

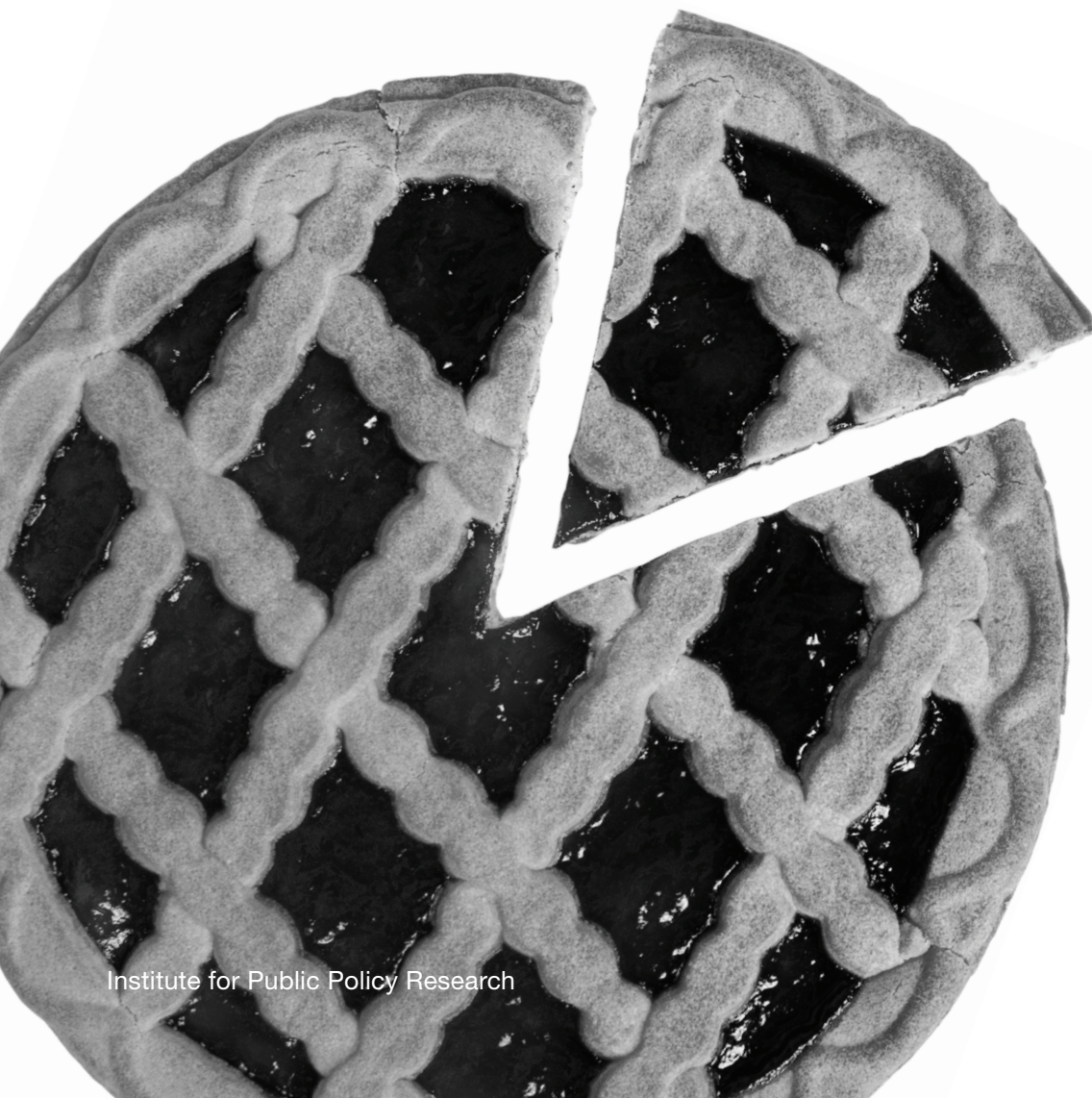
REPORT

Kayte Lawton
and Tess Lanning

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SHARING PROFITS AND POWER

HARNESSING EMPLOYEE ENGAGEMENT
TO RAISE COMPANY PERFORMANCE



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BOLD IDEAS
for CHANGE

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EXECUTIVE SUMMARY

The financial crash of 2008 brought the underlying weaknesses of British capitalism out into the light. Our over-dependence on the finance sector has driven a focus on short-term maximization of profits and weakened incentives for investment and innovation in some parts of the British economy. While many British firms are highly productive and innovative, too many rely on a low-quality growth model based on weak regulation, low skills and low wages.

Too often, the state has to deal with the fallout from these problematic business models – whether by spending heavily on tax credits to top up low wages, or by bailing out failed financial institutions. Too many employees lack autonomy and a sense of purpose at work, and consequently these companies fail to benefit from the collaboration and innovation that drive long-term improvements in productivity.

This report makes the case for an economy built on shared rewards and more democratic workplaces rather than management prerogative, shareholder power and trickle-down economics. Drawing on examples from the UK, US and Europe, we show how the financial and democratic participation of employees in the running of their company can improve its performance. Our goal is to see more British companies harnessing the potential of, and rewarding greater contributions from, the whole workforce in order to drive stronger improvements in productivity.

What has happened to wages over the last 30 years?

Wages across most of the earnings distribution have barely grown in real terms over the last decade. Though this is partly because real wages fell sharply following the 2008–2009 recession, there was also very little real wage growth in the five years before the recession. This is surprising given this was a period of high and rising employment, strong productivity growth and relatively low inflation.

It is not clear what caused the wage squeeze before the recession. The share of national income paid out in wages was lower in the 1990s and 2000s than in the 1960s and 1970s. This could be linked to the rise of the finance sector, increasing global trade and a decline in the bargaining power of low and middle earners. However, these trends predate the wage squeeze which occurred after 2002. Another possible explanation is that occupational pension contributions rose relatively rapidly during the 2000s, meaning that companies had less money available for wages. The balance of evidence suggests that migration had little impact on real wage growth over the last decade.

Real wage growth is expected to pick up from 2015, but it is not yet clear whether the lower share of national income that wages accounted for in the 1990s and 2000s represents a structural change in the distribution of economic rewards. Given the current pressures on benefits spending, securing strong growth in real wages will be vital for raising the living standards of low and middle-income households over the next decade.

The picture in the 1980s and 1990s was very different, with strong average wage growth but rapidly rising wage inequality. This rise in pay disparities has levelled off across most of the earnings distribution in the last decade, but it has not been reversed – leaving the UK with one of the highest levels of wage inequality among the advanced economies. Over the long term, rising pay inequality is the most important explanation for the fall in the share of national income paid to low and middle-earners.

The increase in wage inequality during the 1980s and 1990s was partly the result of advances in the application of technology in the workplace, which increased demand for highly-skilled workers but eliminated some of the jobs undertaken by unskilled and semi-skilled workers. This widened the wage gap between middle and high earners in particular. Wages adjusted to these structural shifts particularly rapidly in countries with relatively weak labour market regulation like the UK and (even more so) the US.

In the UK, the decline of trade union membership and collective bargaining has been associated with rising wage inequality, particularly between those on low incomes and middle incomes. Although the introduction of the minimum wage in 1999 helped raise the wages of the very lowest earners, its impact does not extend very far up the earnings distribution.

Over much of the last 30 years, the top 1 per cent of earners have consistently been able to secure large pay rises, a trend that seems impervious to economic conditions and changes which affect the wages of the bulk of the workforce. The growth in top earners' pay has been driven by the increasing dominance of the financial sector in the UK economy, and an increasing focus on profit-maximisation over mere profit-making. Executive remuneration has increasingly been used as a mechanism for pushing directors to maximise profits. This has sparked a dramatic increase in the complexity and value of executive rewards, which shareholders cannot properly monitor.

At the same time, shareholding has become increasingly short-term, fragmented, and dominated by foreign investors. Shareholders increasingly rely on headline financial indicators to judge company performance. This puts excessive pressure on directors and fund managers to deliver short-term results, while shareholders can quickly divest their investments should longer-term problems arise. In the run-up to the 2008 financial crash, little action was taken by investors in banks and other financial institutions to improve their corporate governance because their complex business practices were delivering the desired strong short-term returns. When the financial crash hit, the negative effects of these practices were borne primarily by customers, employees and the taxpayer.

Sharing profits and power in the workplace: models from the UK and abroad

Rebuilding a more sustainable and dynamic British capitalism that is better able to harness and reward the efforts of the whole workforce is crucial. Companies in the UK and abroad have demonstrated that this can be achieved in part by enabling employees to participate both financially and democratically in the workplace.

Shared capitalism

Models like profit-sharing, employee share-ownership and employee-owned companies are typically referred to as 'shared capitalism'. These approaches incentivise staff to work towards raising company performance – and rewards them fairly when they are successful. Rather than staff simply demanding higher wages, models of shared capitalism provide the means by which higher returns for both staff and owners can be generated and shared. This limits the financial risk to companies or shareholders, as profit shares and dividends for staff are only generated if companies achieve a certain level of profitability.

A large number of studies have shown that shared capitalism is good for both companies and staff. Employees work harder, take less time off and collaborate more with colleagues, while relations with managers are more constructive. Profit-sharing, employee share-ownership and employee-owned firms are most effective when all employees are able to

take part, when rewards are based on collective rather than individual effort, and when financial participation is combined with means of democratic participation like union representation or staff forums.

The UK has a strong track record of using the tax system to incentivise the use of shared capitalism models. Tax relief is available for four different employee share-ownership schemes, although it is skewed towards high earners and schemes that are not open to all employees. Tax relief was previously available for companies owned indirectly by employees and for profit-sharing schemes.

Thanks to this history shared capital models are relatively popular in the UK, although some forms are declining in use and others are static. The employee-owned and co-owned sector is small but growing. Employee share-ownership has traditionally been popular in large companies, but has recently become more common among higher earners in high-growth firms. Around a third of workplaces use profit-sharing to reward at least some of their staff.

Although there is good evidence that businesses benefit from using these approaches, many companies are not using them. This may be because they can deliver profits without them, with little pressure to upgrade and harness the skills of the whole workforce to raise performance. Some companies will need external pressure to be applied before they adopt practices that can deliver returns for businesses, staff, taxpayers and the state.

Democratic workplaces

The benefits of shared capitalism are best realised when combined with forums through which employees can influence decision-making in the workplace. These forums enable employees and managers to work together to resolve problems and raise productivity – for example, by redesigning work processes or reorganising the tasks that make up different jobs. They can also help ensure that employees are rewarded when these changes raise productivity.

Many of the UK's largest companies operate forums that allow employees to have a consultative role in decision-making, but overall a smaller proportion of UK staff have access to these forums than do their counterparts in most European countries. Employees in companies with more than 50 staff have the right to request formal consultation procedures, provided that at least 10 per cent of the workforce sign up. This is a relatively new entitlement, but early indications suggest it has not been widely used. Staff in many private sector workplaces are relatively unorganised, and may either not know about the entitlement or not have the confidence to pursue it.

Many continental European countries have a strong tradition of works councils that play a similar role to staff forums in the UK, but which typically have more power over decision-making and work closely with union representatives. The stronger powers of works councils is partly due to the adoption of a 'stakeholder' model of corporate governance by many European countries. Stakeholder capitalism accepts that people other than shareholders – including employees, suppliers, customers and local neighbourhoods – have an interest in how a company is run and therefore have a legitimate role in corporate governance. In a number of European countries this has been supported by relatively strong union presence in the workplace. In some countries this is because unemployment insurance is tied to union membership, and in others because unions have typically pursued constructive and inclusive strategies.

As well as embedding the role of works councils in decision-making, stakeholder capitalism also offers options like employee representation on company boards, on which staff can have a say in company strategy as well as in workplace-level decision-making. Employees have a right to board-level representation in selected companies in about half of EU countries. Board-level employee representation typically helps to improve relationships between employees and managers, and is also associated with lower levels of executive remuneration. The use of two-tier boards in many European countries makes employee representation more viable – in these cases employees sit on supervisory boards that oversee company strategy, but not on operational boards that deal with day-to-day decision-making.

Ways forward for the UK

The British state has a long history of non-intervention in many areas of economic policy, and particularly in the detail of how companies are run. Britain lacks many of the institutions that elsewhere have traditionally enabled employees to take greater responsibility for improving company performance and to share in the rewards. Changing this will be difficult, and progress will be slow and patchy.

Yet in an era of limited public resources, working people can no longer rely on the state to support rising living standards with more generous in-work benefits. Weak wage growth and high levels of wage inequality highlight the need for bold economic reforms that will enable working people to secure a fairer share of rewards and contribute to building a more innovative, collaborative and sustainable British capitalism.

