance businesses, and further exacerbate the bias towards debt financing.

1.10 Out of the options presented:

1.10.i I support Option (i) to create stakeholder advisory panels on a comply-or-explain basis. Shareholders and stakeholders should work in partnership to enlarge the pie for all. However, these panels may not be simple to design, since in the typical highly international FTSE 100 firm, the vast majority of employees are overseas. This calls for allowing for flexible approaches. For example, webinars may be preferred to physical panels in some firms.

[2] See http://media.wix.com/ugd/1cf1e4_4ccfaa9726d749f8bf7acd8f67f11595.pdf for a template agenda, which includes items on culture, stakeholder management, and ESG management.

1.10.ii I oppose Option (ii) to designate particular directors to represent specific stakeholders. This could absolve other directors of the responsibility to consider these stakeholders and lead to a divisive pie-splitting mentality where (say) the customer and worker advocates conflict.

1.10.iii I strongly oppose Option (iii) to appoint individual stakeholder representatives to company boards for all the reasons discussed in this section. Moreover, mandating stakeholder representation sends the wrong message. It suggests that "consulting stakeholders is bad for firm value, so we must pass a law to achieve it". Instead, we should emphasise that stakeholders and executives are in partnership - it is in a firm's interest to consult stakeholders.

1.10.iv I support Option (iv) to strengthen reporting requirements related to stakeholder engagement. This will lead to greater transparency on how firms are taking into account stakeholders.

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