When capital relinquishes ownership

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As the ownership of firms becomes transferred to algorithmically-controlled index funds, why not put their human employees in charge instead?

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History shows us nothing is forever. Sooner or later, most social systems bite their tails. The saying that each system contains the seeds of its own downfall seems quite true. Perhaps this is now the case with the system we have come to call capitalism—which can be understood as meaning that those who own the capital used in production also hold power over companies.

The Swedish Companies Act, for example, stipulates that those who sit on the board of a company must only have the interests of the owners in mind. This ownership interest is then superior to the consumer, employee and general interest. For this to work, of course, one thing is required—that there be owners. And it must also be possible to affirm, for those who represent them on the board, what the interests of these owners are.

Two problems have arisen. The first is that more than 80 per cent of share capital on the Swedish stock exchange is now controlled by 'institutional' owners, such as pension funds and many different equity funds. The situation is similar in most western countries. The absolute majority of those who have invested capital in these funds cannot be said to perceive themselves as owners of the companies concerned—even less to have opinions on how they should be organised and function.

The professional staff managing equity funds also generally do not have much knowledge of how companies should be run. Their role as 'deputed owners' is usually limited to involvement in appointing the people who sit on company boards—and the grounds on which they do so are usually unknown to those who have put their savings in their hands. Transparency and accountability are thus in practice minimal.

Index funds

The second problem is that these so-called actively-managed equity funds have been challenged by a new type, 'index funds'. In a relatively short time these have become very large asset managers—a trend described by stock-market analysts as 'explosive'. During the 2010s, the proportion of fund capital on the Swedish stock exchange managed by index funds increased from 8 to almost 20 per cent.

Internationally, by 2019 on European stock exchanges index funds held 39 per cent of fund capital and in the United States almost 50 per cent. A US-based index fund is now the second largest asset manager in the world and two others are, together, the largest owners of share capital on the Swedish stock exchange.

Index funds differ in two crucial ways from actively-managed funds. First, no considered decisions are made about which companies' shares to buy. Instead, the investment strategy is deliberately broad and proportional to the majority of the large companies on the stock exchange. The development of capital is intended to follow the entire stock-exchange index—hence the name.

Secondly, index funds do not exercise any ownership power at all. These funds are characterised by very low fees and, among other things, they do not devote any resources to involvement in appointing members to boards. If equity funds in general can be said to be 'faceless' capital, index funds are 'headless': an algorithm is responsible for decisions about share purchases.

Sharply attacked

A few months ago, a relevant debate took place in a leading Swedish business newspaper (*Dagens Industri*). Representatives of certain Swedish actively-managed funds sharply attacked their index-funds counterparts over their lack of interest in the nomination committees which in practice appoint companies' boards, claiming this showed irresponsibility on their part.

The growth and popularity of index funds however stems from their low fees—and, probably even more, from their having proved very successful financially. Most actively-managed equity funds, in which extremely well-paid stock-market specialists seek to invest where profitability is highest, perform worse than a random number generator. Over the past ten years, meanwhile, in the US stock market index funds have yielded higher returns than the average for actively-managed funds.

In a market as transparent as the stock market, all legal information about a company's value and future return opportunities is already discounted in the prevailing share price. So statistically there are only three ways to beat the index: illegal 'insider' information, luck or clairvoyance.

Given existing trends, there are strong reasons to believe that the share of capital on the world's stock exchanges held by index funds will continue to increase. But what will this increasing percentage of 'headless' ownership mean for our businesses and society at large?

One thing is clear: if nothing is done, given increasingly weak and uninterested owners, financial rewards for the business-leadership layer can only become more astronomical. They will have no strong counterweight of active owners against such rent-seeking.

Hiring capital

So if capital is increasingly abdicating *de facto* from governing companies, who will govern them? One possibility, of course, is their employees. Companies that are managed and/or owned by their employees have been studied empirically for four decades. Overall, such companies are doing very well financially and, especially, in terms of staff wellbeing and commitment.

The idea, found variously in Karl Marx and Milton Friedman, that the power of a company is based on the ownership of the capital used, is, as the ingenious American economist David Ellerman has shown, completely wrong. In a market economy, capital can hire (that is, employ) labour and then the power lies with capital. But in a market economy, those who want to start and run a company can equally rent (that is, borrow) the capital and then the working staff decide on production.

Index funds, increasingly in the ascendancy in modern economies, serve as lessors of capital to companies. The corporate-governance vacuum they reveal provides an opening to advance the conversation about the genuine democratisation of working life. The best candidate for stepping into that vacuum is the force of those who are actually governed day to day in our business enterprises—the white- and blue-collar employees in the workplace.

Trade unions have been strangely ambivalent about taking on this challenge to date. New civil-society organisations which glimpse the potential of a more substantial economic democracy should also enter this conversation on the side of employees and help make it happen.

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