Sharing profits and financial rewards

Broad-based models of shared capitalism help to raise productivity and improve company performance, while ensuring that a share of the rewards for doing so are passed on to the employees who helped generate them. To continue to strengthen and promote shared capitalism in the UK, policymakers, unions and employers should focus on the following areas:

- ***Profit-sharing***
The coverage of profit-sharing schemes has been relatively stable in the UK over the last decade, despite its potential to motivate employees to work more effectively and drive performance improvements. Government should ask representatives of employees, employers and investors to develop new proposals to advance profit-sharing and other shared capitalism arrangements. These could include the use of tax incentives, or making profit-sharing compulsory in some firms or sectors. Government should commit to acting on the recommendations of this shared capitalism partnership body.
- ***Employee ownership***
Tax arrangements for employee ownership should be simplified into a single structure to incentivise broad-based share ownership and indirect employee company ownership or co-ownership. Tax advantages should be removed from schemes that are not open to all staff, or that allow staff to immediately sell shares rather than retain long-term ownership. Further work should be done to develop a ‘right to buy’ for employees when a company is likely to be sold, dissolved or floated.

Creating democratic workplaces

Shared capitalism has the greatest impact where employees are able to take part in decision-making in the workplace. To expand opportunities for democratic participation in the workplace, policymakers should focus on:

- ***Establishing a ‘responsibility to participate’ for employees***
This would require employees in larger workplaces to get involved in decision-making through the kind of staff forums that have been shown to be effective in some of Britain’s largest companies. Employees should be consulted on decisions that affect employment conditions, the distribution of pay and profits, the reorganisation of tasks, jobs and teams, and changes to staffing. There should be a large degree of flexibility about how this is implemented, with companies and employees deciding on the arrangements that suit them best. Unions should have a major role in promoting the responsibility to participate, and in helping employees get the most from the process.
- ***Opening up the books of Britain’s leading public companies***
Large public companies should be required to publish more information about how they work, including pay and reward arrangements for the whole workforce and details about how they engage with employees. This would help staff, unions and campaigners to compare similar companies and track their performance on key non-financial indicators over time. Government should consider requiring these reports to be produced in a consistent format and to be externally audited.

Workers on the board? Employees and corporate governance

UK company law requires firms to be run in the interests of only their owners and shareholders. Not only does this create a legal barrier to employee representation on company boards, but it also fuels a corporate culture dominated by the interests of shareholders. Board-level representation of employees is associated with a number of benefits in those countries where it is commonplace, but substantially expanding employee representation in the UK would require a fairly radical overhaul of UK company law – and it would take time to do this well.

Employee board-level representation may also have a limited impact on raising productivity and improving the distribution of financial rewards in workplaces that lack other means of broad-based employee engagement. Boards meet irregularly, take decisions only on major strategic issues, and involve only a handful of decision-makers. The day-to-day decisions that typically affect work organisation, employee motivation and workplace culture are taken by managers below board level, as are many of the detailed decisions about the distribution of financial rewards.

In the long-run, there is a strong case for reforming British corporate governance to create more space for the involvement of a wider set of interests, including employees’. However, a top-down change to company law and board-level corporate governance is unlikely to have a significant impact on company performance and shared rewards so long as opportunities for broad-based employee engagement are weak. Steps towards major legal reform need to be combined with practical reforms capable of more immediately advancing the wider financial and democratic participation of employees.

INTRODUCTION

The underlying weaknesses of British capitalism were starkly exposed by the financial crash of 2008. Over the last 30 years, the UK's over-dependence on the finance sector has driven a focus on short-term profit-maximisation, weakening incentives for investment and innovation. Despite many British businesses being highly productive and innovative, too many have adopted low-quality growth models based on low skills, low wages and low levels of regulation. Corporate governance in major British companies is weak, with short-term, fragmented and often foreign shareholders showing little interest in firms' long-term health. Footloose shareholders and senior executives mop up the rewards in the good times, but move on at little cost when things go wrong. The state too often has to foot the bill for these practices, whether through heavy spending on tax credits to top up low wages, or bail-outs for failed financial institutions.

In this 'winner takes all' environment, the majority of workers have seen their wages progressively squeezed by the growing share of national income paid out in profits and enormous pay rises for the highest earners. British employees have experienced an unprecedented fall in living standards since the 2008–2009 recession, but the phenomenon of weak wage growth predates the crisis – real wages barely grew for most workers in the five years leading up to the recession, despite high employment, rising productivity and low inflation.

Moreover, large increases in pay inequality in the 1980s and 1990s left a legacy of highly unbalanced rewards in the labour market. An excessive belief in the abilities of small groups of executives has driven a corporate culture in which some companies fail to draw on the skills and experience of their whole workforce. This not only undermines employees' sense of autonomy and influence at work, but also reduces opportunities for the collaboration and innovation that drives productivity improvements.

This report makes the case for an economy built on shared rewards and more democratic workplaces, rather than trickle-down economics, shareholder power and management prerogative. Drawing on analysis of alternative models in the UK, US and Europe, we make recommendations for institutional and legislative reforms that could embed a stronger link between effort and reward within firms and across all pay grades, and enable employees to have a greater role in (and responsibility for) driving improvements in their company's performance. More widespread use of profit-sharing and employee ownership would ensure employees are focused on, and properly rewarded for, such improvements. Greater opportunities for employees to participate in decision-making in the workplace – for example, through staff forums – would enable them to work with managers to raise productivity and pay. The goal of this agenda is to push British companies to raise their productivity and performance over the long term by ensuring that all employees have a stake in their company's performance.

This agenda is a crucial component of efforts to build a more dynamic, innovative and productive British capitalism in the wake of the financial crash. In this report we demonstrate that an economy based on collaboration, investment and shared rewards has the potential to out-perform one predicated on low wages, low regulation and low quality. Such a model may also be less susceptible to knock-on effects such as the need for heavy state spending on wage top-ups and the instability caused by the search for short-term profits. In an era of fiscal constraint there is a strong case for bold economic reforms that help people to secure a greater share of the financial rewards of work, and shift part of the responsibility for raising low and middle-earners' living standards away from the state and on to employers.

Scope and structure of the report

The scope of this report is limited to private sector companies. We focus on issues of pay inequality within companies, but do not directly address important related issues such as pay inequalities linked to gender. Chapter 1 starts by outlining trends in pay in the UK over the last 40 years, and explores various explanations for how the distribution of financial rewards has shifted. Chapter 2 describes institutions and mechanisms adopted in the UK, US and Europe to facilitate a fairer distribution of rewards within companies. In chapter 3 we set out a number of proposals for supporting the empowerment of employees within the workplace and ensuring that financial rewards are more evenly spread.

1. WHAT HAS HAPPENED TO WAGES OVER THE LAST 30 YEARS?

This chapter provides an overview of the major trends in the level and structure of wages in the UK over the last four decades. We focus on three key trends: the stagnation of real wages since the early 2000s, the rise in wage inequality during the 1980s and 1990s, and the dramatic increase in high earners' pay across most of the last three decades. We examine the alternative explanations for these trends, including shifts in the proportion of national income paid out in profits, the roles of technology and trade, and changes in the effectiveness of labour market institutions such as unions.

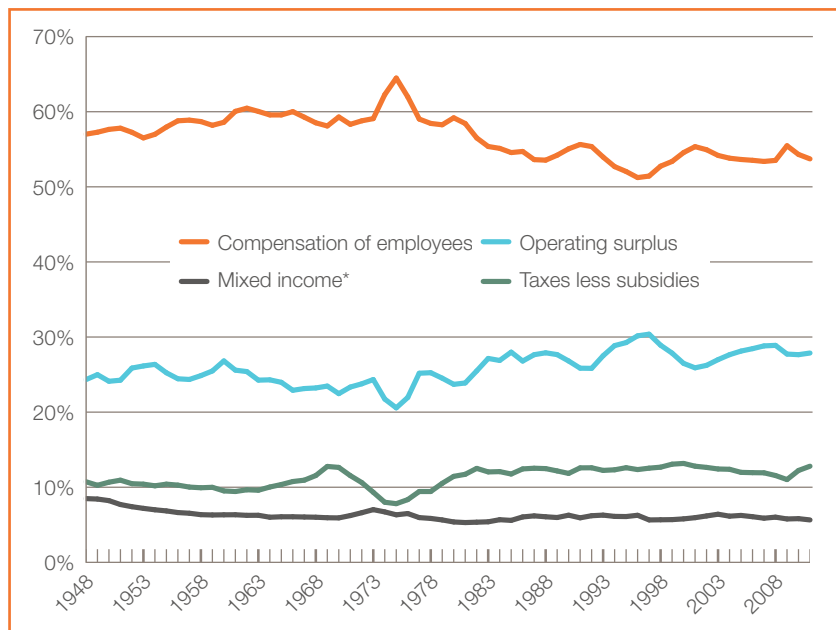
1.1 Wage stagnation since the early 2000s

Average wages fell sharply in real terms in the three years following the 2008–2009 recession – wages grew little in cash terms, while inflation was relatively high on average. This differs from previous downturns in the UK, when real wages either stayed flat or fell a little in the first year of recession before quickly rebounding (Levy 2013). However, the current wage squeeze started prior to the recession. Between 2003 and 2008, median weekly earnings for men fell by 0.2 per cent a year in real terms, and grew by only 0.3 per cent for women over the same period (Commission on Living Standards 2012). Weak growth in real wages was not limited to low earners or those without formal qualifications, but extended across most of the pay scale. Wages only grew significantly for the highest earners, and even this growth was weaker than in the five years before 2003. Flat wage growth in the five years before the recession combined with sharp falls in real wages since mean that workers on the average wage have not seen their pay increase in real terms for a decade (Levy 2013).

Real wage growth was weak between 2003 and 2008 despite high and rising employment, strong growth and relatively low inflation. Labour productivity also continued to grow, but workers did not enjoy significant returns on their rising productivity. This recent pattern in the UK echoes a much longer-term one in the US, where average wages and productivity growth have been 'decoupled' since the 1970s (Pessoa and Van Reenen 2012). It is too early to tell whether the pattern of wage growth in the UK since the early 2000s represents a temporary blip or the beginning of a longer-term shift in the structure of financial rewards.

If a smaller share of national income is going to employees, then a greater share must be going to profits and self-employment income, or to non-wage labour costs like pension contributions. Figure 1.1 (over) shows how the share of national income apportioned to each of these areas has changed in the UK over the last 60 years. The share accounted for by wages peaked during the mid-1970s 'profits squeeze', but then fell relatively consistently until the early 1980s. Since then the wage share has recovered a little and then fallen a little, but on average it was lower in the 1990s and 2000s than in the 1950s, 1960s and 1970s. The share of GDP going to profits was, on average, slightly higher in the 1990s and 2000s than in earlier decades. Possible explanations for the higher profits share (and lower wage share) include the increasing ability of the finance sector to extract excessive profits, rising global trade, and a decline in the bargaining power of a broad swathe of employees. These trends, which are discussed later in this chapter, may also help to explain the increase in wage inequality seen in the 1980s and 1990s. However, they predate the wage squeeze which has occurred since the early 2000s, which makes it difficult to state conclusively that they are responsible for the weak wage growth of the last decade.

Figure 1.1
Share of wages, profits
and taxes in UK GDP,
1948–2010



Source: Reed and Himmelweit 2012

*Income from self-employment, which is a combination of wages and gross operating surplus.

A further possible explanation for the wage squeeze is that non-wage labour costs – which include employer and employee contributions to occupational pensions and national insurance contributions – have increased. The assumption is that, if they did not have to make these contributions, employers would pass at least some of the resultant savings on to workers. Figure 1.1 shows that total taxes (including social security contributions and net of subsidies) on average accounted for a higher share of GDP in the 1990s and 2000s than in previous decades, which may have contributed to a long-run ‘wage squeeze’. The Commission on Living Standards (2012) found that pension contributions rose particularly steeply in the 2000s, which may have been a factor in the relatively flat growth of real wages. This rise in pension contributions was driven by a combination of a faster than expected increase in longevity and very low interest rates. The previous Labour government also increased national insurance contributions, but the effects of this have been less important than rising pension contributions.

One possible explanation that appears to have been less important is the influx of migrants from Eastern Europe that began in 2004, which might have pushed down wages, particularly in low to middle-paying jobs. However, most studies have found that this increase in the supply of labour had little effect on wages in any part of the labour market (Commission on Living Standards 2012). Nickell and Saleheen (2009) estimate that a 10 per cent increase in the ratio between immigrants and British-born workers is associated with a 5 per cent reduction in wages for those in semi- and unskilled service occupations. However, this is only one estimate from one study, and most of the literature has found little impact.

The prospects for real wage growth are uncertain. The Office for Budget Responsibility (OBR) expects real wage growth to return to its long-run trend in 2014 (OBR 2013). However, the significant fall in real wages experienced since the recession means that there is considerable ground to make up before average real pay returns to pre-recession levels. These forecasts are also unable to take into account all of the factors that may

have driven the squeeze on wages in the run-up to the recession. If the lower share of GDP which went to wages in the 1990s and 2000s represents a structural change in the distribution of economic rewards, then the outlook for wages may be less positive than is implied by the OBR's forecast. Even if a strong economic recovery is secured, analysis by Gregg and Machin (2012) indicates that unemployment will have to reach very low levels before healthy real wage growth returns.

Furthermore, reductions in working-age benefits mean that living standards for the less affluent half of working-age households in 2020 are expected to be level with those of a decade earlier – even if the OBR's forecasts for wage growth and inflation prove to be accurate (Brewer et al 2012). Given the pressures on the public finances, raising the value of working-age benefits on a scale large enough to deliver significant improvements in living standards in the decade ahead is unrealistic. One of the biggest challenges facing policymakers over the next decade is how to boost the contribution of earnings to living standards. Raising employment rates will be vital for achieving this, but securing real wage growth for the majority of workers will also be crucial.

1.2 Rising wage inequality in the 1980s and 1990s

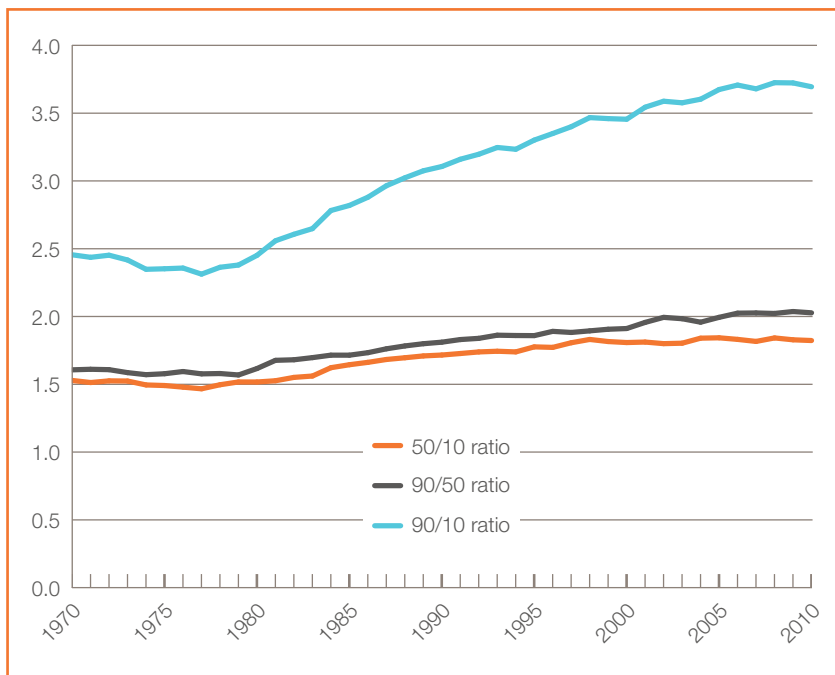
Compared to the last decade, with its poor wage growth, the picture in the 1980s and 1990s was very different. Average real wage growth was strong for most of this period, but inequality between low, middle and high earners was rising rapidly, particularly during the 1980s. Although the rise in pay disparities appears to have leveled off during the last decade, it has not fallen back, leaving the UK with one of the highest levels of wage inequality among the advanced economies. Over the long term, rising pay inequality has been the most important factor in the fall in the share of national income paid to low and middle earners.

A simple way to measure wage inequality is to look at the ratio between the wages of people at different points in the pay scale. The ratio between wages at the 90th and 10th earnings deciles shows the level of inequality across the bulk of the workforce (people earning at the 90th decile have wages that are higher than 89 per cent of the workforce and lower than the top 10 per cent of the workforce). The 90/10 pay ratio rose substantially for men and women from the early 1980s until the early to mid-2000s, when the rise flattened off. In the 1970s, a man whose earnings fell into the 90th decile was paid 2.5 times as much as a man with a wage in the 10th decile, but by 2004 this ratio had risen to 3.7. For women, the ratio increased from 2.3 to 3.2 over the same period.

The gap between low and middle earners (measured by the 50/10 pay ratio) also rose from the early 1980s until the second half of the 1990s for both men and women. This meant that people on average earnings were receiving larger pay rises than people on relatively low pay. However, over the last 15 years low earners have kept up with middle earners, and the gap between the two has remained relatively stable. The gap between middle and high earners (the 90/50 ratio), on the other hand, continued to rise until at least the mid-2000s, with higher earners securing better pay rises than those on average earnings.

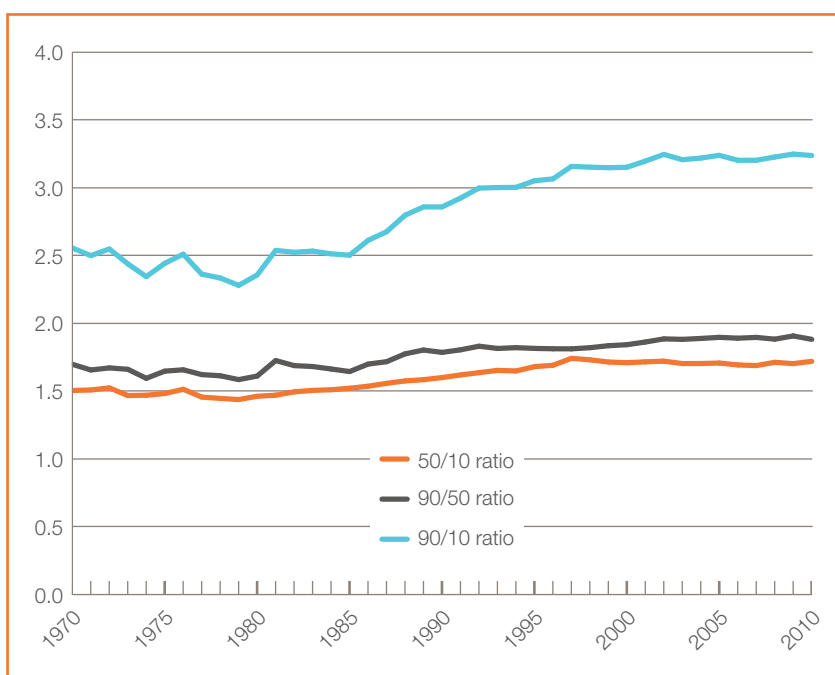
Although the rapid rise in pay disparities that characterised the 1980s and early 1990s has levelled off, the extent of wage inequality in the UK remains high by both historical and international standards. Earnings gaps are substantially higher in the UK than in most European countries, although considerably lower than in the US.

Figure 1.2
Male earnings ratios,
1970 to 2010



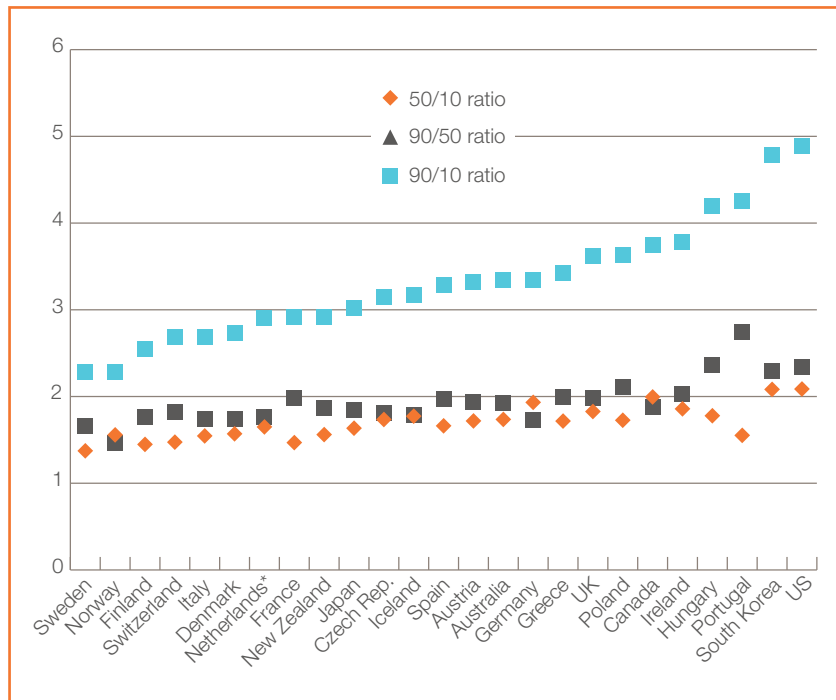
Source: Hills et al 2010
Note: Figures are for gross weekly earnings for full-time workers.

Figure 1.3
Female earnings ratios,
1970 to 2010



Source: Hills et al 2010
Note: Figures are for gross weekly earnings for full-time workers.

Figure 1.4
Wage inequality in
the OECD, 2008
(by earnings ratio)



Source: OECD.StatExtracts¹

*Note: Data for the Netherlands is for 2004

The long-term impact of widening wage inequality has been to reduce the share of national income going to the bottom half of earners. Whittaker and Savage (2011) estimate that this share fell by a quarter between 1977 and 2010, from 16 to 12 per cent. By far the most significant factor driving this change was the substantial increase in wage inequality during the 1980s and 1990s: over the whole period from 1977 to 2010, the widening pay gap is estimated to account for around two-thirds of the shift of financial rewards away from the bottom half of earners. Although wage inequality has not risen significantly during the last decade, the large increase in inequality seen in the 1980s and 1990s has not been reversed. Both securing a more equitable distribution of wages and raising the share of national income that goes to wages are essential if we are to ensure that the majority of workers see improvements in their real wages over the next decade.

1.2.1 What explains the rise in wage inequality?

Changes in the structure of wages are complex. Broadly, there are two sets of explanations for the increase in wage inequality that occurred in the 1980s and 1990s: those that relate to changes in the supply of and demand for different kinds of workers, which are driven by changes in technology and trade; and those that relate to changes in the way the labour market operates and is governed, such as shifts in the role played by trade unions or the introduction of legal wage floors.

Advances in the application of technology in the workplace have increased demand for highly skilled employees capable of using new technology, and have also raised their productivity (Autor et al 2003). This has driven up the wages of higher earners (typically those with a degree) relative to those of other workers. The tasks carried out in many

¹ <http://stats.oecd.org/>

routine jobs, such as those on factory production lines and many clerical roles, have become automated thanks to more productive technologies, which has reduced demand for these kinds of workers, who typically have mid-level skills and earn mid-level wages. This process of 'routinisation' also eliminates some low-level jobs, but those that involve non-routine work and human interaction – such as many roles in retail, food service, personal care and cleaning – are not significantly affected because they cannot be replaced by computers or other technologies.

The increasing liberalisation of trade may also explain rising occupational polarisation in terms of wages. Trade liberalisation may have a similar effect to technological advances because it enables many routine low to middle-wage jobs to be offshored. Studies generally indicate that trade has some role in explaining rising occupational polarisation, though it is less important than technology. Van Reenen (2011) finds little evidence that trade, by increasing competition between low-wage workers in the UK and elsewhere, has dampened wage growth at the bottom of the labour market. Furthermore, trade pressures only apply to jobs that can be easily offshored, whereas many low-wage sectors face only domestic competition. However, increased global trade may have had the indirect effect of quickening the process of routinisation, and therefore depressing wages, by encouraging some firms to speed up their application of new, labour-saving technologies in order to stay globally competitive.

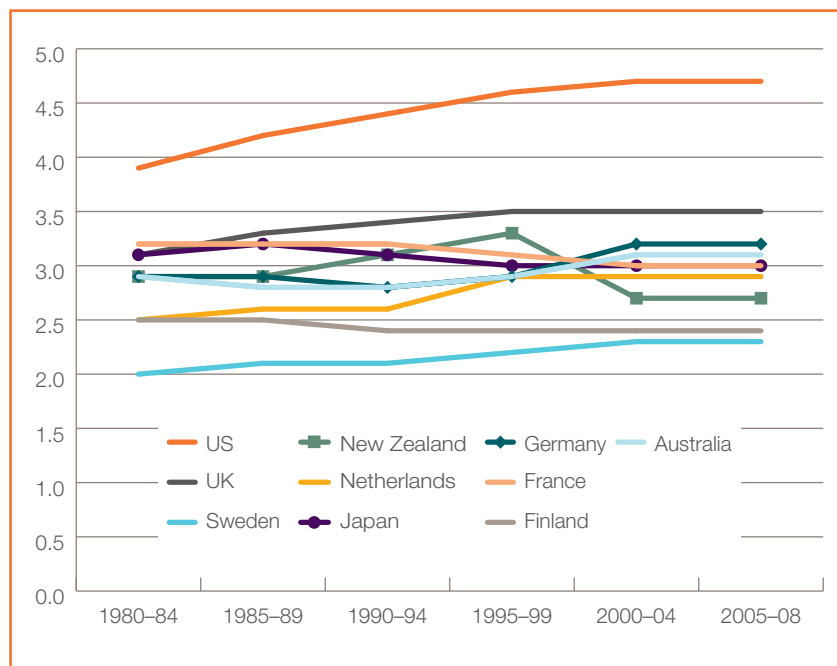
The effect of the twin pressures of technology and trade has been a 'hollowing out' of the labour market – rising demand for both high- and low-skill workers, but a fall in employment for those in the middle. Goos et al (2010) estimate that technology and trade combined account for about 70 per cent of the increase in low-wage employment as a share of the total number of jobs in the UK between 1993 and 2006. Of this, they find that technological advances explain about three-quarters of the shift, with increasing international trade accounting for the remaining quarter.

Together, routinisation and polarisation offer a fairly convincing explanation for the widening pay gap between the top and the middle, as measured by the 90/50 pay ratio. Goos and Manning (2007) estimate that occupational polarisation explains about half of the increase in the 90/50 pay gap in the UK between the mid-1970s and the mid-1990s. However, these explanations are less relevant to explaining the growth in the gap between low and middle earners which occurred in the 1980s and 1990s – they account for only one-third of this increase (Goos and Manning 2007). Lower earners' wages fell relative to mid-earners in the 1980s and early 1990s, which is inconsistent with rising relative demand for low-wage workers. It might be that demand for low-wage workers did not start to rise in the UK until the second half of the 1990s, or at least not by enough to counteract the other factors pushing down the wages of this group. Alternatively, it could be that workers who were displaced from mid-level occupations in the 1980s and early 1990s were able to retain their wage premium, creating new kinds of mid-wage occupations (Holmes and Mayhew 2010).

The substantial changes in Britain's labour market over the last four decades can be clearly linked to the changing structure of wages. Growing demand for highly skilled workers appears to have pushed up the wages of those on higher earnings faster than those of workers in other parts of the labour market. However, changes in the structure of wages also coincided with major transformations in the institutions governing the UK labour market, which also offer some important explanations for the increase in wage inequality in the 1980s and 1990s.

Most advanced economies experienced an increase in wage inequality (and income inequality) over the last 30 years, but the scale and timing of this increase has varied. The US and the UK experienced the steepest rises in wage inequality during the first half of the 1980s, a number of years before the wage gap started to rise in many other countries. The overall increase in inequality has also been greatest in the US and the UK – particularly in the US, where the pay gap was already substantially higher than in most OECD countries at the beginning of this period. In countries like Sweden, Germany, Austria and the Netherlands, wage inequality remained relatively flat in the 1980s, but rose markedly in the 1990s. This may have been because these countries felt the impact of developments in technology and trade later than the US and UK did, although it is not clear why this would be the case in a very open economy like Sweden. Elsewhere, in places like Japan, Finland and France, wage inequality has been relatively stable, or has even fallen, over the last 30 years.

Figure 1.5
90/10 wage ratio
for selected OECD
countries, 1980–84 to
2005–08



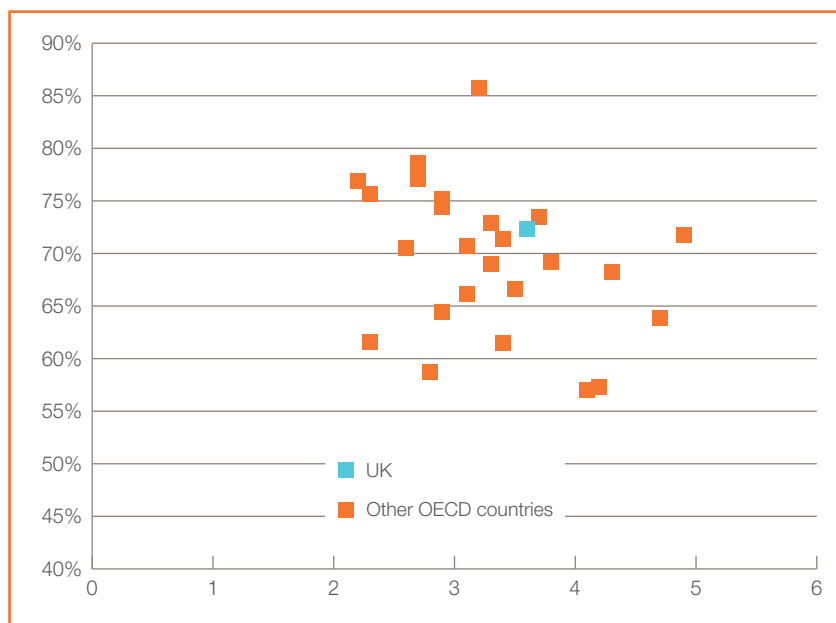
Source: OECD Earnings Database²

The varied patterns of pay inequality across OECD countries suggests that the general factors of technology and trade cannot explain all of the wage gap increase in countries like the UK and the US. Advanced economies were all subject to similar forces of economic and labour market change, but these were filtered through each country's very different institutions, policies and practices. In countries where market forces are more dominant and labour market institutions relatively weak (like the US and the UK), the polarising impacts of routinisation and occupational change appear to have had a starker impact on wage inequality. Relative wages adjusted particularly dramatically to structural shifts in labour demand in the US because it had (and still has) one of the least regulated labour markets and weakest wage floors in the OECD (Prasad 2002).

² http://www.oecd-ilibrary.org/employment/data/earnings_ifs-ear-data-en

Elsewhere, local factors appear to have pushed back against global economic shifts, shoring up the relative value of low and mid-level wages. Typically, the more heavily regulated European labour markets were better able to protect low and middle earners from the pressures of routinisation and international trade. Figure 1.6 shows that there is no necessary trade-off between such protection and levels of employment. The Nordic countries, the Netherlands and New Zealand combine relatively low levels of wage inequality with high employment rates, while countries like Poland, Hungary and Portugal perform relatively weakly on employment and have high levels of wage inequality. Countries with labour market institutions and regulations that help to protect living standards without compromising employment tend to be able to secure political support for policies that promote economic openness and dynamism, which would otherwise cause great insecurity for workers.

Figure 1.6
The relationship between employment rates (%) and wage inequality (earnings ratio), 2007



Source: OECD.StatExtracts³

In the UK, there is substantial evidence that the combined effect of the decline of key labour market institutions and structural changes in the labour market has been to diminish the relative wage position of low and middle earners. Trade union membership in the UK fell from a peak of 13 million, or half of all employees, in 1979 to just 6.2 million, or just over a quarter of all employees, in 2012 (BIS 2013). Membership is particularly weak in many low to middle-wage occupations: 45 per cent of professionals are union members, compared to 16 per cent of employees in sales and customer service jobs, and 17 per cent of people in elementary occupations (ibid). Membership is also concentrated in the public sector, with just 14 per cent of private sector employees reporting union membership in 2012. Collective wage bargaining has also declined in the UK, with the proportion of employees whose pay is affected by collective agreements falling from nearly three-quarters in the late 1970s to less than a third in 2010 (Gallie 2009, BIS 2013). In the private sector, just 16 per cent of workers were covered by collective agreements in 2012.

³ <http://stats.oecd.org/>

A number of statistical studies have identified declines in union membership and collective bargaining as important reasons for widening pay disparities in the UK and other developed countries. Holmes and Mayhew (2010) found that, among a number of economic and institutional indicators, the decline in union membership in the UK had the most substantial impact on wages in the bottom half of the distribution, reducing real low and median earnings by around 3.5 per cent between 1987 and 2001. Pontusson, Rueda and Way (2002) identified union density and centralised wage bargaining as two of the most important explanations for variations in wage inequality across OECD countries between 1973 and 1995. They found that these institutional drivers of pay disparities were more important than economic measures such as unemployment, trade with low-wage countries and the share of employment accounted for by the service sector. The primary effect of high union density and centralised wage bargaining systems was to compress the gap between median wages and earnings at the 10th decile, indicating that these institutions are particularly good at supporting the relative wages of low earners.

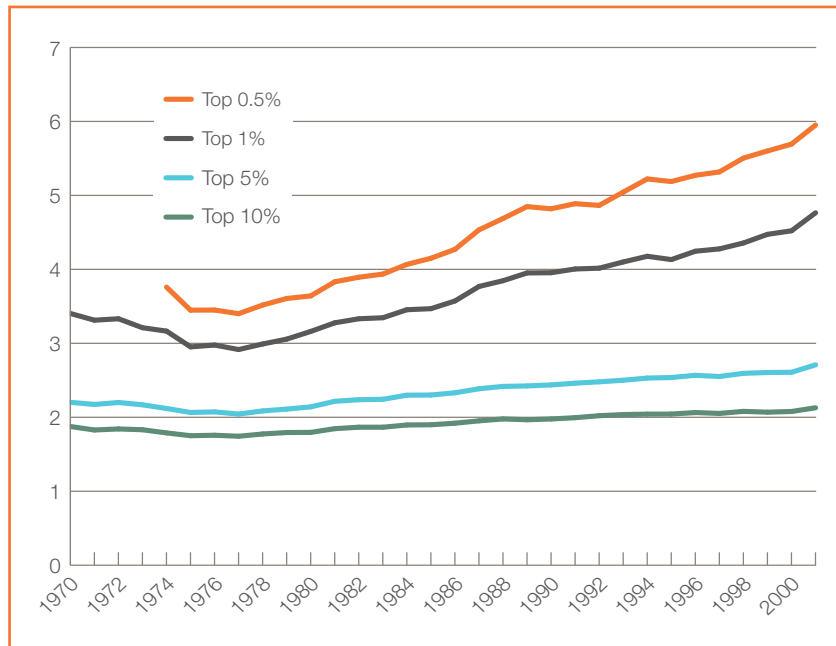
Legal wage floors are also an important labour market institution that can help to lessen the pay gap, and which are particularly effective at boosting the pay of low earners relative to the middle. Prior to their abolition in 1993, a system of wage councils operated in a number of low-wage industries in the UK, setting statutory minimum wage rates based on negotiations between employers and worker representatives (Coats 2007). Wage councils only covered a minority of the workforce (around 12 per cent by the time they were abolished) so their impact on pay disparities in the bottom half of the wage distribution would have been limited. However, their powers were weakened in the 1980s, which may have contributed to the weakening of low earners' relative wages during this period.

Since its introduction in 1999, around 5 per cent of employees have been paid at or just above the minimum wage. This has caused the gap between median earnings and earnings in the fifth percentile to fall, particularly following the relatively large increases to the minimum wage in the early 2000s (Manning 2012). The 50/10 pay ratio also fell between 2001 and 2006, suggesting that these generous increases in the minimum wage helped to push up the relative wages of earners further up the pay scale. However, it is unlikely that this explains the stabilisation of the 50/10 pay ratio since the mid-1990s in full, since this predates the introduction of the minimum wage. There is also debate about the extent of 'spillover' effects which extend beyond the people directly receiving the minimum wage (Stewart 2011a, Butcher et al 2011). However, it is clear that the impact of the minimum wage is not felt very far beyond the lowest 10 per cent of earners. The minimum wage in its current form is not capable of pushing up wages among the bulk of low and average earners by itself.

1.3 The racing ahead of top earners

A major feature of the structure of wages in the UK over the last 30 years has been the very large pay rises secured by the highest earners, typically those in the top 1 per cent. These top earners are not captured by measures of broad wage inequality like the 90/10 ratio discussed above, and have increasingly pulled away from the rest of the workforce. Figure 1.7 (over) shows that in 1977 the top 1 per cent of workers earned around three times as much as the average earner, but that this had risen to almost five times as much by 2001 (the most recent year for which consistent data is available). Using data on incomes rather than wages, the Commission on Living Standards (2012) found that the real incomes of the top 0.1 per cent of households grew by 13.4 per cent a year between 2003 and 2007, at a time when most workers were seeing little improvement in their living standards. The upward trajectory of the wages of the highest earners seems impervious to changing economic conditions.

Figure 1.7
Ratio of top earnings to median earnings in the UK, 1970–2001



Source: Hills et al 2010

Note: Earnings are weekly employee earnings.

The pulling away of top earners means that they have been able to secure a growing share of the total wage bill. Using annual pay data (which includes bonuses, an important source of the rising earnings of high earners), Bell and Van Reenen (2010) found that the share of total wages paid to the top 10 per cent of earners rose from 22 per cent in 1975 to 32 per cent in 2008. The top 1 per cent of earners more than doubled their share of the wage bill, from 5 per cent in 1975 to 11 per cent in 2008.

The top 1 per cent of earners are primarily FTSE company directors and finance sector workers below director level, and they predominantly live and work in London and the greater south east area. This group of workers accounts for almost all of the increase in wage inequality seen during the late 1990s and 2000s – outside of London and the finance sector, there was no significant increase in pay inequality during this period (Stewart 2011b). The rapid rise in earnings among this group is associated with the increasing dominance of finance in the UK economy, largely as a result of the ‘Big Bang’ in the City of London in 1986. The finance sector has been able to grow to such an extent because it has been extracting increasingly large ‘rents’ from the rest of the economy – and this is reflected in the very large pay increases secured by senior finance workers over the last 30 years (Dolphin 2013). Today, finance workers earn on average around a quarter more than similar workers (in terms of age, occupation, experience and education) in other sectors (ibid).

The increasing ability of top finance executives to capture a progressively larger share of total wages has spread into the upper echelons of other parts of the economy, supported by long-term shifts in economic policy which have prioritised profit-maximisation over mere profit-making. The doctrine of profit-maximisation, which has been a key component of the neoliberal economic policy framework dominant in the UK since the late 1970s, brought with it an intensifying focus on executive remuneration as the mechanism by which top directors could be incentivised to maximise profits.

In companies in which ownership is separated from control, and where managers are assumed to have no personal loyalty to their employer, it was argued that top earners had to be turned into 'quasi-entrepreneurs' with strong financial incentives to maximise shareholder value (High Pay Commission 2011a). This sparked a very significant increase in the complexity and value of executive remuneration, with an increasing emphasis on variable pay linked to measures of individual and company performance.

In theory, this complexity ensures that the financial incentives for directors and top earners are finely tuned to generate short-, medium- and long-term profit maximisation, thereby aligning the interests of managers with those of shareholders. In practice, it has made it increasingly difficult for shareholders to monitor pay and performance, while the perceived uncertainty around variable pay has led top earners to negotiate larger total remuneration packages to compensate for the risk that the value of particular elements of those packages may not be realised (BIS 2011). The result is that the median value of all incentives, and the number of directors receiving such incentives, has increased consistently over the last 20 years without a commensurate improvement in company performance. Among FTSE 350 companies, the value of annual bonuses rose by 187 per cent between 1980 and 2010, and the value of long-term incentive plans by 254 per cent; meanwhile pre-tax profit increased by 51 per cent, earnings-per-share rose by 73 per cent and market capitalisation increased by 8 per cent over the same period (Income Data Services 2011).

The British model of corporate governance has done little to reign in excessive executive pay in our largest companies. The basis of UK corporate governance is that directors should promote the interests of the company so as to deliver maximum returns to shareholders. This is in contrast to the European 'stakeholder' model, which balances the interests of shareholders, employees, consumers and the local community, and gives the long-term health of the company itself priority (Gospel and Jackson 2006). The key features of this model are discussed in chapter 2. In the UK model, shareholders and private owners are the only group with a formal role in governance (although directors are required to 'have regard' to the interests of other stakeholders), yet they have repeatedly failed to fulfill this role effectively.

For example, the UK corporate governance code (which outlines how companies listed on the London Stock Exchange should be run in order to maximise shareholder value) recommends that listed companies form a remuneration committee of at least three non-executive directors to set the pay and benefits of board-level directors, so that no director can set his or her own pay. This committee is supposed to take into account the pay and conditions of other employees when making its decisions, but this is rarely done in a systematic way (BIS 2011). There is no evidence that the introduction of remuneration committees in the late 1990s, nor a number of changes to how directors' remuneration has to be reported, has had any effect in restraining to growth of executive pay (High Pay Commission 2011b).

The fact that shareholders (and the non-executive directors who are supposed to represent their interests) face difficulties in governing companies is partly because changes in the nature of shareholding have made it difficult for shareholders to act as responsible owners as well as investors. Shareholding has become increasingly short-term, with the mean holding period of shares falling from five years in the 1960s to less than eight months in 2007 (Haldane 2010). Shareholders are now much more likely to be based abroad: in 2008, foreign investors owned 41 per cent of UK shares by value, up from just 4 per cent in 1981 (ONS 2012). Although institutional investors (pension funds and insurance

companies) are typically expected to exercise a strong corporate governance role, they owned only a quarter of UK shares in 2008. Share ownership has also become increasingly fragmented, and in most UK listed companies no single shareholder has a sufficiently large stake to control management and direct corporate policy (Lehki and Blaug 2010). Fund managers hold hundreds of different shares on behalf of institutional investors, making it impossible for their limited corporate governance staff to engage with governance issues in individual companies effectively (Williamson 2011).

Such fragmented, short-term and increasingly foreign ownership means that shareholders typically rely on headline indicators like quarterly reports and share prices to gauge company performance. This puts excessive pressure on directors and fund managers to deliver short-term results, with few opportunities to consider trade-offs between short-term results and the long-term performance of companies (BIS 2010). Shareholders can quickly divest their shareholdings if governance issues arise, and this is likely to be more profitable to them in the short term than investing in intervention (Cheffins 2010).

This hands-off approach to governance can have significant impacts on other company stakeholders, particularly when directors and shareholders do not have to deal first-hand with the trade-offs involved. Focusing on short-term profits incentivises cost-cutting rather than investment, and so is likely to reduce opportunities for investment in workforce training and drive the poor treatment of suppliers (Lanning and Lawton 2012). For workers in firms which operate a low-cost, low-quality business model, this is likely to mean low wages, few progression opportunities and repetitive work. It is also likely that expensive state benefits will be required to top up those low wages.

The risks associated with the UK model of corporate governance were revealed by the 2008 financial crash. The majority of shareholders in banks and other financial institutions had taken little action to improve corporate governance in these organisations because their complex business practices were delivering short-term profits (Behr 2011). The financial institutions that took the greatest risks delivered the best short-term results for shareholders. This incentivised risky behaviour by managers and executives, and encouraged shareholders to deride cautious managers and push for high dividends and share buy-backs that reduced capital for investment (Cheffins 2010). The long-term negative implications of these actions for other stakeholders – including employees, customers, taxpayers and the state – would probably have been discernible had their interests been prioritised.

Excessive and disproportionate increases in executive pay over the last 20 years, coupled with the 2008 financial crash, demonstrate that shareholders make poor owners of major companies. Distant and fragmented shareholders are incapable of properly holding managers to account or reigning in top pay, and their interests are often at odds with those of other stakeholders. Tackling excessive top pay in the finance sector and among FTSE directors, and securing a fairer sharing out of rewards within large companies, will require a different approach to corporate governance.

1.4 Attitudes to pay and reward

As part of this project we conducted original research to investigate public attitudes towards pay inequality and different approaches to pay-setting, as well as people's own experiences of dealing with issues of pay in the workplace. We conducted a series of workshops with a total of 47 adults living or working in London on a range of salaries, as well as with eight people who were out of work at the time. We also commissioned a poll

of 2,337 adults in Britain from YouGov in March 2011. The full results from the workshops and poll are reported in Lanning and Lawton (2011), and summarised here.

In the workshops, we began by discussing how pay is typically set within companies. Participants were fairly evenly split between those who actively questioned the bases on which pay is currently determined, and those who sought to justify them. Those who were critical of what they perceived to be the dominant model tended to focus on the way in which a small group of people have been able to capture a growing share of wages, which echoes the evidence about and critique of prevalent corporate governance arrangements set out above. They stressed the imbalances of power between employees in different positions on the earnings ladder, and the impact that these have on the processes through which pay is set. These imbalances were seen to lead to disproportionate and unfair rewards for very highly paid individuals. Conversely, participants who were largely content with their own experiences of pay determination had faith in the market to set fair wages through an open and technocratic process. They also had an exaggerated belief in social mobility and in the ability of most people to raise their wages significantly through hard work and by choosing the right jobs.

Despite different perceptions of how pay is typically determined, the vast majority of participants saw both low pay and very high pay as problematic. Almost all participants were very concerned about low pay in the context of the high cost of living (in part because the focus groups took place in London). There was also a strong consensus that all work should pay enough to live on, or a 'living wage'. Concerns about the extremes of low and high pay were also partly related to uneasiness about very large gaps between the pay of high and low earners, regardless of whether these could be ostensibly 'justified'. This was echoed in our polling, in which two-thirds of respondents thought the pay gap between the highest and lowest earners in their own workplace was too large. A total of 78 per cent of respondents supported government action to reduce the gap between high and low earners.

The polling results also indicated that this concern about wage inequality between the highest and lowest-paid individuals is driven primarily by a desire to see pay at the very top significantly curtailed. When asked what the salary of a CEO of a large national company should be, the median answer was £350,579, compared to actual average earnings of £1 million (Lanning and Lawton 2011). There was also support, though not of the same magnitude, for raising the wages of lower earners like cleaners. The workshops broadly supported these findings, with many participants arguing that 'no matter how much work you put in, nothing's worth a million pounds'. However, few of the high earners we spoke to saw excessive pay as a problem in its own right, so long as it was 'deserved'. Yet significant evidence which shows that top pay has grown out of all proportion to both improvements in company profits and the demands placed on senior executives undermines the notion that the levels of top pay in the UK are 'deserved'.

The idea that pay at all levels should act as a reward for or recognition of particular qualities resonated strongly with all research participants, and there was a remarkable consensus about what those qualities should be. Both poll respondents and workshop participants agreed that the key qualities that pay structures should reward are the level of responsibility and difficulty of a job, how hard someone works and how well they do their job, and how useful their skills are. There was agreement that these factors should apply across different roles and earnings brackets. Responsibility, difficulty, effort and skill are widely used to justify the high wages of top earners, and this was supported by the majority of our workshop participants. However, many participants argued that these

qualities are also present in many other roles, including those associated with low and mid-level wages. The fact that these qualities are not sufficiently rewarded through the wages of many lower earners was a source of concern.

The significant increase in top pay in many companies means that rewards are focused on a small number of people at the top, while often failing to reflect the contribution that many other people make to an organisation. The idea that a few ‘stardust’ individuals are almost entirely responsible for how a company performs was strongly supported by the high earners that we spoke to in the workshops. However, many low to middle earners and higher earners in the public sector recognised the nature of this ‘talent myth’, and questioned the extent to which very high pay is deserved in recognition of rare skills. From their own experiences in the workplace, participants recognised that many people, at all levels, are often responsible when an organisation does well.

The idea that, within an organisation, everyone contributes and everyone should be rewarded accordingly resonated very strongly across the earnings groups. A number of very high earners made this point too, although they also argued that responsibility for the fate of a company ultimately rests on the shoulders of a small executive team. The John Lewis Partnership model, by which profits are shared among all workers according to a fixed percentage of basic salary, was discussed approvingly by many participants. It resonated as an example of a fair system of reward – importantly, it was seen to justify the higher pay of senior managers as well as providing fairer rewards for the majority of the workforce. In our polling, half of respondents said that bonuses should be awarded on an organisational or team basis, with only a quarter supporting bonuses primarily linked to individual performance.

1.5 Summary and conclusions

Major structural shifts in the UK labour market and the wider economy over the last 30 years have driven up the wages of higher earners faster than those of low to middle earners, and in some cases have put downward pressure on pay for low and mid-level jobs. The growing dominance of the finance sector, coupled with a narrow conception of corporate governance, has enabled top earners to secure an ever greater share of national income.

These structural transformations have coincided with significant erosion of the institutions that help protect workers from the effects of global pressures and structural change. New institutions like the minimum wage, while vital for protecting the lowest earners, have little impact further up the earnings distribution.

The effect of this combination of structural and institutional change has been to reduce the share of national income going to low and middle earners over the last 30 years. The large increase in pay inequality in the 1980s and 1990s was not reversed during the 2000s, or by the more recent stagnation of real wages for most workers. Meanwhile, a growing share of rewards are going to the top 1 per cent of earners and the share of national income paid to shareholders and company owners has been higher on average since the 1980s than in the previous post-war decades.

The major political challenge for the next decade lies in securing a return to rising living standards for the majority of working people. Given the extent of wage inequality and the uncertain prospects for strong real wage growth in the years ahead, this will require action to ensure that wages once again rise in line with productivity, and that low and middle earners are able to secure a fairer share of rewards.

2. SHARING PROFITS AND POWER: MODELS FROM THE UK AND ABROAD

This chapter asks how employees can be provided with opportunities to drive performance and productivity, shape their working lives, and secure a fairer share of the rewards generated by joint effort. We explore evidence from the UK, the US and a number of northern European countries about the impact that alternative models of financial participation, ownership, employee engagement, social partnership and corporate governance have on pay and company performance.

2.1 Shared capitalism: ownership and profit-sharing

The term ‘shared capitalism’ describes arrangements under which a proportion of the total remuneration of employees is directly tied to the performance of their company. It is a broad term that covers worker cooperatives, employee-owned firms, employee share ownership and profit-sharing models. The aim of shared capitalism schemes is to align the interests of employees with those of managers and owners, so that employees focus on raising productivity and performance. They pursue this aim by providing opportunities for employees to share in the financial rewards of success. Some models also support the democratic participation of employees in decision-making, particularly in employee-owned firms where ownership is linked to formal involvement in governance; in other models, such as direct share ownership, this role can be weaker. Many UK companies have a strong history of adopting these schemes, and they have typically been supported by employers’ organisations like the CBI. Models of shared capitalism, also referred to as ‘financial participation’, are also popular in the US.

There is an extensive literature on the impact of different models of shared capitalism on employees and companies, with most studies finding a positive effect on both (Bryson et al 2011). There is strong evidence across a number of studies for the positive impact of shared capitalism schemes on factors that tend to influence productivity. In the largest US study of its kind, which surveyed nearly 40,000 employees in 14 companies, employees participating in at least one form of shared capitalism reported greater commitment and effort from colleagues, more teamwork, better relations with managers and a more positive workplace culture (Kruse et al 2010a). The largest study of employee-owned and ‘co-owned’ companies (in which employees own a significant stake but not the whole company) in the US found that firms that converted to these ownership models improved their sales by 2.4 per cent on average, while employment in those firms rose by an average of 2.3 per cent (Kruse and Blasi 2000).

The most comprehensive data source on UK workplaces is the Workplace Employee Relations survey. Using data from the survey’s 2004 edition, Bryson and Freeman (2007) found that the use of employee share ownership, profit-sharing and collective performance-related pay were all positively associated with productivity, particularly where more than one scheme was used. In a follow-up study, Bryson and Freeman (2008) found that employees who participated in at least one shared capitalism scheme were more likely to work longer hours and had lower rates of absenteeism than non-participating colleagues in the same firm. Other studies have also linked the financial participation of employees to improved company performance. A report commissioned by HM Revenue and Customs found that tax-advantaged share ownership schemes increased productivity in participating companies by 2.5 per cent over the long term (Oxera 2007). Employee-owned companies have consistently out-performed FTSE All-Share companies since 1980, by an average of 10 per cent a year (Field Fisher Waterhouse 2009).

As well as boosting company performance by aligning the interests of employees and managers and promoting more collaborative working practices, shared capitalism schemes

are also associated with better pay and job quality for workers (Kruse et al 2010a, Bryson and Freeman 2007). This means that shared capitalism can deliver a 'double dividend' for employees – providing a share of the proceeds of success as well as raising base pay – while also promoting productivity improvements within companies.

However, three important conditions arise from the international evidence on the impact of shared capitalism. First, most studies have found that the positive effect on productivity is only present if most of a firm's employees are participating, and is usually non-existent if schemes are only open to managers. Second, performance-related pay appears to have little impact if it is based solely on individual performance. Studies tend to show that these schemes promote competitive behaviour within firms that does not support strong productivity improvements (Bryson and Freeman 2007). Third, the positive effect of shared capitalism schemes on wages and job quality is contingent on the presence of democratic processes of employee involvement. While these are more common in firms that also use shared capitalism, they are necessary in order to capture the full benefits of profit-sharing and share ownership.

Models of shared capitalism typically attract two criticisms. First, they are said to suffer from a 'free rider' problem, whereby less committed workers benefit to the same degree as the hardest working staff. In practice, the evidence shows that the 'free rider' problem is often limited, because staff are more likely to take action against colleagues perceived to be 'shirking' if they have a direct interest in making sure that all workers are productive (Blasi 2004). In fact, this is one of the key benefits of shared capitalism: it aligns the interests of employees and managers so that everyone is working towards raising productivity. Staff at all grades, not just senior managers, have an incentive to make sure this happening. This is why shared capitalism is often used in large and complex organisations, to improve productivity without the need for close supervision of junior staff (ibid). It also has knock-on benefits for staff, because greater autonomy in the workplace is associated with greater job satisfaction and well-being (Gallie 2009).

Second, shared capitalism is said to increase risk for employees by tying both their job and their investments to the same company. This is an important challenge but should not be overstated. For most employees, the proportion of rewards that are tied up in shares, profit-related pay or collective performance-related pay will be small. Kruse et al (2010a), surveying US workers, found that most were very risk-averse but still liked the idea of a portion of their pay being linked to company performance, suggesting that most workers are able to balance the risks associated with shared capitalism. Indirect forms of share or company ownership, where shares are held in trust for the benefit of employees rather than owned directly by staff, remove risk from individual workers. Models of ownership that require employees to tie up a large chunk of their savings in the same company are high-risk and unlikely to be suitable for most workers.

Shared capitalism is relatively popular in the UK, although some forms of it appear to be declining in use. There are around 150,000 employees working in employee-owned firms in the UK (around 0.6 per cent of all employees), concentrated in mid-size companies in retail and professional services. Staff who work in employee-owned firms typically have both a significant financial stake and considerable influence over decision-making. This is often achieved through formal mechanisms like staff councils, where employees help to make decisions about how pay and profits are distributed, and contribute to discussions about work organisation and company strategy.

In companies that are directly owned by employees, staff own shares in their own name. In indirect ownership models, like the one operated by the John Lewis Partnership, shares are held in trust on behalf of current and future employees. As indirect owners, employees typically receive a share of profits, but the integrity of the company is protected because employees cannot sell their shares (Davies 2009). Indirect ownership is also associated with larger employee-owned stakes than direct ownership, because employees can club together to buy a stake, or shares are gifted to employees by the owner. Companies are often described as 'employee owned' or 'co-owned' if employees own a significant stake in a company but not necessarily the entire equity.

Employee ownership is particularly attractive for mid-size firms at the point of business succession. Many company owners develop an attachment to their staff, the local community and their brand, and so are not comfortable selling to competitors or to private equity when they retire. Davies (2009) offers the case study of the family-owned cash-and-carry chain Parfett's in north-west England. The owner was due to retire in 2012 and, loathe to sell to private equity and inspired by the John Lewis Partnership, he decided to transfer the firm to employees. Despite initial difficulty in obtaining professional advice, steps were taken to establish an employee benefit trust at Parfett's, which would allow the employees to buy out 55 per cent of the company from the family, to be paid off over a period of 15 years. Over the transition period, the company was setting up democratic governance structures to maximise employee engagement in company performance.

To encourage responsible capitalism and wealth-sharing, American tax law supports employees to buy a company from the employer if they decide to sell. The 1974 Employee Stock Ownership Plan (ESOP) law enables employees to borrow the necessary capital by allowing legal trusts to be created on their behalf. Employees take ownership of the firm once these loans are paid off. With this law in place and initially combined with tax incentives, the USA's employee-owned sector grew significantly in the 1980s, and has since remained steady at an estimated 10,900 plans involving some 10 million employees.

Employee share-ownership, although more common in the UK than employee-owned firms, appears to be declining in popularity: 10 per cent of private sector workplaces ran an employee share scheme in 2011, down from 20 per cent in 2004 (van Wanrooy et al 2013). However, in contrast to employee-owned firms, employee share ownership is more common in large companies, so the total number of employees with access to these schemes is greater.

The UK government uses tax relief to incentivise employee ownership, but it is skewed towards direct ownership and towards high earners. There are currently four separate tax-advantaged schemes to encourage employee share ownership in the UK. Two of these schemes, the share incentive plan (SIP) and save as you earn (SAYE), must be made available to all employees within a company. However, the SAYE scheme does not require employees to use their savings to buy shares (and many do not), while any shares that they do buy can be immediately sold. This does not encourage employees to take a long-term stake in their company, and for many the scheme operates as an employer-sponsored ISA rather than a genuine model of shared capitalism (Office of Tax Simplification 2012).

The other two schemes can be restricted to particular employees within a company, and are primarily used to incentivise senior executives and other high-earners. Enterprise

management incentives (EMIs) are designed to help small, high-risk companies recruit and retain highly skilled staff, while company share option plans (CSOPs) are primarily used to offer incentives to company directors. HM Treasury will spend an estimated £615 million on tax relief for employee share schemes in 2012/13, of which one quarter is spent on schemes that do not have to be offered to all employees. The popularity of these discretionary schemes has risen over the past decade, skewing tax relief towards a small group of high earners.

Table 2.1
Summary of tax-advantaged schemes to encourage employee share ownership currently available in the UK

Scheme name	Description	Available to	Companies with live schemes (2010/11)	Cost of tax relief (2012/13)
Share incentive plan (SIP)	Employees use their pre-tax salary to purchase shares, which can be matched with free shares by the employer (with limits on both). Shares held for a minimum of five years attract no income tax when cashed in.	All employees	880	£330m
Save as you earn (SAYE)	Employees save regularly for a specified period, at the end of which they can either exercise discounted share options or cash in their savings.	All employees	680	£120m
Enterprise management incentives (EMIs)	Qualifying companies grant tax-free share options to selected employees up to an approved limit.	Discretionary	7,190	£120m
Company share option plans (CSOPs)	Companies grant tax-free share options to selected employees up to a specified limit.	Discretionary	1,800	£45m

Source: Office of Tax Simplification 2012

Tax relief was previously available for shares held in employee benefit trusts (EBTs), whereby shares are held on behalf of employees in a trust, which helped to promote indirect employee ownership. Tax relief for EBTs was removed in 2003 due to concerns about tax avoidance, but this means that they are now treated unfairly by the tax system. Profits are taxed twice: once when they are paid into a trust, and again when they are distributed to employees. This means that every £100 of employee trust shares cost £139 in company cash (Ownership Commission 2012).

Employees and companies can also experience the benefits of shared capitalism in the absence of employee ownership by using mechanisms like profit-sharing, gain-sharing (whereby a portion of pay is based on financial indicators other than profit) and performance-related pay. Profit-sharing is relatively common in the UK, with 32 per cent of private sector workplaces using this to reward at least some employees (van Wanrooy et al 2013). Similarly, performance-related pay is also relatively common in the UK – among private sector employees, 13 per cent were paid partly on the basis of individual performance, 7 per cent on the basis of group performance and 11 per cent on the basis of organisational performance.

In many companies, employees and the owners of capital (such as shareholders) work together to create revenues. Employees receive a fixed wage and any surplus is paid as profit to the company owners. Profit-sharing alters this division between employees and owners by giving both groups a 'fixed wage' and sharing any surplus between the two (White 2009). Profit-sharing is compulsory for larger companies in France, and a similar model has been recommended for the UK by David Lammy MP (Lammy 2011). Tax relief for profit-related pay schemes was introduced by the Thatcher government in 1987,

under which employees could obtain relief on half of profit-related pay up to £3,000 or 20 per cent of their basic salary, whichever was lower. This was later extended to relief on 100 per cent of profit-related pay up to a similar limit. Tax relief for profit-related pay was then phased out between 1997 and 2000 because of escalating costs and, again, concerns about tax avoidance.

Although the UK has a relatively good record on the use of shared capitalism to raise productivity and performance, there is a need to encourage more firms to adopt these models, while ensuring that they are open to all employees and embedded in democratic decision-making processes. The use of profit-sharing in the UK has been relatively stable over the last decade, while employee share ownership appears to have declined. Given the evidence of the positive impact that shared capitalism has on productivity and profitability, we need to understand why more companies do not adopt its methods. One important explanation is that firms can get by without them, because the focus on short-term returns in some parts of the British economy means there is little pressure on them to upgrade. Similarly, many UK companies do not invest in workforce training, despite evidence of its positive impacts, because they can do well enough with low-skill business models (Lanning and Lawton 2012).

This means that some companies will require external pressure before they adopt business practices that can deliver stronger, more sustained returns for the business (and for workers, taxpayers and the state). This pressure can come from the state and from non-state organisations like unions. However, given the weakness of unions in most private sector workplaces in Britain, some level of state action to promote shared capitalism is needed, which explains the use of tax relief to incentivise employee share ownership and profit-sharing at various points over the last 30 years. Cross-country studies have found that the main factor determining the take-up of shared capitalism models is government policy (Bryson et al 2011). Greater take-up has typically been achieved either by compulsion (as with profit-sharing in France) or tax incentives (as with employee share ownership in the UK).

2.2 Employee participation: driving productivity and shared rewards

The evidence from a large body of empirical studies is clear that the benefits of shared capitalism are best realised when combined with democratic forms of corporate governance and employee involvement in decision-making processes. These processes provide formal means by which employees and managers can work together to resolve technical problems or workplace tensions, helping to raise productivity. They can also help to ensure that employees are rewarded when company performance improves. A broad distinction can be drawn between two levels at which democratic participation in workplace decision-making can occur. Firstly, employees can be involved in making decisions that directly affect their day-to-day experiences of work, at the level of the team, the workplace or the whole company. Secondly, employees may also take part in the company-level decision-making that dictates corporate strategy.

Many of the UK's largest companies operate forums that allow employees to have a consultative role in decision-making.

- BT runs a formal consultation and information process, in which staff and managers discuss company performance and strategy as well as staff training and health and safety (Briône and Nicholson 2012).

- Tesco operates an extensive system of staff forums at local, regional and national levels, involving store reps sitting alongside Usdaw⁴ shop stewards. This arrangement is credited with ensuring that Tesco staff have some of the best pay and conditions in the typically low-wage retail sector, with its minimum rate of pay set at £7 an hour for all directly employed staff (Briône and Nicholson 2012).
- The John Lewis Partnership is one of the UK's most democratic companies. A council of elected employee representatives has the power to approve a range of decisions, including those on pay and reward structures across the company. While the council rarely vetoes the recommendations of senior directors, the requirement to put proposals before the council means that directors must think seriously about whether and how their recommendations on pay and rewards can be justified.

Despite these examples of effective processes for employee engagement and participation, the general picture in the UK is less promising. The proportion of UK employees who have access to these kinds of arrangements is substantially smaller than that of their colleagues in continental Europe. Aumayr et al (2011) found that 22 per cent of UK workplaces had formal arrangements for employee engagement or representation in decision-making, covering 42 per cent of employees (because these practices are more common in large firms the proportion of people covered is usually larger than the number of workplaces). Although unions have traditionally been the main vehicle for employee engagement in the UK, other models like staff councils (referred to as 'joint consultative committees' or 'JCCs' in many studies) are also used. Aumayr et al (2011) found that 12 per cent of UK workplaces had a JCC, 5 per cent recognised both a union and JCC, and 5 per cent recognised a union only.

Table 2.2
Coverage of employees by any institutional or statutory employee representation (%), by company size and sector

	Employees					Sector		
	10–19	20–49	50–249	250–499	500+	Private services	Production	Public services
UK	13	20	41	69	78	36	46	52
EU27	26	42	67	83	90	53	62	74

Source: Aumayr et al 2011

Since the mid-2000s, UK employees in companies with more than 50 staff have had the right to request formal consultation procedures through the 2005 Information and Consultation of Employees (ICE) regulations. These can take place either through a pre-existing arrangement such as a union or staff council, or through a newly established process. Under the regulations, employees have the right to be informed about the business's economic situation, and to be consulted about decisions that are likely to lead to substantial changes in how work is organised, or to employment contracts or levels of staffing.

There are two important barriers to using the ICE regulations to expand opportunities for collaborative working between employees and managers. The first is that employers do not need to act unless at least 10 per cent of employees make a formal request, while many unions remain hostile to the regulations. Where unions are not supportive, or where employees lack union representation, awareness of the opportunities created by the new rules has been weak (BIS 2009). Without an organising force to explain the purpose of consultation arrangements and to mobilise sufficient numbers of staff to make the request, it is unlikely that substantial progress will be made. Even where groups of employees are

⁴ The Union of Shop, Distributive and Allied Workers

keen to take advantage of the arrangements, those with little experience of workplace organising and no external support are likely to find it difficult to recruit the required number of staff. The figures from Aumayr et al (2011) suggest that the introduction of this new right to request has not had a major impact on the number of employees who have opportunities to participate in workplace decision-making.

As well as being less common, British JCCs also tend to operate quite differently to the works councils popular in countries like Germany. Works councils are usually formed of employees only and, in Germany, have formal powers of ‘co-determination’. This means that their power to determine the outcome of decision-making processes is equal to that of managers, and their decisions often have a statutory backing. Works councils are typically entitled to negotiate on pay, conditions and work organisation at the workplace level, and they are often consulted on the principles of remuneration across the organisation. German works councils have the right to meet with managers, inspect documents and ensure that employers are complying with relevant legislation (Page 2006).

The explicit purpose of co-determination is to reduce conflict in the workplace by ensuring that processes are in place through which employees can raise concerns and work with managers to resolve problems (Page 2006). As well as helping to resolve workplace tensions, these forums provide opportunities for employees to point out where work processes are inefficient and could be improved, which helps to raise firm productivity. Co-determination is also intended to promote the long-term health and stability of companies, and to control the irresponsible use of economic power by any one set of interests, by making employees and managers jointly responsible for the long-term performance of their company. In practice, a further benefit of this model is that it tends to make pay structures within companies fairer: Zwick (2007) found that pay is on average 10 per cent higher in companies with works councils compared to comparable firms without works councils, with women and low-wage workers receiving the biggest financial returns.

Unlike continental works councils, British JCCs typically include representatives of both management and staff, and operate as negotiating rather than decision-making bodies (Bri ne and Nicholson 2012). They tend to discuss a smaller range of issues, and their decisions have no legal backing. However, the example of Tesco given above demonstrates that the UK model of joint consultation and negotiation is nevertheless capable of securing concrete gains for employees, including on matters of pay. Unions in the UK have been wary of encouraging members to set up works councils because they fear that this will displace their role in collective bargaining. Yet the dominant model in continental Europe is for workers to be covered by both a union and a works council, with the union leading on formal collective bargaining at company and sector-level, while the works council deals with more workplace-level issues. Furthermore, members of work councils are typically drawn from union representatives, so the presence of a works council can provide an additional route for the union to exercise power in the workplace.

The stronger powers of continental works councils rests in part on a European interpretation of corporate governance that differs substantially from typical British and American models. In the European ‘stakeholder’ model of corporate governance, it is considered legitimate for employees (and other stakeholders) to have a formal role in making decisions about how a company is run. This helps to structure the rights and

responsibilities of everyone who has an interest in the firm, and creates alternative mechanisms of accountability for senior managers beyond simple measures of shareholder value (Gospel and Jackson 2006).

This stakeholder model is manifested at the workplace level by both works councils and a more widely accepted role for trade unions (discussed further in the next section). At the higher level of company strategy, the stakeholder model is embodied by the board-level representation of employees. In 17 out of 27 EU member states, employees working in companies over a certain size have the right to be represented on company boards (although in a minority of countries this is limited to state-owned enterprises) (Conchon 2011). The UK is among the minority of countries where employees do not have this right, and one of only two EU15 countries where employees have no right to representation at board level. In Sweden, employees in all companies with more than 25 staff have the right to board-level representation, while in Germany there is a higher threshold of 2,000 employees (ibid). However, in all countries boards are set up so that employees are unable to out-vote shareholder representatives.

Employee representation at the board level generally increases the transparency of executive decision-making and ensures that employees' interests are taken into account in major decisions of corporate strategy. This can help to create a more cooperative working climate in which employees are more likely to buy into difficult decisions. Waddington and Kluge (2006) conducted a major review of employee board-level representation in Europe, and concluded that both employers and employees tend to be positive about the impact that it has. In Sweden, for example, 61 per cent of managing directors were positive about its impact on company performance and only 8 per cent were negative. Employee board-level representation is also associated with lower levels of executive remuneration in large firms, with no negative impact on company performance (Vitols 2010). Bruce et al (2005) suggest that employee representation on supervisory boards was one reason for the more constrained growth of executive pay in Germany during the 1990s compared to the UK.

Board-level employee representation is facilitated in many European countries by the use of a two-tier board structure, which is rare in the UK. This separates the day-to-day management of the company from decision-making about corporate strategy, with employees represented on the latter but not the former. It gives employees a say in the company's long-term strategy and objectives, and enables them to hold managers to account for company performance, but avoids some of the tensions that might arise if employees became involved in more operational issues. The dominance of the single-tier board in the UK would thus make board-level employee representation more difficult.

The current configuration of UK company law also presents challenges to establishing employee representation on both remuneration committees and company boards. Company law effectively prohibits employee representation by requiring board members to govern the company for the benefit of shareholders. Even if employee representatives were allowed to join the board, they would not be able to act in the interests of employees – unless employees also held a significant shareholding in the company. UK company law also states that all members of the board and associated committees are automatically directors of the company, which could make appointing employees to the board legally complicated.

2.3 Trade unions: inclusion, collaboration and high-road competitive strategies

Union membership has been in decline across most advanced economies since the 1980s. The only countries where union membership has not declined are Belgium, Denmark, Finland and Sweden, where unemployment insurance is tied to union membership, and Norway and Canada (Kenworthy 2011). However, countries with stronger and more centralised collective bargaining processes – even where union membership is in decline – have been better able to protect workers from the negative effects of global economic changes by extending pay negotiations across large parts of the labour market.

The ‘social partnership’ model, under which both employer associations and trade unions have a strong voice on pay and other aspects of economic and social policy, is still employed in much of continental Europe, and has given unions wider political influence. Research by Gallie (2007) suggests that the egalitarian impact of unions has been greater where their power is based on strong political influence, rather than on organising and striking within firms. John Monks, the former head of the TUC, has promoted a partnership approach in the UK, suggesting that an adversarial model of industrial relations played a role in the country’s industrial decline.

Studies have found that the egalitarian effect of trade unions is greatest where they adopt an inclusive negotiating strategy which also covers non-unionised workers, and where – either through union and employer confederations or by government mandate – agreements have been extended to cover firms and workers that are not unionised (Kenworthy 2011). For example La Rochelle-Côté and Dionne (2009) examined why, despite higher levels of unionisation, Canada had relatively high rates of low pay compared with Australia. In Canada, as in the UK, collective bargaining agreements are applied largely at firm level. Australia, by contrast, has a long history of government institutions prescribing working conditions and determining wages for non-unionised workers on the basis of collective agreements which cover unionised workers. The study found that this also explained why Australia has a lower gender pay gap than Canada.

In Germany the power of trade unions has been mainly based on their ability to mobilise unionised workers in large firms. However, since many employees lack representation this has resulted in a ‘two-tier’ workforce: employees protected by unions and works councils enjoy good pay and conditions, but non-unionised workers in companies without works councils are unprotected. The majority of employees in the latter group work in low-skilled, part-time and temporary jobs in the country’s service sector. This situation in Germany contrasts with the more inclusive labour market models of the Scandinavian countries, where the participation of trade unions in decision-making is institutionalised at the political level. Gallie (2007) argues that this led unions to promote policies for the workforce as a whole, including ‘solidaristic’ wage bargaining to reduce pay inequality and secure higher pay rises for low-wage employees – whether or not they were union members. Scandinavian unions also promote employment protection legislation, which is designed to prevent the emergence of a two-tier workforce by maintaining legal equality between different categories of workers.

The social partnership approaches common in Europe can also help to push companies into higher-value markets, with knock-on benefits for companies and employees. In contrast to the ‘low-skill equilibrium’ that dominates large sections of liberal market economies such as the UK’s, companies in northern European countries such as Germany and

Scandinavia are more likely to compete on product specification and quality (Lanning and Lawton 2012). Trade unions and other employee representatives have had an important role in supporting and promoting these competitive strategies, which can mitigate some of the downward pressure on wages among low to middle-earners (Streeck 2010).

Quality-based competitive strategies typically require a well-skilled workforce, and are suited to consensus-based approaches rather than top-down managerial relationships. These models are associated with greater employee involvement, better job quality and more opportunities for training and development, even in comparatively low-paying occupations (Gallie 2007). Without pressure from employee representatives concerned about pay, job quality, and the long-term health of the company, it can be hard to encourage managers to pursue higher-value markets if they are already turning a profit by operating in low-value, low-wage markets. Employee representation is also vital for ensuring that improvements in productivity and profitability are passed on to employees as wage gains, rather than disproportionately accruing to managers and shareholders.

The decline of unions in private sector workplaces in the UK presents a major challenge to efforts to secure shared rewards and democratic workplaces, and to pressurise firms into raising their game. Unions have been key to the institutionalisation of most models of democratic participation in other countries, including works councils and board-level representation for employees. There is no sign of a significant reversal of the long-run fall in union membership, although the latest government statistics show a small increase in membership among private sector workers for 2012 (BIS 2013).

2.4 Summary and conclusions

Extending opportunities for employees to participate financially and democratically in workplaces can help raise company productivity and improve aspects of job quality for staff. Firms can become more successful while employees share in the rewards of success.

Shared capitalism can take many forms, with varying degrees of financial participation for employees, and different models may be appropriate for different kinds of firms. The UK has a strong track-record of using the tax system to support shared capitalism but current arrangements are complex and regressive, while support is not available for some important models. Government policy has been found to be important for advancing the use of financial participation models.

Models of shared of capitalism appear to be more successful when combined with opportunities for democratic participation, such as through staff forums or union representation. These arrangements enable employees and managers to work together to resolve problems and make changes in the workplace that help to raise productivity. Employee participation in corporate strategy can also help promote quality-based competitive strategies linked to higher pay, stronger productivity improvements and better job quality.

Many of the UK's largest companies have adopted such practices – and seen the benefits – but overall the scope for employee involvement is weaker in the UK than in many European countries. The UK lacks many of the institutions that have helped to advance these arrangements elsewhere, like a strong and broad union presence in private sector workplaces. Patient engagement and support from the state and other actors, including unions, is likely to be needed to build upon and extend the models of democratic ownership and decision-making that already exist in the UK.

3. WAYS FORWARD FOR THE UK

In this final chapter, we put highlight some ways forward for extending opportunities for employees to contribute to raising company performance and productivity, and to share in the financial rewards of success. The British state has a long history of non-intervention in many areas of economic policy, and particularly in how businesses operate. Britain lacks many of the institutions that elsewhere have traditionally enabled employees to be more closely involved in making decisions about how their company is run, and to secure a fairer share of rewards. Changing this situation will be difficult, and progress may be slow and patchy.

Yet, in an era of limited public resources, working people can no longer rely on the state to support rising living standards with more generous in-work benefits. Weak wage growth and high levels of wage inequality highlight the need for bold economic reforms that will enable working people to secure a fairer share of rewards and contribute to building a more dynamic, collaborative and innovative British capitalism. The ideas that follow set out some ways forward that could begin to deliver change, focusing on strengthening means of both financial and democratic participation among employees.

3.1 Sharing profits and financial rewards

Broad-based models of shared capitalism help to raise productivity and company performance, while ensuring that a share of the rewards are passed onto the employees who helped generate success. To continue to strengthen and promote shared capitalism in the UK, government should ask employers, employees and investors to develop new proposals to advance profit-sharing and other shared capitalism arrangements, and simplify and extend tax reliefs for employee ownership.

3.1.1 Profit-sharing

Profit-sharing ties all employees into the fortunes of their company, and offers a way for all employees to share in the successes that they helped to generate. Only if a company achieves a certain level of profitability will employees see a share of the proceeds, providing an immediate reward for collective performance without tying companies into unaffordable pay deals.

However, the extent of profit-sharing in British workplaces does not appear to have risen over the last decade. Cross-country studies have shown that government policy is the most important factor determining the extent of profit-sharing, yet the UK currently has no policy in place to support profit-sharing. A first step would be for the government to ask representatives of employers, employees and investors, together with academics and other experts, to consider ways of advancing the use of profit-sharing and other forms of shared capitalism in British workplaces. This would build on the success of the Low Pay Commission, a social partnership body that makes recommendations on the minimum wage.

A new partnership body representing employers, employees and investors could be asked to consider different ways of advancing profit-sharing and other forms of shared capitalism, including:

- reintroducing income tax exemptions for profit-related pay, or making profit shares exempt from national insurance contributions
- allowing employee profit shares to be paid before corporation tax, effectively reducing company tax bills
- making profit-sharing compulsory in some companies, for example in very large firms or in particular sectors.

Government should signal that, if partners can agree on a sensible way forward and present a compelling evidence base, ministers would be very likely to accept their proposals and legislate where necessary.

The purpose of asking representatives of employees, employers and investors to jointly make recommendations is to generate a process of negotiation and compromise by which a settlement can be reached that is acceptable to all concerned. This is preferable to the imposition of a top-down solution by government, which would risk pleasing no one and meeting with powerful opposition. However, to ensure that the deliberation process ended with a constructive outcome, government could set out a ‘fallback’ option that would be imposed if the various parties could not agree. This would have to be sufficiently unattractive to all sides to incentivise constructive negotiations.

3.1.2 Employee ownership

A shared capitalism partnership body could consider how to expand the use of profit-sharing alongside a range of other shared capitalism arrangements, including employee share ownership and employee company ownership. In the short-term, government should reform the tax advantages that apply to these models to simplify the regime and end tax reliefs that are likely to generate little value for taxpayers. Tax arrangements for direct employee share ownership should be simplified into a single scheme that must be open to all employees, and tax relief should be extended to indirect employee ownership. Tax relief for share ownership schemes that can be restricted to particular employees should be ended, as should relief for the SAYE scheme, which does not require actual shareholding.

Direct employee share ownership helps to align the interests of employees with those of managers and owners, driving productivity gains and ensuring that employees see a share of rewards. However, schemes that can be restricted to higher earners are unlikely to have a positive effect on productivity, and enable a small group of employees to capture the financial returns generated by collective effort. They also incentivise the use of stock options for senior employees, which has been associated with spiraling executive remuneration. Meanwhile, employee benefit trusts enable employees to hold a substantial stake in their company and promote sustainable employee ownership – yet government lacks a clear strategy to promote this beneficial ownership model, which is treated unfairly by the tax system.

To reform the complex and regressive current system of tax advantages for employee ownership, EMIs, CSOPs and SAYE schemes should be abolished and tax relief for them removed: SIPs should become the only tax-advantaged employee share ownership model. SIPs offer tax relief to all-employee share ownership schemes, and require employees to purchase and hold shares for a number of years in order to benefit from the tax advantages. Tax relief is currently available for SIP trusts held for the benefit of employees on the proviso that the shares are distributed to employees within 10 years. This limit should be removed so that permanent employee benefit trusts receive fair tax treatment; the Employee Ownership Association estimates that this would cost £50 million in the first instance (Davies 2012). Scrapping the EMI, CSOP and SAYE schemes would save the government £285 million which should be ploughed back into tax reliefs for permanent SIP trusts. HM Revenue and Customs approval for SIPs should be retained to limit opportunities for tax avoidance.

As well as reforming the tax advantages surrounding employee ownership, government should also develop a 'right to buy' for employees when a company is likely to be sold, dissolved or floated on the stock exchange. This would be designed for family- and privately-owned companies, including those owned by private equity. Employees would have first refusal, and if more than a minimum proportion (for example, 10 per cent) registered an interest they would be given a reasonable amount of time to put together an offer. However, employees in this position would need access to funding and professional advice, both of which are often lacking for employee-owned businesses (Davies 2009). Alternative sources of financial backing, such as a state-backed fund, would be required before employee-ownership could really take off in the UK.

3.2 Creating democratic workplaces

The evidence on shared capitalism is clear that productivity and performance gains are maximised when employees are able to participate in decision-making within firms. Under democratic arrangements for employee engagement, forums are provided in which employees and managers can work together to resolve workplace issues, improve working practices and collaborate on corporate strategy. They may also provide channels through which employees can negotiate a fair share of the returns from productivity improvements, thereby helping to tackle unfair reward structures within companies.

Staff in larger companies should be given a 'responsibility to participate' to ensure that models of shared capitalism give the greatest possible benefit to companies, employees and the British economy. Information about company performance and the distribution of pay and profits should be brought out into the open, rather than restricted to fund managers and shareholders

3.2.1 Information and consultation: a 'responsibility to participate' for employees

The existing information and consultation arrangements require a level of employee activism and organisation that is missing from most private sector workplaces. This means that in too many British companies employees are not called upon to work with managers to create a collaborative workplace culture and contribute to improvements in productivity. Instead of employees having to proactively take up consultation opportunities, staff in larger companies should be made responsible for getting involved in decision-making in their workplace. Giving employees a responsibility to participate in a consultative process would require them to institute arrangements for selecting representatives and agreeing collective agendas and responses to management proposals. Imposing this on employees would potentially transcend the problem of staff not being sufficiently organised, by giving them an impetus to organise and assume an active role in raising company performance.

A responsibility to participate would operate through a requirement on employers to consult employees, via representatives, about specific workplace issues. These issues should broadly include the same issues as stipulated in the current information and consultation regulations, but with some extra clarification. They should include major decisions that affect employment conditions, including the distribution of pay and profits, the reorganisation of tasks, jobs and teams, and changes to staffing including redundancies. They should also include employee training and health and safety arrangements. All of these issues have a direct bearing on economic performance as well as job quality, and are already discussed by successful staff councils in some of Britain's major companies.

The specific institutional arrangements should be left to individual companies and employees to decide, as they are for current information and consultation arrangements, with basic ground-rules set by government to prevent companies running excessively superficial consultation processes. The requirement should at first only apply to large companies with more than 500 staff. It could initially be implemented through the existing corporate governance code for listed companies, without any legislative changes. In time, depending on the impact that it has, this requirement could be rolled out to other large and mid-size companies. Formal consultation processes would be less relevant to very small companies, where there tend to be more opportunities for informal discussions between staff and managers. There could therefore be a clear stipulation that the arrangements proposed here would not need to be applied by companies with fewer than 50 employees.

Expanding the coverage of workplace consultation arrangements would not necessarily undermine or replace union representation. Workplaces with existing collective bargaining arrangements would retain these as separate processes, and it is likely that effective union reps would be chosen as employee representatives in any additional consultation arrangements. In other workplaces, a new responsibility for employees to participate in consultation arrangements would provide new organising and influencing opportunities for unions. Employees may turn to established unions for advice on establishing effective consultation processes, training for employee representatives and ongoing support in working with managers. Unions could proactively market these services to members and non-members, which may even help to build up membership over time. Rather than being a threat to their unique position in the workplace, these arrangements could provide new forums for unions to demonstrate their ability to raise workplace performance and job quality.

3.2.2 Opening up the books of Britain's leading public companies

UK company law requires companies to publish certain information about their performance over a financial year, with stronger reporting standards for listed companies enforced by the UK corporate governance code. However, the information published under the code is aimed at shareholders, and is difficult to use to compare company performance on issues of pay and productivity within the same industry or over time. Government should require listed companies to publish a standard and externally audited report on company performance and the distribution of financial rewards, so that employees and other stakeholders can easily understand how a company is doing, track its performance over time and compare it to its competitors.⁵

The data about company performance that is currently published in the UK is designed to enable shareholders to hold directors to account and ensure their remuneration reflects their performance. As a result, corporate reporting is fragmented (held in individual annual reports) and weighted towards measures of short-term financial performance. Annual reports lack hard evidence about employee engagement, pay and conditions, and wider social and environmental impacts. Shareholders have not performed their corporate governance role very well in the UK over the last 20 years,

5 This report would be similar to the operating and financial review originally proposed by the previous Labour government as part of the 2006 Companies Act. Labour increased the amount of information about their workforce and social and environmental issues that listed companies have to publish, but dropped the requirement that these reviews should be published according to a standard format and externally audited. This means that the information in annual reports is less comparable than it might have been, and is usually fairly vague about how companies are promoting employee engagement. The Coalition government is making some changes to these reporting requirements in 2013, but will not introduce a standard and externally audited system.

while in most European countries it is accepted that other stakeholders should play a part in this important work. These stakeholders – employees, unions, consumers and other civil society organisations – need comparable, accessible and externally vetted information about company performance and employee engagement if they are to do this job properly. This information, currently buried in annual reports, should be brought together in a single online location with a range of data analysis tools to help campaigners, unions and individuals access and analyse it. This could be easily done by a civil society organisation if companies were to publish information in a standard format.

Standardised and externally audited reviews should contain two specific pieces of information. First, government should follow the High Pay Commission's recommendation to require public limited companies (PLCs) to publish a distribution statement as part of their annual report (High Pay Commission 2011a). This would set out, in one place, the distribution of company income averaged over a three-year period, with details of total expenditure on wages (including directors' remuneration), materials and equipment, reinvestment, shareholder dividends and tax payments. For companies whose shareholders enjoy the protections of publically limited liability, there is a strong case for this information to be made publically accessible (ibid).

Second, large companies should be required to publish simple summary information about remuneration levels across the organisation, rather than simply for company directors. This should include median annual earnings for UK employees; the proportion of UK employees paid less than the geographically-appropriate living wage; and information on whether payment of the living wage is a requirement in UK service contracts held by the company. Calculating the median salary in a company may be complex, given the range of non-wage benefits that many staff receive, so government should consult on the best way to do this. Requiring companies to publish information on the living wage would support existing living wage campaigns by providing easily accessible and independently verified information about the extent of low pay in different companies, which could help guide the focus of campaigns in the private sector (Lawton and Pennycook 2013).

3.3 Workers on the board? The role of employees in formal corporate governance

Company law in the UK is clear: companies must be run in the interests of shareholders. Directors in public companies should have regard to other interests, but ultimately they must act for the benefit of shareholders. Corporate governance structures in public companies are organised around this principle, affording a formal role only to shareholders and those representing their interests. This creates legal barriers to the involvement of employees in the highest levels of corporate governance in our major public companies, meaning that employees cannot sit on the boards or remuneration committees of listed companies. They have no formal role in helping to shape corporate strategy despite the significant contribution they make to, and the unique perspective they may have on, company performance.

The evidence from a number of European countries is that worker participation on company boards helps to promote greater collaboration between owners, management and staff, more sustainable financial returns, fairer rewards for workers and less excessive increases in executive pay. This suggests that employee representation at board level in the UK would help to maximise the gains associated with the models of shared capitalism and employee engagement recommended in this report. However, achieving this would require important changes to UK company law that it would take time to deliver, while

employee board-level representation alone is unlikely to drive the increase in the broad-based financial and democratic participation of employees that is required to sustain improvements in our economic performance.

The first challenge is that considerable thought would have to be given to designing a new framework of legal governance for listed companies in the UK that acknowledges the full range of different stakeholders in a company and provides opportunities for their interests to be represented in decision-making processes. For example, consideration would have to be given to whether board-level representation of employees would require the introduction of two-tier boards, and how such arrangements would function in the UK context. Reforms might also be needed to allow employees to sit on remuneration committees, so that proper consideration is given to company-wide pay and conditions when directors' remuneration is set. These changes would involve a fairly radical overhaul of UK company law which would take time to do well.

The second challenge is that employee board-level representation is likely to have a limited impact on raising productivity and improving the distribution of financial rewards in workplaces that lack other channels for broad-based employee engagement. Boards meet irregularly, only take decisions on major strategic issues, and involve only a handful of decision-makers. The day-to-day decisions that affect work organisation, employee motivation and workplace culture are taken by managers below board level, as are many decisions about precisely how financial rewards are distributed. Board-level employee representatives may also be at risk of co-option by other board members if the bulk of the workforce remains unorganized and disconnected from day-to-day decision-making.

The fact that these challenges exist does not mean there is no value in board-level employee representation, or that reforming UK company law to facilitate this is too contentious or technically difficult. But they do mean that a top-down change to company law and board-level corporate governance is unlikely to have a significant impact on company performance and shared rewards while opportunities for broad-based employee engagement at the workplace level remain relatively weak. Steps towards major legal reforms need to be combined with practical reforms capable of advancing the broad-based financial and democratic participation of employees more immediately. This means promoting more widespread financial participation through profit-sharing and employee ownership, and strengthening democratic participation by establishing a new responsibility to participate in decision-making and opening up information about company performance and financial rewards.

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